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Serbia:
Macroeconomic Stabilization and Reform, 2001 to 2003





The wiiw Balkan Observatory

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About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



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Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

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Serbia: Macroeconomic Stabilization and Reform, 2001 to 2003

1 Initial conditions and reasons for reforms

After ten years of decaying, the Serbian economy faced the challenge of undertaking swift reforms to meet high expectations upon democratic changes in October 2000. At the outset of reforms, GDP per capita slightly exceeded 40% of the one in the second half of the 1980s. During the 1990s the living standard decreased by over 50%. In October 2000 the average net monthly wage was less than 45 euros, while the unemployment is estimated to be around 30%.

Some reforms were initiated in 1990 within former Yugoslavia, and subsequently were slowed down and eventually halted. Having been involved in regional conflicts, Serbia underwent UN economic embargo for eight years. Economic reform agenda was put aside, and even worse Serbia experienced, during 1992-93, second highest and second longest hyperinflation in economic history. The economy further deteriorated and the output sharply declined, in 1999 as the consequence of Kosovo war.

At the start of reforms in October 2000, *property rights* were not well defined. Social property, i.e. some form of workers self-management, and state owned utilities were dominant in the economy. The absence of hard budget constraint together with stop-go privatization, distorted *incentives* in the social sector bringing into the play tunneling and rent-seeking that lead to economic decay. State owned utilities also did not obey hard budget constraint as they were extensively used to subsidize households and enterprise sector through low relative prices. In the economy dominated by the social and state sector, *contract enforcement and rule of law*, were very weak. The latter gave wrong incentives to the emerging private sector invoking distortions. Foreign direct investments could hardly be envisaged in such an environment.

The Serbian economy experienced large *macroeconomic and financial instability* when reform started. After causing and experiencing hyperinflation in 1992-93, authorities were reluctant to opt subsequently for extensive money printing. However the economy, dominated by the social and state sector with soft budget constraint, pressed for the loose monetary policy. The resulting dynamics of the main nominal magnitudes are depicted in Table 1.

Table 1

Dynamics of money, prices, exchange and wage rates

Growth rates, end of period, in %

	1994 ¹⁾	1995	1996	1997	1998	1999	2000
Money supply (M1)	1199.4	33.7	68.8	73.7	13.4	45.7	91.5
Base money (H)	545.8	71.6	63.6	70.3	9.7	38.0	117.4
Inflation	0.0	120.2	58.7	9.3	44.3	58.6 ²⁾	113.3
Exchange rate	50.0	126.7	14.7	28.2	63.0	157.7	42.9
Wages	984.7	63.0	91.0	9.9	37.3	39.7	132.6

1) Dec. 1994. / Feb. 1994. 2) Corrected official data.

As can be seen, all nominal magnitudes grew at the average rate of around 40 to 50% in the period 1994-98, indicating macroeconomic instability. The instability was reinforced after Kosovo conflict in 1999. Also, monthly dynamics clearly indicates the co-movement of money supply, price level and market exchange rate, and corresponding econometric testing points to the money supply as the driving force (cf. Arsic, Mladenovic and Petrovic, 2001).

Reform and macroeconomic stabilization in October 2000 was initiated at the low level of monetization as shown in Table 2 and Figure 1.

Table 2

Real money demand

in %

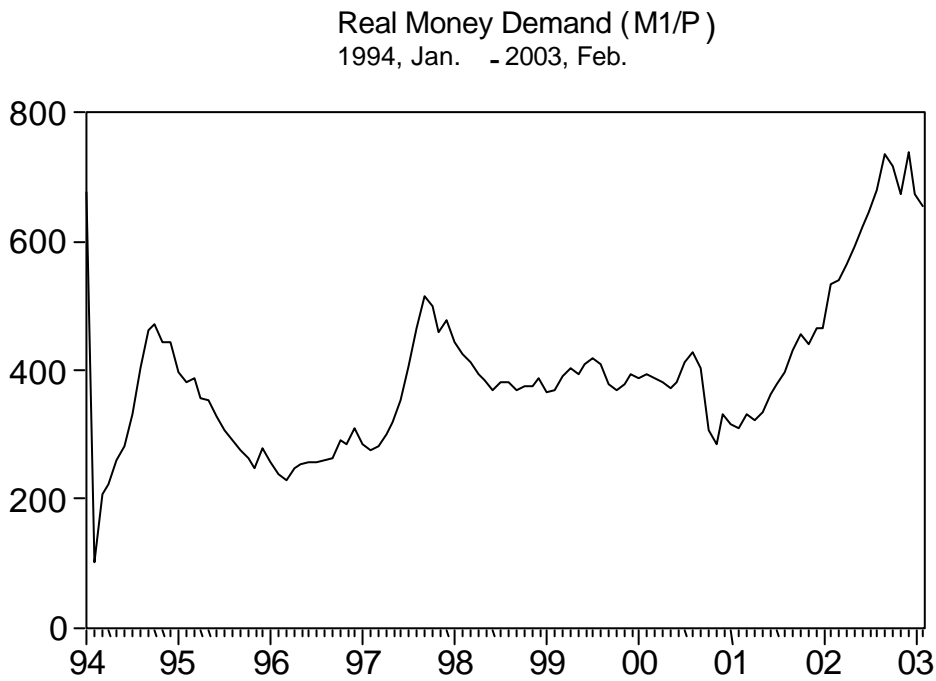
	1994	1995	1996	1997	1998	1999	2000	Average
M1/GDP*	9.44	5.18	5.96	7.98	5.79	5.95	5.30	6.53
H/GDP*	5.16	3.63	4.05	5.32	3.74	3.64	3.50	4.19

*) GDP end of period price level. H is monetary base.

As depicted in Table 2, the share of M1 in GDP was 6%, for most of the period, which is well below 15%, that is the historical figure for the 1980s. Low real money demand for domestic currency indicates that public perceived economic policy, during second half of the 1990s, as completely non-credible.

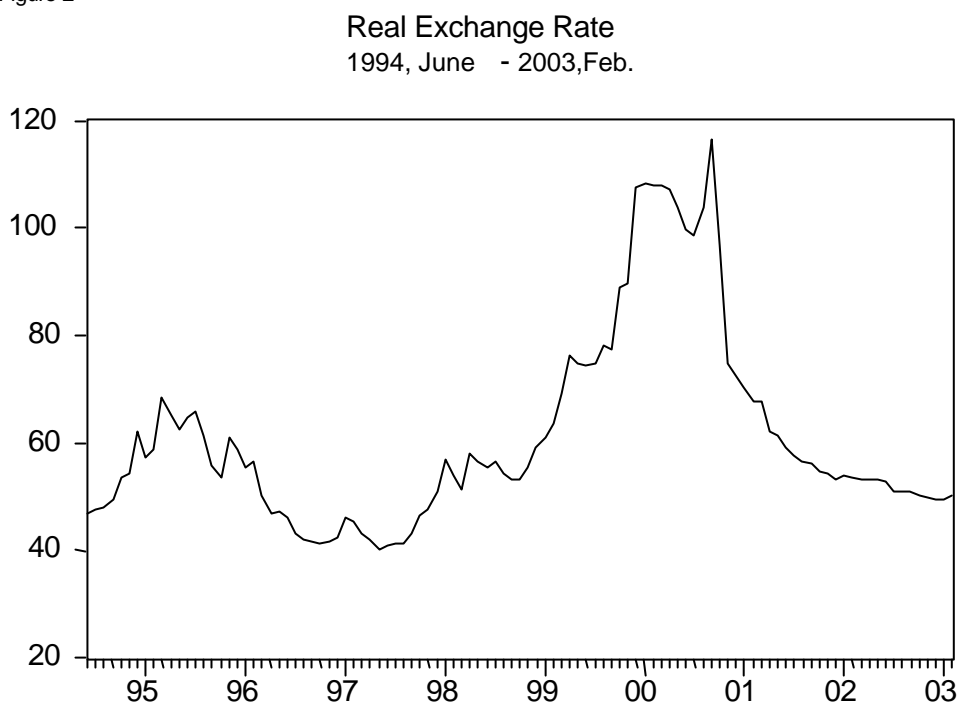
The low amount of real money holdings identified at annual level, also portrays large monthly fluctuations as shown in Fig. 1. By the end of 2000, when macroeconomic stabilization was initiated, real money holdings were at one of their troughs, indicating sharp demonetization. This was a consequence of additional flight from the domestic currency after Kosovo conflict in 1999.

Figure 1



Parallel to demonetization and flight from the domestic currency, severe real depreciation of dinar was experienced. Again, the extreme value was reached at the start of stabilization (cf. Fig. 2)

Figure 2



Another indicator of a large real depreciation is the monthly net wage rate expressed in foreign currency that was only 45 euros at the start of reforms.

Fiscal deficit, open and latent, that was facing reformers was up to estimated 10% of GDP. Although, the estimated cash deficit was only about 1 to 1.5% of GDP, others latent items made it huge.

Thus arrears were regularly recorded, the most important of which were pension's arrears, then arrears towards childcare and social security welfare, as well as wage's arrears in public sector. These arrears emerged due to imbalances between entitlements and disposable funds for servicing these entitlements, and it is estimated that they added 2.5% to 3% of GDP to the deficit.

One should, then, add non-covered losses in public companies, and in particular those of Serbian Electricity Company (EPS). It is estimated that the subsidies equal to 3% of GDP are needed to cover operating costs of EPS.

Finally, in the 1990s the government neither honored its foreign debt nor the debt to its citizens stemming from the frozen foreign exchange accounts. Servicing public debt, both domestic and foreign, even under favourable restructuring of foreign debt varies around 2.5% of GDP.

Although the estimates above are tentative, it might be safely concluded that the inherited fiscal deficit, open and hidden, was up to 10% of GDP. This indicates the size of fiscal adjustment that the Serbian economy faced at outset of stabilization.

The relative size of the public debt, especially the foreign one, indicated that it is unsustainable hence asking for significant restructuring.

Price control was widely practiced in 1999 and 2000 as a substitute for the social policy and to repress the inflation. There were direct and indirect price controls, but also unofficial one, often without any adequate legal basis.

Direct price control, was applied to staple food products, electricity, oil and oil derivatives, a majority of pharmaceuticals, basic hygiene products, some chemical products and main public services. We estimate that over 40% retail trade of goods and services were under direct price control.

Indirect price control, binding enterprises to report price changes, increased in addition the scope of control. Furthermore, during the second half of 1999 and through September 2000, unofficial price control was extensively practiced. Antimonopoly regulations are

mainly misused to control directly the prices that are supposed to be freely set. In addition, pressures were exerted on enterprises not to increase prices even if they were formally allowed to do so. The informal pressures were pursued through frequent and excessive administrative control and selectively fining the companies for what in fact were “normal”, widespread operations.

The main consequences were large price disparities, high losses in enterprise sector, shortages and expansion of gray economy.

As to the *microeconomic distortions*, one should point out to *relative price distortions*. They were particularly severe in the case of utilities. The outstanding problem is that of the Serbian Electricity Company (EPS), as the Company extensively subsidized households and enterprise sector during UN economic embargo. Under the price of 0.94 US\$ cents/kWh at the beginning of 2001 EPS was far from covering its operating costs. It is estimated that this price covers just one fifth of its economic cost, indicating a huge distortion. Prices of most other utilities were below operating costs at the start of the reforms, thus calling for substantial adjustments.

Inherited *tax system* was highly distorted. The major distortions were recorded in the case of retail sales tax and excises, which account for more than third of public revenues. There were seven different retail sales tax rates, ranging from 1% to 28%, thus giving apply space for lobbying. Earmarked surcharges were introduced on an ad hoc basis to deal with the deficit that emerged in pension and health care funds.

Foreign trade restrictions mainly emerged through import quotas. Overprotection of employees was the main characteristic of *rigid labour markets*.

The reason for undertaking reforms was collapsing economy. However, the necessary economic reforms are made feasible by political turnaround that occurred in October 2000. These political changes made a shift from inward conflict oriented and anti reform attitude to outward and cooperative, pro reform one. This move gained wide international support which has been indispensable for initiating reforms.

2 Reform strategy and sequencing

Reforms introduced in Serbia in October 2000, aimed to removing large distortions outlined above and placing the Serbian economy on sustainable growth path. Reform programme thus contained macroeconomic stabilization intended to curb large repressed inflation, introduce sound money and unify exchange rates. Then it advanced a fiscal reform to address both macroeconomic imbalances, i.e. fiscal deficit and public debt sustainability, as well as microeconomic distortions related to the tax system and public expenditures.

Price liberalization and adjusting utility prices, as well as trade liberalization, are meant to tackle relative price distortions. Labour market reform is intended to bring in flexibility to these markets. Privatization is hoped to introduce clearly defined property rights and appropriate incentives, and bank rehabilitation to enhance savings and intermediation. The reform programme in Serbia thus has been quite alike those in most other transition economies.

The sequencing of reforms again is not that different from the one in other transition economies, but is however rooted in specific Serbian conditions. The realized sequence has been: macroeconomic stabilization with price liberalization, fiscal reform, privatization, and bank rehabilitation.

Curbing inflation and stabilizing exchange rate were widely expected by public in Serbia upon democratic changes in October 2000. This was also high point on pre election agenda. Currency and price stabilization is highly valued by public in Serbia, since it experienced two hyperinflations, in the late 1980s and the early 1990s, as well as prolonged period of high inflation during the 1990s. Economic profession had at the time anti inflationary bias, subscribing rightly to the view that economic stabilization is a precondition for subsequent reforms. A quite number of them went as far as to forcefully advancing, at the time (2000), fashionable monetary arrangements such as currency board or introducing euro, which was luckily avoided. Due to the reasons above, reformist politicians, that seized power upon October 2000 turnaround, put disinflation and stable currency high on agenda. Additional motive for doing this is that the results of anti inflation policy can come fast and are widely visible.

The intended monetary stabilization was also a politically feasible policy option immediately upon the October 2000 elections. Namely, the elections were Federal (Serbia and Montenegro), enacting changes in the federal government and central bank, but only power sharing in government and parliament of Serbia. Thus monetary policy and exchange rate policy, as well as trade liberalization, were under control of reformers, and they were readily pursued to curb inflation. The partial control of Serbian government proved sufficient to secure temporary fiscal balance, thus removing any pressure on the Central bank for deficit financing. However, extensive fiscal reform had to wait for changes in parliament and government of Serbia.

International support, which came immediately upon changes in October 2000, made also macro stabilization policy possible. This support gave credibility to stabilization efforts, which is decisive at the beginning of a disinflation programme. Namely, credibility initiated return of the public to domestic currency, thus easing exchange rate stabilization and, subsequently, lowering inflation.

Finally, starting with macro stabilization enabled price liberalization across the board, the exception being utility prices, thus addressing relative price distortions at the very beginning of reform. Without the stabilization programme, price liberalization could have led to uncontrolled inflation surge.

After December 2000 election for the Serbian parliament, reformist government of Serbia took office beginning of February, thus laying grounds for subsequent reforms. An urgent task was adoption of the budget for 2001, which would support initial stabilization and made it sustainable. Budget preparation faced large inherited tax and public expenditure distortions. Its execution, targeted at considerable lowered deficit, would be very difficult without changes on both revenue and expenditure side. Using the period of 'extraordinary politics', tax and expenditure reform was prepared and passed through the parliament, together with the budget, in less than the two months.

Adoption of the 2001 budget laid ground for social policy aimed at alleviating impacts of reform on vulnerable population segments. It also insured regular servicing of socially related payments, thus avoiding additional arrears and decreasing them. The budget openly quantified the very large deficit in the pension fund, pointing that it is unsustainable to finance it in the medium term. This triggered pension reform that started in 2001.

Similarly, the size of quasi-fiscal deficit i.e. losses in public enterprises were explicitly recognized and subsidies were allocated, but again this initiated relative price adjustment of utilities. Budget also allocated certain resources to enterprise restructuring activities, thus allowing initiation of reform of enterprise sector. Part of those resources was for severance payments, which made easier the move towards more flexible labour markets, i.e. labour market reform. Labour law that initiated labour market reform, was adopted by the end of 2001.

In summary, the adoption of the 2001 budget was a precondition for a number of subsequent reforms, and it made them feasible.

A new start of privatization in Serbia is initiated by adopting a concept to privatize through selling of a majority stake (70%), representing a U-turn with respect to inherited solution. Thus Serbia took an advantage of being latecomer and capitalized on large privatization experience in other transition economies. With its sizeable public debt and fiscal deficit, which could not be eliminated in the medium term, privatization proceeds have been most needed. However, putting in work the chosen concept was time consuming. The new law has to be drafted, as well as supporting decrees, and passed through parliament, which took six months i.e. through mid 2001. Then supporting institutions were to be put in place, which took another six months. Thus privatization started after a year time, at the beginning of 2002. Opting for privatization through selling, as oppose to giveaway, implies

that privatization would take more time to be completed. Based on privatization dynamics achieved so far, it seems that the socially owned enterprises will be sold out through 2004. Exceptions are large social enterprises, big loss makers, which are to be restructured first. Also, it will take additional time to privatize state monopolies.

The rehabilitation of the banking sector could have started very early in the reform process, as it was by and large under the Central bank responsibility. The auditing of the large social owned banks, i.e. 'owned' by social enterprises, started soon after changes took place in October 2000. The concept was, however, defined and accepted with considerable delay, i.e. only after almost a year time (September 2001). It contained radical measures, i.e. closing down the four largest social banks, and it was advanced and pushed by the World Bank and the IMF. Nevertheless, the bold measures were to be taken, and the resulting pressure born by domestic reformers. The closure of the four banks was enacted beginning of January 2002. Thus the large problem has been addressed with relatively small fiscal costs. The next move was made in mid 2002, when other major social banks were in fact nationalized, and it was announced that they would be sold. Privatization of these banks will take several years, for sure, and some recapitalization will be needed.

3 Implementation of reforms

3.1 Macroeconomic stabilization

The start of stabilization, upon changes in October 2000, faced the economy placed in an extremely bad position. As explained above, the economy experienced severe flight from domestic currency, extreme real exchange rate depreciation, distorted tax system leading to low tax collection from excises and widespread smuggling of excises' goods. A credible stabilization thus offered a 'free lunch', that is a sharp increase in real money demand that could be used to build up foreign currency reserves; large real appreciation of domestic currency that may restrain inflation by using nominal exchange rate as an anchor, and enhanced tax collection by broadening the tax base, which can help keeping the budget deficit under control.

Substantial credibility, of course, was in place at the outset of economic stabilization. After ten years of inward looking, conflict inclined authority, which earned international economic embargo, the October 2000 elections represent a regime change to outward, internationally supported government. Thus the credibility could be used to substantially reverse the position of the Serbian economy, which in fact has been done.

Stabilization programme turned to be, although not announced as, exchange rate based stabilization. Immediately upon changes, the nominal exchange rate is set at its black market level and stayed unchanged for more than two years, with some depreciation only

in the third year. On the other hand, an officially announced exchange rate regime is a managed float.

3.1.1 Monetary and exchange rate policy

Monetary and exchange rate policy had to cope with outburst of inflation after across the board price liberalization at the start of the programme. The main idea of this initial stabilization policy was to regulate money supply only through foreign exchange operations, while at the same time fixing nominal exchange rate. Net domestic assets were kept constant in the last quarter of 2000, decreased in the first quarter of 2001, and then remain constant through August, hence being well below initial September 2000 level. At the same time money supply (M1) increased 111% and monetary base 93% from September 2000 through August 2001.

From there on, the Central bank extended some loans to the government, albeit very restrictively. In 2001, most of the relatively small fiscal deficit (1.5% of GDP) was financed by the Central bank loans, i.e. 78% (1.2% of GDP), while that share decreased in 2002, being 20% (0.7% of GDP). However, net government borrowing from the banking system is much lower in these two years, i.e. 0.7% and -0.5% of GDP (IMF, Sept. 2003). In mid 2003, National Bank of Serbia (NBS) law was passed prohibiting central bank lending to government, apart for within the year liquidity support.

Technically, monetary policy has been conducted to meet targets agreed with IMF, i.e. ceilings for net domestic assets (NDA) and floors for net foreign assets (NFA).

Contribution to base money creation of increase in foreign currency reserve (NFA) and domestic credits are summarized in Table 3.

Table 3

Base money creation

End-year growth rates %

	2001	2002	2003*
Base money growth	89.1%	48.1	1.0
NDA contribution	2.3	-4.2	-24.0
NFA contribution	86.8	52.4	25.0

Source: IMF, September, 2003; *NBS (2004) preliminary data

Thus in the first two years of stabilization large increase in nominal money supply was recorded (89.1% and 48.1% respectively) reflecting sharp remonetization of the Serbian economy. Namely, base money, in real terms, also rose in these two years (31% and 14% respectively), since the inflation was lower than nominal money growth. Money creation, in

both years, was done through inflow of foreign currency and increase in foreign reserves (cf. NFA contribution). Increase in domestic credits were negligible or negative (cf. NDA contribution)

Preliminary National Bank of Serbia data for 2003 indicate small nominal increase in base money (1%) and hence its decrease in real terms (6%) compared to the end of 2002. These dynamics is an outcome of large increase in NFA and contraction of NDA. On the other hand, M1 increased somewhat in real terms (6%) in 2003, thus implying the increase in money multiplier. However, both result do suggest that the period of sharp increase in nominal money supply and real money demand, driven by portfolio shift back to dinars, was exhausted in 2003.

3.1.2 Prices and wages

Extensive price control and repressed inflation were inherited from the previous regime. In October 2000 all prices, apart from public utilities and some basic goods prices, were liberalized and inflation went open. Monetary and exchange rate policy, as explained above, put the inflation under control through March 2001. Thereafter, administrative price adjustments came on agenda.

The main issue concerning price policy is adjusting public utilities prices. The outstanding problem has been that of the Serbian Electricity Company (EPS).

Under the price of 0.94 US\$ cents/kWh at the beginning of 2001 EPS was far from covering its operating costs. It is estimated that this price covers just one fifth of its economic cost. The subsidy needed in 2001, if price adjustment would not take the place, should be around 3% of GDP. The latter points to the existence of the large quasi-fiscal deficit.

Several adjustments in course of 2001 double the price of electricity by the end of the year. Further increases were done in 2002 and 2003, reaching the price of 4 US\$ cents per kWh, while the target is 4.5 to 5 cents.

The following illustrates the size of administrative price adjustment in the first year of reform. Communal utility prices were increased by 70%. The price of gas was increased by 103% and railway tariffs by 180%. The prices of postal services were raised by 80%, and that of TELECOM Serbia by 2.12 and 1.8 times for household and non-households respectively.

The prices of bread increased in the range of 65% to 135%, and those of medicaments by 80%.

It is estimated that the above relative price adjustments accounted for inflation rate of 28%, while the core inflation, encompassing indirect effects of price adjustments and all other components is estimated at 16%. This led to the end of the year inflation rate in 2001 of 44%.

Wage control was introduced in the public enterprises by freezing their wage bills at the January 2001 level. This was a first step towards intended restructuring of these enterprises and preceded their administrative price increases. These enterprises employ more than two hundred thousand workers, which makes almost 15% of those employed in social and public enterprises. On average, in 2001 wage bill in public enterprises increased 10% in nominal terms, which together with 44% inflation lead to almost 24% real decrease. Thus, the wage control in public enterprises were important in containing overall real wage increase. The control also diminished relative wage dispersion, since the wages in public enterprises were generally well above the average.

Wages of those employed in public services (government, army, education, health care etc.) are by definition under control. The total number of employees in these sectors is around 400 thousand. These sectors exhibited different nominal wage dynamics, but on average they together recorded real growth in 2001 of approximately 7%.

3.1.3 Outcomes and Analysis

Monetary and exchange rate policy, exposed above, put inflation under control upon its outburst after price liberalization at the start of the programme. Thus monthly inflation was 27% and 19% in October and November 2000 respectively, and it decreased to 1% in March 2001. From there on, a substantial portion of inflation is due to the, above explained, administrative price adjustments of public utilities.

The inflation path profile, depicted in Table 4, shows that fast disinflation was achieved, which is the result of fixing exchange rate and the corresponding monetary policy.

Table 4

Inflation rates
end-year, %

2000	2001	2002	2003
112%	44	15	8

The inflation pattern in Table 4, concurs with experience in other countries that also applied the exchange rate stabilization programme. Alternatively, one could have considered opting for the flexible exchange rate arrangements, like in Hungary and Poland, which

would result in somewhat slower pace of disinflation, but importantly would avoid large currency appreciation.

Foreign currency reserve increased enormously, around ten times, although from the very low level at the outset of stabilization (0.3 bill. US\$).

Table 5

Foreign currency reserves
end-year

	2000	2001	2002	2003
Gross NBS Reserves (USD billion)	0.5	1.2	2.3	3.5
Reserves/Base money		1.88	2.03	
Reserves in months of imports		2.4	3.2	5

Rise in reserves came out as a consequence of the swing from the extreme non credibility and consequent flight from dinars, to some credibility of the enacted stabilization and resulting portfolio shift to dinars. Another source of the increase in foreign currency reserves has been international financial support, and then privatization receipts.

Reserves to base money ratio is very high, e.g. it is greater than in almost all EU countries where it varies around one (cf. Obstfeld and Rogoff, 1996, Table 8.1, p.566). Thus the ratios above indicate the solid backing of the base money. This is a result of monetary policy where money is created almost exclusively through foreign currency operations.

Compared with imports, foreign currency reserves reached the level of 5 months of imports, thus exceeded the standard benchmark of being able to cover three months of imports. However, judged against the foreign debt, the reserves are still on the low side and hence should be further increased.

Real interest rates have fallen as a result of stabilization. The declining trend could be best captured by comparing pre stabilization first quarter of 2000 with second quarter of 2003. Thus, the average weighted annual real interest rate on loans were 24% and 8% respectively. Within this period nominal interest rates were steadily declining, while real ones varied due to temporary spikes in inflation.

It was been already indicated that real money demand sharply increased in 2001 and 2002. Hand-in-hand dinar appreciated in real terms, as nominal exchange rate was kept fixed in the presence of inflation. Both remonetization and real appreciation should have been expected as the Serbian economy was moving away from the extreme position at the beginning of stabilization. Table 6 summarizes the extent of these shifts upon stabilization,

while Fig. 1 and 2 above compare it with pre stabilization period of the 1990s by depicting monthly dynamics before and after the stabilization.

Table 6

Remonetization and currency appreciation

	Real money M1/P	M1 in EUR	Wage rate in EUR	Real appreciation
Dec.2002/Sept. 2000	1.72	4.1	4.4	2.78
July 2003/Sept.2000	1.59	3.8	4.2	2.7

For somewhat more than two years, through December 2002, real money holdings almost doubled (1.79), and they are well above any level achieved during the 1990s (cf. Fig. 1).

Increase in money (M1) expressed in euros captures both remonetization and real appreciation of dinars. As can be seen the increase since October 2002 is enormous, i.e. four times. By the end of 2002, M1 expressed in euros equaled 1.4 billions, and was 50% higher than the maximal value realized in the 1990s (0.95 billions). Nevertheless, ratios of the base money and M1 over GDP in 2002 were 7% and 9.5% respectively, being still on the low side.

Large swing in real value of dinar occurred upon stabilization. The value increased almost three times in real terms through 2002. Fig. 2 above gives these changes in historical perspective. It shows that, although dinar experienced large appreciation from the end of 2000 through beginning of 2003, it is still nevertheless at some average level for the 'normal' 1994-1998 period. This would suggest that the dinar is still not overvalued.

However, dynamics of wage rate expressed in euros and corresponding unit labour costs suggest that overvaluation might be present. Rise in wages expressed in euros combine both real appreciation of currency and real wage growth. As shown in Table 6, euro wages increased 4.4 times through 2002. Some international comparisons, given in Table 7, points that wages in Serbia, expressed in foreign currency, are on the high side relative to its GDP pc.

Table 7

2002, in US\$	Serbia	Bulgaria	Romania	Croatia	Hungary
GDP pc,	2054	1966	1979	4.992	6220
Gross average monthly earnings in the economy	217	117	182	556	426

High euro wages translate into high unit labour cost, hence undermining competitiveness of the economy. Indeed, unit labour costs, based on euro wages, increased dramatically

upon stabilization, and are well above any level recorded in the 1990s. Fig. 4 below demonstrates this.

As a consequence, export to import ratio has declined upon stabilization, and on average is lower than any ratio in the 1990s (cf. Fig. 3), when for the most of the period international embargo on foreign trade was in place. This decline is a result of a large increase in imports after October 2000. This assessment is supported by some estimates of import functions for post 1999 war period through 2002. The estimates show highly significant positive relation between imports and real exchange rate appreciation or increase of euro wages. Also, there is significant, but much weaker, negative dependence of export to import ratio on real exchange rate or euro wages (cf. Arsic et al., 2003). Both results indicate that import, and hence deficit has been driven by real exchange rate appreciation and increase in wages expressed in euros.

Thus whatever is the case, i.e. either dinar is overvalued or wages are too high, some adjustments are in need. This is also strongly suggested when current account deficit is inspected for post October 2000 period (Table 8).

Table 8

Current account deficit

	2001	2002	2003	2004
CA as % of GDP before grants	9.7	12.8	10.9	10.2
CA as % of GDP after grants	4.6	8.8	8.2	8.6
Export as % of GDP		21		
Foreign debt as % of GDP	103	61	61	

Source: IMF (September 2003)

Current account deficits before grants are excessively high, and even those after grants are very large, plus they are not predicted to decrease in 2004. Thus, this might be the major macroeconomic imbalance of the Serbian economy.

Export of goods and services, as shown in Table 8, is very low both by international standards and with respect to historical record in the late 1980s. Thus despite large import, the main action should take place on export side.

Major foreign debt reduction of some 66% was achieved with Paris club creditors by the end of 2001, and the first phase (some 50%) of debt reduction is reflected in 2002 and 2003 figures. The debt figures reported in Table 8 assume that the comparable debt reduction will be achieved with other creditors. In that case, the obtained debt to GDP ratio appears sustainable.

Figure 3

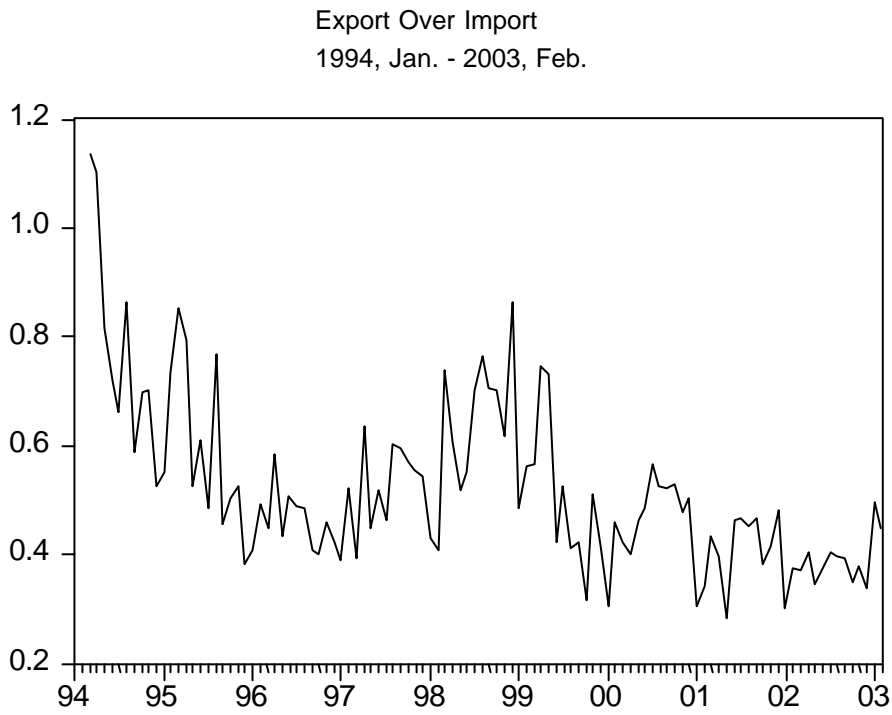
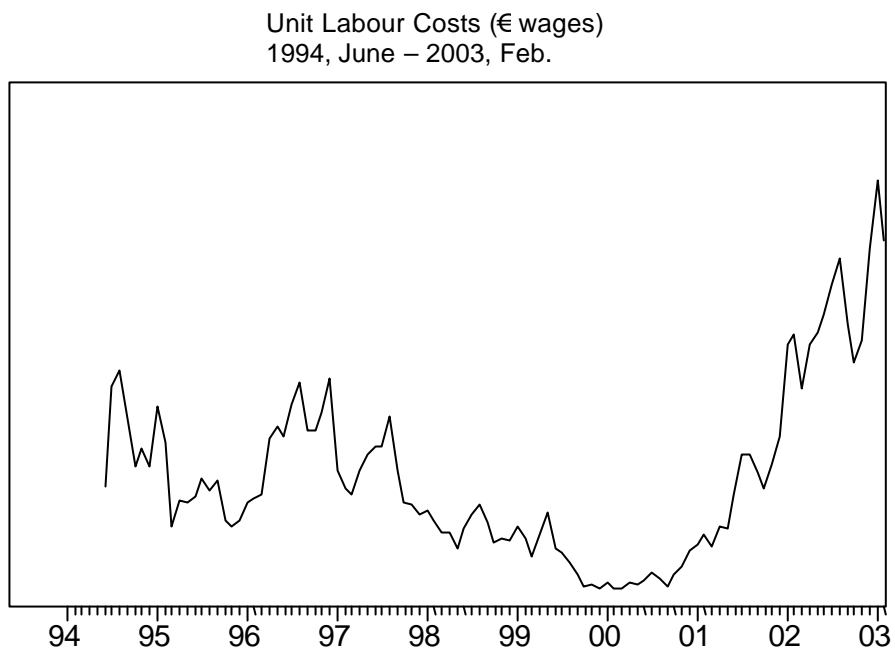


Figure 4



3.2 Fiscal adjustments and reform

As explained above, large fiscal distortions were present at the start of reform, i.e. large latent fiscal deficit, distorted tax system and deformed pattern of public expenditure.

3.2.1 Tax reform

The tax reform has been enacted in three steps. Substantial changes took place in 2001 aiming at removing inherited large tax distortions, simplifying the tax system and achieving allocation neutrality. As a second step in 2002, some tax incentives for investment and employment were introduced. Finally, preparations for the introduction of value added tax (VAT) were done in 2003, intending to institute it in 2004.

A thorough tax reform in Serbia was advanced in March 2001 along with the budget for that year. The major changes were proposed in the area of retail sales tax, excises and in payroll contributions and taxes. These taxes account for 80% of total fiscal revenues in Serbia. Some other taxes, e.g. corporate income tax, property tax etc., have been changed as well. Federal Government pursued, in May 2001, reform of import tariffs.

Tax reform unified retail sales tax at the rate of 20%, from seven different rates ranging from 1% to 28%. Retail tax exemptions were very limited.

The goals of the enacted changes in retail sales tax are to reduce the allocation bias of the previous system, avoid the strong lobbying, simplify the calculation and reduce the cost of calculation and control. Also, the unification of retail tax rate is a good starting point for the planned introduction of the value-added tax.

Radical simplification of the taxation of excise products is also enacted. A consolidated excise is introduced by combining the existing excises and 48 charges calculated for excise products. Except simplifying calculation, selective increase in excises was proposed.

Change in the fiscal treatment of wages and salaries are the third, and probably the most important measure within the fiscal reform. The changes were accepted in April and have been effective from June 2001. They encompass: a) shift to the system of gross wage, which represent the uniform base for levying all fiscal charges on wages and salaries; b) tax exemption for minimum wage was abolished; c) luncheon bonus and vacation vouchers are included in gross wage; d) introduction of minimum base for each qualification and a maximum one for levying contributions. At the same time, contribution rates were lowered so that the reduction of fiscal burden on average wage decreased by about 10%.

The combined effect of widening tax base, i.e. gross wage that now includes the whole take home income, and the lowering of contribution rates have led to the reduction of fiscal burden on take home wage from 105% to 72%.

The introduction of gross wage, as the taxable base, has strong impact on depressed sectors (e.g. textile, metal processing etc.) in which the dominant part of take home income was previously nontaxable allowances. This puts the strong pressure on them to restructure or close down. However, in medium and long run, the introduction of gross wage as a tax and contribution base would by definition lead to the higher pensions. This is not well understood by employees since they even before tax reform wrongly perceived take home incomes as the base for their prospective pensions.

The steps towards fiscal decentralization have been already taken since the start of reform in order to strengthen local self-government and reduce inherited extreme centralization.

In the course of 2002, decrease in corporate tax rate was advanced, from 20% to 14%, thus achieving the lowest rate in the region. Some tax incentives for investment were introduced, and distortions removed, i.e. by decreasing the tax on financial transactions with the intention to phase it out. During 2003, preparation for value added tax has been intensified, and its introduction is announced for the mid-2004.

3.2.2 The size of government, fiscal deficit and the public debt

The following Table 9 summarizes the consolidated government finance in Serbia, which includes all levels of government and social funds (pension, health, etc.).

Table 9

Fiscal revenue and expenditure % GDP

	2001	2002	2003
Revenue	38.0	42.5	42.4
Expenditure	39.5	46.1	46.1
Deficit	1.5	3.6	3.7
Primary deficit	0.9	2.6	1.9
Public debt		92.2	80.3

As the result of tax reform and expenditure adjustments, both public revenue and expenditure relatively increased in 2002. Their share in GDP is comparatively high, and reaches an upper limit of successful transition economies, albeit with significantly higher GDP pc. On the other hand, government in Serbia has been efficient in collecting taxes as oppose to a number of unsuccessful transition countries where tax collection collapsed at

the start of reform. Anyhow, the size of government should decrease, and this is recognized in the government medium term plan (cf. Budget Memorandum, 2003).

The size of fiscal deficit is reasonable having in mind that it refers to the period of initial large fiscal adjustments.

Table 10

Financing of the deficit

total deficit = 100

	2001	2002	2003
Grants	32	18	11
Privatization proceeds		36	64
Credits (WB and alike)		26	25
Central bank (NBS)	78	20	

Financing of the deficit shifted from central bank loans and foreign grants in 2001 to privatization receipts and subsidized credits from IFO (WB, etc.). Primary deficit, i.e. the one before interest payments, is present, indicating that public debt might be growing faster than GDP. However, since the primary deficit is covered from noncredit sources such as grants and privatization receipts, the deficit would not lead to increase in the public debt relative to GDP. Given that the primary deficit is going to be present in the medium term, privatization receipts necessary for its financing are decisive for non increasing public debt and hence the debt sustainability.

The public debt in Serbia consists itself of foreign and domestic debt, the latter being the debt to population for frozen foreign currency deposits. As noted above, the foreign debt has been considerably written off, while the annual servicing of the domestic debt has been reschedule to be less than 1% of GDP. This is hoped to lead, in the medium term, to relative decrease of the public debt to sustainable 60% of GDP level, from high levels now recorded. Reaching sustainable 60% of GDP implies, among other things, at least 3% medium term growth of GDP.

3.2.3 Public revenues and expenditures

The share and dynamics of public revenues are depicted in Table 11. The share of revenues increased due tax reform and the broadening of tax base. Namely, half of this relative increase was due to the rise in revenues from sales tax and excises, the latter coming from increasing taxing of the grey economy.

Table 11

Consolidated public revenue

% GDP

	2001	2002	2003
	Actual	Actual	Plan
Total revenue	38,0	42,5	42,4
I Current revenue (1.+2.)	38,0	42,5	42,4
1. Tax revenue (1.1+...+1.10)	36,2	40,6	40,2
1.1. Taxes on international trade	2,0	2,6	2,3
1.2. Personal income tax	4,5	5,1	5,2
1.3. Corporate income tax	0,5	0,5	0,5
1.4. Retail sales tax	9,9	11,1	11,6
1.5. Excises	3,6	4,7	4,9
1.6. Property tax	0,3	0,4	0,4
1.7. Tax on financial transactions	1,4	1,1	0,3
1.8. Tax on 'extra normal profit'	0,2	0,3	0,0
1.9. Other taxes	3,4	4,3	4,2
1.10. Contributions to pension, health... funds	10,4	10,5	10,7
2. Non tax revenue	1,8	2,0	2,1
II Capital revenue	0,0	0,0	0,0

Sales tax and excises shares have already reached levels that concur with international standards. Therefore, the introduction of VAT will hardly increase these shares as it usually happens.

The share of social contributions is higher than in comparable countries, and still social funds are recording large deficits that are covered with the transfers from the budget. Both, the large share and deficit ask for large adjustments in pension and health system.

Imports tariff share is on the high side, i.e. larger than in benchmark transition economies. However, since accession to the World Trade Organization, and Stabilization and Association Agreement with EU are due, one may expect decrease of tariffs' share in the medium run.

The share of corporate tax revenues is well below the reference level. There are two reasons to it, which are extensive evasion that has been a standard attitude since the 1990s and widespread losses in the enterprise sector. Both are expected to change in the medium run. There are now incentives to report correctly realized profits since a good track record is needed e.g. to qualify for loans that are becoming available. Also, corporate tax rate is at only 14%, i.e. at the lowest level in the region. Secondly, as privatization advances and budget constraint is hardening, one should expect profits to increase. Some indication of these dynamics has emerged in 2003.

The tax on financial transactions was introduced in the 1990s, as a reaction to the widespread tax evasion. Namely, this tax can be easily collected with practically no time lag, which makes it inflation proof. On the other hand, the tax on financial transactions introduces distortions. Thus it has been substantially decreased in 2003, with intention to be phased out.

The tax on 'extra normal profits' is a windfall tax aimed at capturing rents acquired in 1990s, legally at the time but obtained through close relation with political elite. This once off tax is expected to be phased out in 2004. It is interesting to note that an idea of windfall tax is also suggested as a way to approach Russian oligarchs that secured their wealth through controversial privatization in mid-1990s (e.g. Khodorkovsky and Yukos oil group case, cf. Financial times editorial, October 31, 2003).

Shares of the main public expenditure items and their dynamics upon reform are given in Table 12.

Table 12

Consolidated public expenditure: economic classification

% GDP

	2001	2002	2003
Total expenditure	39,3	46,1	46,1
1. Wages and salaries	8,7	10,1	10,3
2. Expenditure on goods and services	6,7	7,0	7,0
3. Pensions	9,4	11,7	11,7
4. Social protection	3,2	4,1	4,0
5. Subsidies and restructuring	5,7	6,3	6,2
6. Capital expenditure	1,3	2,0	2,1
7. Servicing of the public debt	1,7	2,1	2,5
7.1. Interest payment	0,8	0,9	1,3
7.2. Repayment of the debt	0,9	1,2	1,2
8. Other expenditures	2,6	2,6	2,1

The share of total expenditure in GDP increased considerably in 2002, and the main drivers were pensions and wages in public sector.

The most important distortions in public expenditure in comparative perspective are as follows. The share of wage bill is large compared to relevant comparative benchmark. The large share is due to the over employment in the public sector, and not to the wage rates. The share should be lowered in medium term by simultaneously lowering employment and increasing its productivity and hence wage rates.

The share of the expenses on goods and services is on the mark by relevant international standards. Nonetheless, some restructuring within it is in demand, in particular to improve the equipment of health, education and security sectors. Some savings, on the other hand, are expected from introducing public procurement procedures.

The part that goes to pensions is large and unsustainable in the medium term. Both the average pension is high relative to wage rate, and the number of retirees is large. As to the first some measures were undertaken, i.e. indexation of pensions to weighted average of wage and price increase as oppose just to wages, relating the pension level to the average wage of the whole working life as opposed to ten best years etc. Increase in the length of the working period has been introduced to decrease the number of retirees.

Expenditure on social protection is envisaged to decrease somewhat in the medium run, as the growth of economy lowers the number of beneficiaries. Subsidies related to restructuring are also expected to decrease in relative terms while enterprise restructuring advances. The single largest item is subsidy to the state railway: 1% of GDP.

Capital expenditures (2% of GDP) are half the international standard level (4%), and hence increase should be envisaged. The share of debt servicing will increase as the servicing of the whole foreign debt starts.

When one looks at functional expenditure classification, the four functions are major candidates to be reformed. On the high side, by international standards, are expenditures on defense and security. Thus the current share of the army is 3.8% of GDP and the target is 2.2%, while in the case of police the share should decrease from current 2.8% to 2.1%. On the low side is education with the share of 3.6% of GDP with the target being 4.5%. Health care expenditures (5.3%) seem to be in line with international standards, and with some increase planned (to 5.6%) the main focus will be on the restructuring within the given share.

Thus the broad picture on the evolution of expenditures is as follows. Concerning priorities, the share of education and capital investment should be increased, while that of army decreased. Reform of the pension system is needed to decrease relative expenditures on pensions to the sustainable level. The public sector should raise its labour productivity while decreasing employment, which then would lead to higher wage rates. As to restructuring related subsidies, they will decrease as the restructuring advances. Finally, the public debt is by and large given exogenously.

3.3 Privatization

Privatization in Serbia started at the beginning of the 1990s, and out of estimated 4500 social firms in 1991 one third was privatized through winter 2001, according to laws valid at that time. These laws favoured employees allowing them large discounts first (1990 and 1992), and give away of majority stake to employees later on (1997). The privatization was not compulsory, and in spite of attractive conditions granted by 1997 Law, only 450 firms were privatized through October 2000 (cf. Arsic, et al. 2003). Once it became apparent that the privatization concept was to be changed, another 350 firms opted to be privatized through winter 2001, in order to capture favourable conditions granted by 1997 Law. Then the authorities halted further privatization until the new law was enacted. The self-selection of the firms that were privatized from 1990 through winter 2001 was obviously biased towards relatively good performing enterprises.

Thus at the new start, there were somewhat above 3000 socially owned firms for privatization. As explained above, the concept was changed placing in the center the selling of majority stake (70%) while giving away minority stake to employees and citizens. The process contained three steps: accepting laws and decrees (on privatization, Agency for privatization etc., decrees on tenders and auctions), building institutions (e.g. Privatization agency), and finally the very privatization, which started in a year time i.e. at the beginning of 2002. Large and viable enterprises are to be sold through tenders, while medium and small firms through auctions. The state has also been holding the minority packages of the previously privatized firms, and these packages are to be sold as well. In the process of privatization, two amendments were made in order to further spur privatization. Auction's procedure is made simpler and the starting price lower (mid-2002). In the case of tender (beginning of 2003), the weight attributed to price offered is increased while the weights of committed investment and the social programme are decreased.

The number of privatized firms is reviewed in the Table 13.

Table 13

Number of privatized social firms in Serbia

	2002 and 2003	2002	2003	Employment 2002 and 2003
Tenders	30	12	18	27 326
Auctions	801	203	598	68 355
Minority packages	158	48	110	33 930
Total	989	263	726	129 611

Source for this and all other tables in section 3: Privatization Agency Report, December 2003.

The pace of privatization increased in 2003 in terms of numbers of firms. This is mainly due to the sharp increase in number of firms sold through auctions. Amendments to

privatization law related to auctions, mentioned above, triggered this increase. Based on privatization dynamics in 2003, one may expect that the privatization of small and medium enterprises (auctions) and large enterprises (tenders), as a going concern, can be completed through 2004. It is estimated that about two thirds (2000 firms) would be privatized as a going concern, and one third through bankruptcy. The new bankruptcy law, that would facilitate the latter, was drafted but not passed in 2003 due to parliamentary crises.

The number of firms sold as a percentage of those offered indicates the successfulness of the process.

Table 14

Number of firms sold as % of those offered

	2002 and 2003	2002	2003
Tenders	44	52	38
Auctions	91	81	95
Minority packages	54	55	54

The auctions are quite successful and the tenders less so. The latter is due to the fact that the large firms offered through tenders usually need to be restructured, implying labour shedding and additional investments to modernize. Also, the percentage of firms sold through tender decreases over time since less and less attractive firms are offered out of the small pool of viable large enterprises.

Privatization receipts, as explained above, are decisive for financing fiscal deficit without raising the public debt.

Table 15

Privatization receipts

EUR million

	2002 and 2003	2002	2003
Tenders	801	202	599
Auctions	289	60	229
Minority packages	151	84	67
Total	1241	346	895

From the point of view of receipts, tenders are the main driver of privatization as they have accounted for 65% of all privatization receipts. Auctions come second with 18%, with almost all revenue realized in 2003.

The total revenue collected from privatization in the first year (2002) is 346 millions euros, which is 2.2% of GDP. In 2003 the receipts increased 2.5 times, reaching 5% of GDP. This is mainly due to the privatization of two tobacco factories, and hence the share of 5% cannot be sustained over next years.

A buyer, as a part of a deal, also commits to invest agreed amount.

Table 16

Committed investments

EUR million

	2002 and 2003	2002	2003
Tenders	627	306	321
Auctions	62	14	48
Minority packages	6	6	
Total	695	326	369

In 2002 obligations undertaken were 326 millions euros, making 2% of GDP or 17% of fixed investment in 2002. Approximately the same result has been achieved in 2003, despite doubling the value privatized. This is the result of amendments to the privatization law at the beginning of 2003, mentioned above, that changed weights for selecting an offer away from investments and social safety net and towards the price.

The commitments to invest, of course, will be realized in several years to come. According to the privatization law, these commitments are mainly related to tenders. Thus, in so far 0.78 euros of investment is promised for each euro paid for capital in the case of tenders, while only 0.21 euros in the case of auctions.

Finally, there are commitments for social safety net, and they are exclusively related to tenders. The corresponding commitments were 141 and 134 millions euros for 2002 and 2003 respectively. The absolute decrease despite larger volume of privatization is, again, due change in the privatization law, i.e. to the decrease in weight attached to social safety net.

When attempting to sell a large number of firms an issue might be raised whether the price is well below their potential value. Some indication could be obtained by comparing the selling price with the book value of a firm.

Tenders achieve almost 50% higher price than the book value, and so do minority packages. But even auctions, with intentionally low starting price to spur privatization, command prices that are not that below corresponding book values.

Table 17

Selling price over book value of privatized firms

	2002 and 2003	2002	2003
Tenders	1.44	1.47	1.43
Auctions	0.80	0.76	0.81
Minority packages	1.61	2.54	1.10

While assessing privatization indicators given above, one should point out that most of firms offered for sale have had poor economic performances (cf. Arsic, et al., 2003). Thus out of the 700 firms to be privatized through auctions, 77% ran losses in 2001, i.e. before privatization, while the auctions turned out to be relatively successful. It is estimated that firms offered for tenders have even a weaker performance. On the other hand, large fiscal debts through 2001 are taken away from the privatized firms, while the debt is proportionally reimbursed from privatization revenues. Removal of the fiscal debt has obviously improved the performance of enterprises to be sold, hence facilitating their privatization.

Recession in developed economies since 2001 has had negative impact on tender privatization in Serbia. One should also add political instability in Serbia since mid 2001, which, among other things, questioned the privatization concept. Issue that have been raised are that the selling prices are too low so that privatization is in fact give away, then that it will last too long and finally that it will lead to large social inequality. The first two remarks seem to be rejected by the results so far, as reported above. Concerning social inequality facts are yet to be collected. However, evidence from other transition economies does not point to the correlation between privatization method and social inequality. Hungary and Bulgaria opted for the sale, and the former has low inequality while the latter relatively high. Similarly, both Czech Republic and Russia opted for give away privatization, but are recording very different levels of economic inequality.

There is however an important segment of privatization that has been hardly tackled, i.e. restructuring of about 50 large enterprises chosen already in mid 2001. As it stands now, their restructuring and privatization will take another three years (through 2006), and some of them might be privatized through bankruptcy. In the mean time, they are receiving considerable subsidies from the budget. Restructuring of these enterprises is also related to the rehabilitation of the banking sector and in particular the closure of the four large banks. Namely, most of the bad loans of these banks are extended to the enterprises to be restructured.

Privatization of public utilities is yet to come. In 2003 necessary institutional set up started to develop, and non-core activities of these state monopolies began to spin off, e.g. in the

Serbian Electricity Company (EPS). The proper privatization is hoped to take place in the years to come.

Post privatization activities, specifically control of buyers' commitments become increasingly important. In case of auctions the firms could be bought on credit, hence privatization Agency should control the servicing of credits. Also commitments to investments and social programmes, both in case of tenders and auctions, should be overseen by the Agency. Next issue to be closely followed is the fiscal discipline of the newly privatized firms. Before privatization quite a number of them had tax arrears, and there are some early signs, in the case of SMEs (i.e. auctions) that these firms try to run new arrears. It will be a challenge for tax administration to make U-turn in these cases, despite the fact that some of these firms would go bankrupt. One should recall that most of the firms to be auctioned, recorded losses in the preceding year.

Macroeconomic and fiscal effects of the privatization are multifold. Privatization through selling has effects on both internal and external balance. Internally, it is important for covering the budget deficit, and to do it in such a way to keep the public debt under control. As reported above (Table 11), privatization proceeds covered 36% and 64% of the consolidated fiscal deficit in 2002 and 2003 respectively. It is 2.4% of GDP in 2003, and it is hoped that privatization proceeds will be of this order in the next three years, thus covering 2/3 of the consolidated fiscal deficit in the coming years. This would allow a smaller fraction of the deficit, i.e. 1.5% of GDP, to be financed through lending, and then mainly from World Bank, EU etc. with low interest rate. The key implication of above is that the public debt could then be lowered below the benchmark value 60% of GDP in the medium term. Thus it is announced that thanks to privatization proceeds in 2003, government would decrease its debt to the banking sector by 1.5% of GDP.

As explained above in section 1., large current account deficit, of around 10% of GDP, represents the main macroeconomic imbalance of the Serbian economy. In the short-run the major issue is its financing, while in medium-run the deficit should be substantially decreased. Privatization through tenders, by attracting foreign capital, should help in both cases.

Namely, in the short-run it would supply foreign currency proceeds necessary to finance a part of current account deficit. Since foreigners mainly buy large enterprises through tenders, it is estimated that foreign currency inflow, for the capital bought, committed investments and social programmes, will be 2.5 to 3% of GDP in the next few years. Thus 25 to 30% of the current account deficit could be financed out of this inflow.

In the medium-term, the Serbian economy should substantially increase its ability to export. Foreign direct investments in transition countries turned out to be a main net export

generator. Privatization through tenders, together with green field investments, should attract FDI and consequently spur exports.

4 Assessments and further prospects: concluding remarks

4.1 Further prospects: programme announced for 2004

Immediate prospects and some announced plans for 2004 suggest that macroeconomic stability can be sustained and reforms carried on. However this is contingent on political dynamics after December 2003 parliamentary elections. It may well be that either political instability and/or focusing away from economic agenda may emerge, thus stalling or even undermining reforms.

NBS has proclaimed monetary policy for 2004 (National Bank of Serbia, 2004), targeting further decrease in inflation to 7% end of the year, additional increase in foreign currency reserves and exchange rate policy that would also take care of external viability. Non-base inflation would be affected by the planned rise of electricity price and by the effect of introducing VAT, the two being estimated to account approximately the half of the targeted inflation rate. Announced modest increase in money supply should ensure inflation target to be achieved, but also contain aggregate demand and consequently imports. NBS intends to rely more on market-based monetary instruments, as opposed to crude compulsory reserves mechanism.

Fiscal deficit is envisaged to decrease somewhat in 2004, thus additionally checking aggregate demand and hence current account deficit. Wage control in the public sector would also work in the same direction. All above should lead to current account deficit that could be financed.

Envisaged reforms for 2004 are the follow-up of those in previous years, containing mainly the measures that were already envisaged but not accomplished so far.

Tax reform, as mentioned above, predicts introduction of VAT with the standard rate of 20% and the reduced rate of 5%. It will also aim at reducing the tax burden in 2004 by approximately one percent of GDP. Consequently, public expenditure should decrease even more since the deficit is to fall, and its composition would improve. Thus wage bill in public sector will be controlled, subsidies to enterprises reduced somewhat, and capital spending increased. If privatization proceeds again exceed the target, they will be channeled to decrease government debt.

Bank reform should deal with 16 banks where government has large share. They are all announced to be privatized ultimately, and the plan should be adopted in 2004, with some

privatization occurring in this year. The other segment of bank reform is further development of supervision and regulation of financial sector, e.g. enhancing on-site supervision, collecting timely off-site information, etc., and on the regulatory side introducing international auditing standards.

Enterprise restructuring encompasses state owned public utilities and large socially-owned enterprises. As to the former, their wage bills are to be kept constant in real terms, some labour shedding is announced and a number of non-core activities should be spin-off. In order to restructure and privatize about 50 large loss makers, a plan for debt workout scheme has been present for quite sometime, and it is again announced for 2004. Basically, a substantial write-off of their debts to 'state' is envisaged conditional on their privatization. The debts comprise of the fiscal debts, including social security, debts to the four bankrupted social banks, to public utilities and to the government controlled banks. This plan is to be accompanied with a substantial labour shedding. It is ambitiously hoped that some 15 large loss makers will be restructured along the above lines, and privatized in 2004.

Privatization should carry on in 2004, expecting around 500 SMEs to be auctioned, and another 15 large enterprises to be offered for sale through tenders. As noted above, this should complete privatization of socially owned firms as going concerns, while what remains will be privatized through bankruptcy.

Next crucial step towards integration with Europe is the conclusion of a Stability and Association Agreement with the EU. One of the basic preconditions is harmonization of trade tariffs and indirect taxes between Serbia and Montenegro. Most of that was done in mid-2003, but still there are some highly disputable leftovers for 2004. Importantly, in the process of harmonization all import and export quotas were abandoned. Activities on WTO accession are planned to carry on with the first Working Party for Serbia and Montenegro to take place in 2004. A series of bilateral Free Trade Agreements were concluded or initiated with neighboring countries, which are hoped to enhance trade.

Thus the announced plans are in the right direction, but as mentioned above the issue whether they will be politically feasible.

4.2 Some assessments

Macroeconomic policies aimed at achieving economic stability have been by and large successful, resulting in sharp disinflation and sound domestic money.

Fiscal policy kept the budget deficit relatively low compared to starting position (estimated up to 10% of GDP) and comparative experience, i.e. it varied from 1.5 to 3.7% of GDP.

Furthermore apart from the first year, deficit financing did not rely on central bank financing although sharp remonetization of the economy could have allowed it. On the other hand, low deficit has been achieved with relatively high tax burden and public expenditure, which are comparable only with more developed advanced transition economies. It seems that it will take quite some time for sectoral reforms on the expenditure side to be accomplished, and hence public expenditure to be relatively decreased. Only then, the tax burden can be lowered.

Monetary and exchange rate policies have been aimed at quick disinflation. Their task was easy due to the initial position of extreme demonetization and enormous real depreciation of the currency on one hand, and no pressure from the fiscal side on the other. The initial demonetization of the economy allowed for the non-inflationary increase in money supply in the course of stabilization. This increase in money supply has been used mainly to acquire foreign currency reserves, which increased almost ten times thus supporting strongly domestic currency. Exchange rate has been in fact used as nominal anchor, thus containing inflation but at the same time exhibiting enormous real appreciation. Prices were liberalized at the outset of the Programme, while the main adjustments of utility prices have been already put in place.

Accomplished disinflation has been sharp, from 112% end of 2000 to 8% end of 2003, while the core inflation is at most half of the latter. At the same time real exchange rate appreciated almost three times. Thus it may well be that less abrupt disinflation accompanied by substantial lower real appreciation of currency could have been more appropriate. Current exchange rate combined with nominal wage rate does indicate overvaluation of currency.

This assessment is reinforced by the large current account deficit recorded by the Serbian economy in these years. In fact this deficit is the main macroeconomic imbalance of the economy that might threaten economic stability in the medium term.

Medium term sustainability of macroeconomic stabilization crucially depends on the ability of the Serbian economy to generate GDP growth of 3 to 5% annually. In that case fiscal deficit can be kept below 3% of GDP, together with lowering relatively the tax burden and public expenditure. Nevertheless, privatization proceeds will be still vital to finance, decreasing but still existent primary deficit, thus ensuring relative reduction in public debt and making it sustainable.

Current account deficit, pose a more serious threat to medium term stability compared to the fiscal one. Substantial increase in export and steady inflow of FDI are decisive for sustaining medium term external viability.

As to the structural reforms, privatization has been crucial for setting clear property rights that social ownership lacked. Privatization through selling rather than giving away has been the right choice. It has supported fiscal deficit while keeping the public debt under control, and facilitated FDI, both central for medium term sustainability of the Serbian economy. The privatization of the social sector is to be accomplished in four years, which is reasonable period having in mind that laws and institutions were to be put in place, and that selling takes time. However, enterprise restructuring, both of state monopolies and large socially owned loss makers, is still at the very beginning.

Bank reform, was first delayed more than a year. Then a bold measure of closing four largest socially owned banks was undertaken, leading to substantial improvement in banking sector with relatively low fiscal costs. However, privatization of some 16 banks where government has important stakes, although announced in mid-2002, is still on agenda. One should add on the positive side that the domestic payment system, for decades performed by a state agency, was at the beginning of 2003 successfully overtaken by the banking sector.

4.3 Economic growth: achievements and prospects

The prospects for successful accomplishment of reforms hinges on their social viability, while the later ultimately on the sustainable growth of output and employment.

An impact of stabilization and reform on output, wages and employment is shown in Table 18.

Table 18

Output, wages and employment

	2001	2002	2003*
GDP growth	5.5%	4	1
Industry growth	0%	1.8	-3.5
Real wage rate growth	16.5%	29.9	13.3
Rate of unemployment	29%	31	32
Investment/GDP	11%	13	16

*Estimates, NBS (2004)

The achieved results reported in Table 18 are mixed. In spite of recessional effects of implemented reforms, GDP grew at substantial rate in the first two years, of around 4%. Namely, sharp swings in agriculture output, mainly due to climate conditions, pushed the growth rate upwards in 2001 and but lowered it in 2003. Consequently, the growth slow down in 2003 is partly due to the large drop in agriculture output, estimated at 10%, but however also to decrease in industrial output. Thus, it is industry that has been hit by

transitional recession. Its sharp decay estimated for 2003 is somewhat over-exaggerated as the increasing private sector has not been captured properly, and the value added in industry performed better than its reported output due to decreasing share of the loss makers. Real wages increased sharply hand in hand with rise of official unemployment. Wage increase is mainly due to labour shedding in nonviable firms, that had hardly been paying any wages at all, thus lifting the average wage rate in the economy.

Large unemployment is the main structural problem of the Serbian economy, and the major threat to continuation of reforms. Official statistical figures, reported in Table 18, overestimate unemployment since according to labour surveys, which capture temporary employment and gray economy, the rate is around 15%. Even in this range, i.e. 15 to 30%, unemployment is excessive thus asking for considerable medium term growth.

Investment ratio, one of the main determinants of medium term growth, is very low, although there is encouraging improvement in 2003. A benchmark rate, having in mind successful transition economies, should be between 20 and 25% of GDP. Low domestic savings stands behind small investment ratio, and this becomes apart when investment rate is compared with current account deficit (Table 8). Thus in the first two years saving rate varied between 4 and 6% of GDP, and then increases to 8% in 2003.

As noted above, in the first two years of reforms an expected recession was avoided, while in the third year it seems to emerge. This dynamics ask for an explanation and for exploration the prospects for the future growth. Growth in these two years was driven by the large increase in aggregate demand and in particular consumption as by far the largest component of the demand. This is apparent from the large increase of money supply in real terms and in average real wage rate, both of which rose 1.7 times in two years. However the growth of aggregate demand was lower, since considerable part of real money upsurge was due to portfolio shift towards domestic currency, and average real wage raise is partly due to labour shedding. Nevertheless, aggregate demand increased substantially.

The immediate consequence of the aggregate demand surge, combined with outsized real depreciation, was a large current account deficit (cf. Table 8). The most part of the deficit was financed by grants, i.e. 53% in 2001 and 31% in 2002, and this is obviously non-sustainable in medium term.

Large increases in money supply are over. In 2003 money supply hardly increased in real terms and same dynamics is envisaged for 2004. Current account deficit has been put into focus in 2003 and 2004, and containment of aggregate demand and consumption starts to dominate economic policy. Thus the period of growth, driven by aggregate demand, is finished.

The issue is whether supply side response will take over in generating growth, the latter being indispensable for social viability of reforms and medium term economic sustainability.

Extensive econometric evidence do support the positive impact of macroeconomic stabilization and reforms on growth in transition economies (cf. O. Havrylyshyn, I. Izvorski and R. van Rooden, 1998, IMF, WP 141, and Fischer and Sahay, IMF, WP 30, 2000). Thus disinflation, relatively low fiscal deficit and public expenditure, as well as structural reforms enhance the growth. Serbia, reached one digit inflation with good prospect to keep it low, fiscal deficit can be held around 3% of GDP, both stimulating medium term growth. However, public expenditure, being on the high side, might pull in opposite direction. Structural reforms entered in estimation through degree of liberalization, extend of the privatized small and medium enterprises and alike. Both liberalization and particular privatization should foster future growth in Serbia. Thus, what has been achieved and is planned to be, should guarantee some acceptable growth pace.

Investment climate and removing government-imposed barriers are advanced as main growth factors (Stern, 2001). Macroeconomic stability, moderate government wage rates, property rights achieved through privatization, low government bias towards to large firms are by and large now present in Serbia, thus supporting future growth. The contract enforcement and to some extent the tax burden are, however, the weak points that impede growth. Even more threatening for a favourable investment climate and growth is a potential period of political instability and ambiguous attitudes to reforms, which Serbia might face as consequence of the December 2003 parliamentary election's results.

Alternatively, market imperfections inherent in low-income economies, such as the Serbian one, are put forward as obstacle for growth (Rodrik, 2003). These imperfections block investment and entrepreneurship in nontraditional sectors, and hence ask for some policy to propagate these activities. Interestingly enough, a substantial and sustained real depreciation of the currency emerges as a strong stimulus for developing nontraditional activities in a small open economy. Intervention is market friendly while the subsidized sectors are disciplined by external competition. Chile in the 1980s is an example. As shown above, Serbia missed this opportunity to spur the growth in nontraditional sectors by sharply appreciating its currency in real terms. However, the extreme real depreciation of the currency at the start of the stabilization allowed for a more balance policy towards real appreciation, which would both check the inflation and still prevent large real appreciation. Evidence from Slovenia in the 1990s demonstrates that it has been doable.

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