From the Editor

In 2018, Serbian economy achieved solid results, although there are certain weaknesses. Positive results include acceleration of GDP growth, employment and wage growth, low and stable inflation, low interest rates, positive fiscal balance, decline in public debt, decrease in the percentage of nonperforming loans, etc. Along with positive, there are also negative trends such as the growth in foreign trade deficit, growth of unit labor costs and slow investment growth. The results achieved by a small open economy, such as ours, are greatly influenced by international economic trends, which were favorable during the year. Economic activity and demand in the countries which are the main economic partners of Serbia are growing strongly, interest rates are extremely low, while the offer of low-cost capital is high. Moderate deterioration of price parities, due to a growth of energy prices, is one of the few changes in the world economy that have negatively influenced the economy of Serbia in the current year.

The growth of Serbia's economy in 2018 of 4.3% is at the level of CEE average, but its significant part is a result of one-time factors. Without one-off factors, the growth of Serbian economy in 2018 would be 3.3%-3.4%, which is much slower than the CEE average. The economy slowed down its growth in the second half of the current year, therefore it will start 2019 with a modest growth.

Labor market situation has improved in 2018, wages in real terms increased by around 4%, while wages in euros increased by around 8%. Registered employment increased by 3.3%, while unemployment was reduced by as much as 13.2%. Although at first it seems that all performances in the labor market are improving, a more careful analysis reveals some results that undermine the competitiveness of the Serbian economy in the future. Labor productivity in non-agricultural sector stagnates, and unit labor costs are rising strongly (especially in euros), which will adversely affect international competitiveness and the movement of balance of payments in the future. Beside that, a strong reduction of unemployment rate is not only the result of the growth of employment opportunities in Serbia, but also massive departure of workers abroad, which results in a lack of workers with certain qualifications in domestic enterprises and institutions.

In 2018, the growth in deficit of trade balance and current account balance continued. The deficit of current account of the balance of payments in this year will amount to about 5.5%, while the trade deficit will amount to about 8.5% of GDP. The worsening in trade and current account balance in the past year and this year is predominantly the result of faster growth of domestic demand than GDP growth, increase in unit labor costs, and strengthening of the dinar. Cumulative deterioration of the terms of trade in the last year and first nine months of this year (mainly the growth of energy prices) is 2.5%, so it can explain the smaller part of deterioration in trade balance. The rise in energy prices has affected the deterioration of the current account balance this year in other Central and Eastern European countries as well, but even with this, these countries on average achieve a surplus on the current account of the balance of payments. The growth of the economy causes an increase in deficit of trade and current account balance only if it is dominantly generated by domestic demand, which is precisely the case in Serbia. In 2017, domestic demand in Serbia was by 9% higher than GDP, while in the CEE countries it was on average 3% lower than GDP, and only in Romania and Latvia it was by 1%-2% higher than GDP. Domestic demand is growing faster than GDP this year, and this will continue in the next year according to the adopted economic policy. High level of domestic demand relative to GDP reveals fundamental imbalances in the Serbian economy, such as low level of domestic savings in relation to investments and high level of current consumption in relation to productivity and income.

The international circumstances for the growth of Serbian economy in the following year, despite turbulent political events, look favorable for now. In 2019, we expect growth of Serbia's GDP of 3.5%-4%, which is somewhat slower than during the current year, primarily because in the next year we cannot count on a large positive impact of one-off factors, such as agricultural growth in this year. Nevertheless, the GDP growth trend in the next year will be somewhat faster than in this year, primarily due to the growth of investments. To achieve growth of 3.5-4%, the average agricultural season needs to be achieved, and also economic policy needs to be more growth incentive, with gradual solving of structural problems and improvement of institutions.

The expected growth of the economy in the next year will provide opportunity for further growth of real wages at a rate of about 4%, while the average wage in euros could reach the level between 440-450 euros. Faster growth of real wages and average wage in euros than the growth of economic activity is a consequence of 9% growth of public sector wages, as well as estimates that the exchange rate will depreciate slower than inflation. In the next year, we expect employment growth by 2-3%, while unemployment will decrease faster due to a massive departure of Serbian citizens to work abroad. Due to the expected high growth of domestic demand, we estimate that the current account deficit in the next year will be approximately at the level of this year, that is, between 5.5% and 6% of GDP. Although gradual growth of interest rates is expected in the world market in the second half of the following year, it is estimated that it will be relatively modest and will not significantly affect the interest rates in Serbia. In the next year, we expect inflation to move below the midpoint of the target corridor, i.e. that it will be below 3%.

Over the past decade, the economy of Serbia had a much slower growth than the CEE average. The direct reason for the slower growth of the Serbian economy is low level of investments, which since the beginning of the global economic crisis did not exceed 20% of GDP, while in the CEE countries they were above 22% of GDP. The reasons for low level of investments and slower growth of Serbian economy lie in weak institutions, modest progress in structural reforms and economic policy that insufficiently stimulates growth of the economy.

The decisive factor for the long-term growth of the economy are good institutions that encourage people to perform productive activities such as work, savings, education, innovation, investments, etc. Such institutions efficiently protect property rights and contracts, exclude the possibility of expropriation of profits and assets, ensure equality of market participants, and reduce corruption and privileged enrichment to a minimum. Serbia has not made any progress for several years in institution building, and in some segments the situation is worsening, and therefore it is not certain whether the improvement can be expected in the coming years.

Progress in restructuring public enterprises over the past few years has been very modest. Some indicators of the inefficiency of public companies are: long-term delays and high road construction costs, extremely poor rail services, occasional problems in electricity generation, low investment in utility infrastructure, etc. Although the restructuring of public enterprises is in the focus of a new agreement with the IMF, it is still not certain if there is a political readiness to conduct it. It is not certain if there is a will to abandon the policy of using public enterprises as a party prey and will to free these companies from social and fiscal functions.

Some significant improvements have been made in economic policy over the last 3-4 years, which have led to the consolidation of macroeconomic stability. Fostering macroeconomic stability is a key contribution of economic policy to economic growth, but more sustainable growth is needed in the long run. In order for economic policy to stimulate growth of the economy, it is necessary for the state to lead a responsible income policy, leaving sufficient space for the growth of domestic savings and, hence, investment. This primarily means that wages in public sector, pensions, as well as minimum wages in the country should move in line with the country's economic capabilities, which means that they should not push out savings and investments and undermine long-term economic progress. Instead, wages in public sector in this and next year are growing at a rate of 9%, which is much faster than GDP growth and wages in the private sector.

By increasing the volume and efficiency of public investment, the state would most directly stimulate economic growth, but there is an important difference between various segments of public investments. Investments in traffic, water management, utilities, and other infrastructure influence the growth of economy as they increase domestic demand in the period of realization, and upon completion, they have a favorable effect on the increase in private investments, that is, on the offer. On the other hand, investments in the purchase of weapons, which are maybe justified from the point of view of the security of population, will not significantly affect the growth of economy through the growth of demand, since mainly weapons of import origin are purchased, and the purchase of weapons does not have a positive impact on the long-term growth of the economy.

In addition to increasing investment in physical infrastructure, an important incentive for the growth of economy would be an increase of investments in education, research and innovation. However, the growth of investments in these areas is justified only if it is implemented along with structural reforms. This means that the funding of educational institutions should partly depend on the quality of education, while in the case of universities, funding will depend on the quality of scientific research. Finally, fiscal policy would be more incentive for private investments and growth if the possible fiscal space in the future would be used to reduce fiscal burden on labor.

In this issue of Quarterly Monitor, beside regular analyses of economic trends and policies, there is also a Highlight of Svetozar Tanasković, which analyzes the position of Serbia's economy on the international ranking lists.