From the Editor

In the second half of the year, Serbia's economy is still expressing divergent trends. On the one hand, the moderate growth of economic activity and the reduction of foreign deficit is continuing, while on the other, the financial position of companies, banks and the state is getting worse, investments and employment are declining, and high inflation is replaced by deflation. It is our estimate that the GDP growth in 2013 will be around 2%, inflation by the end of the year will be around 2%, balance of payments deficit around 5% of GDP, while unemployment will stagnate at a high level of around 25%. GDP growth is still concentrated in just a few activities, while most of the economy is in recession. Dominance of recession tendencies is confirmed by deflation that Serbia has been facing since the middle of this year. Deterioration of the financial position of companies is expressed through a reduction in real value of loans, increased percentage of bad loans, reduced tax discipline, and increased freezing of accounts. The negative tendencies in the economy are transferred to banks as well, and the government spending on the recovery of companies and banks is growing.

In the following year, we expect Serbian economy to stagnate, with an assessment that a decline in economic activity is more probable than its growth. The growth of Serbian economy this year has been slightly higher than of the economies in the Region, but Serbia's prospects for the following year are weaker than those of surrounding countries.

Factors on the supply side (recovery of agricultural production, production growth of FIAT and NIS) that have been driving economic activity throughout this year are depleted, while no new drivers of growth have emerged. On the demand side, a decline in personal and government spending is expected, a slow-down in the growth of exports and a modest increase of investments. Reduction in government and private spending is a necessary consequence of adjusting local spending to the available GDP, and any attempt to use government spending to jump-start the economy would be counterproductive. In the previous issue of QM, we estimated that the economy could realise some growth in the coming year only if there is a significant growth of investment. Now, it is almost certain that earlier announced large investments will not be realised next year or at best, they might be realised on a much smaller scale. Also, the economic system reforms, even if implemented at the end of this and the beginning of next year, wouldn't have a considerable impact on the growth of investment and economic activity in the coming year.

Formal employment is still moderately declining, which is in line with the recession tendencies in most of the economy. In the coming year, a significant decline of formal employment is expected as a result of lay-offs in companies undergoing restructuring, caps on public sector employment, and stagnation of the private sector. Labour market reforms together with other reforms could influence an increase of employment, but not before 2015.

At the beginning of the fourth quarter, inflation reached a record low year-on-year level, while Serbia has been facing deflation as of June. Deflation is predominantly the result of decline in domestic demand and the recession in most parts of the economy, but it is deepening the recession tendencies in return. Dinar exchange rate has mostly been stable since the middle of the year, mostly due to decisive policies of NBS to prevent sudden depreciation or appreciation of dinar by intervening on the foreign exchange market. Stability of dinar combined with high dinar interest rates yields high real profit in short term, which has attracted speculative capital. Deflation of prices, recession in most parts of the economy, decline in bank lending activity, and high illiquidity of the business sector create a need for reduced restrictiveness of the monetary policy. Mild depreciation of dinar and bringing inflation back on target track are necessary not only for the credibility of the target inflation model, but for mitigating recession as well.

Trends in the current account balance of payments are extremely positive – current account balance of payments deficit will be halved compared to the previous year, although it will still be at a high 5% of GDP. Reduction of deficit is predominantly the result of growth of exports, but to some extent of the decline in domestic demand as well. Coverage of imports by exports in Q3 reached a historic high of 82%, but the share of Serbian exports in GDP is still low compared to countries of similar size. While the trends in the current account balance of payment can be characterised as positive, this is not the

case with the capital account. Businesses and banks are still deleveraging, inflow of foreign direct investment is very low, and most of the inflow of foreign capital is directed to financing the state deficit, while more than half of the borrowing is used for financing current spending. Since the beginning of October, government financing is largely based on short-term securities, which are an expensive and very risky source of financing. After a long time, the current account balance of payments deficit in 2013 is lower than the fiscal deficit, which means that the entire foreign deficit is directly or indirectly the result of fiscal deficit.

In the following year, a continuation in the improvement of current account balance of payments is expected, but at a slower pace than this year. Exports will have a slower growth, while low domestic demand will prevent a fast growth of imports. For an improvement in the trends on capital account, it is crucial that reforms be implemented that will improve the economic environment and attract foreign direct investment, while the state should reduce the fiscal deficit and foreign borrowing.

According to international methodology, the fiscal deficit in 2013 will be 6.5% of GDP. Fiscal deficit this year will be approximately at the level of last year's deficit, which means it will be almost twice as high as planned. Increase of fiscal deficit is mostly the result of significantly lower revenue compared to the planned one, which is due to several factors, most important being: overestimated revenue, faster decline of domestic demand and inflation than planned, deterioration of fiscal discipline (growth of grey economy and tax debts).

For 2014, the Government has planned a fiscal deficit of 7.1% of GDP, which means that the deficit will be by 0.6% of GDP higher than this year. The growth of fiscal deficit is the result of mitigating the announced austerity measures (wages), delaying certain reforms (pensions, Srbijagas), as well as emergence of new expenditures. In order to ensure credibility of the fiscal consolidation programme and returning of public finances to a sustainable track, it is necessary to implement additional savings of around 1% of GDP in 2014, as well as adopt reforms of the public sector that would guarantee continued reduction of the fiscal deficit in the coming years as well. From the standpoint of fiscal consolidation, it is especially important to adopt the following reforms as early as next year: fundamental pension reform, programme of systematic rationalisation of the number of public sector employees, programme of restructuring of Srbijagas and other public enterprises, measures for combating grey economy, etc. In order for the Government to have credibility, it is important to be consistent in the implementation of the already adopted reforms, such as resolving the status of companies undergoing restructuring.

Reduction of fiscal deficit to 6.1-6.3% in the following year would make fiscal consolidation plans for 2015-2016 realistically achievable. On the contrary, if the fiscal deficit in 2014 is 7.1% of GDP, it is highly improbable that the fiscal deficit in 2015 would be reduced to 5.2% of GDP, and in 2016 to 3.2% of GDP. Additional government savings, which would lead to reduced fiscal deficit in 2014, as well as to its decline in the following years, are necessary not only from the standpoint of public finances, but from the standpoint of economic recovery as well. In conditions when investors suspect a possibility of public debt crisis in Serbia, the growth of domestic demand generated through fiscal deficit is completely neutralised by the decline in private investment and private spending. In highly indebted economy such as Serbian, increase of fiscal deficit has no effect on GDP growth, it rather reduces it. Fiscal multipliers in a small open economy with flexible foreign exchange rate are generally low, and in the periods of high indebtedness they become negative.

The main obstacles to economic growth are on the supply side, i.e. in the weaknesses of the economic system that destimulate investment and entrepreneurship, such as financial indiscipline, administrative barriers, inefficient judiciary, bad infrastructure, rigid labour market, etc. That is why the key to economic growth are reforms and not stimulating domestic demand through the increase of fiscal deficit. In addition to fiscal consolidation and reforms, it is necessary to take measures for improving the dramatically bad condition of economy's liquidity. Measures for improving liquidity could help solvent companies that are faced with temporary financial difficulty to overcome the crisis, while an efficient bankruptcy procedure would ensure elimination of insolvent companies from the market.

This issue of QM, in addition to regular analyses, also contains four Highlights and one Spotlight On. Highlight 1 (by Arsić and Ranđelović) analyses fiscal policy for the period 2014-2016 and gives suggestions for its correction; Highlight 2 (by Gligorić) analyses foreign direct investment in Serbia and surrounding countries before and during the crisis, with a special focus on the efficiency of direct subsidies in attracting investments; Highlight 3 (by Arsić) denies claims that bad privatisation is the most important reason behind reduced employment over the last two decades; Highlight 4 (by Handjinski, Šestović, and Šljivančanin) analyse the role of Turkey in the economic trends of Southeast Europe. This issue also contains Spotlight On (by Molnar) which analyses the trends in decentralisation in EU member states, as well as their impact on economic growth.