From the Editor

The growth rate of Serbian economy in the first quarter was 4.6% - above the average of Central and Eastern Europe Countries (CEECs), which grew by 3.8% in the same period. The growth of economic activity in the first quarter is in line with our last year's estimate that we can expect a growth of about 4% at the level of entire 2018, which is approximately equal to the expected growth of CEE countries. Besides, the growth of Serbian economy in the current year is partially under the influence of one-off factors, such as the recovery of agriculture, electricity and coal production, construction, etc. If the influence of one-off factors is excluded, GDP growth in this year will probably only be just above 3%, meaning that the growth trend is still slower than in CEE countries. The direct cause of the slower growth of the Serbian economy, on which we have repeatedly wrote, is a low level of total investments, while the fundamental problems that slow down the growth of the economy are in weak institutions, high corruption level, and so on.

Beside the fact that the growth trend is slower than in other countries of the region, it has certain characteristics that may jeopardize its sustainability in the future. During the previous and over first quarter of this year, domestic demand grew faster than the GDP. In the previous year, with GDP growth of 1.9%, domestic demand increased by 2.9%, while at the beginning of this year the difference between the GDP growth and domestic demand growth was further increased, and so the GDP growth of 4.6% was accompanied by domestic demand growth of 6,8%. Although the growth of domestic demand during the past and at the beginning of this year is not dramatic, it is worrying because its level is already high in Serbia when compared to GDP. Domestic demand in Serbia in 2017 was about 9% higher than GDP, while in 11 new EU member states from Central and Eastern Europe it was 3,4% on average lower than GDP. Romania where a demand in the last year was 2.1% higher than GDP, has already taken measures to "cool down" the economy in this year.

The other effect of the exaggerated demand growth is the increase in Serbia's foreign trade deficit, which largely reflects on the growth of the current account deficit. Trade deficit increased from 6.4% in 2016 to 8.2% of GDP last year and reached 9.8% of GDP in the first quarter of this year. Quarterly dynamics of domestic demand and deficit in foreign trade balance during the past and at the beginning of this year suggest that these are not one-off factors, influenced by some extraordinary factors, but rather a more permanent trend.

In general, the economic growth model in the past year and at the beginning of this year has certain similarities, but also differences, with the model of economic growth that existed in Serbia in the pre-crisis period 2005-2008. The similarly is in the fact that the growth of the economy now, as well as during the pre-crisis period, is accompanied by the faster growth of domestic demand, the strengthening of the Dinar, the growth of foreign trade and the current account deficit, low interest rates in the world, high inflow of foreign capital... The difference is that a relatively high fiscal deficit was generated during the pre-crisis period, while fiscal surpluses are now being achieved, as well as the fact that public sector wages and pensions were rising significantly faster than the GDP, which is not the case now, although government officials are announcing it. Therefore, if the announcements of high wages and pensions growth, tax cuts, etc. are implemented in the forthcoming period, this will result in the fiscal deficit growth which would have little impact on the growth of the economy, but would further increase domestic demand and external deficits. However, the public debt to GDP ratio and international net asset position of the country to GDP ratio are now significantly less favorable than in the pre-crisis period, which means that the economy growth potential based on the growth of domestic demand is now time-limited.

The fastest growth within the framework of domestic demand growth, during the past and at the beginning of this year, was achieved by investments based on which we could conclude that this is a long-term sustainable process, regardless of the fact that it generates an increase in foreign trade and current account deficit. Such a conclusion would be correct only on condition that the dominant part of investments was directed to the interchangeable goods sectors, i.e. sectors that are largely oriented towards exports. However, data on structure of foreign direct investments in the last year, and this year as well, suggest that a larger part of investments is directed towards the non-tradable sector. In the last year approximately a third of realized investments was directed to the industry, agriculture and other activities that produce interchangeable goods, while around two thirds were invested in non-tradable activities such as construction, real estate, financial services, trade, etc. Thus, a large part of foreign investments in Serbia will not affect the increase of exports in the future, but will affect the outflow of capital from Serbia on the basis of the withdrawal of dividends. Foreign direct investments in the manufacturing industry are relatively low and are largely followed by high state subsidies as well as by media promotion, which creates the impression that such investments are dominant. High investments in the non-tradable goods sector are a relatively reliable signal that the real Dinar value is overvalued. Namely, when the Dinar is overvalued, it reduces the profitability of the investment in the activities that are mainly export oriented, which is one of the reasons why foreign investors are granted with high subsidies to invest in the industry.

There are opinions that growth of the current account deficit is not worrying as long as it is covered by foreign direct investments. Undoubtedly, it is better if the current account deficit is covered by foreign direct investments rather than loans, because the loans will surely generate outflow of capital on the basis of interest and principal in the future. In the case of foreign direct investments, it is not certain, but it is quite likely that investors will draw dividends in future, and perhaps part of the capital, from Serbia. At the end of the last year the total value of foreign capital in Serbia amounted to 23 billion euros, on the basis of which the owners recorded a profit in the amount of 2.1 billion euros last year. Out of the total profits earned by foreigners in the past year, 0.9 billion euros was withdrawn abroad in the form of dividends, while 1.2 billion euros was reinvested in Serbia. Dividends paid to foreign owners in the past year were only slightly lower than the total interest expenses paid to foreign creditors by domestic private debtors and the State. Nevertheless, the total net profit of foreign capital in Serbia amounted to more than two billion euros, and it can in principle be withdrawn in the event of a world crisis or crisis in Serbia, which would seriously worsen Serbia's balance of payments position.

The international net investment position of the country represents an important indicator of macroeconomic risks in the future, as besides the net liabilities on the basis of foreign loans it includes liabilities on the basis of foreign capital. The international net investment position represents the difference between foreign exchange reserves, foreign loans given and foreign capital invested on one side, and foreign loans received and foreign capital invested in the country, on the other. At the end of the last year, the international net investment position of Serbia amounted to -35.8 billion euros, which is -97.4% of GDP, while in the 11 EU member states from Central and Eastern Europe it averaged -46% of GDP, with Slovakia having the most unfavorable value of -64% GDP. Only four countries in Europe have worse international net investment position than Serbia - Ireland, Greece, Cyprus and Portugal – and they all had problems with public debt in the previous years.

The direct cause of the unfavorable international net asset position of Serbia has been a high current account deficit in almost every year since 2000. If in the forthcoming period Serbia continues to realize a high current account deficit of 6-7% of GDP, this, accompanied by a GDP growth of 3 -4%, would lead to an additional deterioration of Serbia's international net asset position by about 2.5 percentage points a year. Any further deterioration of the international net asset position would have the consequence of rising capital outflows on the basis of interests and dividends in the future, which could be particularly enhanced in the period of some future economic crisis.

The fundamental cause of the high current account deficit and unfavorable asset position is a low level of domestic savings. Therefore, a substantial part of otherwise modest investments, which have rarely exceeded 20% of GDP in the last 18 years, is financed by foreign funds - loans or foreign investments. Although domestic savings increased during the previous decade, they are now only slightly above 10% of GDP, which is insufficient to finance otherwise modest investments of around 18% of GDP. Economic policy can directly influence the increase in domestic savings by ensuring that wages, pensions and current government spending in the next few years grow somewhat slower than the GDP growth. Additionally, for the growth of domestic savings it is important to improve the investment environment for all participants in the economy, which means removing various administrative barriers, reducing corruption, equality of market participants, and so on.

This issue of the Quarterly Monitor, in addition to the regular texts, contains two Highlights. In the Highlight 1 Arsić, Ranđelović and Altriparmakov estimate the dynamics of gray economy in the 2012-2017 period, while in the Highlight 2 Živanović analyzes the financial performance of the Serbian economy in the 2013-2017 period.