From the Editor

In the first months of 2014, negative trends are predominant in Serbian economy, which is in line with our previous forecasts. According to some preliminary estimates, GDP stagnated in the first quarter, while the unemployment slightly increased. Mixed tendencies continued in foreign trade – while the foreign trade balance is improving, the outflow of foreign capital is continuing. Low and stable inflation is maintained by a policy of almost fixed foreign exchange rate. Over the last year, NBS has informally switched to a significantly firmer forex policy, but it is not certain for now whether this is a temporary policy or a long-term commitment.

Prospects of economic recovery are far less favourable than what it seemed a few months ago. Due to the crisis in Ukraine, Serbia's international position has worsened, economic activity will be reduced due to the floods, and it is not certain how firm is the Government's commitment to fiscal consolidation and reforms. First negative consequence of the Ukraine crisis for Serbia is the delay of the construction of South Stream, which should have been the largest single investment in Serbia this year. If the Ukraine crisis does not end soon, Serbia will probably be forced to choose between EU and Russia, and either choice will bring economic losses to it. Disastrous floods in the second half of May have caused property damages which, according to some preliminary estimates, are 2-3% of GDP. The floods will have a negative, but a relatively moderate and short-term effect on the economic growth of Serbia, and the recovery of the damaged property will partially neutralise this effect. It is our estimate that the net effect of floods and recovery will not be more than 0.5% of GDP, as well as that the floods will affect the slower improvement of the foreign trade balance, while the impact on inflation will be negligible. The readiness of the Government to implement firm fiscal consolidation and comprehensive and thorough reforms is now less certain than it seemed right after it was formed. It would seem there is a risk that the Government will repeat the policy from the previous term, which was characterised by announcements of large reforms and cuts, only to gradually give up on them or postpone and mitigate the announced measures. Delay of the visit of the IMF mission indicates that there are still big differences between the Government and IMF with respect to what kind of economic policy and reforms Serbia should implement.

The fiscal deficit in the first four months was significantly higher than planned, and in case the current trends continue in 2014, it will reach around 8% of GDP and even increase due to floods by additional 0.2-0.3% of GDP. Serbia's fiscal deficit this year will be the largest since the hyperinflation of the 90s and it will also be the highest fiscal deficit in Europe. Worsening trends in fiscal policy call into question the Government's credibility, since it was announcing severe measures of fiscal consolidation for the previous and this year, as well as a significant reduction of the fiscal deficit. However, in both years, the fiscal deficit was considerably higher than planned, and this year, the deficit is significantly growing compared to the previous year.

There are many reasons why Serbia has been realising a significantly higher deficit than planned for the second year in a row. Among the more important ones are: delaying solving the problem in the economy, and especially problems in the public and other state companies (Srbijagas, GSP Belgrade, Železara Smederevo and other companies in restructuring), inconsistency in implementing policy (large revenue is planned based on combating grey economy, but no measures are taken to actually fight it), weak coordination between fiscal and monetary policy (inflation is much lower than the one planned by the Government), optimistic planning of macroeconomic aggregates (GDP, domestic spending, employment). Therefore, the Government has to have a much more responsible and thorough approach to solving problems of fiscal deficit, otherwise its not so high credibility will plummet even lower.

Due to unfavourable results in public finances in the previous part of the year, the Government, and with good reason, announced severe and painful austerity measures. However, concrete measures that are certain for now will have a modest reach, which means that the fiscal deficit in this and several coming years will remain at a very high level, and the public debt will continue its accelerated growth. Austerity measures announced by the Government come down to reduction of wages in the public sector by 10% and cuts of unproductive expenses (use of cars, etc.). The Government still hasn't come out with credible plans for preventing the outflow of budgetary funds to cover losses of public and state enterprises, reducing the number of public sector employees and reducing pension expenditures. Additional problem is that the relatively modest savings, as well as possible additional revenue from taxing the grey economy, will for the most part be spent on financing new Government programmes. Even when they are, according to our estimate, justified, as in the case of mass construction of affordable apartments and approving subsidies on loans, the new Government programmes cannot jeopardise the reduction of the fiscal deficit. The Government is still counting on significant revenue from combating grey economy, although no comprehensive operating plan has been presented yet.

The macroeconomic effects of slow consolidation would be unfavourable, since insufficient fiscal consolidation would reduce the public spending, but that reduction would not be enough to gain the trust of private investors and increase their activity. Reduction of public spending would be accompanied by a drop in private investments and private spending through the withdrawal of foreign capital from Serbia and so on, which would mean an additional decline of GDP and employment. In such circumstances, the risk of public debt crisis would be high. Relatively favourable borrowing conditions, which enable the easy financing of the fiscal deficit, represent a sort of a trap similar to the one that the countries of Southern Europe fell into after entering the eurozone.

Fiscal consolidation would have much better chances of success if strong austerity measures would be implemented at its beginning, which would significantly reduce the fiscal deficit in the first year already, with parallel adoption of measures that would guarantee the continuation of the reduction of the fiscal deficit in the following years. In this case too, the GDP at the beginning of the consolidation would drop, while the unemployment would rise, because the private investors would wait a while to make sure the Government is committed to implementing the consolidation. Based on the experience of a large number of countries it would follow that a year or two of consistent implementation of consolidation would be enough to gain investors' trust and to see a growth in private investments, which would be the main driver of GDP and employment growth in the following years.

Inadequate economic system is an important cause of the slow recovery of Serbia's economy, but it is one of the more important generators of the growth of fiscal deficit and public debt. Economic system reforms in Serbia have significantly slowed down in 2006, only to be upstaged by the ensue of the economic crisis. The Government has been trying for years to compensate for the weaknesses of the economic system with generous, but also economically inefficient and fiscally unsustainable subsidies for investments and hiring. Results of that policy were quite modest – investments were low, employment declined, while the economic activity mostly stagnated. Problems of companies under state control (public enterprises, companies in restructuring) were solved with measures that lead to a temporary bridging of problems, while permanent solutions in the form of successful restructuring and privatisation were rare.

In the second half of the previous year, ambitious economic system reforms were announced, which include the reform of labour legislation, building laws, and bankruptcy legislation. In addition, finalisation of the restructuring of former state enterprises was announced, as well as restructuring and partial privatisation of public enterprises. Due to the election in March 2014, the reforms have not been implemented, but after the Government was formed, it was confirmed that the economic reforms are its top priority. Adopting laws that improve the business environment, as well as concrete steps on restructuring public enterprises and finalising the restructuring of former state companies, together with its readiness to adopt additional measures of fiscal consolidation will be the crucial test of the Government's commitment to reforms.

Strong decline of investments, decline of the real scope of lending activity, drop of employment, stagnating overall economy, along with recession in many sectors, justify the implementation of anti-recession measures in Serbia. Even though the economic incentives are justified, it is necessary to bear in mind that these are temporary measures with limited reach, whose aim is to mitigate the recession, but that the long-term perspective of Serbian economy will heavily depend on the economic reforms. Therefore, the temptation of neglecting economic reforms due to anti-recession measures and recovery from flood damages should be avoided.

This issue of Quarterly Monitor, in addition to regular research, contains two Highlights. Highlight 1 (Arsić) analyses first Government measures, as well as options and challenges the Government is facing. Highlight 2 (Arsić, Brčerević) estimates the effects of floods on the trend of GDP and public revenue, and recommends a possible strategy for minimising the negative effects of floods on public finances.