SPOTLIGHT ON:

Economic Policy in Serbia - Retrospective, Reforms and Medium Term Perspective

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In mid 2014, Serbian economy officially entered recession again, since it recorded a decline in real terms for two consecutive quarters, which deteriorated even further in the third quarter. Therefore, it is estimated that the decline of GDP in real terms in 2014 will be around -2% (while initially a 1% increase had been planned). The recession that Serbia entered in 2014 is the third one since the beginning of the global economic crisis in 2008, so Serbia's GDP in 2014 will be lower in real terms by 1.5% compared to the period before the crisis (2008), while the GDP in EU countries in the same period, regardless of two phases of recession, had cumulatively grown by 0.7% in real terms. The first two recession cycles in Serbia (in 2008 and 2011) were considerably related to unfavourable economic trends in Europe and beyond, since the European Union countries, where most of Serbia's exports are going, also recorded negative economic growth rates in 2008 and 2011. However, after this period, there was a gradual recovery in EU countries, so in 2014 an economic growth rate of 1.6% in real terms is expected, which indicates that the third wave of recession in Serbia is caused primarily by internal factors. Unlike the pre-crisis model of economic growth, which was based on strong growth of private and state consumption, which have been financed by revenues from privatisations and borrowing, the economic growth episodes since 2008 (in 2010-2011 and 2013) have mostly been fuelled by investment growth and net exports, since the private consumption has been steadily declining since 2009 (due to the decline in real income and loans), while the growth of state consumption has slowed down, which is seen as desirable rebalancing. Still, the strong growth of investments in 2011 and 2012 was focused on several projects/companies (FIAT and NIS), while no new significant investment projects had been agreed in the meantime. Also, the strong growth of exports in the previous years is mostly related to the automobile and oil industries, which, bearing in mind their current product range and capacity, cannot be expected to considerably increase production and exports in the coming period. Observed by business activities, it can be noted that since 2008, the biggest decline was recorded in the construction sector, which is the result of the decline of income/employment and loans, as well as limitations on the supply side (issuing construction permits, registering property in the cadastre, etc.). In the second half of 2014, there was a significant deceleration in the manufacturing industry, which is mostly associated with negative trends in the automobile industry and lack of new investments. Accordingly, it can be concluded that the negative trends in economic activity are the consequence of differences related to extremely high fiscal deficit and fast growing public debt, which discourage private investments and inflow of loans, as well as unfavourable business and investment conditions and, to a lesser extent, unfavourable international environment (slower growth of economic activity than expected in the countries that are Serbia's key trade partners – Italy, Germany, Russia).

1. Macroeconomic Trends 2008-2014 – from one crisis to another

According to the official data of the Statistical Office of the Republic of Serbia (SORS), based on data from the Labour Force Survey, the unemployment rate in Serbia in the third quarter of 2014 was 17.6%, which is by 7.9 pp less than in April 2012, where the unemployment rate in the third quarter of 2014 alone dropped by as much as 2.7 pp. Since Serbia's GDP in the period 2012-2014 cumulatively dropped by around 0.7% in real terms, and that the

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third quarter of 2014 recorded a 3.4% decline of GDP, which was mostly caused by a decreased activity in labour intensive sectors (such as construction), a reduction of the unemployment rate by almost a third in a two year period, i.e. by over 10% in one quarter, would be unexpected and difficult to explain with economic reasons. Data on the trends of employment and unemployment structure show that in the first two years of the crisis (2009 and 2010), the biggest decline of employment was recorded in agriculture, which was unexpected given that agriculture did not record a significant decline in production and the elasticity of employment with respect to production in this sector is relatively low (since these are mostly family households). Similarly, the reduction of unemployment rate in the period 2012-2014 is explained by a considerable increase in the number of helping farming household members, while the number of wage workers is declining. Accordingly, the reliability of measuring trends on the labour market is questioned, since the acquired results/trends are contradictory to other macroeconomic trends. Given that the unemployment rate from 2008 to 2014 increased cumulatively by 3.6 pp, which could be consistent with other macroeconomic developments in this period, it is possible that the new results on the level of unemployment reflect the actual state, but then it is unlikely that the unemployment rate in the previous years increased so much (exceeding 25%), but rather that in the conditions of recession, it drastically declined (by one third) in short term. Regardless of whether the data on unemployment level or its variation reflect the real situation, the problem of unreliable statistical data presents one of the more significant limitations for efficient implementation of economic policy.

Table 1. Macroeconomic Trends in Serbia from 2008 to 2014

	2008	2009	2010	2011	2012	2013	2014
GDP growth rate (%)	5.4	-3.1	0.6	1.4	-1	2.6	-2
GDP growth rate in EU (%)	0.4	-4.3	2.1	1.5	-0.3	0.1	1.6
Unemployment rate in 15-64 age group (%)	14	16.6	19.2	23.7	22.4	20.1	17.6
Deficit of the current account balance of payments (% of GDP)	-20.9	-6.2	-6.3	-8.6	-10	-4.6	-6
Foreign Direct Investment (% of GDP)	5.4	4.5	2.9	5.5	2.1	3.6	4.1
Foreign Debt (% of GDP)	64.6	77.7	85	76.7	86.9	80.8	80
Rate of inflation (%)	8.6	6.6	10.3	7	12.2	2.2	2
Dinar exchange rate against euro (end of year)	88.6	95.9	105.5	104.6	113.7	114.6	121.2
Rate of real depreciation of dinar exchange rate against euro [1]	3	1.5	-0.3	-7.3	-3.1	-1.4	3.6
Growth of corporate and personal loans (in millions of euros)	1.125	1.306	1.657	1.784	589	-875	-300
Rate of non-performing loans (%)	5.79	10.8	11.9	14.2	16.5	21.9	22
Fiscal deficit according to domestic methodology (% of GDP)[2]	-2.5	-4.2	-4.4	-4.6	-6.6	-4.6	-5
Fiscal deficit according to international methodology (% of GDP)[3]	-2.5	-4.2	-4.4	-4.6	-6.6	-5.6	-7
Public debt (% of GDP)	28.3	32.8	41.9	44.4	56.1	59.4	70

1) Negative sign marks the real appreciation of the exchange rate, while the positive sign marks the depreciation
2) Fiscal deficit without the "below the line" spending (for the bail-out of banks, payments for activated guarantees issued to public and state enterprises for bank loans, etc.)
3) Fiscal deficit expressed according to the international GFS methodology, including the "below the line" spending ("below the line" spending data available only for 2013 and 2014).
4) Some of the 2014 data are related to the end of the year estimate (GDP growth rate, fiscal deficit and public debt), while others refer to the end of the third quarter.

In the period since 2009, there has been a significant deceleration of imports, caused by the decline of real income and loan activity, while exports, after the significant drop in 2009, have been growing strongly since 2010 and were by around 51% higher in real terms in 2014 than in 2008, which led to increased coverage of imports by exports, from 46% in 2008 to 73% in the first three quarters of 2014. Growth of exports, which was especially dynamic in 2010 and 2013, was caused by launching a large number of investment projects agreed in the period before the crisis, and by the recovery of the demand in EU countries (this explains the growth of exports in 2010), as well as the start of operations in the FIAT factory and other cooperating companies in the automobile industry, and significant growth of exports of oil derivatives in the region from the renewed NIS facilities (which explains the growth of exports in 2013), while in 2014 there was a significant reduction of the export growth rate, since export potential of the aforementioned projects were mostly depleted, without any significant new investments. It is estimated that the results of the net exports until 2013 would have been even better if it had not been for the significant appreciation of dinar exchange rate in real terms (by almost 12%) in the period between 2011 and 2013, which had a negative impact on the international competitiveness of Serbia's economy. In line with the aforementioned trends, the current account balance of payments deficit was significantly reduced compared to the period before the crisis (even though it grew in 2010, due to a significant growth of capital equipment imports for FIAT and NIS), but it was still relatively high in 2014 (around 6% of GDP), which is unsustainable in the long term in the conditions of relatively small inflow of investments and deceleration of foreign borrowing. High current account balance of payments deficit until 2008, its moderate value in 2009 and 2010, decelerated inflow of foreign direct investments, considerable decline of GDP in 2009 and moderate depreciation of dinar exchange rate, affected the significant growth of the country's foreign debt from 64.6% of GDP in 2008 to 85% of GDP in 2011. Reduction of balance of payments deficit, strong real appreciation of dinar exchange rate, and a mild recovery of economic activity in 2013, affected the moderate decline of the country's foreign debt to around 80% of GDP at the end of 2014, which is considered an upper limit of the long-term sustainable level of foreign debt. At the same time, there was a considerable increase in the share of public debt (from 29% to almost 54% of total foreign debt), and the reduced share of private debt (from 71% to 46%), which was the result of state borrowing in order to finance the fiscal deficit, and net foreign deleveraging of the business sector. Structure of the country's foreign debt according to maturity dates indicates that in the following three years, and especially in 2017 and 2018, a considerable share of foreign debt will be up for payment, which is why it is necessary to take timely action (during 2015) to prevent issues with country's foreign liquidity, even though foreign reserves are relatively high, which could include long-term refinancing of certain larger short-term and medium term obligations.

Inflation rate in 2013 and 2014 was quite low (around 2%), which is the result of the decline in domestic demand, fall of oil prices, as well as relatively restrictive monetary policy of NBS. Even though low inflation and recession tendencies in the economy indicate a need for reducing the restrictiveness of the monetary policy, high degree of euroisation reduces the potential effectiveness of monetary policy in inciting economic activity and makes the effects of reducing its restrictiveness on the foreign exchange rate even bigger. Still, a very low inflation rate, which was below the planned target in 2014 (4+/-1,5%), and which was used to make fiscal projections, complicates the implementation of fiscal policy making the revenue from tax on consumption lower than expected, which is why it would be necessary for the monetary policy measures to be used more intensively with the aim of reaching an inflation rate that is closer to the middle of the target corridor.

From 2010 to 2013, the dinar exchange rate against euro continuously appreciated in real terms (by 12.1% in total), due to reduced current account balance of payments deficit, moderate level of foreign direct investments, and considerable inflow of portfolio investments (primarily into state bonds). In 2014 this trend stopped, and (from the beginning of the year until the end of the first week of December) a real appreciation of the exchange rate was recorded by 3.6%, but the real value of dinar is still higher than in 2010. Considerable real appreciation from 2010 to 2013 had a negative impact on international competitiveness of domestic economy, so the real depreciation which happened in the second half of 2014 only partially removed the effects of appreciation from the previous years. The dynamic and intensity of NBS interventions on the forex market indicate that the principle of interventions for the purpose of preventing extreme daily fluctuations of the exchange rate has mostly been abandoned and instead, interventions are used to influence the trend, which can also be concluded from public appearances of the NBS top management. Depreciation of the dinar exchange rate had a positive effect on the economy's international competitiveness, but it had negative effects on balances of banks and net assets of the citizens and business that have foreign currency loans. Since it is desirable to use the depreciation of the exchange rate to offer an incentive to exports, and that the inflation rate is very low, but at the same bearing in mind the fact that the rate of non-performing loans is high and that real income of the citizens is declining, it is estimated that continued mild depreciation of dinar presents an optimal outcome.

Signing of the "Viennese Initiative" caused the banks not to withdraw funds at the beginning of the crisis from Central and Eastern Europe, so until 2011, loan activity toward citizens and businesses grew. Expiration of this agreement, which coincided with the big crisis in the Eurozone, caused by the public debt crisis in Greece and fiscal problems of other countries of the South Europe, with growing macroeconomic (primarily fiscal) risks in Serbia, affected the sudden deceleration of credit activity in 2012 (approved loans to citizens and businesses were by 1.1 billion euros lower than in 2011), and the negative tendencies increased considerably in 2013, when there was a significant net deleveraging of the citizens and businesses. Credit activity in 2014 continued to drop, even though that decline was somewhat slower than in the previous year. Introduction of the programme of subsidising loans for business sector liquidity in May 2014 affected the temporary halt of credit activity, but without resolving the issue of non-performing loans, removing other limitations (financial indiscipline, etc.) and reduction of (macroeconomic and microeconomic) risks and cost of doing business in Serbia, and therefore interest rates as well, no significant growth of credit activity can be expected. In the conditions of shallow financial market, revival of micro-loan organisations combined with measures of resolving issues of non-performing loans, could contribute to growing credit activity in the coming period.

Due to the economic downturn, acute problems of the business sector with liquidity and solvency, inefficient bankruptcy procedures and change of property ownership, abuse of loan approvals within state banks, and a considerable decline of real income and employment, the rate of non-performing loans in Serbia grew almost four times in the period 2008-2014, reaching the level of around 22%, where the credit default of the businesses was much larger than that of the citizens. As such, the rate of non-performing loans is among the highest in Central and Eastern Europe (along with Montenegro, Albania and Romania). Still, it can be observed that during 2014, there has been a certain slow-down in the non-performing loans growth rate compared to previous years, since the growth in the first three quarters amounted to 0.1 pp, and in the previous three years it was on average 2.6 pp annually. This was partially due to closing down of four banks with large amounts of non-performing loans and excluding their portfolio from the calculation of non-performing loans growth rate. The high rate of non-performing loans was considerably influenced by abuse in loan approval to private companies, often by the state banks, which led to four banks losing their licenses in the past four years and declaring bankruptcy, creating budget spending of around 3% of GDP for the purposes of deposit payments. Those expenditures could have been lower if the state had paid only the guaranteed deposit amounts (up to 50,000 euro per depositor), but at the cost of increasing lack of trust in the stability of the banking system. That is why state's exit from bank ownership, with a possibility of keeping a minority share in Komercijalna Bank, is estimated as economically justified, which should, together with a significant improvement of the control function of the NBS, prevent these types of risks and budget expenditures in the future. High rate of non-performing loans significantly increases the costs of the banks and thus has a large impact on the value of the interest rates, as well as on the readiness/caution of the banks to approve new loans. Given the importance and magnitude of this problem, it is necessary for the state (NBS and the Government) to create an appropriate institutional framework for its solution through facilitating trading of bank receivables (and encouraging the entry of large international companies dealing with these matters), and through improving the bankruptcy procedure (adopting the amendments to the Law on Bankruptcy during the summer of 2014 represents an important step in this direction) and settlement of state obligations in full and on time. Taking over obligations of private companies or bank receivables by the state is not an economically justifiable solution, because it would encourage moral hazard and at the same time jeopardise the sustainability of public finances.

Serbia entered the crisis period with a relatively low fiscal deficit and public debt, where the structural deficit in 2008 was higher than the actual one due to high economic growth and large absorption gap. Discretionary measures of fiscal policy (increase of wages in the public sector and reduction of taxes in 2006-2007, out of turn pension increase by 22% in 2008, fiscal decentralisation in 2011, increase in the number of public sector employees, the need for state intervention in the banking system bail-out, and a considerable growth of subsidies for public and state enterprises, etc.), have made the fiscal deficit in Serbia grow steadily since the beginning of the crisis, while in other European countries it had started to decline as of 2011. Therefore, it is estimated that consolidated fiscal deficit in 2014, according to the internationally comparable methodology which includes "below the line" spending as well, will be around 7% of GDP and, as such, one of the highest in Europe. As the result of continuously high and growing fiscal deficit since 2008, the public debt has increased by over 40% of GDP, and it is estimated that it will be around 70% of GDP by the end of 2014. This level and trend of public debt for a country with a low level of development and low credit rating is estimated as unsustainable in the long term. Considering the fact that most of the fiscal deficit in Serbia is of structural nature and that economic growth will not lead to its considerable reduction, it is necessary to reduce the fiscal deficit by 4-5% of GDP to below 3% of GDP in the medium term (the next four years) by measures of fiscal consolidation. In the conditions of low values of fiscal multipliers, which is characteristic of small open economies with flexible exchange rate, it can be achieved primarily through lowering current public spending.

Since 2007, Serbia has stagnated or regressed on international lists of competitiveness, business conditions and economic freedoms. In 2007, Serbia was ranked 91st on the competitiveness list of the World Economic Forum and in 2014, it was ranked 94th, where among the countries of Central and Eastern Europe (CIE) only Albania had a lower rating. According to the ranking of countries by the degree of economic freedom, published by the Heritage Foundation, Serbia is ranked 91st, which is the worst result among the CIE countries. Given this result and that fact the public spending accounts for about 44% of Serbia's GDP (while the CIE average is around 42% of GDP), that spending on subsidies is over 3% of GDP (while EU average is around 1.5% of GDP), and that almost 32% of the employed are working in the public sector, it can be concluded that the degree of state intervention in Serbia's economy is extremely high. This refutes the argument that poor economic situation in Serbia is the result of liberalism, as a paradigm of economic policy since 2001.

Three recession episodes since 2008, high long-term unemployment, relatively high current account balance of payments deficit and foreign debt, extremely high fiscal deficit and unsustainable tendencies in public debt development, bad business environment (compared to other CIE countries), conditions of declining credit activity, high rate of non-performing loans and relatively low investments, economically and politically unstable international environment, indicate that Serbia's unfavourable economic position is the result of accumulated large number of structural problems, some of which have been inherited from previous years, while some are newly created. Causes of this unfavourable situation lie in high macroeconomic risks (primarily due to unsustainable public finances), poor business environment, which is reflected in inefficient public sector and low quality of public services (public administration, healthcare and education), widely spread financial indiscipline, and in unpredictable conditions of doing business, which makes risks and costs of investing and doing business in Serbia quite high. So, in order to significantly increase prospects for a faster economic growth in the medium term, it is necessary to relatively quickly (practically by the end of 2015) and in synchronised and coordinated manner implement a series of structural reforms with the aim of completing the process of transition to a market economy. Such reforms do not guarantee accelerated economic growth, because it depends on a number of external factors that are not under the state control, but they represent a necessary condition for growth, because without their implementation, even in conditions of positive tendencies in the international environment, faster economic growth of Serbia would be highly unlikely.

2. Economic Policy and Reforms

The main weakness of economic policy as of 2000 was in the fact that Government representatives, when making decisions, gave priority to short-term rather than long-term effects of economic policy and reforms. Examples of such policies are numerous, some of the more important ones being giving priority to growth of current consumption rather than growth of investments, considerably faster growth of domestic demand than growth of production, assessment of the dinar exchange rate, attracting investment with fiscally unsustainable subsidies, subsidising citizens and businesses through low prices of infrastructure services, taking dividends from public enterprises and using them for state current spending, etc. The reforms that were implemented in Serbia after 2000 were slow, partial and insufficient to establish functional market economy that exists in continental European states. The role of the state in the economy is exaggerated, which in combination with inefficient state is the main cause of problems in the economy. That is why it is necessary to accelerate reforms in Serbia toward market economy, reduce the scope of state interventions, and make the state more efficient.

Resolving accumulated problems in Serbia's economy, as well as creating conditions for long-term sustainable growth, requires a decisive change of course in economic policy and faster reforms. The need for such a change has existed for several years, but now there are conditions for its realisation, while the possibilities for its delay have been almost completely exhausted. The current Government has a stable majority in the Parliament and a relatively long horizon until the next elections, which is an important political precondition for accelerating reforms and changing course in economic policy. In addition, the Government reached an agreement with IMF on economic policy and reforms for the next three year period, and the obligation of implementing certain reforms stems also from the process of EU accession. It is our estimate that the reforms that Serbia is implementing within the IMF arrangement and EU accession represents the minimum of what Serbia needs to do in the coming years. Probability of implementing announced economic policies and reforms has increased compared to the previous years (and the decade), but certain difficulties and problems in their implementation should be expected as well.

2.1 Fiscal Consolidation and Improving the Public Sector Efficiency

The key change in economic policy should be implemented through the announced fiscal consolidation, which would reduce the fiscal deficit from the current level of around 7% to around 3.5-4% of GDP in the period of three years, which is the lower limit of sustainability, because this would only slow down the growth of relative public debt in 2017, but it would not stop it, without creating a space for more significant increase of public investments and investments into education, which have a considerable impact on future economic growth. Reduction of spending on wages and pensions will bring permanent savings of around 400 million euros, i.e. a bit over 1% of GDP. Detailed content and dynamic of applying other measure for reducing the fiscal deficit still have not been represented to the general public, but it is quite certain that, in addition to already realised reductions of wages and pensions, large additional savings will be needed as well. The biggest savings potential lies in the reduction of subsidies and spending on servicing guaranteed loans. Implementation of fiscal consolidation requires that spending for these purposes, at the level of consolidated state sector, is reduced from the current level of around 3-3.5% of GDP to about 1.5% of GDP in 2017. Savings of 1% of GDP could be realised by reducing the number of employees in the public sector, not including public and other state enterprises, by around 10%, which is around 50 thousand. Greater reduction of the number of public sector employees will be difficult without jeopardising the quality and accessibility of public sector services.

Implementation of fiscal consolidation will create a space for a gradual reduction of the restrictiveness of monetary policy. Central Bank should reduce the restrictiveness of monetary policy until inflation is back to the middle of the target corridor. In conditions of high euroisation, this practically means that NBS should allow a mild depreciation of dinar until it starts jeopardising keeping the inflation within the targeted scope, while taking care of the effects of depreciation on non-performance of bank loans.

Fiscal consolidation implementation is tightly related to public sector reforms, including public enterprises, but also business sector/economic reforms. In order to realise savings from reducing subsidies and servicing guaranteed loans, it is necessary to adopt quickly key measures for restructuring public enterprises. In almost all state-owned companies, there is significant room for a reduction of costs, such as cost of labour, but also to stop the overflow of resources to privileged private companies. In addition, in some public enterprises such as EPS, Srbijagas and some utility companies, it is necessary to increase the price of their products as well. However, it is our estimate that the most important individual measure in restructuring public enterprises is to stop delivering products (gas, electricity, utility services) to buyers who do not pay for these services. This measure should be applied as soon as possible and by the middle of next year at the latest, and it should be applied unconditionally, regardless of whether they are applied to companies in restructuring, local self-governments or state institutions. If this measure is delayed, it can be expected that the public enterprises will again ask for state's help, and this means that the necessary reduction of subsidies and spending for guaranteed loans will not be realised. Additional requirement for reducing subsidies is giving up on generous subsidies granted to investors. Reforms of the economic system which would reduce the costs and risks of doing business (construction permits, efficient protection of contracts and property, lower cost of paying taxes, etc.), building of infrastructure, etc. should attract more investments than is currently managed with subsidies.

Reduction of number of public sector employees by around 10% over the next three years should be implemented together with reforms which would lead to increased quality of public sector services, from justice and security to infrastructure, education and healthcare. Reduction of the number of employees can only partially (around 50%) be achieved by natural outflow[4] (retirement, transferring to private sector), which means that a substantial part would have to be achieved through targeted firing of employees who hold unproductive job posts.

Some of the announced measures of reducing fiscal deficit, such as taking dividends from public enterprises or introducing excise duty on electricity, are highly problematic. Reducing deficit by taking dividends from public enterprises is an unreliable measure (if the enterprise does not realise profit, there are no dividends either), which is also quite damaging to the reliability and quality of its services, as it would considerably decrease investments in replacing worn out infrastructure (of power plans, electricity grids, etc.). Some of the public enterprises, such as Telekom, do business in competitive conditions, so taking dividends and reducing investments could lead to a decline in the enterprise's value – what the state gains from taking dividends, it would lose from the sale of Telekom. Constant taking of dividends by the state would also have a negative impact on the overall economy, because the profit of these enterprises is used for investments, while the state would use dividends almost entirely for financing current spending, which decreases investments at the level of society approximately by the same amount of dividends taken by the state.

In line with the above, it is estimated that a considerable improvement in managing public enterprises is needed, as well as of the supervisory function of the state over them, in order to improve their profitability in the medium term, and the additional profit created in such a way should be used to reinvest in those enterprises and raise the quality and reliability of their services. Possible introduction of excise duty on electricity could secure steady and relatively significant revenues for the budget. However, introducing excise duty on electricity in conditions where more than half of the produced quantity of electricity is sold at a price that is by around 30% below the costing price, would be highly unfavourable for the operation and development of EPS, and it could even cause problems in the medium term for Serbia's budget. Introducing excise duty on electricity over the next year would almost certainly delay the

4 Given that in the first 11 months of this year, natural outflow did not lead to a reduction of public sector employees, there is some doubt as to the efficiency of this measure of employee reduction.

increase of electricity production price, which would mean that EPS in the coming years would have insufficient funds for current operations and capital repairs, which would cause its problems with liquidity to accumulate. With low electricity prices and, for now, very foggy plans for improving cost efficiency of the company, there is a considerable risk that EPS liquidity problems would escalate in the coming years to a level where the company would need help from the state, which would mean additional spending from Serbia's budget.

Aside from fiscal consolidation, the Government also announced numerous reforms, such as: finalisation of privatisations of former state enterprises during 2015, restructuring of public enterprises and privatisation of some of them, improvement of business environment, and public sector reform. The mentioned reforms are mutually connected, which means the improvement in one area has a positive impact on the functioning of other areas. Implementation of these reforms is a necessary requirement for starting a long-term sustainable economic growth and for fiscal consolidation. Fiscal consolidation, finalisation of privatisation and restructuring of public enterprises will contribute to the improvement of business environment.

Privatisation of public enterprises in Serbia started almost two and half decades ago and it still has not been finalised. The deadline for finalising privatisation of state enterprises, which are now mostly state-owned, has been pushed several times. The latest plan for privatisation, adopted by the Government at the end of 2013, foresaw all ex social enterprises to be privatised by mid 2014 or start bankruptcy proceedings in case privatisation is not possible. However, not one enterprise has been privatised in this period nor have any bankruptcy procedures started, which seriously questions Government's credibility. Prospects for successful privatisation of most of these companies are quite small, because almost all companies that have not been privatised until now have gone through one or more unsuccessful privatisations. Therefore, the finalisation of privatisation greatly depends on Government's readiness to quickly implement bankruptcy procedures in case these companies cannot be privatised. Finalisation of the privatisation of former socially-owned enterprises is of great importance in order to stop the overflow of losses from these enterprises to other enterprises and the state, but also to put in operation valuable assets that these enterprises are using unproductively. In order to prevent establishment of new state enterprises, it is necessary, in case of unsuccessful privatisations, to sell these companies automatically to another private owner instead of being taken over the by the state, as has been the case so far.

Restructuring of public enterprises is a necessary requirement for reducing state spending on subsidies and services of guaranteed loans, and thereby for the success of fiscal consolidation. Privatisation of certain public enterprises that are operating in competitive conditions, with the finalisation of privatisation of former socially-owned enterprises and state-owned banks would enable the state ownership in Serbia's economy to be reduced to a level closer to European economies. Reducing state ownership in economy is important not only from the standpoint of economic efficiency and economic growth, but also from the standpoint of sustainability of public finances. Huge state budget losses incurred from relatively small and ruined banks and enterprises that have not been privatised are the price of excessive state intervention in Serbia's economy.

2.2 Businesses Environment Reform

Changes to the business environment, together with public sector reform, are probably the most complex task that the Government of Serbia is facing. Over the past few years, very little progress has been made in this area, as confirmed by Serbia's modest placement in international rankings on competitiveness and business conditions. Improvement of the business environment could be achieved by a government who cares about long-term implications of the policies it implements. In mid-2014, the current Government implemented certain important reforms, which improve the business environment, such as amendments to the Labour Law, Bankruptcy Law and Law on Privatisation. Amendments to the Labour Law are by nature such that they will have a positive impact the labour market, while the effects of amendments to the Bankruptcy Law and Law on Privatisation will critically depend on the efficiency of their implementation. In December, amendments to the Law on Planning and Construction were adopted, whose main goal was to reduce the time needed to issue construction permits to one month and as of second half of 2015, cut down the regulatory costs as well through introducing a system of electronic submission of requests and issuing construction permits. By cutting down the time needed for issuing construction permits, one of the biggest obstacles for construction and for investments will be removed, but there would still be obstacles related to inadequate records of property rights in the cadastre. The way of solving the problem of conversion of city construction land in privatised companies is not regulated by these amendments to the Law, which creates uncertainty with respect to property rights and hampers business transactions.

In addition to the announced reforms for improving business environment, many others are needed, for which it is now uncertain when they will be implemented, among which the most important being introduction of firm budgetary restrictions, improvement of the protection of property rights and contract enforcement, construction of modern transportation, energy, utility and telecommunications infrastructure, and removal of administrative barriers.

Improvement of the quality of state services is equally important, as well as reduction of its costs. For the functioning of economy, as well as the total social progress, it is necessary to improve the operations of all state institutions, from justice and cadastre, security services, through state and local administration to education and healthcare. For each of these areas it is necessary to adopt plans for improving efficiency, as well as define measurable criteria for checking progress in realising those plans, as well as the responsibility in case of no progress. One of the key areas for improving public sector efficiency is creating competent, dedicated and honest public administration. A necessary requirement for achieving this goal is to change the policy of recruiting, promoting and awarding all public sector employees, including the top management. Instead of the currently dominant partisan, family, regional and other channels of recruitment and promotion, which lead to negative selection, it is necessary to strictly apply competitive procedures, which would favour the best candidate in each step of the process.

2.3. Institutional and Organisational Assumptions/Premise of Economic Reforms

For the first time since 2000, one party has a parliamentary majority which eliminates the risk of a smaller party blocking some reforms or imposing anti-reforming measures and populist economic policy, as was often the case over the past few years. Even though the current Government is homogenous, proportional election system is still applied in Serbia, so there is a big chance that future governments will be again formed with many parties. That is why a change in the election system, which would reduce political fragmentation, is a necessary precondition for political stability, and it would increase the chances of implementing a long-term sustainable economic policy and the necessary reforms. Still, that is not a sufficient condition for strong fiscal consolidation and implementation of reforms – that would require Government's readiness to implement unpopular measures, which could have negative short-term effects on its rating.

Low administrative capacities are an important limitation to implementing complex reforms, such as the reform of the justice system, cadastre, local and state administration, tax authority, public enterprises, etc. The problem of low capacities in the public sector is a permanent problem in Serbia, which has additionally escalated during the current Government's mandate by mass recruitment and promotion of people with inadequate degrees. Instead of capability and results, the key channels of promotion in the public sector are party affiliation and informal contacts (family, native, etc.). Long term negative selection has led to creation of a network of incompetent and partially corrupt staff. As the result, there is a large number of managers in the public sector who are not capable of improving the capacity of the institutions they run. Furthermore, reforms are not even in their interest, as they would directly jeopardise their positions. Therefore, instead of the real reforms, we can expect their staging and a latent obstruction by these officials. The problem of insufficient capacity for public sector reforms in Serbia could be mitigated through direct involvement of the representatives of international financial institutions and EU in the implementation of the reforms. Generally speaking, their engagement will have a positive impact, although there is a risk in certain situations of imposing templated, less than optimal solutions.

Fiscal consolidation and reforms will most probably be implemented in unfavourable international circumstances, which will make the negative effects on economic growth, employment and living standard even bigger and longer lasting. EU economy, which is crucial for Serbia in the coming years, will probably stagnate or recover slowly, so we cannot count on high growth of demand or a strong inflow of foreign direct investments in Serbia. In such circumstances, what Serbia can do is attract as much of the scarce capital as possible through the exchange policy and improvement of the business environment. Additionally difficulty from the international surroundings could occur if the Ukraine crisis is not resolved relatively soon. Deepening and possible escalation of the crisis will almost certainly exacerbate pressures on Serbia from the USA and EU on the one hand, and Russia on the other. In such circumstances, the neutrality policy may no longer be possible, while siding with either party would additionally worsen Serbia's economic position. Perseverance in maintaining good relations with Russia in those circumstances would probably result in some form of sanctions from the EU, while supporting EU policy toward Russia would jeopardise the agreement on duty-free trade with Russia.

Economic Perspectives in the Period 2015-2017

Forecasts of economic growth in 2015 are quite unreliable for now, as there is an unusually high number of still unpredictable factors, which could significantly affect the growth. For example, it is not yet quite clear what fiscal consolidation planned for 2015 will look like, what will be the fate of the biggest companies undergoing restructuring, but also of the large private companies such as Farmakom, Interkomerc, Beohemija, etc. On top of that, there is a problem with a great unreliability of SORS data, which change often, for several years back and to such an extent that it completely changes the trend assessments for economic activities and the conclusions reached based on analyses.

For the GDP trend forecast for 2015, two different approaches were used, which do not yield the same results: 1) through analysis and projection of trends of seasonally adjusted GDP, we estimated that the GDP in 2015 could drop 0 to 0.5%, and 2) through analysis of possible trends in individual GDP components (private consumption, state spending, investments and net exports), we found that the decline of economic activity in the following year could amount to around 1%. Given that the second method takes into account all currently available information on effects of planned measures of economic policy and reforms (which is not the case with the first method), we believe it is more reliable and conclude that economic activity in 2015 could have a decline of around 1%.

Based on the analysis of possible trends in the most important determinants of citizen income (wages and employment, pensions, consumer loans, remittances, welfare, etc.), it is estimated that private consumption in 2015 will have an over 3% decline in real terms. At the same time, given the projected trends in public sector earnings in 2015, it is estimated that state spending in 2015 will decline by over 6% in real terms. Net exports in 2015 will make a positive contribution to GDP growth by around 1.5 pp of GDP, which will be due to reduction of imports, caused by a reduction in domestic demand and depreciation of dinar, and by stagnation of exports, due to previously analysed reasons – slow economic growth in EU and lack of large new investments in the previous year, etc. Forecasting the investment trends is related to the bigger uncertainties than projecting other GDP components. Still, given the expected growth of public investments (by 0.3-0.5% of GDP) and private investments, we estimate the total investments in 2015 could increase by over 5%. The risk of this growth being smaller is primarily related to inefficient realisation of public investments. Public investments in 2014 were planned at an approximately the same level as they are now being planned for 2015, but significantly less were realised. Moderate growth of private investments could occur due to the finalisation of the process of privatisation and strengthening of investors' trust due to the signed IMF agreement.

The Government of the Republic of Serbia has already announced that it expects the real GDP growth rate in 2016 to be 1.5% and then 2% in 2017 (and that these are very conservative estimates). Our analysis, however, shows that GDP growth rate of 1.5% in 2016 will be hard to achieve, and that any positive growth that year would be a good result. Simply speaking, current economic difficulties of both the private and the public sector are too great to end in only one year and enable a more significant economic growth already in 2016. Real GDP growth in 2017 of 2% is possible, but it too will not be achieved if key issues that Serbian economy is currently facing are not resolved.

Economic growth in the medium term will greatly depend on the still unknown and uncontrolled factors, such as the outcome of privatisations of large state companies or the speed of medium term economic recovery of the EU. It should be noted that the estimate of GDP growth in 2016 and 2017 cannot be made with the simplest method, which would include forecasting GDP trends so that its growth gradually approaches the potential medium term growth rate. In 2016 and 2017, there will still be dangerous imbalances, which will cause the GDP trends to deviate from the medium term trend – such as the implementation of the three-year fiscal consolidation agreed by the IMF arrangement. Let us stress that it is also uncertain what the new potential medium term GDP growth rate in Serbia will amount to, as it has been quite atypical in the past ten years – first because of the enormous influx of foreign capital in the country from 2005 to 2008, and then because of the global economic crisis. That is why the forecast of possible trends in economic activity in 2016 and 2017 requires a more detailed analysis of the existing and expected trends and the announced economic policies.

Year 2016 will be entered from the recession of 2015. Even though the total decline of GDP in 2015 will probably be only 1%, it will contain large growth rates (around 20%) of mining and electricity production – because of the comparison with the deep temporary decline in 2014 due to the floods. If it were not for this temporary growth, the economic activity in 2015 would decline by around 1.7% and that is actually the main unfavourable trend in economic activity after which a sharp turn is expected together with a 1.5% GDP growth in 2016. So, in order to achieve the 1.5% economic growth in 2016, it is necessary to accelerate the trend of economic activity by over 3 pp compared to 2015, which is a considerable change that is not likely to happen that quickly. Such acceleration of economic activity (of over 3 pp) in one year has happened three times since 2001: *first time* in 2004, when the GDP growth rate increased from 3% in 2003 to 9% in 2004, *second time* in 2010, when after a real decline of 3.1% in 2009, a positive growth of 0.6% was achieved, and *third time* in 2013, when GDP went from a 1% drop in 2012 to 2.6% rise. We only consider the second episode (from 2010) to be relevant for the analysis, since the other two cases of fast acceleration of economic activity were under a great influence of large year-on-year changes in agricultural production caused by climate factors.[5] Additional advantage of analysing the second episode (2009-2010) is that the recovery of economic activity came after a relatively deep recession, which would also be the case in 2016. Analysis of the shift in the growth of economic activity that happened in 2010 quite clearly shows why it is highly unlikely that a similar shift will occur again in 2016. In 2010, the state and private consumption had remained approximately unchanged compared to 2009 and the exports had a high real growth rate of 15%. In 2016, these parameters will be quite different. State spending will be in great decline in real terms due to the inevitable implementation of the fiscal consolidation (the alternative would mean a public debt crisis), private consumption will have a real decline which also cannot be avoided, and the growth of exports will not be able to be that high.

Due to the continuation of fiscal consolidation, the state spending in 2016 will have a real decline of around 5% (frozen wages and downsizing of the public sector). Private consumption will also be in a real decline, which we estimate to be between 1 and 1.5%, as the sources of its financing will continue to decrease in real amounts (mild growth of mass wages in the private sector, which is also uncertain, would not be enough to compensate for the considerable decline of pensions and wages in the public sector, and a considerable increase of loans cannot be expected either). So, private and state consumption in 2016 will jointly contribute to the decline of total economic activity by around 2 pp, which means that achieving the planned economic growth of 1.5% in 2016 would require a growth of net exports and investments to first compensate this decline and then additionally contribute to GDP growth by another 1.5 pp of GDP. In other words, in order to realise a GDP growth of 1.5% in 2016, net exports and investments would have to jointly contribute to the growth of GDP by as much as 3.5 pp of GDP, i.e. over 1.2 billion euros – which is very unlikely (there has not been a comparable example since 2001).

However, what is possible is to use good economic policies and secure a sufficient growth of net exports and investments, which would help avoid an extended recession and set good foundations for a solid and sustainable growth in 2017 and the coming years. We feel that any positive growth in 2016 would be a great success, but still achievable, provided the Government implements an adequate economic policy in 2015 and 2016. It is also interesting to note that the trends in private consumption are quite inert, as it considerably depends on slowly changing trends on the labour market (mass wages is by far the biggest source of funds for private consumption), and reduction of state spending is practically already defined by the three-year arrangement with IMF, so the key difference between the extended recession and economic recovery in the medium term will depend on the growth of net exports and especially investments. Government's economic policy could have a deciding effect on both of these GDP components. The growth of net exports in 2016 is possible, but it will be limited in that year by objective circumstances. It is our estimate that the most the foreign trade deficit could decrease in 2016 is probably by 1-1.5% of GDP (around 400 million euros). There are no preconditions for a bigger growth of net exports, neither on the demand nor on the supply side. Relatively speedy recovery of EU economies, which accounts for most of Serbia's exports, is currently not projected, so it will probably be no great incentive for the growth of exports. Also, the high growth of exports in 2016 would have to be preceded by a high growth of investments in previous years, which is currently not happening and it is highly unlikely that during 2015 there will be a dramatic change.6 Possible inflow of an individual large private investment directed to exports (such as the FIAT investment) during 2015 is still not certain (although there are many announcements), and if it did happen, it probably could not have a large impact on the growth of exports in 2016.7 A possible successful privatisation of Železare Smederevo (Steelworks) would significantly impact the growth of exports, but this company is also one of the biggest importers, so its contribution to net exports would be relatively small. On the imports side, it is unrealistic to expect its significant decline in 2016, because domestic consumption will not continue falling as much as in 2015, and a slightly stronger growth of investments which could be expected

5 It is possible, of course, for a similar scenario in trends of agricultural activity to occur in 2015 and 2016, but it would mean a bigger decline of GDP in 2015 than the forecasted one.

6 We projected the real investment growth in 2015 of around 5%

7 Implementation of individual projects of that size would require time for preparation, investment, achievement of full production capacity, which means that if negotiations on an investment like that are started at the beginning of 2015, the full effect on net exports would be visible in 2017 at best.

during 2016 would push a certain growth of imports. Realisation of the growth of net exports would also depend on the trends in the real dinar exchange rate, to which economic policy makers should pay special attention. QM analyses show that at the end of 2014, the dinar exchange rate is coming closer to its competitive level, from which it would probably be possible to realise the forecasts from the previous paragraph.8 Allowing again stronger real appreciation (as was in the period 2010-2013) would be damaging to net exports and sustainable economic growth in the medium term, which should be kept in mind when implementing monetary policy.[9] As far as trends in investments in 2016 are concerned, after a relatively deep recession in 2015, it is hard to expect that there are capacities of the domestic economy for a significant market growth of investments. The public sector could contribute to investment growth in 2016, although it has its own limitations as well – it is limited by the size of the fiscal deficit and a high public debt.[10] As of 2016, even public enterprises could start increasing their investments, but first the biggest part of the huge problems in their operations would have to be resolved during 2015. A certain growth of foreign investments is possible and it would largely depend on business environment reforms in 2015 (a good indicator for it would be advancement on the relevant competitiveness lists). If the Government manages to secure during 2015 arrival of some of the big global companies, it could also have a positive impact on the investment trends. Still, a precondition for a considerable growth of investments is a decisive implementation of economic reforms, which we have already discussed in this text. If these policies are not implemented, the growth of investments will probably not be enough for the economic activity in 2016 to have a positive growth rate, so Serbia's economy would stay in a prolonged recession.11

Laying solid foundation for sustainable economic growth during 2015 and 2016 and a solid investment growth in 2016, would make the real GDP growth of 2% in 2017 possible. If, for example, in 2016 the real GDP growth was around 0.5%, the 2% increase in 2017 would be possible, as an acceleration of GDP growth b 1.5-2 pp is achievable (which has already happened several times in the past 15 years). However, if the growth in 2016 fails and Serbia ends that year in recession (which, simply put, means that the Government has not led good enough policies and has not been successful in their implementation), it would jeopardise any GDP growth in 2017, while the planned 2% growth would probably be unattainable.

In case the projected rates of economic growth (0.5% in 2016 and 2% in 2017) are achieved, this would create conditions for improving trends on the labour market in 2017. If there is the projected growth of investments, the private sector could probably compensate for further reduction of the number of employees planned for the public sector, which would cause private consumption in 2017 to no longer be in a real decline. The state spending would still have a real decline, but this decline would gradually decrease in relation to 2016. It is our estimate that the decline of state spending together with unchanged private spending in real terms could make a negative contribution to GDP growth in 2017 by around 0.5 pp. A positive contribution that net exports and investments could then make to overall GDP growth of 2% would be around 2.5 pp, which is still quite optimistic, but possible. Compared to 2016, there should be some mitigating circumstances in 2017 as well, which would support it, such as a slightly higher growth in EU. Also, a good fiscal policy would be encouraging due to country's risk reductions, and a successful reform of public enterprises, which would start in 2015, could enable them to increase their investments more an more.

Taking into account all conducted analyses of medium term trends, we can see that the official forecast for the movement in economic activity in Serbia in the medium term is quite optimistic and not conservative (where the one for 2016 can hardly even be possible). Current options that Serbia's economy has are long-term (maybe even deep) recession or painful treatment for many years, whose first tangible results the economy and private citizens would see only in several years. That is why we feel that the Government should redefine its medium term projections and goals, responsibly present to the public the real difficult state that the economy is currently in, and start immediately with implementing decisive and credible measure for getting out of the crisis.

8 Current level of unit costs of labour measured in euro are indicating this.

9 Exaggerated depreciation of dinar would not be useful either, due to balances of the state and companies burdened with foreign currency obligations.

10 It is possible that the public sector would influence the increase of investments without these limitations through concessions and public private partnerships, but these are usually atypical and perhaps even risky projects with an uncertain impact on GDP (for e.g. if the material and workers are from abroad)

11 We have an example in the region (Croatia) where the recession has lasted six years.

CIP - Katalogizacija u publikaciji
Narodna biblioteka Srbije, Beograd

33 (497.11)

QUARTERLY monitor of economic trends and policies in Serbia / Editor in Chief Milojko Arsić. - 2011, iss. 1 (january/july)- . - Belgrade (Kamenička 6) : The Foundation for the Advancement of Economics, 2005- (Belgrade : Alta Nova). - 30 cm

Dostupno i na: http://www.fren.org.yu. - Tromesečno. - Ima izdanje na drugom jeziku: Kvartalni monitor ekonomskih trendova i politika u Srbiji = ISSN 1452-2624 ISSN 1452-2810 = Quarterly monitor of economic trends and policies in Serbia
COBISS.SR-ID 126940428