

From the Editor



Q2 2007 was more important for what it sowed than for what actually went on in the economy. This was a quarter when the 2007 Budget was passed, with a delay because of the formation of the new government. Immediately after that, a government Memorandum on the Budget, Economic and Fiscal Policy in 2008 was adopted. The 2007 Budget envisages a major rise in wages and public investments until the end of the year. This not very welcome fiscal expansion is the result mainly of obligations undertaken legally by the previous government. The new government's Memorandum announces a needed turnabout – cutting of spending and wage controls. Whether this will actually happen is a question.

In Q2, the economy sailed into calmer waters, albeit with the albatross it has been carrying for a long time – the high foreign trade deficit.

Inflation is under control and will probably be around 8% in 2007. There is some public concern over the rate being higher than projected (6.5%) and above last year's (6.6%). Nonetheless, this for Serbia is still a low rate and, more importantly, was triggered primarily by the necessary adjustment of controlled prices, not the expansion of demand. As there was almost no adjustment of these prices in the 2004-2006 period, 2007 had to foot the bill. Consequently, it is better to compare core inflation as determined by supply and demand on the market. This year it declined relative to 2006 – we estimate it will lie between 4% and 5% by the end of 2007, the low end of the NBS target band (4%-8%). Since core inflation fell, this means that inflation in Q2 was not driven by demand and, hence, that there is no danger at present of it running out of control. Core inflation did rise in August, but by all accounts owing to one-off supply-side shocks: the drought, possible monopolistic behavior and the like, which should not unleash an inflationary wave. But the risk is still there and inflation should be closely monitored in September.

GDP grew strongly in Q2 too and we estimate it at an annual 7.3%. It would have grown even more if agricultural production had not fallen short. The movement of nonagricultural production therefore better reflects economic activity and the impact

aggregate demand has on it. The high 8.5% growth of nonagricultural production indicates that economic activity was above the long-term growth trend, which was doubtless triggered by the high aggregate demand.

As in the preceding quarter, the high demand was manifested in a *high current account deficit of 13.5% of GDP* and not in inflation. This level of deficit is an improvement over the excessive deficit in Q1 (17.7%) but is still the second worst in the past two years. The reduction was the result of a major slowdown of the growth of imports, which, unfortunately, was for the most part due to a temporary drop in the import of energy products (Table T6-7).

Though still high, aggregate demand slowed its growth in Q2. Total demand grew somewhat faster than production in the quarter, causing an above-average GDP growth. Interestingly, the growth of domestic demand (total demand minus imports) slowed and was below the GDP growth (see Box 1, Section 5, Economic Activity). It follows then that imports, as an element of demand, are becoming increasingly significant, which is good news. Another piece of good news is that domestic demand decelerated as a result of fiscal tightening. A surplus was achieved in Q2 even when the payment of FFCDs is factored into expenditures (see Section 7, Fiscal Flows and Policy). What then is the role of the remaining two sources of the growth of demand: wages and credits?

Wages recorded substantial y-o-y growth in Q2 too (18.6% in real terms), but primarily as a reflection of the high level achieved, and not as a further acceleration of their growth. Wages jumped in Q1, far more than GDP, and triggered higher domestic demand. The high level and aggregate wages of Q1 continued in Q2, but their share in GDP did not increase: 37.3% in Q1 and 36.6% in Q2 (see Table T4-5). Consequently, wages did not spur demand or inflation in Q2, though they can be blamed for the high demand. The growth of wages can also affect inflation through rising labor costs. The movement of unit labor costs shows growth in Q1, which was retained at the same high level in Q2 (see Table T4-5). This indicates that the wage growth may have been a cost shock in Q1 but not in Q2. It must be emphasized here that wages in the public sector rose more than the average in the

economy, which is a strong argument in favor of the controls announced for 2008.

Credit expanded in Q2 and was the main driver of the growth of demand. Banks granted €1 bn in new loans in Q2 and companies additionally borrowed some €0.5 bn abroad (excluding the credit taken by Telekom Serbia). The increase in credit in Q2 was higher than the increase in production, with the share of credit increase in GDP rising from 15.9% in Q1 to 21.2% in Q2. The faster growth of credit than GDP indicates that it pushed up demand, which in turn pushed GDP growth above the long-term trend. Luckily, the bulk of the credit increase found its way into the economy – some €1.1 bn (15.8% of quarterly GDP), while a new €350 mn (5.3% of quarterly GDP) was granted to households. The greater part of this, however, was in the form of cash loans (over €150 mn or more than 2.5% of quarterly GDP), which prompted the NBS to react (see Box 1, Section 8, Monetary Flows and Policy).

In addition to banks turning toward the economy, another positive development was that the banking sector ceased additional foreign borrowing and even started reducing its liabilities. Thus the main sources of bank credit became capital increases and domestic deposits. Both to a considerable extent avert the possibility of a banking crisis. Finally, it was also good news that banks are cutting “unproductive” investment in NBS papers and making the released funds available to the economy.

For the second quarter, *monetary policy* has not been under the pressure of major inflows of foreign capital, a problem it had to tackle in 2006. Moreover, the NBS could allow itself to issue currency through moderate foreign exchange purchases without subsequently having to withdraw it with costly lending (repo operations) from the private sector. This was a luxury the NBS could not afford in 2006 when it was forced to withdraw funds arising from the inflow of foreign capital through expensive repo operations. It was these repo operations that led to the NBS recording a real loss in 2006 (see Box 3, Section 8, Monetary Flows and Policy). After a longer period, the trend has been reversed and the NBS is now in a position to reduce its liabilities by buying its papers and with a small cut in the reference rate to 9.5% (and again as a signal, a mild raise to 9.75% in August following the price hikes). This reduces the costs of monetary policy but leads to additional issuance of currency which, however, is tolerable for the time being. The NBS’s costs are still very high as its liabilities (repo stock) remain large as does also the interest it pays on them.

Additional NBS issuance in Q2 was tolerable as it did not lead to an acceleration of the growth of money supply (M2). Quite the contrary, this growth slowed in Q2, while the growth of credit pushed M2 up. The net effect was a slowing of the growth of money supply. This is consistent with the deceleration of domestic demand mentioned above as it is connected with the movement of M2 in its broadest definition.

Fiscal policy played a positive role in Q2, as well as in July, achieving a surplus and savings. This enabled the position of the economy in Q2 to come close to the desirable: government is saving (albeit still modestly) and thus creating room for a significant growth of credit to the private sector and its expansion. But this is just too good to last.

The prospects are that macroeconomic stability will be shaken by the end of the year. The greatest challenges, however, will be in 2008 and lie in the budget that is currently being prepared.

Major fiscal expansion until the end of the year is built into the 2007 Budget, which takes us back to the beginning of this note. The expansion will be through the substantial growth of the already high wages in the government sector, the rapid growth of public investments as part of the National Investment Plan (NIP), and increased spending on current government operations. On the revenue side, higher spending will be prompted by the cutting of conveyance tax and the abolition of tax on first-apartment purchases. This will entail a shift from the surplus in the first semester to a substantial fiscal deficit in the second. The real deficit in 2007 will therefore amount to some 2% of GDP.

The forthcoming fiscal expansion will rely on the described high growth of credit to the private sector, and lead to a surge in domestic demand. The already high current account deficit will deteriorate further and inflationary pressures will be increasing. In that event, the NBS will have to react by raising interest rates, and probably, limiting the growth of credit. The result will be suppression of the private sector by government and the slowing of its growth. The rise in interest rates will be an impetus to the appreciation of the dinar, additionally worsening the current account deficit. As a result, the economy will rapidly slide away from the desired position.

The problems described above will be transient (or less glaring) if the 2008 Budget is restrictive, which government has promised in its Memorandum on Fiscal Policy next year. The envisaged reduction of public expenditure by 1.7 percentage points of GDP can only be acclaimed, while public revenue is to remain

unchanged. But this will require difficult and politically courageous decisions: freezing of wages that come out of the budget (and the funds) in 2008, albeit at the high level of November 2007, cutting back of the investments envisaged by the NIP, lower government spending and lower subsidies (see Section 7, Fiscal Flows and Policy). On the other hand, trade unions have announced strikes in the event of a wage freeze. There are also demands for additional spending in 2008 – for restitution, early settlement of debts (of which half is the debt of the Serbia Roads public company amounting to 23 bn dinars), payment of social security for people without coverage and the like. If these demands only are met, spending would go up 2 percentage points of GDP and completely cancel out the effects of the planned cuts in expenditure. And there is also the issue of adjusting pensions to the suddenly much higher wages, i.e. raising them from 50% to 60% of the average wage; full adjustment would mean an additional growth of public spending by 1 percentage point of GDP. And to add to all this are the upcoming elections, a period when fiscal policy as a rule is ridden over roughshod (as in late 2006 and late 2003).

If the government backs down and allows *fiscal expansion in 2008*, the problems described above would become full blown. The current account deficit would rise to a dangerous level and threaten a balance of payments crisis, and only very high interest rates and forceful restrictions

on the growth of the private sector would be able to curb inflation. This is to say that high public spending and the resultant deficit is not a “game” some win and everyone else stays where they were. On the contrary, only a few win and the overwhelming majority of the population loses because of the stagnation of economic growth and/or inflation. The government should work in the interests of the majority, not partial interests, regardless of how strong the pressures to this end.

The danger of an excessive growth of demand and its curbing is the point of the above discussion, which is justified when macroeconomic stability is directly involved. In the medium and long run, however, the “problem” of high growth of demand can be resolved with a high growth of supply, i.e. substantial economic growth. Structural reforms are an essential factor in the growth of supply. For this reason, the topics under the spotlight in this *QM* deal with the segment of structural reform in Serbia where the common thread is regulation. Also important and topical are the issues of the privatization and restructuring of big public enterprises, a sounder financial market (how *the legislation regulating the financial market is applied*), and promoting risk control in banking operations in keeping with international standards (implementing the Basel 2 standards).

