Presentation for the Kopaonik Forum

# Serbia: Addressing Stability and Growth Challenges

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# Global Economic Outlook

**Global activity was strong in 2010, but support from the fiscal stimulus and re-stocking of inventories is over: growth set to slow to 4½%**

**The "three-speed" recovery in 2011:**

- **Subdued growth in most of Europe and Japan (1-2%)**
- **More robust pace in the US and other advanced (3-4 %)**
- **Brisk pace in some key emerging markets (5-7-10%)**

# Global growth slightly revised up in 2011, but not in 2012

## Real GDP Growth Projections

*(percent change from a year earlier)*

| | World | U.S. | Euro Area | Japan | Emg. Europe Plus | Brazil | Russia | China |
|---|---|---|---|---|---|---|---|---|
| 2011 (Jan 11 WEO) | 4.5 | 3.2 | 1.5 | 1.6 | 4.2 | 4.5 | 4.5 | 9.6 |
| 2011 (Oct 10 WEO) | 4.2 | 2.3 | 1.5 | 1.5 | 4.0 | 4.1 | 4.3 | 9.6 |
| 2011 (Apr 10 WEO) | 4.3 | 2.6 | 1.5 | 2.0 | 3.5 | 4.1 | 3.3 | 9.9 |
| | | | | | | | | |
| 2012 (Jan 11 WEO) | 4.5 | 2.7 | 1.7 | 1.8 | 4.2 | 4.1 | 4.4 | 9.5 |
| 2012 (Oct 10 WEO) | 4.5 | 3.0 | 1.8 | 2.0 | 4.2 | 4.1 | 4.4 | 9.5 |

Consensus forecasts of the main investment banks have generally moved higher in February, especially for the US… but there may be a "pull" from Middle east development

# Global Tensions and Risks

**Despite the recovery, tensions are significant:**

- Dichotomy between real economy and financial markets
- Inflationary pressures – commodity/food prices a sparkplug
- Political and social tensions in the Middle East – pours oil on the flames of risks

**… entailing risks for global growth:**

- Commodity prices' pull
- Eurozone periphery
- Capital stop-go pattern to emerging markets
- Global imbalances (growth when fiscal stimulus is withdrawn…)

**On balance, different challenges: gradual adjustment and financial system repair in advanced countries but policies against overheating in EMs… but each country has a different set of circumstances and priorities**

# Downside risks to growth and upside risks to inflation remain elevated: due to rebounding commodity prices



# The Crisis and Serbia

**<u>Huge vulnerabilities in Sep08</u>**

Risky growth model in 2001-08:

- based on absorption, instead of exports
- based on consumption, instead of saving;
- dominance of nontradables, noncompetitive sectors
- financed by foreign capital (bank) inflows
- nondynamic trading partners…

**<u>with uneven policy legacy</u>**

- The good – banking supervision
- The decent – monetary policy
- The bad – fiscal policy (procyclical)
- The ugly – structural reforms

**CAD was 21% of GDP in 2008 : then the crisis hit and there was a serious risk of total implosion due to banks' pulling out… prompting to turn to the IMF for support**

# Serbia's IMF program: taking stock

**What "worked"**

- Financial crisis prevented despite large depreciation
- Banks kept exposure at a critical time in 09-10
- Regained cost competitiveness: CAD correction to 7% of GDP
- Fiscal deficit levels in 2009-10 (just over 4%) reasonable
- Key fiscal rules put in place

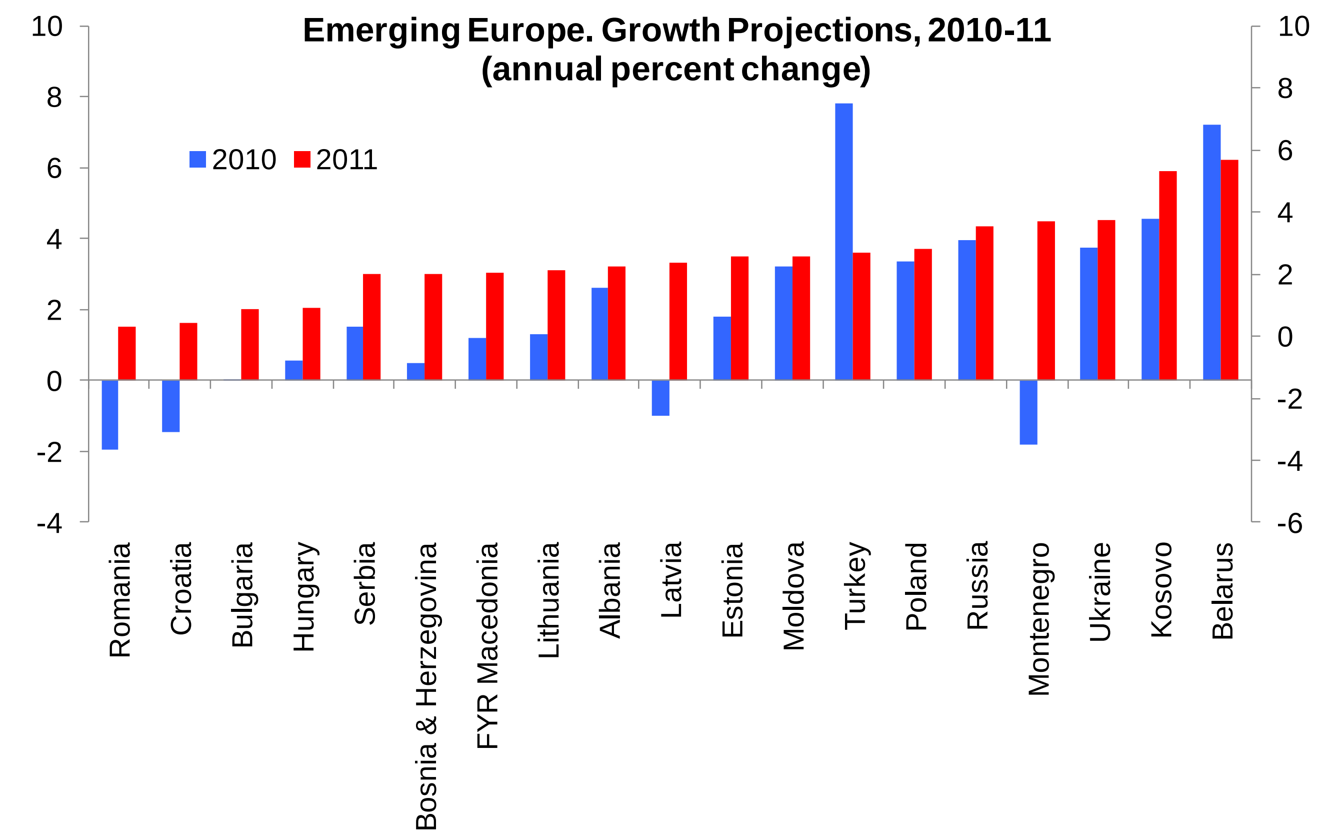
**What did not (quite) work**

- Inflation resurfaced
- Employment contracted sharply
- Structural fiscal reforms sputtered
  - Public employment rationalization defeated
  - Pension reform too modest
  - Public investment sacrificed
- Pro-growth structural reforms slow

…

**The program bought time and started policy corrections -- the key challenge remains medium-term, growth-oriented structural reforms, entailing short-term/political/special interest costs for longer-term broader benefit**

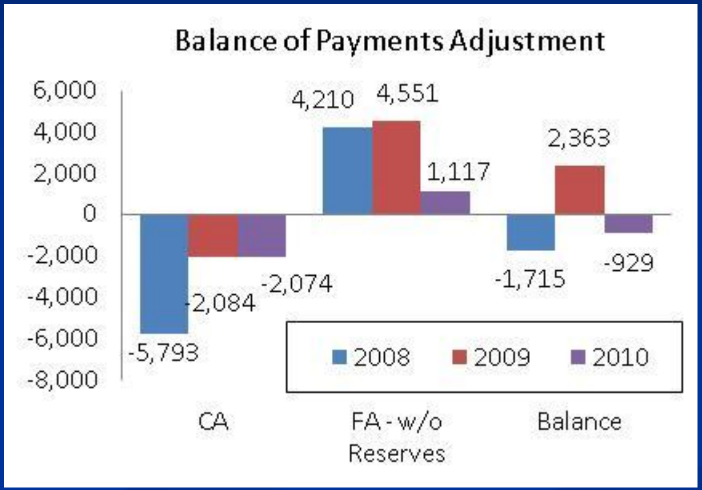
# Serbia's growth outlook positive but not impressive

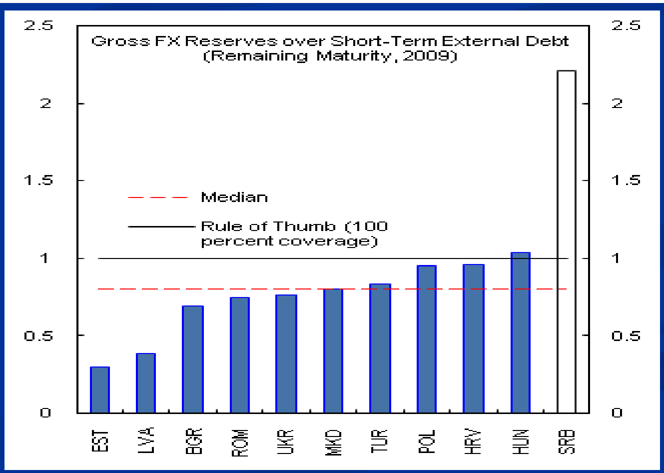



Sources: IMF *World Economic Outlook*, October 2010; and IMF staff calculations

# External imbalances have been correcting, but only partially

- Current account deficit lower but still high relative to others
- Financial account contracting not only because of Vienna Initiative relaxation
- Private capital inflows have yet to recover
- But external reserves are comfortable

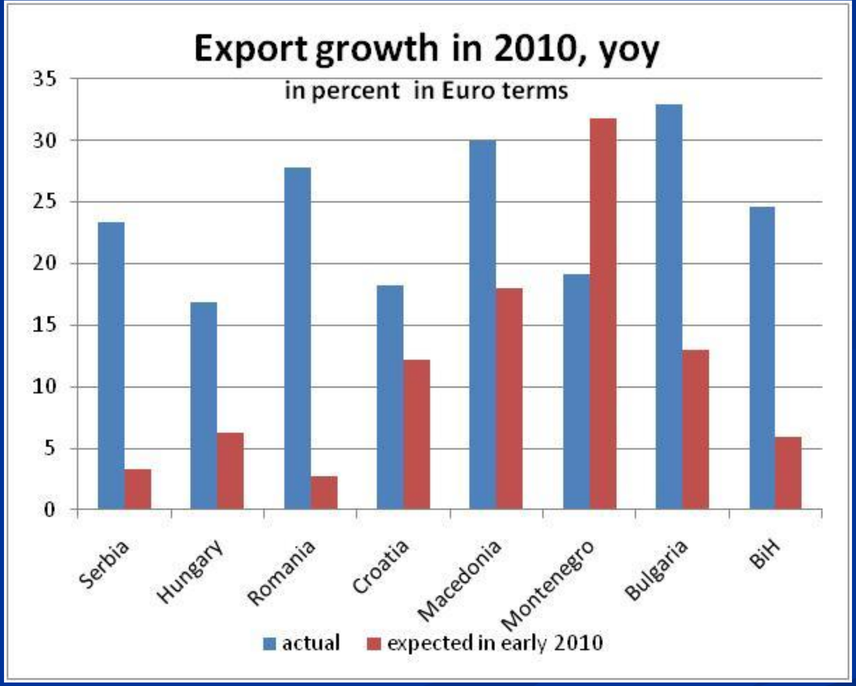



Source: NBS Statistical bulletin

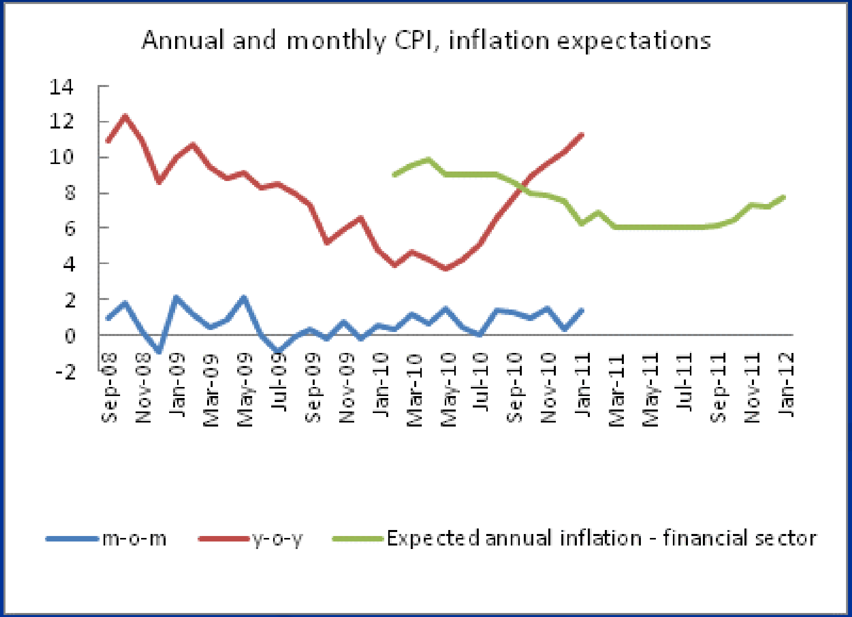
# Serbia's export response

- Serbia's exports looked good in 2010
- But regional peers also performed well
- The effect of past depreciation still may play a role
- But export response muted by structural bottlenecks…



# Inflation has resurfaced as the main policy challenge

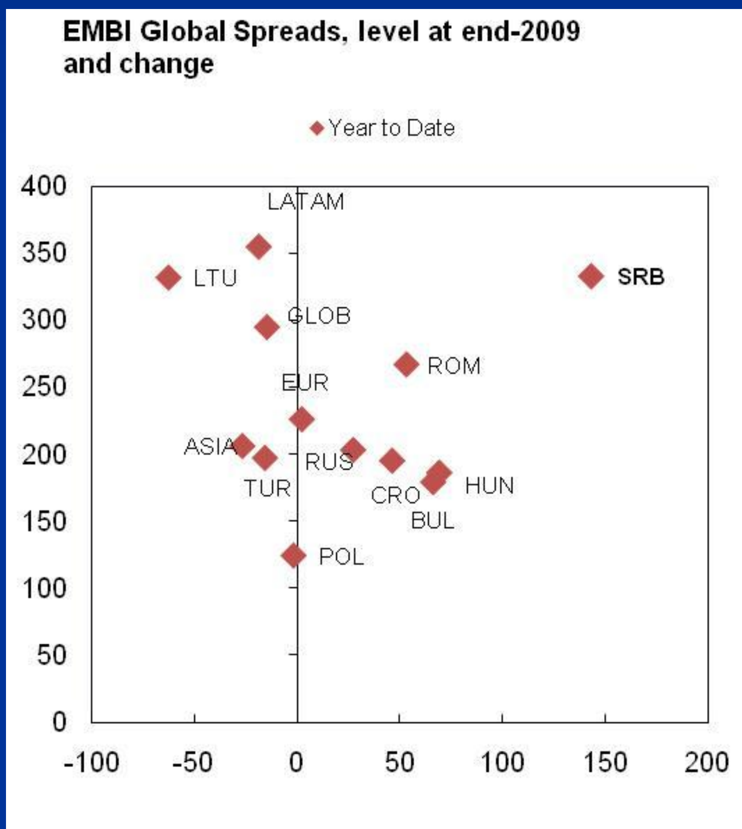
- Food price shock has been the main surprise, but this is regional
- Lagged exchange rate pass-through contributed, <u>but is now reversing</u>
- We expect inflation to return to the NBS targeted range in late 2011
- Regulated prices present a risk, due to loss-making public enterprises



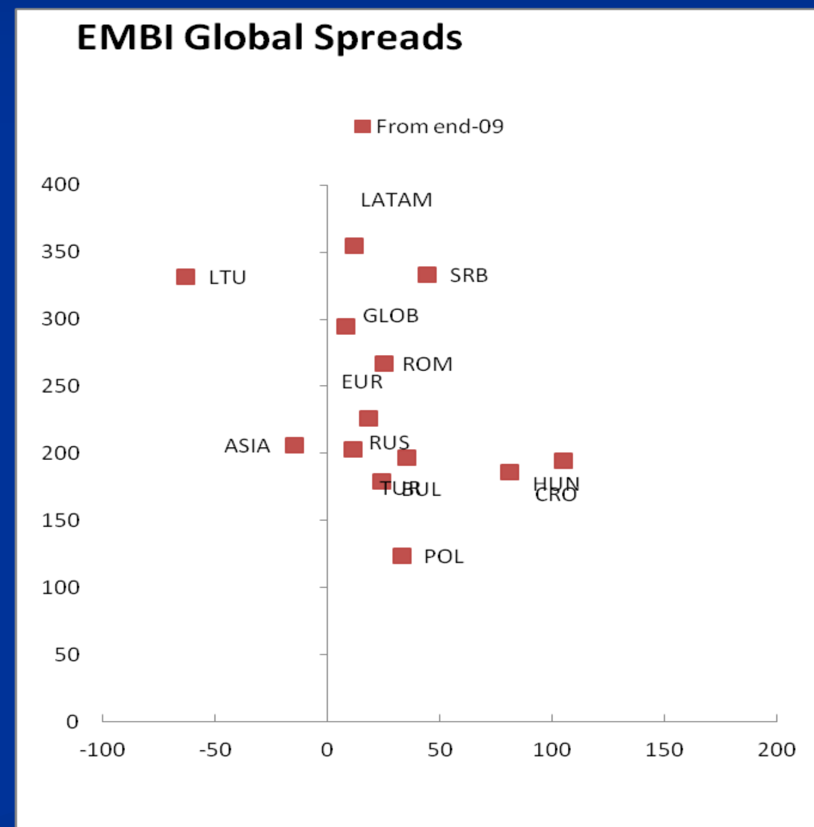

**Structural reforms fixing food markets, agriculture supply, and public enterprises are an important complement to monetary policy in controlling inflation: NBS tightening appropriate for inflation, but will weigh on growth and may attract speculative capital flows….**

# Serbia's sovereign spreads are improving: financial markets (including FX) giving a vote of confidence…

## As of October 2010

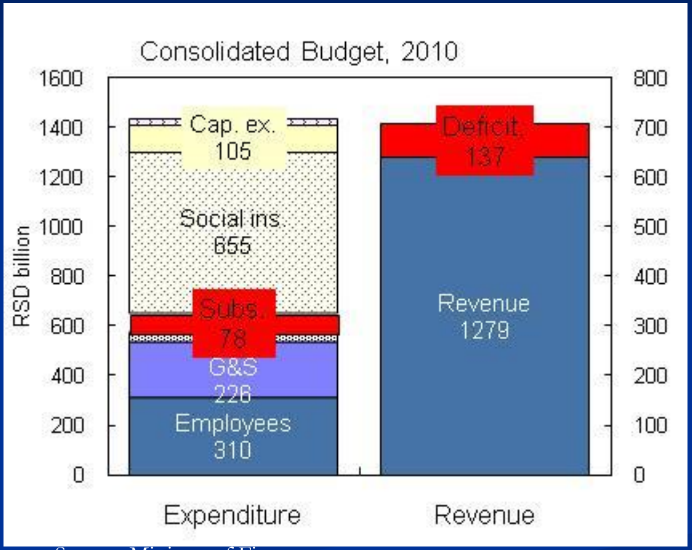



## As of February 2011

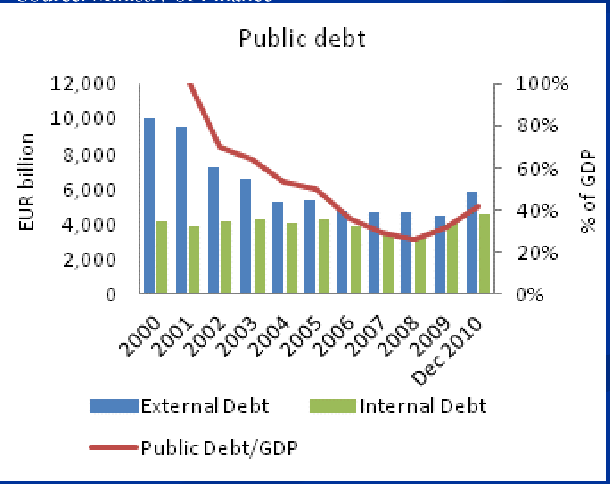


# Fiscal Policy: A Mixed Record

- **Achievements (mainly short-term)**
  - 2009-11 deficits of around 4% of GDP were neither too high, nor too tight;
  - Wage/pensions freezes of 2009-10 adhered to; social spending protected;
  - Fiscal rules in place, target 1% MT deficit;
- **Lack of progress (mainly structural, medium-term):**
  - Underlying spending reforms slow (pensions, health, education, civil service)
  - No medium-term budget focus: hence poor quality of spending (chart)
- **Risks**
  - Public debt is not high, but rising with further risks (restitution)
  - Public enterprises weigh on the budget
  - Will fiscal rules work?



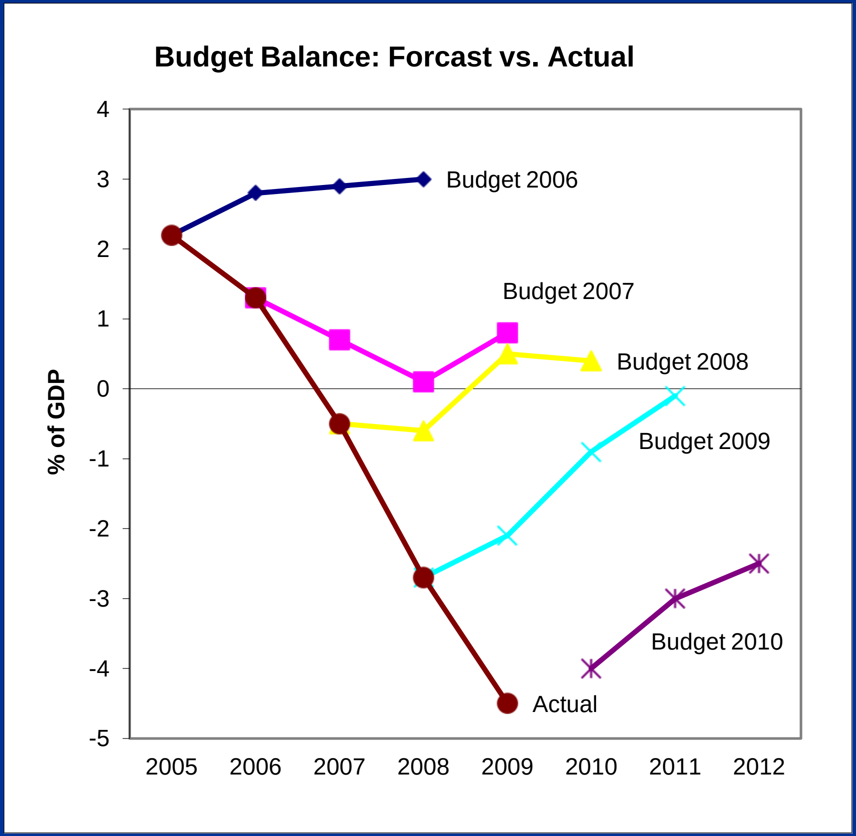

Source: Ministry of Finance



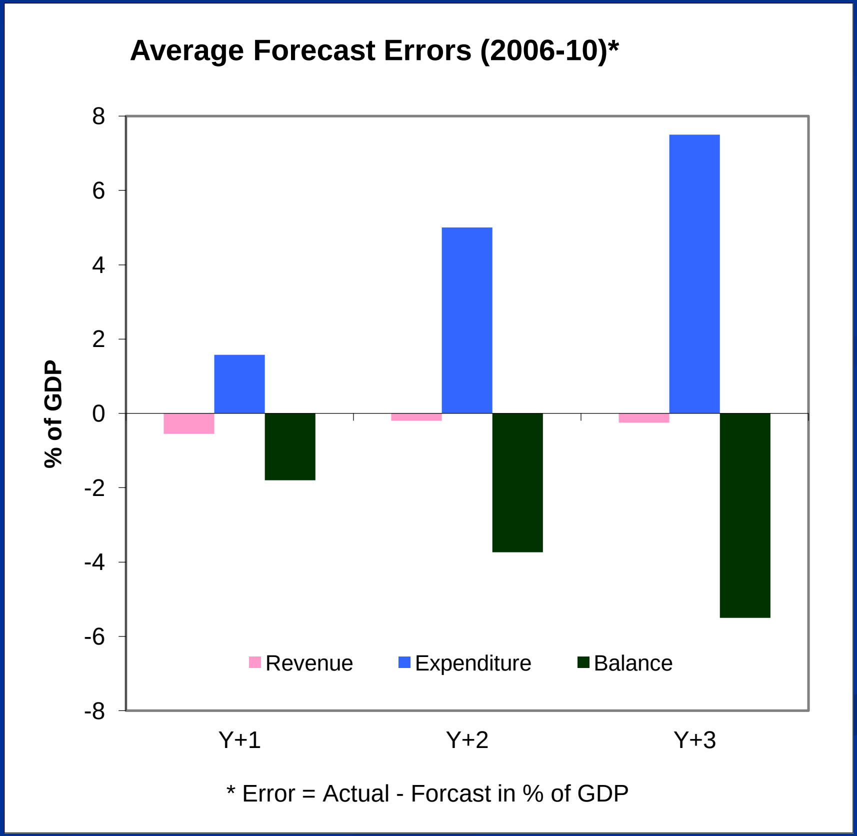

Source: Ministry of Finance

# Poor medium-term expenditure planning figures to be the main risk for the fiscal rules…

Serbia tends to overestimate the medium-term budget balance.….




due largely to the underestimation of future expenditures…




Key specific emerging risk: raising public wages/pensions

# Unfinished agenda: toward a new growth model

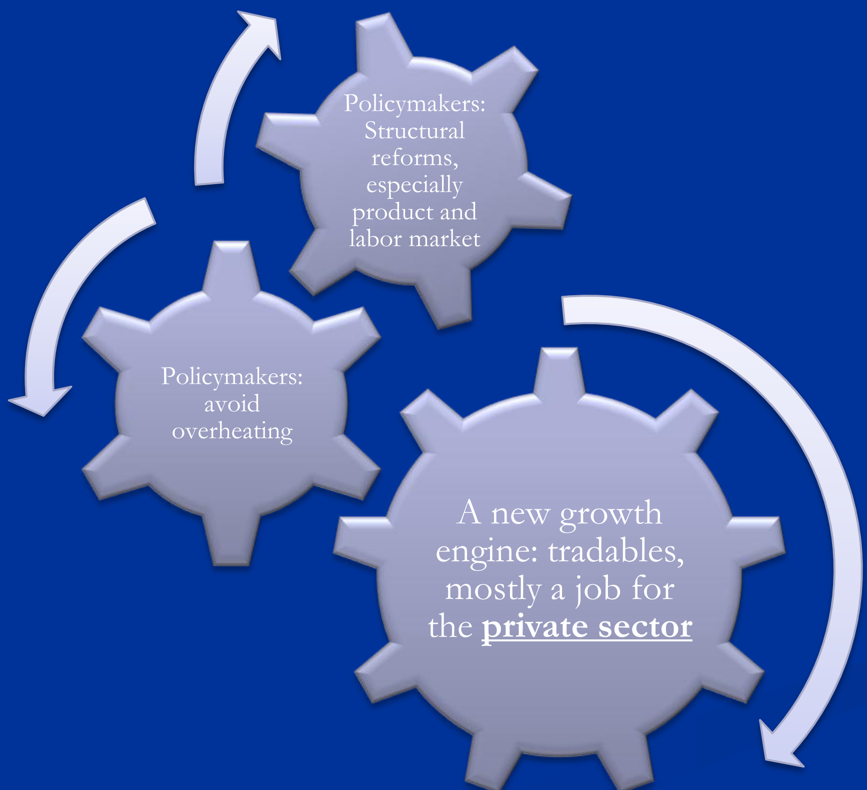


**<u>What to do?</u> – move to higher quality, export-led growth, be among reform leaders, do not wait for 2015 or 2020….**

- Direction is well-known – (i) fiscal rebalancing toward investment and (ii) liberalization of product and labor markets; but the specifics are up to each country.
- Greece was forced by the crisis, examples of Germany or Spain anticipating the crisis… **Better to anticipate crises…**
- The transition to export-led growth is proving painful, **but this is not a good reason to stop in mid-stream! Significant and sustained additional increases in public wages and pensions will be a step toward an old growth model!**
- Faster structural reforms could have alleviated lessened the pressure on FX depreciation

# New growth drivers needed ➡ export sector: how?

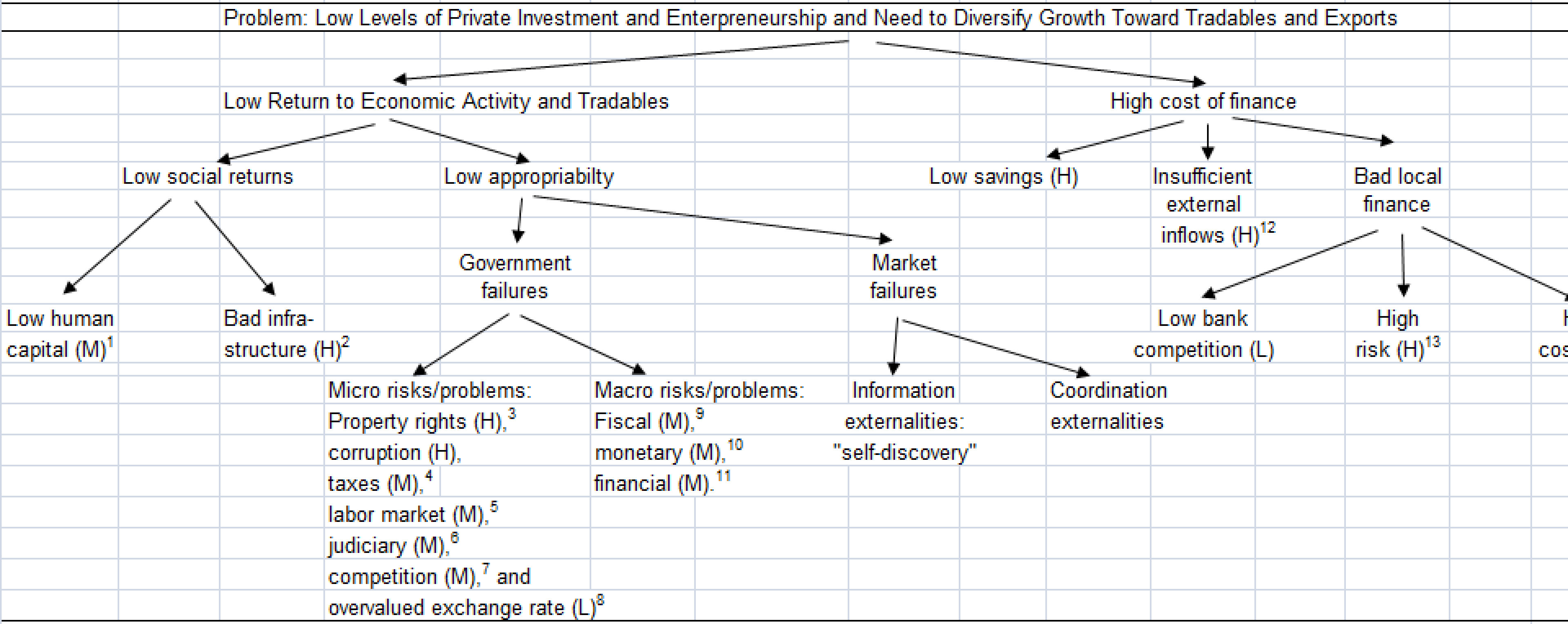
**Public policy: avoid boom-bust! Lower the risk premium and cost of capital…**




**Private sector developoment is key. ..**

- Private sector drive and innovaiton is key to productivity/competitiveness
- Most tradables sectors (agriculture, manufacturing, most tradable services) are proven to be best privately managed.
- Private sector share is positively correlated with both exports and savings in transition economies!

Serbia: A Growth Diagnostic Decision Tree




[1] Serbia has improved the university education system, although schools at lower levels are unable to provide students with the needed practical knowledge.

[2] Monopoly in the energy market and low energy prices have deterred private investment in the sector, leading to unreliable electicity supply. Public investment in Serb also relatively low relative to regional peers, constrained by high current spending, particularly on transfers and subsidies.

[3] Legal framework amended in 2009 to facilitate transfer of land ownership, but implementation is lagging. Issuance of construction permits remains cumbersome.

[4] While various new fees have been introduced and old ones increased, the tax rates are among the lowest in the region, except for social security contributions.

[5] Severance payments are relatively high for older workers.

[6] Recent reforms of the judicial system have aimed at EU standards, but insufficient number of judges makes courts slow and inefficient.

[7] New Competition Law (2009) is in line with EU standards, but implementation has so far been inconsistent, and there is a need to increase transparency and legal ce

[8] The exchange rate was overvalued before the 2008 crisis, but not any longer.

[9] While fiscal deficit is currently relatively high, public debt is relatively low and on favorable terms. In addition, the authorities have committed to reduce fiscal deficit to about 1 percent of GDP over the medium term, but this will require politically difficult structural fiscal reforms (particularly in pensions, health, and education).

[10] Inflation has increased in recent months above 10 percent, reflecting mainly food price shock but also exchange rate pass-through. Pressures in the FX market also The NBS response to inflation and exchange rate developments has been appropriate, and inflation is expected to fall within the NBS tolerance band around end-201

[11] NPLs have increased sharply since the crisis, but banks are well provisioned to withstand even a protracted corporate restructuring process.

[12] Inflows (including FDI) have fallen sharply since the crisis, following excessive bank-intermediated capital inflows previously.

[13] Level of euroization is very high, and exchange rate depreciation since the crisis has been among the highest in the region.

[14] Banks' costs are very high, given high level of NPLs, high reserve requirements, and one of the highest sovereign risk premia in the region.

# The problem of unemployment: both labor and product market regulation

**Why it is high?**

- Delayed transition
- Poor-quality prior growth
- Poor investment climate
- Labor market rigidities
- Higher reservation wages (remittances, public sector)
- Non-payments
- Skill mismatches

**What policymakers can do?**

- Improve investment climate
- Generate growth in tradables
- Good public investment
- Relax labor market rigidities (for example, severance benefits for the old!)
- Improve payments
- Active labor market policies
- Educational reforms

**Private sector job creation is key – (public sector is overstaffed); it's about growth now..**

# Changing the mindset toward private-sector growth

| **Actions by the government** | → | **Benefits for Serbia** |
| --- | --- | --- |
| De-politicize key economic policy dimensions: | → | Places focus on economic efficiency |
| - **Public enterprises** | | - Productivity dividends |
| - Infrastructure priorities | | - Supply-side response |
| - Subsidies | | - Focus on "win-win" measures |
| **ACT** quickly | → | Lowers costs of investment |
| Err on the side of permitting | → | Encourages initiative |
| Keep commitments | → | Boosts confidence |

**The government can do a lot to facilitate private sector growth, if it wants!**

# Making the private sector a responsible player

## Level the playing field – has to come from within

- Clear property rights
- Competition (markets, public procurement, etc.)
- Evenhanded regulation
- Tax policy
- Tax administration
- Transparency (audits)
- Effective courts

**Serbia needs a game-changer now to succeed in the highly competitive race for prosperity!**

# Thank you!

# Hvala!

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