From the Editor

After almost four years of expansion, the growth of European economies began to slow down in the middle of last year, and soame of them, such as Italy, have entered a mild recession. Similarly, the economy of Serbia slowed down slightly in the third quarter, after which the slowdown in the fourth quarter was amplified. The slowdown in European economies has raised the question of whether this is a new deep recession, such as the one in 2008, or is it a slowdown of growth in market economies which averagely occurs every 3-4 years? The second question is related to what can economic policy do to mitigate the slowdown and make it shorter? In the case of Serbia, questions arise as to whether the slowdown in the economy in the second half of 2018 is the result of movements in Europe or internal weaknesses, and which economic policy measures can mitigate the recession? Considering the slow growth in the previous 3-4 years, in the case of Serbia, the question arises as to whether our main problem is a slow long-term growth trend or a cyclical slowdown of the economy?

From the beginning of 2014 to mid-2018, the EU countries achieved average growth rates of 2.2%, whereby old member states recorded an average of 2%, while 11 new member states from CEE averaged 3.6% annually. In the fourth quarter of 2018 the y-o-y growth of the EU declined to 1.4%, with the old member states recording only 1.2%, while the new member states recorded a solid 4.1%. The largest EU economies stagnated in the second half of last year (Germany) or were in a mild recession (Italy) while France and Britain achieved modest growth. On that basis, we can conclude that the slowdown in economies of old, large, member states of the EU has not yet significantly influenced economic activity in the new EU member states.

After the release of data on GDP movement in the third and fourth quarters of 2018, announcements of a big new recession were actualized, based on the claims that large and developed economies have formed significant price bubbles on stock and real estate markets. Although the possibility of such a recession has not been ruled out, for now it is more probable that this is only a slowdown in economy. Namely, in the period after the Second World War market economies were characterized by cycles in which the expansion phase lasted for 3-4 years on average, followed by a slowdown which lasted 1.5-2 years on average. The application of cyclical monetary and fiscal policies, as well as the introduction of prudential standards in banking, made global recessions, which were characterized by a large decline in GDP, relatively rare after the Second World War. Global crises were the result of strong supply side disruptions, such as the oil crisis of the 1970s, or major financial sector losses as was the case in 2008. Problems in the financial or public sector of the smaller and middle-sized countries (the crisis in the Scandinavian countries in the early 1990s or in Asia in 2007) mainly led to a decline in economic activity in these countries, without global disorders.

The important issue for Serbia and other CEE countries is how the slowdown of large European economies will affect their growth? Based on a number of research, it is quite certain that the slowdown in growth of large European economies affects, with a delay of 1-2 quarters, the slower growth of CEE countries. A significant slowdown in industrial production in CEE countries at the end of last year and at the beginning of this year is the first signal of a slowdown of their economies. The average y-o-y growth rate of industrial production in CEE countries in December last year and January this year was 1.5%, while in the previous 11 months of 2018 industrial production grew at a rate of 3.7%. Accordingly, it can be expected that in 2019 the growth of CEE countries will slow down, compared to the growth achieved in the previous four years. The depth of this slowdown will depend on the movement of economies of large EU member states, but also on specific characteristics of individual countries, such as their dependence on foreign capital inflows, fiscal position, situation in banking sector and others. The slowing down in Western countries will have larger effect on CEE countries that are more dependent on the inflow of foreign capital, that is, the countries whose domestic savings are low, as well as countries with a high fiscal deficit and high public debt.

Serbia's economy slowed down y-o-y growth from 4.9% in the first half of the year to 4.1% in the third quarter and 3.4% in the last quarter. The achieved y-o-y results in all quarters in 2018 are largely a result of the recovery of agricultural production (growth of 15-16%) compared to the dry 2017. If Serbia had achieved normal agricultural growth of about 3% last year, total GDP growth in the last year would have amounted to 3.3%, while in the last quarter it would have amounted to 2.4%. The slowdown in

GDP can be noticed when the seasonally adjusted GDP trends are observed by quarters of 2018. While the GDP growth rate in the first three quarters, compared to the previous quarter, amounted close to 5% annually, it fell to only 1% in the fourth quarter. While industrial production slowed down its growth in CEE countries, it dropped significantly in Serbia in December last year and January this year. The decline in industrial production in these two months compared to the same period of the previous year was 5.9%.

The decline in industrial production and significant slowdown in GDP compared to CEE countries indicate that deterioration of economic trends in Serbia is for now more under the influence of domestic problems than international circumstances. Most of the indicators that show the influence of the world economy on Serbia are still favorable - exports have high growth, terms of trade stagnate, inflow of foreign capital is high, interest rates are low.

A strong slowdown of GDP growth and fall in industrial output during the second half of the previous year are largely a result of specific factors such as a decline in EPS production, reduced exports to KiM due to the introduction of prohibitive duties and fall in production at FIAT. It is estimated that the aggregate impact of these factors on the fall in quarterly GDP in the last quarter of the previous year was between 0.5% and 0.6% of GDP. For the time being it is uncertain whether and how many of these factors will have a negative impact on the Serbian economy in 2019. The general public is not informed about the kind of problems EPS is facing or when they will be eliminated, and it is not possible to estimate when customs duties imposed on the KiM exports will be abolished. Also, it is unclear whether FIAT, and when, will introduce a new model to reverse the downward trend in vehicle production in Serbia, which has been lasting for several years now.

The question is what the Serbian government can do to stop the slowdown of the economy and boost its growth? The measures that the Government of Serbia might undertake can be divided into three groups: the first are the measures for solving specific problems, the second are simulative measures of fiscal and monetary policy, and the third are structural and institutional reforms. In the case of specific factors that slow down the growth, the most direct impact the Government of Serbia has on EPS problems, which could be solved with fundamental changes in management and the way the company is organized. Other specific factors, which have a negative impact on GDP, such as customs duties on exports to KiM, decline in production in the FIAT, the EU export quotas, and other, only partially depend on Serbia.

Certain incentives for economic growth can be created through simulative measures of fiscal and monetary policy. The room for increasing fiscal policy expansion is not large, as public debt is still relatively high. In addition, the effects of simulative fiscal policies in small open economies are modest and mainly carried out through the growth of public investments and tax cuts. In doing so, the short-term effects of public investments on growth are higher if they are realized by engaging domestic labor and other domestic inputs. A long-term effects of public investments on growth are greatest if they reduce private sector costs, as is the case with investments in traffic, energy and public utilities infrastructure. An additional stimulus could be created by Government's withdrawal from taking dividends from public companies and increase of their investments. If the fiscal space existed, the Government could further reduce the fiscal burden on labor, in order to increase funds of companies for investments. In small open economies, increasing current government spending, such as public-sector wages and pensions, is almost entirely transferred to the growth of the external deficit, while the impact on economic growth is negligible. Generally, wages and pensions need to follow production and productivity trends, because they cannot be their drivers. The possibilities of stimulating economy through monetary policy measures in the case of Serbia are even smaller, and they are also mostly exhausted because the interest rates are already at a low level.

Structural and institutional reforms have the biggest potential for accelerating the growth of Serbia's economy. While fiscal and monetary policy have an impact on economic cycles, structural and institutional reforms affect the long-term growth trend of the economy. In the case of Serbia, these reforms are key because the trend of economic growth even before mid-2018 was slower than the average of CEE countries. Key structural reforms include: Restructuring of republic and local public enterprises, state administration reform, education reform, etc. Implementation of these reforms implies overcoming interest groups in each of these sectors, to which the existing situation enables the appropriation of various types of rent. Intentional reforms in the widest sense imply the adoption of laws in accordance with the best world practice and their strict implementation, suppression of corruption and gray economy, equality of market participants, avoidance of frequent and unpredictable changes in regulations that create uncertainty, etc. Implementation of these reforms would enable Serbia to, as one of the least-developed countries in Europe, have high growth rates and thus gradually catch up with the countries of central and western Europe.

In this issue of the Quarterly Monitor, in addition to regular analyzes of economic trends and economic policies, there is a Highlight of Prof. Diana Dragutinovic dedicated to the analysis of the impact of financial innovations on the stability of the economy and regulation of the financial sector.