Bojan Marković: Strategic management in overcoming the economic and financial crisis

Speech by Mr Bojan Marković, Vice Governor of the National Bank of Serbia, at the 17th International Scientific Conference on "Strategic management in overcoming the economic and financial crisis", Palić, 20 April 2012.

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Ladies and gentlemen,

Before answering the question which strategy should Serbia follow in order to overcome the economic and financial crisis, allow me to remind you of the message put forward repeatedly by the National Bank of Serbia in recent years – it is better to have low but sustainable, rather than high and unsustainable economic growth rates.

In the decade preceding the crisis we tried to compensate for a substantial decline in economic activity of the 1990s. Between 2001 and 2008 average annual GDP growth rate was 5.4%. But the structure of economic growth, was far from conducive to its stability and sustainability because it implied excessive reliance on consumption and speedy expansion of services, while the production of tradeables, in industry and agriculture in particular, lagged substantially behind. Since most types of fiscal revenues came from sources linked to higher consumption – such as VAT or import tax duties – an apparent and temporary fiscal balance was attained. These sources of growth were also politically popular as rising consumption created an impression of a lasting rise in the living standard. Nevertheless, faster growth in consumption relative to production led to the rising foreign trade deficit, which in 2008 culminated with a record high current account deficit in excess of 20% of GDP. The fragile balance was sustained by privatisation receipts and cross-border borrowing by the private sector, but this was not destined to last long.

The outbreak of the global economic crisis lessened Serbia's capacity to attract foreign capital and made it obvious sooner that the consumption-led growth, is unsustainable. It became clear that Serbia had to adopt a different, sustainable model of growth which implied a shift from imports and consumption towards exports and investment. Such a model should help remove external imbalance, which is one of the two key factors focused by foreign investors, economic analysts, and credit rating agencies when assessing macroeconomic sustainability.

External balance

Since 2009, the current account deficit adjusted sharply. After the record high of 21.6% in 2008, it fell to 7.2% in 2009 and 7.6% of GDP in 2010. Slashing the current account deficit to that extent, required increasing net exports and investment and cutting down real consumption. The largest positive contribution to GDP growth in 2009 and 2010 was indeed that of net exports (9.3 pp and 2.5 pp, respectively), while the contribution of investment in 2011 was 3.5 pp. According to the National Bank of Serbia's estimates, real consumption subsided by 3.4% in 2009 and by 1.8% in 2010. Scaling down real consumption was painful for our households, but at the same time necessary for achieving sustainable economic growth. One of the key measures for reducing consumption was the freeze on pensions and nominal public sector wages in 2009 and 2010. Allow me to remind you that some countries, such as Romania and the Baltic states, had to base their adjustment not on the freeze, but on a significant cut in nominal wages. In Serbia, the process of reducing consumption was aided by the flexible exchange rate, which lowered real wages and other income through nominal depreciation and higher import prices.

Chart 1 **Current Account Deficit and Remittances**
(% share in GDP)

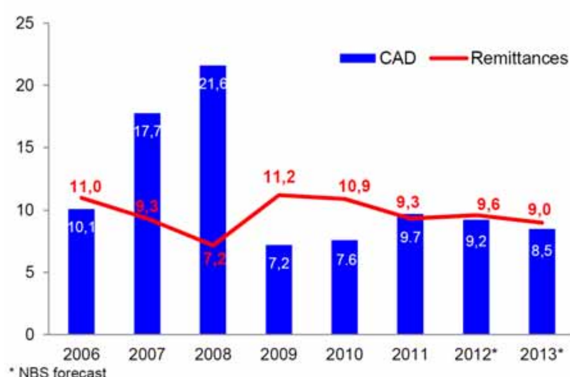
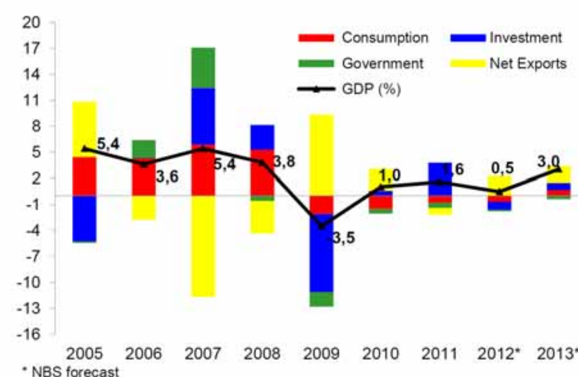


Chart 2 **Contributions to Real GDP Growth**
(in p.p.)



Is every current account deficit a bad signal? Not necessarily. If caused by a temporary growth in imports of equipment and intermediate goods prompted by higher investment in export-oriented industries, a temporary increase in the current account deficit might be desirable. By contrast to a consumption-led deficit, this, let's call it, "good" deficit ensures higher productivity, production and exports, better investment climate, and a stable inflow of foreign direct investment over the medium run. In Serbia, for instance, the current account deficit rose to 9.7% of GDP in 2011, but mostly as a result of increased investment in export-oriented industries, indicated by the 48% growth in imports of equipment that year. According to the National Bank of Serbia's estimates, completion of the investment cycle and the expected growth in exports will lead to a reduction in the share of current account deficit share in GDP as early as of 2012.

In practice, there are three basic mechanisms for eliminating the current account deficit:

1. Structural changes to encourage the tradeables, rather than the services sector.
2. Income- or expenditure-related fiscal policy measures to stimulate production and savings, and discourage consumption.
3. Depreciation of the dinar.

Implementing structural changes to improve the business environment for export-oriented and import-substituting sectors is the best possible way forward that will strengthen medium-term productivity and competitiveness of the Serbian economy and gradually remove the current account deficit. Fiscal policy, may contribute on the side of revenue through tax recomposition, which stimulates production and discourages consumption – for instance, by raising the VAT rate, while at the same time lowering wage taxes. On the side of expenditure, fiscal policy may contribute to the medium-term narrowing of the current account deficit by shifting the budget from transfers and consumption towards investments that target export-oriented and import-substituting sectors.

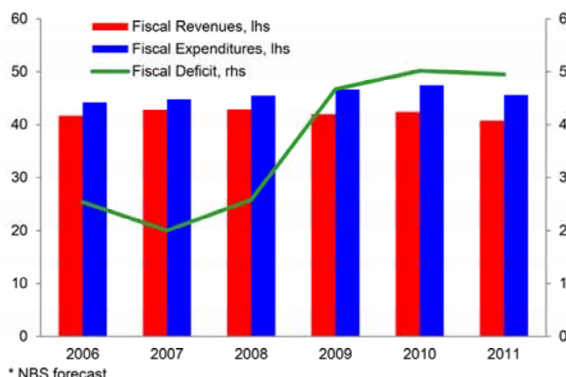
The more effective the use of these two mechanisms, the lesser the need for adjustment through depreciation of the dinar. In fact, I am convinced that efficient structural measures aided by fiscal policy would be more than sufficient to fully eliminate our current account deficit, with no medium-term adjustment of the exchange rate whatsoever.

Fiscal balance

While the composition of fiscal revenues and expenditures represents a potent tool for the reduction of external imbalances in Serbia, the balance between fiscal revenues and expenditures represents another key factor for the assessment of credit rating and the country risk premium. Recent fiscal problems experienced by some eurozone members, which contributed to the second wave of the crisis, have further heightened the significance of fiscal balance and public debt levels in the assessment of macroeconomic sustainability of many economies.

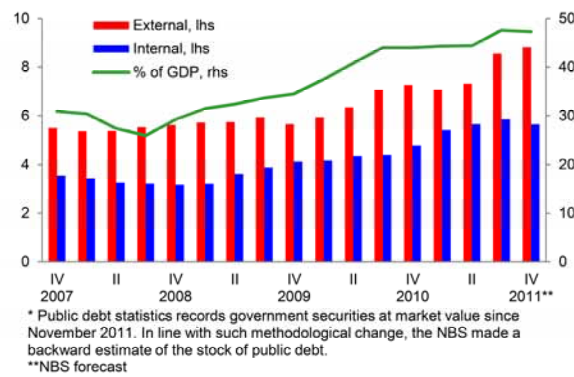
Though the share of public debt in GDP in Serbia is lower than in many other European countries, it has reached the prudent limit of 45% as laid down by the fiscal rule (as defined by the Law on the Budget System) and this created the need for valid fiscal consolidation. Fiscal consolidation may induce a decline in demand in the short run, but has advantages in terms of improving economic activity and growth over the medium run. High fiscal deficit and growing public debt boost the country risk, which increases the cost of borrowing for the Serbian state, corporates, banks and households alike, and discourages the inflow of foreign capital. Together, this results in lower economic growth and lower living standard in the medium and long run.

Chart 3 **Fiscal Revenues, Expenditures and Deficit**
(% share in GDP)



* NBS forecast

Chart 4 **Public Debt***
(EUR bln)



* Public debt statistics records government securities at market value since November 2011. In line with such methodological change, the NBS made a backward estimate of the stock of public debt.
**NBS forecast

Fiscal or monetary stimuli

Fiscal consolidation and implementation of a responsible fiscal policy would create more scope for the counter-cyclical impact of monetary policy, i.e. its capacity to support the economic recovery and contribute to faster recovery at a lower level of real interest rates.

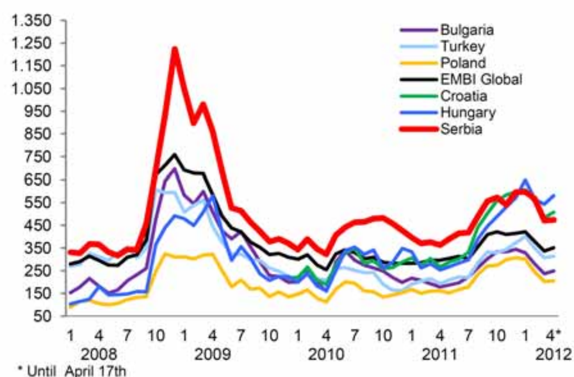
In the initial wave of the crisis many countries, including Serbia, implemented expansionary fiscal policy to stimulate economic activity. But in this phase of the crisis relying on fiscal expansion would be rather risky due to the limited room for its financing and the fact that foreign investors, credit rating agencies and international financial institutions, such as the IMF, are particularly sensitive to high deficits and growing public debts. One should bear in mind that the scope for using fiscal stimuli is rather limited in countries with high levels of foreign debt since increasing public consumption leads to a further increase in foreign debt and higher cost of borrowing. Serbia's foreign debt is already relatively high – almost 80% of GDP and any further increase in fiscal deficit would only lead to its further rise.

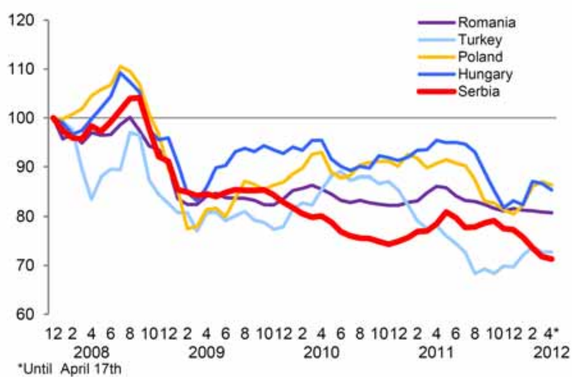
It is probably more opportune in such circumstances to consolidate fiscal policy and thereby open up the room for a more efficient implementation of the monetary policy on the way to recovery.

Allow me to reiterate – fiscal and external imbalances are often connected and, represent the key factors for the assessment of macroeconomic sustainability and the risk premium of any country. Therefore, any valid strategy of recovery, i.e. exit from the economic and fiscal crisis, must take into account the effect of such growth on the external and fiscal balance of the country. Only growth which leads to the achievement and maintenance of external and fiscal balance in the medium and long run is sustainable growth. Only this growth can lead to a sustained decrease in Serbia's risk premium and hence cheaper credits for the Serbian state, corporates, banks and households. And that is precisely why it is better to have low but sustainable rather than high and unsustainable growth rates.

The argument that Serbia should persevere on the path of investment and export-led economic growth and that the key role in its achievement should be played by structural reforms and fiscal consolidation was also suggested by Standard&Poor's in its official statement in March 2011 when Serbia's credit rating was improved from BB- to BB:

> "The increase of Serbia's credit rating reflects the agency's belief that the implementation of economic policy in Serbia has improved and that the country has gained a new momentum when it comes to fiscal consolidation, structural reforms and economic rebalance."





The National Bank of Serbia, on its part, shall continue to strive towards stabilising inflation at a low level and preserving a healthy financial system, which, I am utterly convinced, represents the best way to help the economy in current circumstances and contribute to the creation of an environment conducive to business and investment. The more effective fiscal consolidation and structural changes are, the more easily will the National Bank of Serbia achieve its objectives with less monetary policy restrictiveness.