SERBIA: Fiscal dilemma

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In Serbia, where fiscal adjustment is urgently required, this year's recession may at best be followed by stagnation or slow growth in the medium term. The risks are on the downside owing to the need to cut public expenditures rather significantly, the sole dilemma being whether fiscal consolidation will have to be frontloaded. Consumption, investment, and employment will depend on that issue. A certain increase in exports to Russia is forecast; this year, however, exports have in fact declined to date. The regime of sanctions currently emerging in Europe is exposing Serbia to growing pressure from Russia, which the country will find difficult to resist.

This year's GDP will shrink by as much as 1%. On the demand side, it is only net exports that might have a positive contribution. Investment may still recover somewhat due to public efforts to deal with the aftermath of the devastating floods. But this is uncertain due to institutional failures. Fiscal consolidation is very much on the agenda, the only open issue being how frontloaded it will be. If indeed it amounts to about 2% of GDP annually in the next three years, stagnant or very slow growth will be a success in the medium term.

After passing some reform legislation dealing with the labour markets and privatisation, the government has turned to fiscal consolidation and public sector reforms, the first elements of which should be incorporated in the revised budget for this year and in the three-year fiscal strategy. Those should also be subjects of intense negotiation with the IMF on a new, most probably three-year standby agreement to be signed before the end of this year. Out of all these intended measures, some elements of the budget cuts have been made public. Those are still not definite, but they are indicative of the direction the government intends to take.

The aim is to stabilise the public debt to GDP ratio at about 75% by the year 2017. After that, the fiscal deficit should be such that this ratio will stop increasing and will start declining towards the legally mandated level of 45%. In order to accomplish this goal, the government intends to cut spending by about 2% of GDP per year. Those savings should come from the elimination of subsidies to loss-making public enterprises, and to a much lesser extent other subsidies, and from cuts in public sector wages and pensions. The latter have received most public attention.

However, it will be easier to cut incomes than subsidies. In the past, inflation was used to reduce real incomes, e.g. compensations and pensions, often speeded up through an exchange rate adjustment.

The rising inflation rate would then trigger demands for wage increases and consequentially pensions, which are indexed on the former. In the current circumstances of falling consumption and worsening expectations, which have driven headline inflation down to around zero, a quite significant devaluation would probably be needed to engineer a significant rise in prices; that, however, the central bank would certainly want to avoid. There is scant experience with labour market response to nominal wage cuts, though resistance in some sectors can be expected, while pensioners will have difficulties staging protests given that their party is in the government coalition. There could still be strikes and social protests, but those are unlikely to succeed because the government enjoys high public and electoral support.

Subsidies are a different matter. Those that cover losses would have to be eliminated with price hikes and employment cuts. The needed increases in the price of gas and electricity may have to be quite substantial. In other cases, e.g. the railway company, cuts in employment will also have to be substantial. Other public firms will have to be sold, which besides being unpopular may also lead to more costly services and lay-offs. As for subsidies to agriculture or for investments, these cuts are rather small, but are still not going to be popular with their recipients. It may prove difficult to overcome all the resistance and dissatisfaction that these measures will provoke and mobilise.

Fiscal consolidation, if achieved through expenditure cuts, which is not certain, does little to promote economic growth. In fact, the initial effect will be negative, i.e. recessionary. The economy is already experiencing negative growth of about 1% this year. With some luck, next year and the year after the decline should stop, but not much more can be expected. For things to turn around, a rather significant increase in investment will be needed. In the first half of this year, investment continued to decline as has been the case for most of the crisis years. At the moment, it is not easy to see what would turn this trend around. Without that, however, there will also be no increase of employment, which is sorely needed.

So, after these fiscal consolidation measures, there have to come other reforms that will boost investment, production, and employment. Those would have to include financial consolidation, product market liberalisation, and much more efficient public administration with a complete overhaul of the regulatory system. If these reforms are delayed further, then fiscal consolidation will run into growing resistance and may have a hard time being fully implemented and delivering the desired results.

Prospect for this year are negative and an improvement in the medium term is quite uncertain. Much will depend on the additional policy measures that should be adopted until the end of this year. In any case, practically the whole transition agenda is being faced and risks are significant. That will test the social stability while growing pressure from Russia to take its side is challenging the government's strategy of integration in the EU. Serbia has a trade regime that Russia considers unacceptable in Ukraine, i.e. it has a deep trade agreement with the EU and a free trade agreement with Russia. Currently, that does not present problems, but that may no longer be true once Serbia advances enough towards EU membership and approaches the customs union of the EU, which will require the discontinuation of the free trade agreement with Russia. That may be politically testing.

Table 1 / Serbia: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013 January-June	2014 January-June	2014 Forecast	2015 Forecast	2016 Forecast
Population, th. pers., mid-year 2)	7,291	7,234	7,199	7,164	.	.	7,070	7,040	7,010
Gross domestic product, RSD bn, nom. 3)	2,882	3,209	3,349	3,618	1,703	1,700	3,700	3,800	4,000
annual change in % (real) 3)	1.0	1.6	-1.5	2.5	0.4	-1.1	-1.0	0.0	1.0
GDP/capita (EUR at exchange rate)	3,800	4,400	4,100	4,500	.	.	.	.	.
GDP/capita (EUR at PPP)	8,500	8,900	9,000	9,200	.	.	.	.	.
Consumption of households, RSD bn, nom. 3)	2,283	2,438	2,544	2,643	.	.	.	.	.
annual change in % (real) 3)	-1.0	-1.2	-1.9	-1.5	.	.	-2.0	-1.0	0.0
Gross fixed capital form., RSD bn, nom. 3)	512	593	717	743	.	.	.	.	.
annual change in % (real) 3)	-5.5	8.4	14.4	-7.7	.	.	0.0	3.0	4.0
Gross industrial production 4)									
annual change in % (real)	1.2	2.5	-2.2	6.3	3.9	-1.1	-3.0	5.0	5.0
Gross agricultural production									
annual change in % (real)	1.0	0.8	-17.3	22.1	.	.	0.0	10.0	8.0
Construction output 5)									
annual change in % (real)	-7.1	10.4	-0.8	-25.7	.	.	3.0	5.0	5.0
Employed persons, LFS, th, average 6)	2,396	2,253	2,228	2,311	2,227	2,408	2,400	2,400	2,400
annual change in %	-8.4	-6.0	-1.1	3.7	3.2	8.1	5.0	1.0	1.0
Unemployed persons, LFS, th, average 6)	569	671	701	656	709	612	.	.	.
Unemployment rate, LFS, in %, average 6)	19.2	23.0	23.9	22.1	24	20	21	23	23
Reg. unemployment rate, in %, end of period	26.7	27.6	28.2	28.2	29	29	28	28	28
Average monthly gross wages, RSD 7)	47,450	52,733	57,430	60,708	59,307	59,865	.	.	.
annual change in % (real, gross)	0.6	0.1	1.0	-1.9	-4.6	-1.3	-1.0	0.0	1.0
Average monthly net wages, RSD 7)	34,142	37,976	41,377	43,932	42,834	43,398	.	.	.
annual change in % (real, net)	0.7	0.2	1.1	-1.5	-4.6	-1.0	-1.0	0.0	1.0
Consumer prices, % p.a.	6.8	11.0	7.8	7.8	11.3	2.3	2.0	4.0	3.0
Producer prices in industry, % p.a.	13.7	12.7	6.8	2.7	4.6	0.6	.	.	.
General governm.budget, nat.def., % of GDP									
Revenues	42.5	40.6	42.0	40.6	.	.	.	.	.
Expenditures	47.3	45.6	48.5	45.6	.	.	.	.	.
Deficit (-) / surplus (+)	-4.8	-5.0	-6.6	-5.0	.	.	-7.0	-5.0	-4.0
Public debt, nat.def., % of GDP	44.5	48.5	59.8	63.7	.	.	72.0	71.0	75.0
Central bank policy rate, % p.a., end of period 8)	11.50	9.75	11.25	9.50	11.0	8.5	8.0	7.0	6.0
Current account, EUR mn 9)	.	.	-3,640	-2,092	-1,055	-866	-1,950	-1,950	-2,100
Current account, % of GDP	.	.	-12.3	-6.5	-6.9	-5.9	-6.2	-6.0	-6.0
Exports of goods, BOP, EUR mn 9)	.	.	8,394	10,540	4,729	5,279	11,200	11,900	12,700
annual change in %	.	.	.	25.6	20.5	11.6	6.0	6.0	7.0
Imports of goods, BOP, EUR mn 9)	.	.	14,028	14,693	6,964	7,131	15,100	15,900	16,700
annual change in %	.	.	.	4.7	1.4	2.4	3.0	5.0	5.0
Exports of services, BOP, EUR mn 9)	.	.	3,104	3,423	1,524	1,680	3,700	3,900	4,100
annual change in %	.	.	.	10.3	7.8	10.2	7.0	5.0	5.0
Imports of services, BOP, EUR mn 9)	.	.	2,965	3,103	1,419	1,540	3,300	3,500	3,700
annual change in %	.	.	.	4.7	1.9	8.5	5.0	5.0	5.0
FDI inflow (liabilities), EUR mn 9)	.	.	926	1,485	333	423	1,000	1,000	1,000
FDI outflow (assets), EUR mn 9)	.	.	257	257	105	87	100	100	100
Gross reserves of NB, excl. gold, EUR mn	9,555	11,497	10,295	10,734	10,206	9,597	.	.	.
Gross external debt, EUR mn	23,786	24,125	25,721	25,842	26,072	25,384	.	.	.
Gross external debt, % of GDP	85.0	76.7	86.9	80.8	.	.	.	.	.
Average exchange rate RSD/EUR	103.04	101.95	113.13	113.14	111.92	115.66	118	120	122
Purchasing power parity RSD/EUR	46.73	49.57	51.46	54.39	.	.	.	.	.

1) Preliminary. - 2) From 2011 according to census October 2011. - 3) According to ESA'95 (FISIM not yet reallocated to industries). - 4) Excluding arms industry. - 5) According to gross value added. - 6) Survey in April and October. - 7) Including wages of employees working for sole proprietors. - 8) Two-week repo rate. - 9) BOP 6th edition.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.