From the Editor

Progress made in achieving macroeconomic stability over the past three years raises the question of the long-term sustainable growth of the economy, which would gradually compensate for the historical lag of Serbia behind European countries. The issue of accelerating growth is critically important because since 2010 Serbia has seriously lagged behind Central and Eastern European countries, and so the difference in the level of development increases rather than decreases. The cumulative growth of Central and Eastern European countries in the period 2010-2017 is 18.9%, while in the same period, Serbia recorded growth of only 6.7%. Relatively high growth rate of about 4%, which will likely be achieved in this year, should not deceive us because it will partially be based on the effects of a one-time recovery of agriculture and energy production - without those effects growth would amount to about 3%, which would be one of the lowest growth rates in the region.

It is therefore understandable that there are different proposals in the public how to create the conditions for a faster growth of the Serbian economy. Some economists and politicians are proposing to increase domestic demand, i.e. private and government consumption, in order to accelerate economic growth, which is theoretically and experientially controversial. If the growth of the economy could be achieved with higher consumption then there wouldn't be any underdeveloped countries in the world, because it is economically easy and politically desirable to increase consumption by increasing wages, pensions, social assistance, subsidies, public procurements, etc. However, in the same way individuals cannot become richer by spending more, neither can societies - if consumption grows faster than GDP it leads to growth in fiscal and external deficits, than growth of external and public debt followed by the depreciation of the domestic currency and increase in inflation. The final result of such policy is stagnation or decline in economic activity, followed by the decline in consumption.

Of course, for the economy to grow consumption growth is needed, however, consumption cannot be the driver of the economic growth, it can only follow. The goal of the responsible Government is not to maximize consumption in one year but to achieve a steady growth in consumption in every year, which is only possible if the economy is recording high growth rates and a precondition for this are high investments. Therefore, responsible policy implies that consumption at present is as high as needed to enable growth in consumption in the future, which means that consumption should not squeeze out investments. This policy was implemented by all rapidly growing economies in the world from the Western European countries in the past, to the Far East and the countries of Central and Eastern Europe at present.

In the case of Serbia, there are additional reasons why an attempt to generate growth of the economy by increasing consumption would be particularly damaging, because the private consumption and the government consumption are already high compared to GDP, while the deficit in trade with the world is relatively high. Government consumption in Serbia, including transfers to citizens, amounts to 43% of GDP, which is higher than the average for Central and Eastern European countries, though it should be smaller because Serbia is one of the least developed CEE countries. Also, private consumption, although small by absolute value, is now 72.4% of GDP, while in CEE countries, the average is 56.5% of GDP. The high share of private and government consumption in GDP suggests that for a longer period of time in the past they have grown faster than GDP. Therefore, the current government and private consumption in Serbia are oversized in relation to GDP, which leads to the squeeze out of investments that are the main driver of the long-term growth of the economy. Therefore, the government and private consumption need to grow slower than GDP as long as investments do not reach the level required for the economy to grow at high rates in the long run. Last year, Serbia experienced a high deficit in goods and services trade of 8.2% of GDP, which is 1.8% more than in 2016. The faster growth of domestic consumption than GDP growth, combined with a real strengthening of the dinar, would lead to an additional increase in the external deficit. This deficit is now successfully funded by foreign investments, but foreign investments could suddenly stop, as it happened in 2009, followed by a sharp depreciation of the dinar and a fall in economic activity. To reduce these risks Serbia needs to influence the gradual reduction of external deficits through consumption an exchange rate policies, and not to encourage them.

Based on the experience of a large number of countries which have experienced high growth rates in the past it can be concluded that high investments are a direct requirement for high rates of economic growth. Other factors directly affecting growth, such as innovations, good infrastructure, etc., are closely related to investments. Numerous empirical studies suggest that for the fast growth of the economy, which is approximately at Serbia's level of development, investments of about 25% of GDP are needed. The second lesson from empirical research is that domestic investment funds are crucial for growth in the long run. Foreign direct investments may play an important role in some stages of development, but in the long run domestic, above all private, investments are crucial. Simply put, no one has reached a high level of development relying on foreign funds in the long run.

Since the beginning of the world economic crisis Serbia's share of investments in GDP is 17-19%, and with so small investments it is not possible to achieve high rates of economic growth. Although this is well known, Serbia has not been able to increase its investment rate significantly for years. With a low level of total investments, Serbia is faced with a seemingly paradoxical situation – for several years back Serbia has been in the top of the list comparing countries by foreign direct investments, and in the past year it reached the top. In 2017, foreign direct investments amounted to 2.4 billion euros, which is 27% more than in the previous year, while their share in GDP was 6.5%, the highest among the countries of the region (see section "Balance of Payments and Foreign Trade"). High FDIs were followed by public praises of foreign entrepreneurs, and occasionally by foreign analysts, about good investment and business conditions in Serbia. Unlike foreign investments, domestic public and private investments in Serbia are among the lowest in Central and Eastern European countries. Domestic public investments have been around 3% of GDP for years now, while in other CEE countries their share is 4-5% of GDP. Domestic private investments account for about 10% of GDP, while in CEE countries that number is around 15% of GDP. As far as domestic investments are concerned, there is currently no evidence that the situation will improve, as public investments declined by 6.7% in the last year, while private investments declined by 3-4%. Unlike foreign investors, domestic investors give mostly negative reviews of business and investment conditions.

Therefore, the key issue for the growth of Serbian economy is why are domestic investments so low? When it comes to public investments the answer is quite obvious. The low level of public investments is a consequence of the low efficiency of the state, which, in spite of available financial resources, fails to realize the planned investments. The consequences of low public investments are the delay in the implementation of infrastructure projects, such as the Corridor 10, for several years now, poor condition of rail and communal infrastructure, etc. However, the answer to the question why are domestic private investments so low deserves a more detailed analysis. One possibility is that domestic investors do not see the investment opportunities foreign investors do, or they lack the resources and knowledge that foreign investors have. Another possibility is that investment conditions, in some important aspects, are more favorable for foreign than for domestic private investors. The possibility that domestic investors do not see the opportunities foreign investors do can quite certainly be excluded, as the number of potential domestic investors is incomparably higher than the number of foreign investors interested in our market. In addition, it is a realistic assumption that in most markets domestic investors are not lagging behind the foreign investors on the ability to spot investment opportunities, because they are operating for a longer period of time in the Serbian market, they mostly know trends in the world markets, etc. Also, lack of resources cannot explain low levels of domestic investments because domestic entrepreneurs have achieved good financial results over the past two years, and at the same time have a large offer of credits at interest rates which are lower than ever.

The possibility that foreign investments are higher compared to domestic due to more favorable conditions for foreign investors seems more probable. There seem to be at least three important areas in which foreign investors have advantages over domestic ones. The first advantage concerns the possibility of obtaining state subsidies, which are generally available to everyone. However, conditions for granting subsidies are defined so that they are more easily met by foreign investors. Another advantage of foreign investors is that they receive direct state aid in bypassing numerous bureaucratic barriers. Only a small part of domestic entrepreneurs can count on such assistance, and those are the ones closely connected to the government. Other entrepreneurs overcome such obstacles slowly and at a high cost. Finally, foreign entrepreneurs are better protected from various forms of law violations, such as fraud, extortion, and the like, which makes the business environment more secure for them. To sum up the above, the costs of doing business for foreign entrepreneurs in Serbia are smaller, and also they are largely protected from the risks domestic entrepreneurs are exposed to.

Based the above it can be said that rapid economic growth cannot be achieved by giving one group of entrepreneurs' high subsidies and the help of civil servants in overcoming bureaucratic barriers, protecting them from fraud, extortion etc. The prerequisite for rapid economic growth is the adoption of rules that would be equal to all, creation of competent and just state administration that would strictly adhere to these rules, effective judiciary that would equally protect all businessmen, etc.

In this issue of the Quarterly Monitor, in addition to regular analyzes of current economic trends, economic policies and reforms, there are two Highlights. In the Highlight 1 prof. Biljana Jovanović Gavrilović and Mirjana Gligorić analyze the quality of Serbia's economic growth, while in Highlight 2 Nemanja Vuksanović and Milojko Arsić analyze the determinants of average wages in Serbia.