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Dušan Vujović
Ministry of Finance
Government of the Republic of Serbia
FEFA Faculty
Belgrade

SERBIA BEYOND FISCAL CONSOLIDATION: A QUEST FOR DYNAMIC, SUSTAINABLE, INCLUSIVE GROWTH*

Srbija posle fiskalne konsolidacije - u potrazi za dinamičnim, održivim, inkluzivnim rastom

Abstract

The fifth fiscal consolidation in Serbia was based on a comprehensive, multi-year program built on broad-based expenditure cuts, better revenue performance, and related structural reforms and pro-growth policies. The program exceeded all planned fiscal results (both nominal and structural) and had a beneficial impact on economic growth. To sustain macro-fiscal results and prepare the basis for dynamic, sustainable and inclusive long run growth, pending institutional and structural reforms must be completed, supplemented by a set of carefully designed and well implemented pro-development and pro-growth policies. In addition, improved competitiveness, enhanced capabilities and stronger connectedness are needed to respond to challenges of new technologies and changing global patterns.

Keywords: *Fiscal consolidation, fiscal deficit, public debt, institutional reforms, structural reforms, sustainable growth, inclusive growth*

Sažetak

Peti program fiskalne konsolidacije u Srbiji zasniva se na sveobuhvatnom programu smanjenja rashoda, povećanju budžetskih prihoda i povezanim strukturnim reformama i politikama koje podržavaju ekonomski rast. Program je premašio sve planirane fiskalne rezultate (kako nominalne tako i strukturne) i, pored toga, ostvario pozitivno dejstvo na ekonomski rast. Da bi se održali postignuti makro-fiskalni reyultati i pripremila osnova za dinamičan, održiv, inkluzivan dugoročni rast, moraju se kompletirati važne institucionalne i strukturne reforme, praćene skupom pažljivo pripremljenih i dobro sprovedenih politika koje podržavaju rast i razvoj. Pored toga, neophodno je unapredjivati konkurentnost, produbljivati znanje i sposobnosti, i jačati povezanost da bi se uspešno odgovorilo na izazove koje nameću nova tehnologija i promenjeni globalni tokovi.

Key words: *Fiskalna konsolidacija, fiskalni deficit, javni dug, institutcionalne reforme, strukturne reforme, održivi rast, inkluzivni rast*

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Introduction

After more than three years of successful fiscal consolidation Serbia has restored macroeconomic stability and is now safely out of dire straits experienced in the aftermath of the global financial crisis. Fiscal balance has improved from a 6.6 percent deficit in 2014 to a 1.2 percent surplus at the end of 2017. GDP went through a turning point in the third quarter of 2014 and has retained a positive trend expected to level off at 3.5 percent growth this year and around 4 percent thereafter. Debt to GDP has declined by 10 percentage points and is likely to come down to 60 percent by the end of 2018. Current account balance declined from double digits to around 4 percent of GDP and is fully covered by FDI inflows. Unemployment is down by more than 10 percentage points. Inflation is very low at around 2 percent and very stable. And so is the exchange rate. Credit rating has been upgraded and the interest rate spreads have improved by more than 500 basis points significantly lowering the cost of both public sector debt and private borrowing.

In short, Serbia has successfully completed a 3-year fiscal consolidation program supported by the IMF and is now ready to address the new challenges of completing structural reforms, reaching investment grade in international financial markets, and embarking on a faster GDP growth path that is both sustainable and inclusive. And this has to be done within the very difficult domestic political economy landscape while being extra mindful of the EU integration requirements and the ever growing complexity of downside risks from new technologies and changing globalization patterns.

Reaching and sustaining a dynamic medium-run GDP growth under those circumstances is not simple. A very recent World Bank study on The Future of Manufacturing-Led Development [12] identifies inevitable changes in the traditional manufacturing-led development strategy in the presence of new technologies brought by the fourth industrial revolution.

This change will bring significant costs of adjustment as well as present open and hidden opportunities. The net impact will depend on how we respond. How we enable firms to adapt and continue to add value and create jobs in the new and evolving global environment. How we educate and train future generations to perform to their potential in both domestic and international arena. How we identify new policy priorities and adjust development strategies to account for changing technology and globalization patterns.

"As heightened global competition raises the bar for what it takes to succeed in export-led manufacturing, the feasibility agenda is at the heart of expanding the set of available opportunities." [12] The study further postulated that this feasibility agenda can best be achieved through increased competitiveness, enhanced capabilities, and better connectedness.

Increased *Competitiveness* is needed to shift the burden from workers (low wages) to quality business environment in securing productivity (low unit labor costs).

Enhanced *Capabilities* are indispensable for individuals and firms to adopt and use new technologies in a continuously growing regulatory and policy complexity.

Better *Connectedness* indicates that both shifts in the trade agenda and growing synergies across sectors will be necessary to achieve and sustain success in manufacturing.

Following this introduction, the paper is organized as follows. Section 2 explains the role of fiscal consolidation in establishing an indispensable stable basis for dynamic sustainable long run growth and provides a short account of previous four attempts at achieving it in Yugoslavia, Serbia and Montenegro, and Serbia. Section 3 reviews the results of the latest 2015-2017 fiscal consolidation program, while section 4 analyzes the sources of economic growth in the 2001-2017 period to draw lessons learned and sketch the space for future policy interventions with sustainable outcomes. The remaining structural reform agenda is covered in section 5. In section 6 we evaluate Serbia's readiness to reach sustainable manufacturing-led growth along the proposed "3C" dimensions, as well as apply an alternative methodology based on composite development potential index. Section 7 concludes and proposes a set policy recommendations.

Fiscal consolidation as an indispensable basis for sustainable growth

The quint-essential purpose of fiscal consolidation is three-fold: Closing internal and external gaps (twin deficits) in the short-run; securing sustainability of fiscal consolidation outcomes; and creating a basis for dynamic, sustainable growth in the medium-to-longer run. Internal gap refers to fiscal balance, monetary and overall macroeconomic stability, while external gap refers to trade and current account balance, as well as the level of external debt relative to the size of GDP. Sustainability of fiscal outcomes hinges on the completion of key institutional and structural reforms needed to resolve dysfunctional gaps related state owned and public utility companies and prevent misuse of public resources and uncontrolled leakages of constrained fiscal revenues.

Fiscal consolidation programs in the post-Tito period were always designed and launched in haste, under time pressure, and out of dire necessity. The triggers usually included need to stop growing and unsustainable twin deficits, looming debt crisis or even sovereign default. The results of past fiscal consolidation programs were partial, limited to measurable (often superficial) improvements in select macroeconomic indicators (less overall macroeconomic performance, and unsustainable in the absence of the necessary institutional and structural reforms. Ipso facto, these programs fell critically short of securing the necessary (and sufficient) conditions for creating a basis for launching dynamic, sustainable, and inclusive economic growth in the medium-to-longer run, completion of the endless transition process and reaching a long awaited entry into the club of developed countries.

A long sequence of utterly wrong economic policy choices and public investment decisions from the „rich classical socialist repertoire of the self-managed kind“, enabled by easy external financing from IFI's, commercial banks and supplier loans, pushed Yugoslavia into a deep fiscal and debt crisis at the beginning of 1980's. A rational, justified, timely and painful response offered by the *first fiscal consolidation program* (attributed to then Prime Minister Milka Planinc) was never properly understood, nor politically and socially accepted. Less than two years after inception, soon after achieving the initial improvements in visible macroeconomic indicators, the program was abandoned with a popular bang. The front page of daily Politika happily exclaimed: "Goodbye stand-by". The sustainability of hard won short-term macroeconomic results was in jeopardy in the absence of substantive institutional and structural reforms. These reforms were flatly rejected by the collective political and state leadership of the country as they questioned the very substance of the non-market socialist economy with a human face resting on a "generalized soft-budget constraint". The wake-up call voiced by the program was put on a multi-year snooze. The drift from reality continued, floating on "ideological illusions" and "old economic misconceptions" justified by the appeal of promised future, and unreal social expectations.

The ensuing series of missed opportunities and forced policy decisions deepened the economic chaos during the rest of the 1980's until a solution was finally offered through the well-known *second program of fiscal (and the overall macroeconomic) consolidation* marked by then Prime Minister Ante Marković. It is hard to determine to what extent the ensuing chaos addressed by the program contributed to the break-up of Yugoslavia, but it appears almost certain that the war and diverging non-economic forces destroyed the rationale and effectiveness of this late program before the non-austerity (expansionary) nature of proposed macro-monetary and fiscal policies and structural reforms could be tested in reality. The impressive nominal macroeconomic results (attributable to fixed exchange rate and loose fiscal stance) coupled with a battery of laws allowing massive privatizations and marking discontinuity with self-managed enterprise and other core self-management laws, were stopped short of meaningful implementation. Politically inspired implosion of the fiscal and monetary system, and the destruction of the very substance of (federal) state in favor of forming independent national mini-states, partitioned the economic space and dis-empowered the monetary and fiscal authority.

The third program of primarily monetary stabilization, as well as fiscal consolidation, designed by Dragoslav Avramović, offered a solution for one of the highest hyperinflations in history caused by a non-existent never-declared war. Following notable initial successes stabilizing the inflation and the exchange rate, the program was gradually abandoned as it imposed "unacceptable limitations" on the conduct of (economic) policy and state strategy. The multi-year unfortunate outcome is well known. Despite the fact that many important privatizations were initiated and completed during this period, and that the vast majority of the new owners and business elite was formed during that period, it is not easy to establish a clear correlation (let alone a causal relationship) between this ownership restructuring and the introduction of much needed rational market institutions and the consistent implementation of structural reforms. Actually, much of the privatizations during that period were done in a legal and institutional vacuum. Furthermore, in parallel with privatizations in an incomplete institutional setting, we observed strong expansion of the state both in terms of ownership and its role in the economy, as well as the introduction of some failed socialist concepts successfully resisted during the decades of soft self-managed socialism.

The fourth fiscal consolidation and macroeconomic stabilization program (authored by Miroljub Labus, Mladjan Dinkić and Božidar Djelić) came into existence at the start of the millennium soon after the change of guards in late-2000 and early 2001. The objective was to offer a comprehensive reform framework to address the enormous debt overhang after a decade of economic and financial sanctions, achieve fiscal balance and monetary (and exchange rate) stability, as well as complete a huge number of pending institutional reforms and restart the engines of economic growth in an economy running at about half of its pre-war capacity. The program was successful in lowering and stabilizing the inflation, securing a stable exchange rate, restore trade, lower (or eliminate) much of tariff and non-tariff protections, continue the privatization process and kick-start the consolidation of the banking sector.

This program also managed to restart economic growth by fueling aggregate demand primarily through external sources of income and financing (public and private debt). Despite the fact that the underlying increase in nominal and real incomes received an undivided political, social and even professional (analytical) welcome, this method of initiating growth through extreme and inappropriate application of Keynesian approach produced two undesirable outcomes: it created an increase in the long term structural fiscal deficit and fueled a similar structural increase in the trade and, consequently, current account deficit. These weaknesses surfaced in full strength after foreign official grants predictably dried up around 2005-6, remittances dipped and external sources of financing became more expensive and less available after the outset of the global financial crisis in 2008. Even if these shocks had not happened, it was obvious that aggregate demand stimulus could not produce sufficient supply response in an economy badly in need of new equipment, technology, productive labor force and modern management. The increase in twin deficits and the secondary notorious impact on inflation in non-tradeable sectors, including but not limited to real estate price bubble, further eroded real wages, increased unit labor cost harmed competitiveness of tradeable sectors. All these effects of the "easy solution" were predictable and painfully visible. But neither politicians nor polity were ready to see that. In that respect it appears that we were experiencing a déjà vue of the 1980's.

Irrespective of political and social denial, real economic developments followed a negative trend through 2011 and continued, due to inertia and adverse external shocks, until the second half of 2014. *The fifth and still current fiscal consolidation and economic reform program* (Aleksandar Vučić, Dušan Vujović) was conceptualized in the midst of this combined recession and economic crisis to stop the imminent slide to fiscal bankruptcy, as well as reopen the painful issues of completing the unfinished reform agenda (regarding both institutional and structural reforms) and creating a solid basis for dynamic, sustainable and inclusive long-run economic growth.

The results of fiscal consolidation program 2015-2017

Compared to the aforementioned previous four fiscal consolidation programs, the current, fifth program has achieved a real and huge improvement in the twin deficits (internal – fiscal and external – current account); turned around GDP growth dynamics (from stagnant and/or declining trend after the start of the global crisis, to a growing trend stabilizing at around 3.5-4 percent annual growth rate); it significantly reduced the unemployment level, increased FDI, improved the business environment and strengthened Serbia standing in international financial markets.

More precisely, after more than three years of exceptionally successful fiscal consolidation Serbia has fully restored its macroeconomic stability, ended the trade, economic and fiscal weaknesses revealed and triggered by the global financial crisis. Fiscal balance improved from a 6.6 percent of GDP deficit at the end of 2014 to a 1.2 percent of GDP surplus recorded at the end of 2017. The turning point in GDP dynamics was passed in the third quarter of 2014 when GDP declined by a 3.7 percent (annualized). Since then GDP has consistently followed an upward trend and is expected to grow 3.5 percent this year and around 4 percent in the following few years. On a related dimension, by the end of 2017 the share of debt in GDP declined by more than 10 percentage points and is expected to further fall, below the 60 percent Maastricht target. Current account deficit (also expressed as a share of GDP) has been reduced from double-digit levels (ranging between 12 and more than 20 percent) to around 4-5 percent and is fully covered by the inflow of (low-risk) FDIs. Unemployment has been reduced by more than 10 percentage points. Inflation is low (around 2%) and very stable. And so is the exchange rate. Country credit rating has been improved by all rating agencies during 2017. Financial markets offer an even more robust recognition of improved macroeconomic performance and good prospects through a record reduction in spreads by more than 550 basis points to less than 100 recently. This will further strengthen the macroeconomic fundamentals by lowering the cost of public debt and narrowing the gap between primary and total fiscal balance, and improve investment and growth prospects by providing more affordable access to (domestic and international) financing for the private sector.

In more detail, fiscal performance substantially exceeded the original and the revised deficit targets set in the IMF supported three-year precautionary program. Nominal and structural improvements in fiscal deficit (presented in Table 1) indicate that the targeted overall improvements have already been achieved during the first two years of the program, and far exceeded by the end of the program.

The mix of actual adjustments on the revenue and expenditure side has also changed during the implementation. The original plan to place the brunt of adjustment burden

Table 1: Serbia – improvement in fiscal deficit explained, in % of GDP

	2015	2016	2017	Total
TOTAL ADJUSTMENT IN THE FISCAL BALANCE	**2.9**	**2.4**	**2.8**	**8.1**
Of which: permanent structural fiscal balance change	2.6	1.8	2.4	6.8
Total adjustment on the revenue side	**1.9**	**3.7**	**3.3**	**8.9**
Of which: permanent structural revenue changes	1.0	2.5	2.8	6.3
Revenue changes with one-off effects including:	0.9	1.2	0.5	2.6
Extra dividends and profits of public companies	0.8	0.3	0.3	1.4
*Increases in other non-tax revenues**)*	0.1	0.9	0.2	1.2
Total adjustment on the expenditure side*)**	**1.0**	**-1.3**	**-0.5**	**-0.8**
Of which: permanent structural expenditure changes	1.6	-0.7	-0.4	0.5
Pension reductions	0.6	0.0	0.0	0.6
Public sector wages reductions	1.0	0.0	-0.1	0.9
Other expenditures w permanent effect on fiscal balance****)	0.1	-0.7	-0.3	-0.9
Of which:				
Interest payments	-0.4	0.0	0.2	-0.2
*Subsidies*****)*	0.4	0.0	0.0	0.4
Capital expenditures	-0.4	-0.6	0.1	-0.9
Increase in expenditures	0.0	-0.7	-0.4	-1.1
Assumed debts******)	-0.1	0.7	0.0	0.6

*) In 2016 includes 0.4% CIT, 0.7% VAT, 0.5% contributions, 0.2% excise taxes and 0.2% Telecom dividends.
**) Includes 0.3% effect of the change in methodology.
***) Positive number indicates reduction in expenditures i.e. positive fiscal impact.
****) Includes 0.3% goods and services, 0.1% social transfers, and 0.3% other expenditures.
*****) Includes reductions/changes in all subsidies
******) Includes assumption of public company debts, recapitalization of banks and insurance companies, military pensions, ad ag-subsidies.
Source: Ministry of Finance and own/staff calculations.

on expenditures (as suggested by theory [1], [2], [3], [6]) was fully observed only in the first year of the program: Out of 2.6 percent structural deficit improvement in the first year 1.6 percent (or more than 3/5) was achieved on the expenditure side and one percent on the revenue side. In the subsequent two years the situation has changed. Due to allowed increases in pensions and public sector wages, the contribution of expenditure adjustment became negative (-0.7 percent of GDP in 2016 and -0.4 percent of GDP in 2017). Permanent revenue adjustment (2.5 and 2.8 percent of GDP in 2016 and 2017 respectively) was sufficient to sustain the continued progress towards the overall structural improvement of 6.8 percent of GDP over three years of the program.

In short, large nominal fiscal consolidation over three years (8.1 percent of GDP) included an impressive 92% share of structural fiscal deficit adjustment (6.8 percent of GDP). This adjustment was owed mainly to permanent improvements on the revenue side (92 percent) and only marginally to expenditure cuts. After the first program year, the contribution of expenditure cuts (focused initially mainly on pensions and public sector wages) became negative which reduced their contribution over three years to only 0.5 percent of GDP. Despite good overall result, we should be keenly aware of the inherent pressures to increase pensions, public sector wages, and other costs of delivering public services relative to available GDP envelope.

Those risks notwithstanding, lesser emphasis on expenditure-cuts also helped ameliorate the risks of a potential recessionary impact [5], [6], clearly one of the major concerns of governments embarking on this type fiscal a consolidation programs, especially when implemented in the presence of global recessionary pressures [10], external shocks [7] and multiple constraints to growth [11] all relevant for Serbia. The prevailing perception was that fragile growth could not withstand an additional shock from fiscal consolidation [8], [9].

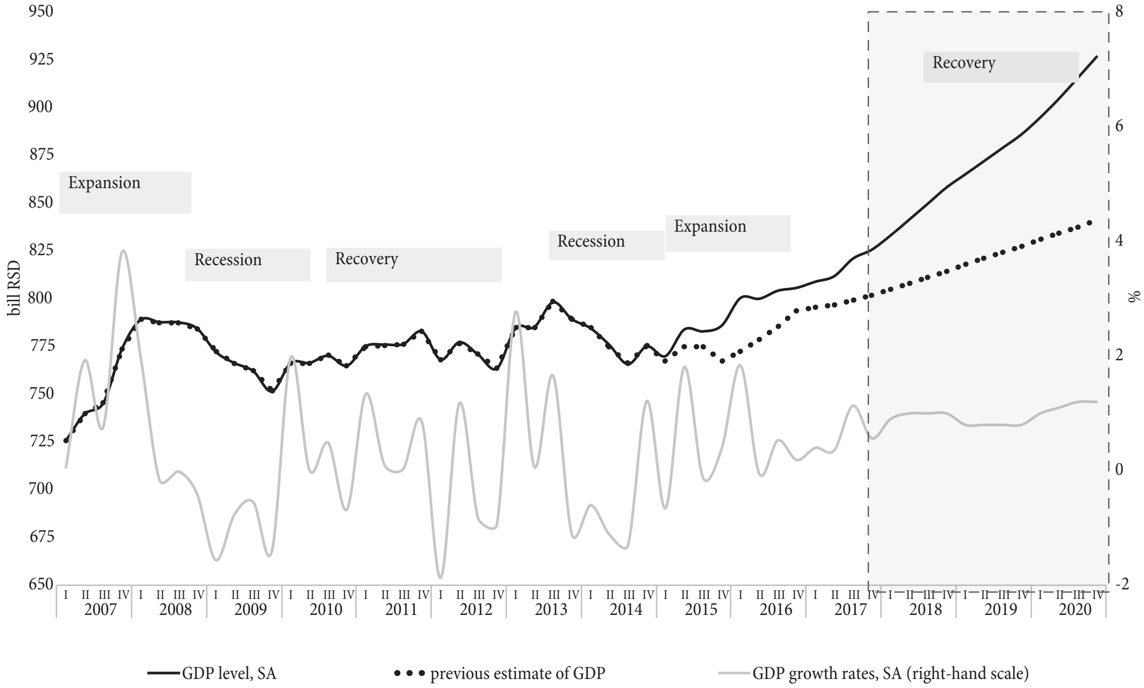
Another concern regarding growth impact of a possible fiscal consolidation program came from the fact that brief economic expansion in 2013 was to a large extent attributed to the introduction of new FIAT car production and exports. Although car production and exports continued, additional effects on economic growth were negligible and recessionary pressures resumed in the first quarter of 2014. The next downward push came from the negative impact of May 2014 floods creating another dip in GDP growth. It clearly demonstrated how fragile the un-restructured economy was and, actually, reversed the sentiments in favor of tough reforms that would ultimately create a more robust economy. It became apparent that the call for fiscal consolidation and economic reforms was not just an electoral pitch for more votes, but a sign of ownership and clear commitment to follow a difficult path out of decades-long economic decay [4].

As indicated in Figure 1, the turning point in GDP dynamics occurred after the third quarter and the economy started recovering in late 2014-early 2015. Despite conservative projections from the IMF and other IFIs that growth will remain negative throughout 2015 (between -0.5 and -1.0 percent), the economy dipped out of recession and reached a positive 0.8 percent growth for the entire year. The path to strong growth recovery established in 2016 with 2.8 percent GDP growth is expected to continue throughout the 2018-2020 period covered by the latest Fiscal Strategy despite the lower than projected result in 2017 caused by the supply side factors. The difference between originally projected and actual quarterly GDP numbers from the start of the reform program is depicted by the area between the GDP levels predicted without the reform (dotted line) and with the reform (full line).

The program was equally successful in stopping the buildup of public debt, one of the primary reasons for embarking on a fiscal consolidation program. As can be seen in Figure 2, an expansionary trend of fiscal deficit observed after 2008 was reversed after the introduction of the fiscal consolidation program. The reduction in fiscal deficits from 6.6 percent in 2014 was continued to 3.7 percent in 2015, 1.3 percent in 2016 and a 1.2 percent surplus at the end of 2017. Conservatively planned small 0.7 percent deficit for 2018 is likely to be sustained in the medium run (2019-2020) and beyond. The level of public debt (expressed as debt-to-GDP ratio) peaked in 2016 and then followed a sharp downward trend.

Fiscal surpluses implied by the intersection of fitted lines in Figure 2 below do not represent projections or commitment to adhere to restrictive fiscal policies. As

Figure 1: Serbia GDP level and growth rates, quarterly data



Source: Statistical Office of Serbia, Ministry of Finance Staff Calculations.

shown in Figure 3, the prevalence of primary fiscal surpluses in 2016-2017 (1.8 and 3.9 percent of GDP respectively) is likely to be continued in the coming years as the cost of international borrowing declines in line with continuously improving credit rating. This will finally reverse the negative developments triggered by the global financial crisis resulting in a large build-up of public debt and a record expansion of primary deficit during the 2008-2012 period: Increased country risk and large borrowing needs quickly increased the cost of public debt from 0.4-0.6 percent of GDP in pre-crisis years to 1.0-3.2 percent in the subsequent period. This tendency could not be changed quickly due to built-in lags. Starting with 2016 Serbia is increasingly reaping the benefits of fiscal consolidation (and improved credit rating) through lower cost of borrowing. This has already eliminated the difference between the overall and primary fiscal balance and, together with stable GDP growth rates, will help achieve long-run debt sustainability. Equally important, this will free up additional fiscal space for well-designed and carefully selected public investment projects crowding-in private investment and preparing the country to address the challenges of long-run economic growth discussed in the final sections of the paper. Before that, we analyze the sources of economic growth in the 2001-2017 period and draw some lessons for the future.

The sources of economic growth in the 2001-2017 period

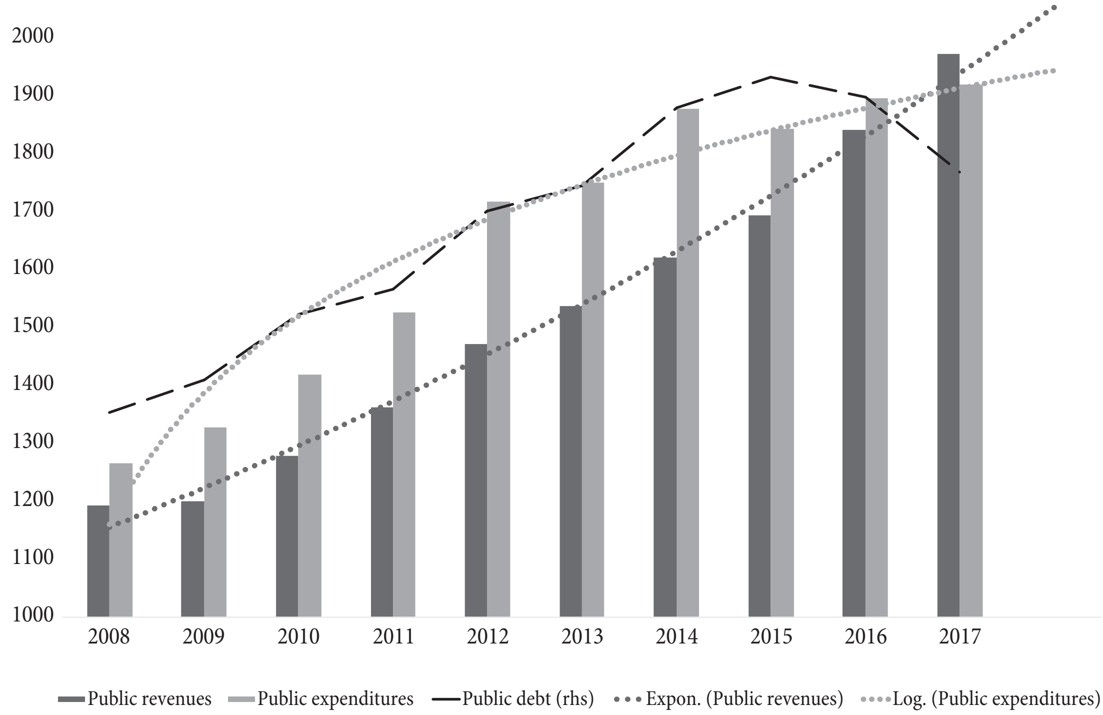
The political changes in October 2000 also marked a paradigm shift in economics. It changed the concept of public sector governance and macroeconomic management, and triggered a new wave of institutional, policy and structural reforms. We, therefore, limit our analysis of the sources of economic growth to the post-2000 period to avoid the complexities of analyzing and isolating the impact of admittedly very different underlying governance rules and institutional set-up.

The gist of our analysis can be summarized in the five figures presented below. The sources of growth on the demand side are presented in Figure 4 (by sub-period) and Figure 5 (ungrouped annual data). The sources of growth on the supply side are presented in Figure 6 (by sub-period) and Figure 7 (ungrouped annual data). Finally, Figure 8 presents the developments of the current account balance and the main sources of external financing following the same sub-period groupings.

The data clearly show that four distinct sub-periods can be identified.

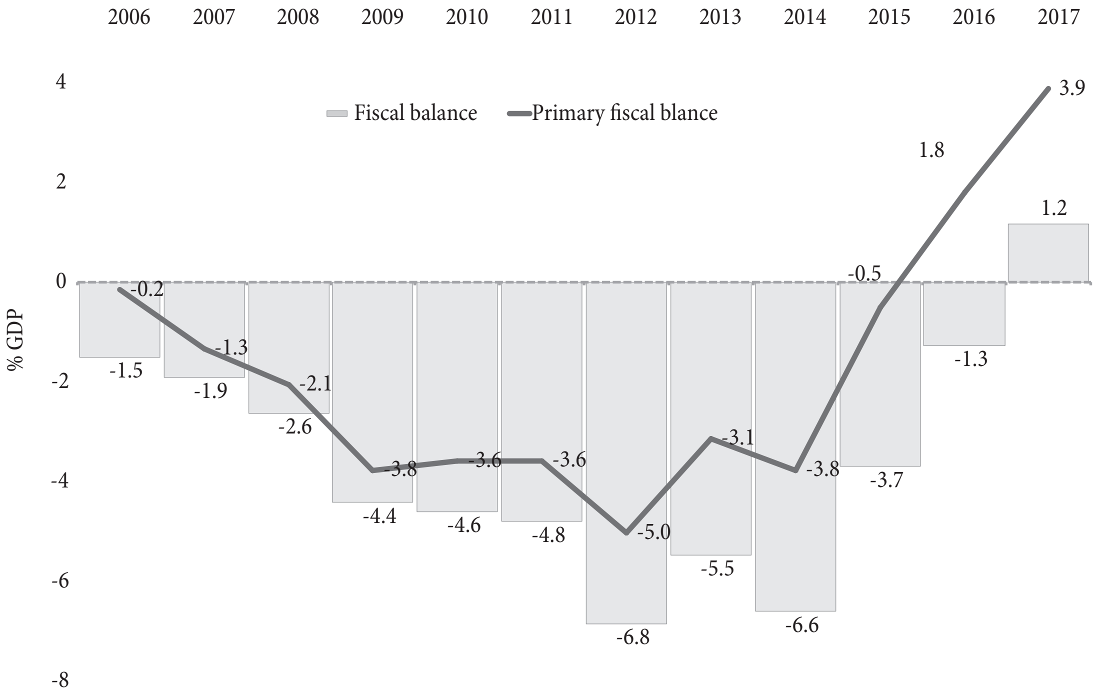
The first sub-period (2001-2008) is characterized by high average GDP growth rate of 5.9 percent annually (with annual rates ranging from 4.4 to 9.0 percent). *On the demand side*, the main positive drivers of growth were private consumption, government consumption, investment, and "the change in inventories". Net exports exerted a large negative impact on GDP growth mainly due to huge increase in imports. *On the supply side,* by far

Figure 2: Serbia - public revenues, public expenditures, and debt-to-GDP ratios



Source: Ministry of Finance, Public Debt Department.

Figure 3: Serbia - primary and overall fiscal deficit: Sustainability issues



Source: Ministry of Finance.

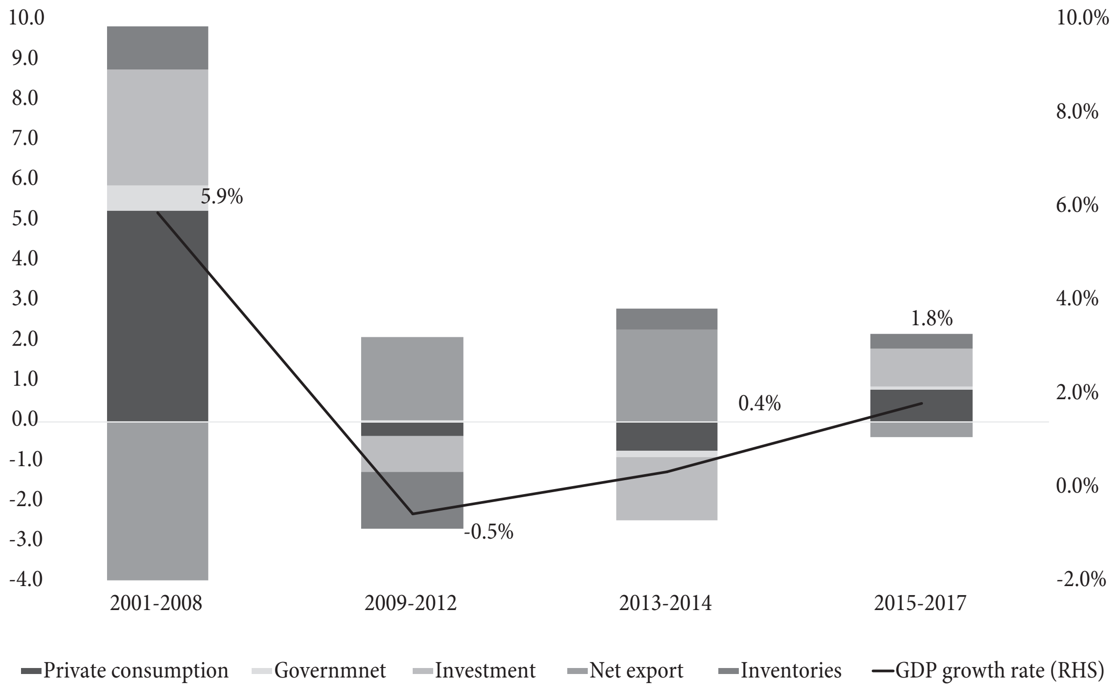
the largest contribution to GDP growth came from non-tradeable sectors (services and taxes). Supply response of agriculture and construction was very modest, and that of industry (manufacturing) was minimal. *On the external side*, average current account deficit was 10.0 percent of GDP. FDI inflows amounted to 6 percent of GDP and provided 60% of financing of the CAD.

The second sub-period (2009-2012) showed a negative average GDP growth rate of 0.5 percent annually (with annual rates ranging from -3.1 to +1.4 percent) caused by the onset of global financial crises. *On the demand side*, the main positive driver were improvements in net exports due mainly to lower imports as real incomes declined. The main negative drivers (in order of contribution) were "the change in inventories" (decline), investment, private consumption, and government consumption. *On the supply side,* all sectors went through a contraction (i.e. negative contribution to GDP growth) except industry which finally started to respond. *On the external side*, average CAD remained high at 9.0 percent of GDP. FDI inflows declined to about 5 percent of GDP and together with a large increase in portfolio investment (to almost 3 percent of GDP) continued to provide the main source financing CAD.

The main characteristic of *the third sub-period (2013-2014)* is the lack of clear economic concept. It showed a small positive average GDP growth rate of 0.4 percent annually (with annual rates ranging from -1.8 to +2.6 percent). *On the demand side*, the main positive drivers were again improvements in net exports due both to lower imports and higher exports, and "the change in inventories" (increase). The main negative drivers (in order of contribution) were investment, private consumption, and government consumption. *On the supply side,* all sectors again went through a contraction (i.e. negative contribution to GDP growth) including industry. The only exception was agriculture which had a bumper crop in 2013 plus a cyclical recovery from poor 2012 result. *On the external side*, average CAD declined to 6.0 percent of GDP. FDI inflows declined further to less than 4 percent of GDP, portfolio investment continued to increase, while other investment substantially declined.

The fourth sub-period (2015-17) focuses on the actual results of the reform program in 2015-2017. As an indication it adds forecasted 2018 values in graphs with ungrouped annual data. The average annual GDP growth rate increases to 1.8 percent (with annual rates ranging from 0.8 to 3.5 percent). *On the demand side*, the main

Figure 4: Serbia – Sources of GDP growth (the demand side by sub-period), 2001-2017

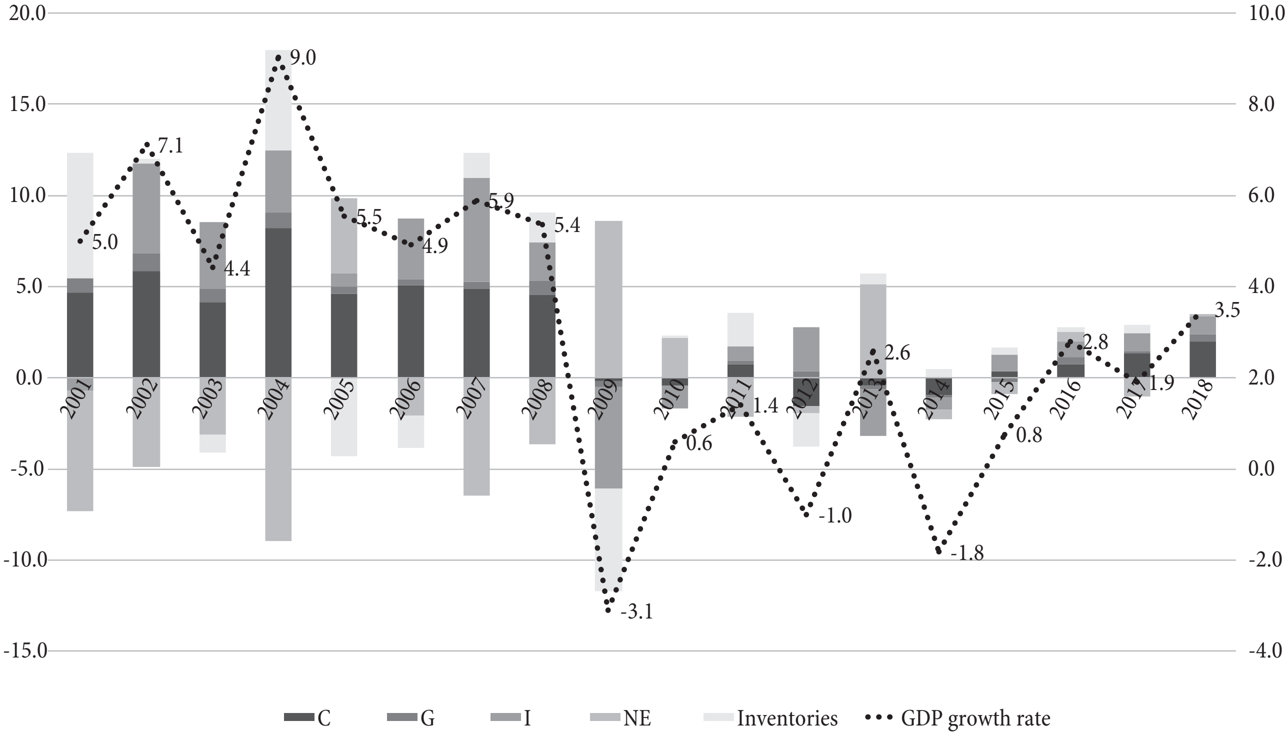


Source: Statistical Office of Serbia, and Ministry of Finance.

feature is that all components of aggregate demand are positive drivers of GDP growth (except small negative contribution of net exports). *On the supply side,* all sectors show positive contributions to GDP growth except agriculture with a small net drag on GDP growth resulting from continued cyclical dynamics (quite visible in Figure 6). *On the external side*, average CAD was reduced to 4.5 percent of GDP. FDI inflows recovered to above 5 percent of GDP on average. Moderate cyclical capital outflow moved to portfolio investment allowing ample CAD financing.

Based on empirical evidence presented in Figures 4-8 we can reconstruct a plausible explanation of the

Figure 5: Serbia – Sources of GDP growth (the demand side annual data), 2001-2017



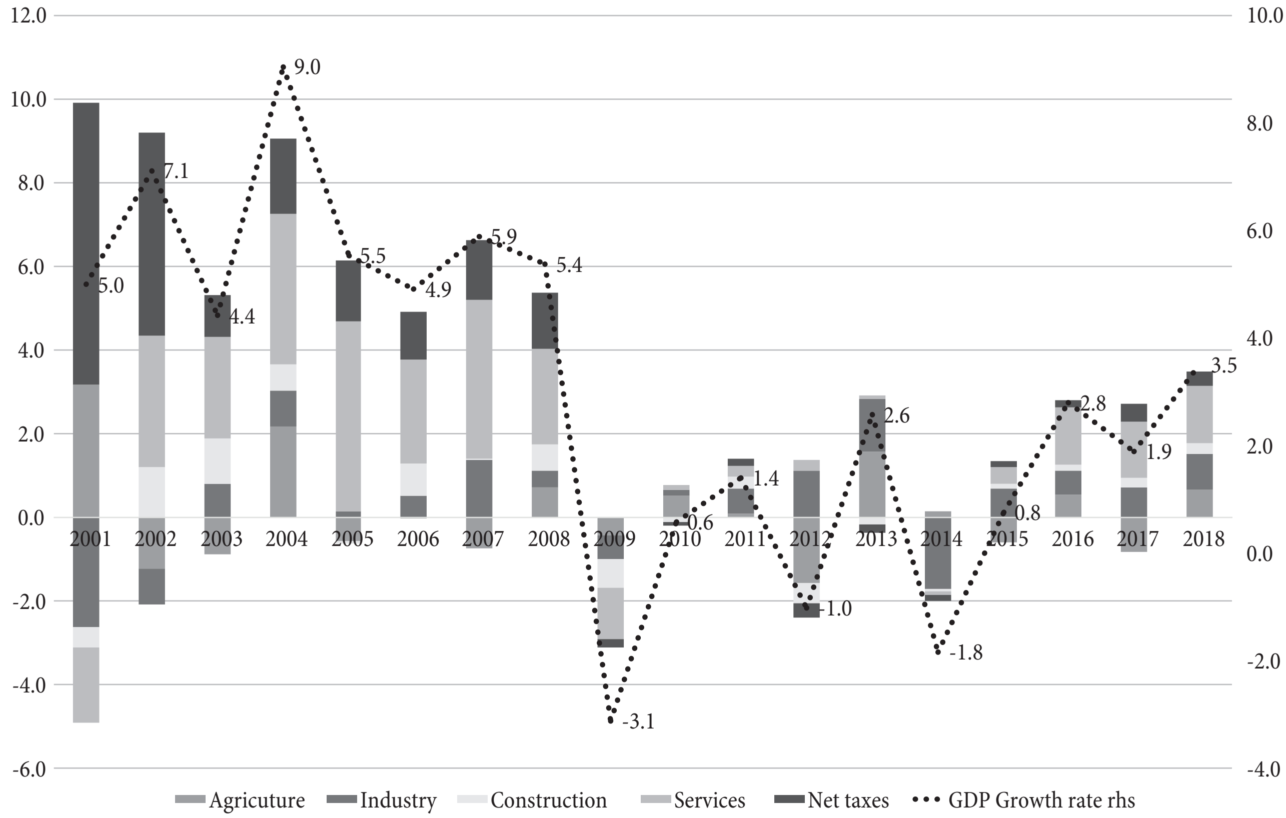
Source: Statistical Office of Serbia, and Ministry of Finance.

Figure 6: Serbia – Sources of GDP growth (the supply side by sub-periods), 2001-2017

Source: Statistical Office of Serbia, and Ministry of Finance.

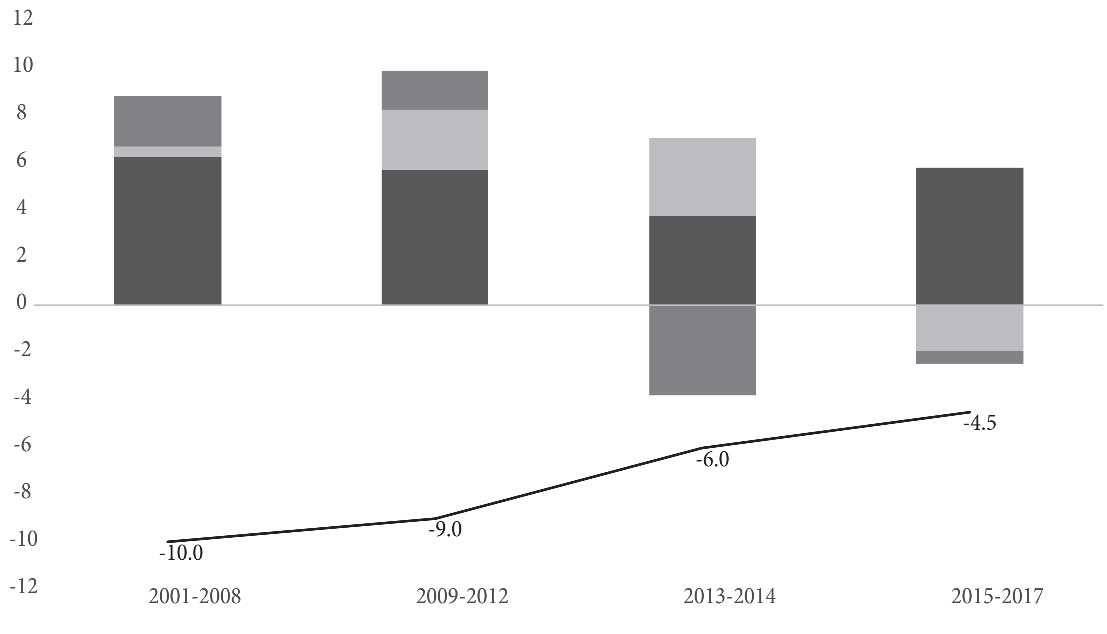
sources of GDP growth (5.9 annually) in the 2001-2017 period. The initial impetus for growth came from a large and sustained increase in private consumption, investment and government consumption. Given the sluggish performance on the supply side, it is clear that the source of increased incomes and consumer demand was not domestic employment. Rather, the impetus came from an abundant inflow of external sources of financing

Figure 7: Serbia – Sources of GDP growth (the supply side annual data), 2001-2017



Source: Statistical Office of Serbia, and Ministry of Finance.

Figure 8: Serbia – Balance of Payments, 2001-2017



Source: NBS, Statistical Office of Serbia, and Ministry of Finance.

dominated initially by grants and remittances (fueled by positive expectations triggered by the end of economic sanctions and good prospects for the start of reforms), as well as privatization proceeds. In the later years of this sub-period, following the resolution of old debts in the Paris and London club, new loans supplemented the external sources of financing. The hypothesis of externally fueled aggregate demand growth is corroborated by the large increase in imports leading to a growing trade deficit (i.e. negative net exports) and current account deficit, as well as by the huge increase in (non-tradeable) services and taxes assessed on imported goods. Additional confirmation is found in the appreciated real effective exchange rate and the continuous increase in real estate prices.

Unfortunately, this approach to generating a basis for long-run growth was not sustainable in the absence of hard institutional and structural reforms. Easy external financing sources and ample privatization proceeds could not possibly last long enough to generate the necessary governance improvements and deep structural reforms needed to address the legacy of the past. In reality, all these sources lasted even less. Most sources came to an end even earlier than originally promised (official grants) or could have been expected (remittances, privatization proceeds). The global financial crisis brought an abrupt stop to soft sources of financing, negatively affected remittances, and markedly raised the cost of commercial sources due to heightened risk pricing for countries like Serbia.

True, the global crisis brought some external shocks and made things worse. Without the global crisis, fiscal crisis would have been postponed by few years but not avoided in the absence of deeper institutional and structural reforms that would move the economy back on an unsustainable path. In other words, the negative effects of the second sub-period (-0.4 percent annual decline of GDP) would have been smaller without the global crisis, but a significant slowdown from the almost 6 percent annual GDP growth rate recorded in the 2001-2008 period was inevitable after the easy financing stopped and tough reforms were never implemented.

The third short sub-period (2013-2014) was singled out as it did not represent continuation of policies which defined the first sub-period and created vulnerabilities that led to the second; nor a start of the new fiscal consolidation program launched in 2015.

The fourth sub-period shows improved traction of reforms, clear export and investment orientation and more stable sources of growth on the supply side (especially industry). It is worth noting that private consumption gradually becomes an important source of growth, but this time based on domestic incomes.

Remaining challenges faced by the fiscal consolidation program

After three years of very good implementation results, often exceeding expectations, the fifth fiscal consolidation program comes to an end. At least an end of phase one. The continuation of the program in phase two will build on results achieved thus far and pursue the same long run objective of securing a basis for dynamic, sustainable and inclusive growth. Four intermediate objectives (depicted in Figure 9) are macroeconomic stability, improved investment climate, productivity growth, and efficient financial sector, mapped into three overlapping areas of multiple policy intervention and pending reforms (fiscal framework, business environment, and financial markets).

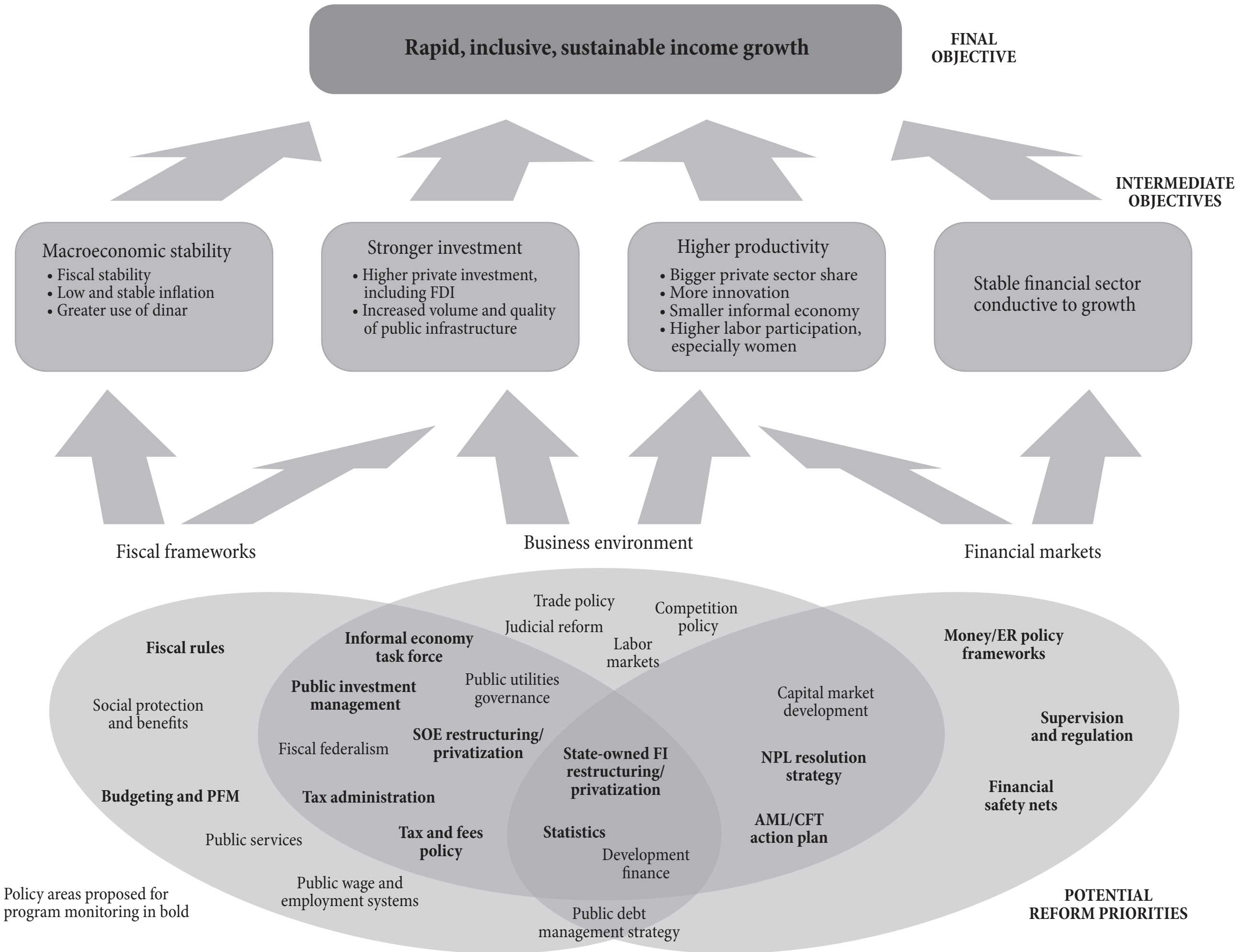
We have tentatively identified 25 policy (reform) areas that should receive adequate government attention in the medium term, out of which 14 policy areas (depicted in bold) are likely candidates for monitoring under a possible IMF supported future program based on Policy Coordination Instrument.

The proposed comprehensive size and scope of continued institutional and policy reforms is self-explanatory. The selection of priority policy and reform areas and the timing of implementation must be done in the coming months to be reflected in the next year budget and completed within the mandate of this government.

Quest for dynamic, sustainable, and inclusive GDP growth

For the first time in four decades we are in a position to discuss pending institutional and structural reforms from a strong macroeconomic and fiscal position. Without

Figure 9: Serbia – pending institutional and policy reforms for dynamic, sustainable, inclusive growth



these reforms it would be impossible to sustain present level of fiscal and monetary stability. More importantly, we have created a conducive policy space to discuss ways of extending these successes into creating a platform and an eco-system, to use the new buzzword, needed to launch a more dynamic sustainable GDP growth that would help close the income gap with Europe (income convergence) and be truly inclusive through employment and education opportunities and shared prosperity. Ultimately, the objective is to exit the transition and join the club of developed high income countries.

To make things more complicated, this demanding and complex multi-year task must be performed in the context of complicated political economy involving diverse political parties, business interests, and social aspirations. At the same time due attention must be paid to multiple legal, technical, policy and political requirements associated with the EU accession, as well as the need to embrace the new technology and adapt to fast changing global trends and patterns.

Achieving and sustaining dynamic medium-to-long run GDP growth under such circumstance is neither simple nor easy. A recent World Bank study on The Future of Manufacturing-Led Development has done a valiant effort to identify the indispensable changes in our traditional thinking about industrial-led (or better manufacturing-led) growth and development in order to be able to properly understand and include (endogenize) the true characteristics of the new technologies brought about by the fourth industrial revolution.

Although the ensuing global changes will generate large costs of adjustment, not least because of jobs that will become obsolete or lost to robots, they will also create new opportunities and reveal now hidden development opportunities. The net impact on each country could be positive or negative depending on its readiness to face the challenges ahead and the policy response to global changes. More specifically, will the enterprises be ready to adapt and continue to create new jobs and add value in the changing global and domestic markets. Will the education and training systems be able to equip the new generations with skills and attitudes needed to effectively perform under ever changing circumstances. Will we be able to adjust our development priorities and develop new strategies which would adequately take into account (internalize) the true impact of fast changes in technology, work ethics and global flows.

As the World Bank study indicates [12], our ability to face new demanding norms and performance standards will critically depend on "3Cs": improved Competitiveness, enhanced Capabilities, and better Connectedness.

Improved Competitiveness is needed to move the burden of continuously increasing productivity from individuals/employees (i.e. wages) to the quality of the business environment and corporate governance. This is the only way to ensure that low and decreasing unit labor costs are not translated on wages, and hence the wellbeing of employees and the population at large. This is one of critically important aspects of inclusiveness.

Enhanced Capabilities, expressed among other things, through greater knowledge, capacity, and ability is vital for individuals and enterprises to smoothly adopt new technologies and work processes, and effectively use them in an ever changing regulatory and policy space.

Finally, better Connectedness is essential not only to closely monitor and adapt to changes in the free movement of goods, services and factors of production, but also to reach optimal synergy between sectors at the national, regional and global level needed to attain and sustain good performance in continuously changing redefined modern industry with embedded high-value services.

To evaluate the global pro-development characteristics (i.e. potential) of individual manufacturing sectors, the World Bank study combines indicators related to export orientation (share of exports in output), productivity (value added per worker), education level and qualifications of the work force (i.e. the share of blue-collar workers as a limiting factor in achieving maximum pro-development impact), sector size (i.e. sector share in manufacturing employment), and innovation potential (i.e. expenditures on research and development).

Based on empirical results the study identifies seven groupings with distinct global pro-development characteristics (see Figure 11):

Commodity-based regional processing (with seven manufacturing subsectors such as food, wood, basic metal, fabricated metal, nonmetallic products, paper, rubber and plastics) has large share of blue-collar workers, large share of manufacturing employment, and low share of exports in total output (around 25%).

Capital-intensive regional processing (with two manufacturing subsectors: coke and petroleum products, and chemicals) has lower share of blue-collar workers, relatively small share of manufacturing employment, and a relatively large share of exports in total output (around 40%).

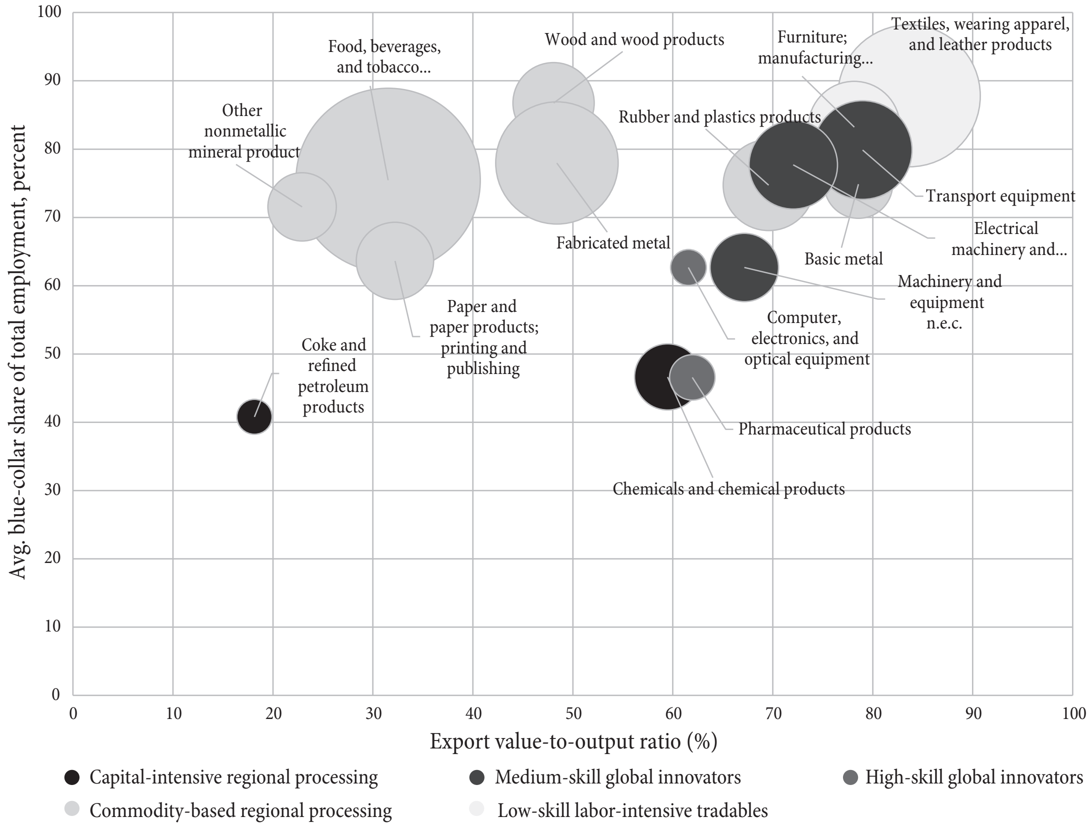
Low-skill labor-intensive tradables (with two manufacturing subsectors: textiles and apparel, and furniture) has a large share of blue-collar workers, very large share of manufacturing employment, and a large share of exports in total output (around 50%).

Medium-skill global innovators (with three manufacturing subsectors: transport equipment, electrical machinery and equipment and other machinery and equipment) has a slightly lower share of blue-collar workers, large share of manufacturing employment, and a large share of exports in total output (around 50%).

High-skill global innovators (with two manufacturing subsectors: pharmaceuticals, and computers and ICT) has the lowest share of blue-collar workers, relatively small share of manufacturing employment, and a very large share of exports in total output (over 70%).

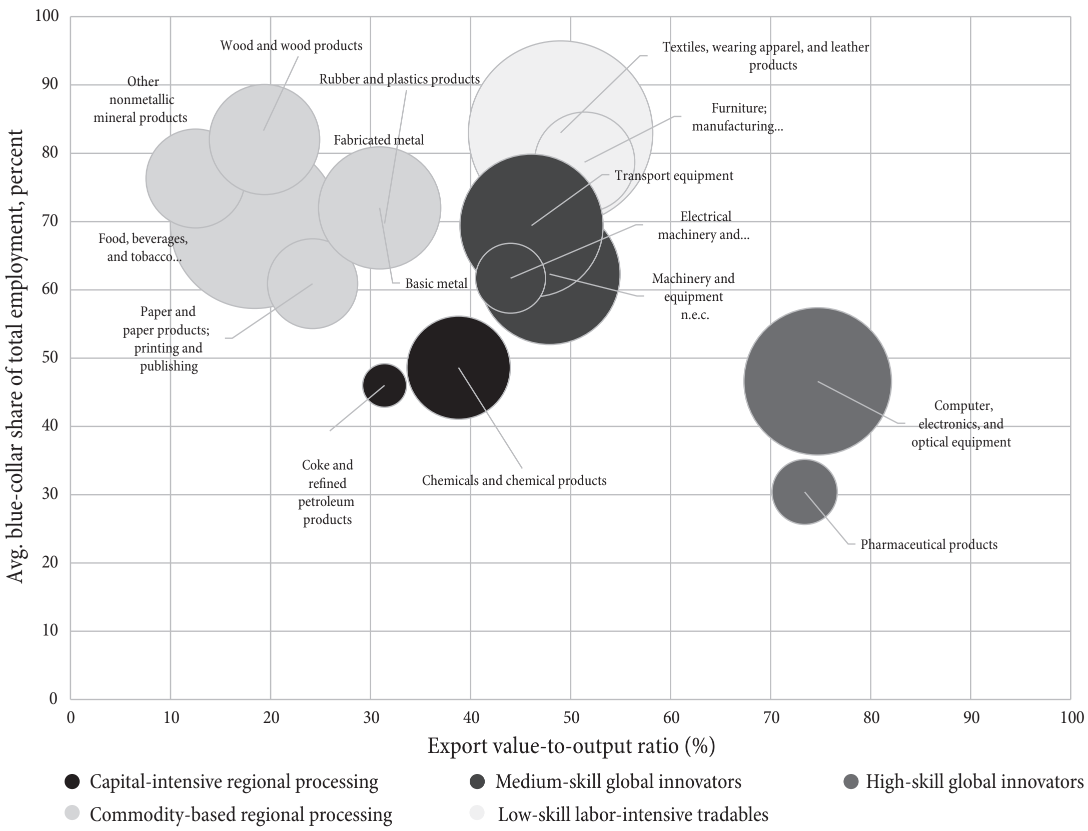
Compared to the global patterns (Figure 11), Serbia (Figure 10) has similar export shares in medium-skill innovator sectors and capital-intensive sectors (such as transport and electrical equipment). However, Serbia exhibits a much larger share of exports in sectors with large employment ad low-skilled labor force (e.g. wood and fabricated metal with 50% share of exports, and rubber, basic metals, and furniture with export shares

Figure 10: Serbia: Global Development Potential – Manufacturing subsectors



Source: Serbian Statistical Office, Ministry of Finance, own calculations.

Figure 11: World: Global Development Potential – Manufacturing subsectors



Source: World Bank study [12].

between 70 and 80%). By contrast, sectors with the best pro-development characteristics (pharmaceuticals, and computers and ICT) have lower share of exports and notably smaller size (i.e. share of manufacturing employment).

A detailed study [13] of Serbian manufacturing sectors done by the Serbian Chamber of Economy and the Center for high economic studies (CEVES) identifies competitive sectors on the basis of a composite Development Potential Index of Tradable Sectors. The index evaluates: 1. Business track record; 2. Potential for future development including the positive multiplier effects within and across sectors; and 3. Contribution to social and economic development priorities. This analysis identifies the following ten best ranked sectors on the basis on their development potential: (1) automobiles and transport equipment; (2) textiles (socks); (3) electrical and electronic equipment for cars; (4) military industry; (5) household appliances; (6) automobile tires; (7) electricity; (8) plastic parts; (9) special equipment; and (10) general equipment.

Based on the key parameters and characteristics of global pro-development manufacturing sub-sectors in Serbia (based on the World Bank methodology) and the profile of 10 leading sub-sectors identified by the Development Potential Index we derive the following suggestions for pro-growth industrial and economic policies: First, Serbia will likely face substantial challenges in adjusting to present and future trends in new technology and changes in the global economy. Second, time and resource limitations will require selective interventions in favor of sectors and sub-sectors well positioned to become the leaders in pro-development global innovation sub-sectors, and hence create new well-paid high and medium-skill jobs. Selective interventions exponentially increase risks of failure (both in selecting sectors and measures) and, thus, require well organized highly professional effort to mitigate the risk. Third, present investment promotion activities aimed at creating new jobs and boosting equal regional development will have to be revisited in light of the new approaches to manufacturing-led development. The same applies to all other subsidies in agriculture and industry (manufacturing). Fourth, many of the sectors that presently generate the brunt of exports but do not have the desirable global pro-development characteristics, should get ready to boost their ability along 3C dimensions to successfully adjust to new technologies and keep their competitive edge safely ahead of the middle income trap. Fifth, the sectors with strong pro-development features (computers and ICT, pharmaceuticals etc.) appear to be relatively small in size (share of employment and value added) to generate a more substantial positive impact on employment, exports and GDP growth. Increasing the size of these sectors requires not only substantial investment in new production facilities, but also public and private financing of innovations, research and development, and massive education of required technical profiles in line with declared strategy to boost the digital economy. Finally, sectors with large import content and relatively low productivity (i.e. low value added per worker) cannot be the focus of policy attention nor represent development priorities in the medium run.

Conclusion

The fifth fiscal consolidation in Serbia recorded exemplary improvements in fiscal performance and substantially exceeded the original and revised growth, deficit and debt-to-GDP targets set in the IMF supported three-year precautionary program. Achievements in improving structural deficit were even more impressive in overall size, albeit the sources of adjustment moved more towards better revenue performance.

To secure sustainability of these fiscal results the attention must now shift to completion of institutional and structural reforms, and to creation of a stable base for more dynamic, sustained and inclusive longer-run growth. Our analysis of sources of GDP growth during the 2001-2017 period confirms that easy solutions, based on boosting aggregate demand through external sources of financing, are not feasible nor sustainable in the longer run.

Policy lessons learned from the analysis of global pro-development manufacturing sub-sectors (based on the World Bank methodology) and leading sub-sectors (based the Development Potential Index methodology) appear to be as follows:

- First, Serbia will likely face substantial challenges in adjusting to new technology and changes in the global economy.

- Second, selective interventions in favor of sectors with high pro-development potential are risky and should be done with great caution.
- Third, present investment promotion activities and subsidies must be aligned with new approaches to manufacturing-led development.
- Fourth, sectors that presently generate the brunt of exports should boost their ability along 3C dimensions to successfully adjust to new technologies and keep their competitive edge safely ahead of the middle income trap.
- Fifth, the sectors with strong pro-development features (computers and ICT, pharmaceuticals etc.) must be bigger to have the full beneficial impact on the creation of new jobs and GDP growth.
- Sixth, sectors with large import content and low value added per worker cannot be the focus of policy attention nor represent development priorities in the medium run.

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Dušan Vujović

is Minister of Finance, the Republic of Serbia, since August 2014. He was Minister of Economy from the appointment of new Government in April 2014 through July 2014. Dr Vujović is Full Professor at FEFA (Faculty of Economics, Finance and Administration), Belgrade and affiliate MOC faculty member of the institute for Strategy and Competitiveness of the Harvard Business School, USA. He was a World Bank consultant in the areas of R&D for innovation, macroeconomic policy, fiscal and governance reform, and a USAID consultant on budget and fiscal reform. He was a research fellow at CASE Institute, Warsaw. Dr Vujovic past career includes various positions at the World Bank, such as Country Manager for Ukraine, and Co-Director of the Joint Vienna Comprehensive program for government officials from the transition economies, Lead Economist in the World Bank ECA region and in the Independent Evaluation Group. He authored and co-authored a number of publications on macroeconomic policy, development, and institutional reform and transition issues published as papers in international and domestic journals, and chapters in books published by The World Bank, Oxford University Press, North Holland, Edward Elgar, etc.