From the Editor

Unfavourable trends in Serbia's economy additionally deteriorated in the second quarter, and there are signals that negative trends will continue in the third quarter as well. In the second quarter, the economy entered recession for the third time since 2008, while the two-year improvement in the foreign trade balance came to a halt. Inflation has been below the target for several months now, while the months with deflation are getting more frequent. The three month period of dinar exchange rate stability was interrupted at the beginning of July, and depreciation pressures were strong during August and September. Mid-year, the Government adopted reform laws on labour and retirement, which are important for improving the business environment and long-term sustainability of public finances. Growing macroeconomic risks, stemming from a high fiscal deficit and fast growing public debt, now present basic threat to the economy's stability and growth. Government's responses to macroeconomic risks have been slow so far, indecisive and insufficient.

Economic activity declined in the second quarter by 1% compared to the same period last year, while seasonally adjusted GDP is dropping for the third consecutive quarter, which leads to an undoubtable conclusion that Serbia's economy has entered recession for the third time since the beginning of the crisis. Worrying data on the trends in industrial production and exports in July are for the most part incidental, but they still confirm the deepening of recession trends. The main causes of the decline in economic activity have deeper roots located in poor business environment, while catastrophic floods only intensified the negative trends. Poor business environment, now dominated by macroeconomic risks related to the fiscal deficit and public debt, directly influences the decline of economic activity by discouraging investments and lending activity. Recession was present even last year in most of the economic sectors, but it was masked by the high growth in only a few sectors – automobile and oil industry and agriculture. However, due to the lack of new investments, the growth in the stated sectors has declined during this year.

Catastrophic floods uncovered another problem, which is the drastic inefficiency of the state, proven by inability to repair the damages to the electrical grid, transport infrastructure and residential buildings within a reasonable time frame. Compliance to the procedures and prevention of corruption are important, but they cannot serve as an excuse for state's inefficiency. The inability to repair flood damages raises an important question: is the state capable of implementing complex programmes such as mass construction of affordable housing, combating grey economy, improvement of education, public administration reform, etc.?

The fall of GDP in 2014 will be at least 1% of GDP, out of which the decline of 0.3% is the result of fundamental factors, while the decline of around 0.7% is the result of temporary factors (floods). In the following 2015, we expect GDP to drop by around 1%, because fundamental weaknesses of the economy will not be eliminated by then, and the austerity measures by the state, as well as shutting down the loser state enterprises will additionally increase the decline of GDP. The statistical data on the labour market trends are still disturbing. Formal employment is declining, which is in line with the trends in economic activity, but total employment is rising as a result of growth in informal economy?!

Another unfavourable tendency we have also predicted is the strong slow-down in Serbia's exports this year. In the previous two years, high growth of exports was the main driver of otherwise modest GDP growth, and it compensated for the decline in investments, private and public spending. The slow-down in export growth stopped the further improvement in the current account balance, which was stabilised at a high level of around 5% of GDP. Current account deficit of 5% of GDP is unsustainably high for a country facing low inflow of foreign capital, which mostly relies on government borrowing. Therefore, it is necessary to use economic policy and reforms to encourage export growth and import reduction in order to prevent potential balance of payments problems. In the short term, the key instruments are decreasing domestic demand and moderate depreciation of dinar, while in the long term, the measures for encouraging development of export oriented economy are crucial.

Based on the trends in the first seven months, it is estimated that Serbia's fiscal deficit this year will amount to around 8% of GDP, which will be the highest deficit in Europe, as well as the highest fiscal deficit that Serbia has had since 2000. As the result of the deficit, the public debt this year will increase by around 2.5 billion euros and will reach 70% of GDP by the end of the year. The state will spend around a billion euros this year on paying interests, which is more than expenditures for the military or the police, and equal to half of the total public expenditures for healthcare. Unless the fiscal deficit is reduced, the public debt next year will reach close to 80% of GDP, and 1.15 billion euros will go toward paying off the interests.

Procrastination and indecision of the Government in implementing fiscal consolidation have launched a torrent of proposals which challenge the need for fiscal consolidation or suggest "lighter" measures for its implementation. Challenging fiscal consolidation is nothing new, it exists in other countries as well and it is the result of effects of political factors on economy. Challenging consolidation justifiably raises a question of whether we as a society will regulate public finances in an organised fashion or will we leave it to chance, i.e. bankruptcy? In a democratic society, both choices are legitimate, although we believe the former is better.

Representatives of various interest groups are trying to avoid, postpone or at least decrease the savings related directly to them. To this end, there are estimates in the public that the situation is not that serious, so no big savings are necessary. Alternatively, austerity measures are proposed which should be realised anyway within the fiscal consolidation, but their effects are over-exaggerated in order to prove that cuts in wages and pensions are not necessary. For example, there are claims that the public sector employs twice as many people per 100 inhabitants than in other countries, which is the result of hiring 200 or 300 thousand party activists after 2000?! This leads to a conclusion that the fiscal deficit could be eliminated by firing public servants employed through partisan hiring. There is no doubt that the public sector has too many employees and that it is partly due to partisan hiring, but their number is significantly lower and is measured in tens, rather than hundreds of thousands.

Claims of enormous number of employees in Serbia's public sector are based on subjective observations, while the use of comparable statistical data is rare. These exaggerated estimates of the surplus of employees in the public sector find fertile ground in the public opinion, who does not have a good understanding of the state functions. Forming of this public opinion was also influenced by irresponsible statements by politicians, usually during election campaigns, according to who Serbia has an enormous surplus of public sector employees. Furthermore, it is paradoxical that these claims often came from parties who lead in partisan hiring.

That is why we will show here statistical data on the number of employees in Serbia's public sector and other countries, not including public and other state companies. In Serbia, in the state and local government, education, healthcare, police, military, social protection, agencies, etc. there are around 550-570 thousand workers, which is 7.7 employees per 100 inhabitants. Number of employees in the public sector is slightly higher than the average in European countries, which have 7 employees working in the public sector per 100 inhabitants. In European countries who have predominantly state education and state healthcare, the number of public sector employees varies in a narrow interval between 6 and 8 employees per 100 inhabitants. Similar number of employees per 100 inhabitants across countries is the result of the fact that availability of state education implies a certain number of teaching staff per 100 kids, while the availability of healthcare requires a certain number of medical staff per 100 inhabitants. Similarly, there are standards as to how many policemen, firemen, taxmen, judges are needed per 100 inhabitants. Comparison of Serbia to the countries of Central and Eastern Europe is relevant – the number of public sector employees in Serbia per 100 inhabitants is similar to that of Romania, but higher than in Bulgaria, while it is lower than in Hungary, the Czech Republic, Slovakia or Poland.

Comparative data convincingly show that there is no enormous surplus of public sector employees in Serbia (e.g. surplus of 30 or 50%), but it is quite certain that, through better organisation, the number of employees could be reduced by 10-15%, which is not negligible. However, the 30-50% reduction in the number of employees that is daily suggested by the public is possible only if state functions employing the largest percentage of the employees are abolished or significantly reduced, and these include education, healthcare, police, military, etc. That is why it would be good if those proposing reduction of public sector employees by a third or a half, come out with concrete proposals as to how many employees should be cut in each sector. Unsubstantiated claims of enormous surplus of public sector employees are upstaging other more important issues, such as: irregular hiring in the public sector, negative selection in promotions, no dedication to work, insufficient education of the employees, corruption, etc.

Aside from regular research, this issue of the Quarterly Monitor contains also a Highlight (Arsić), which analyses the reasons behind fiscal consolidation, possible alternatives, as well as consequences of various choices.