THE ROLE OF GOVERNEMENT IN OVERCOMING THE EFFECTS OF GLOBAL ECONOMIC CRISIS IN SERBIA – OBSTACLES FROM THE PAST

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Abstract

Economic policy in Serbia as in other countries in the process of economic transition and consolidation of democracy emerges as a source of opportunistic and ideologically motivated political manipulation. This manipulation was primarily by fiscal policy, motivated by opportunistic motives of policymakers. Due to the type of government - coalition governments, which have been present in Serbia since 2000, we can acknowledge the problem of distributional conflict, as a conflict between the coalitions partners concerning the agreement about burdening particular social structures with fiscal stabilization, as well the total cost of reform. Simultaneously, the size and structure of government expenditure was also determined by privatization revenues, which were partly channeled to the state budget. Fiscal manipulation therefore prevented formation of an efficient fiscal system and a transparent budget process which created an additional restriction on the macroeconomic policy in Serbia during the period of the global economic crisis when the need to stimulate economic activity required measures of fiscal stimulus. In such unfavourable circumstances Serbia was hit by the global economic crisis in 2009 and policymakers were not able to significantly use fiscal stimulations due to frequently use of fiscal manipulation in the past.

Key words: *political macro economy, fiscal stimulus, gobal economic crisis.*

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1. Introduction

The "new democracy" countries, whose economies are simultaneously in the process of economic and political transition, Serbia included, experience more significant political business cycles than those with developed democratic system and market economy (Brander and Drazen, 2005). The facts that democratic societies implement those policies that receive public support in elections, and that economic performance affects election results, which politicians in Serbia immediately become aware of, have resulted in attempts to show economic performance in Serbia better than it really is, that is, at least temporarily in the election period, to improve the position of individuals – the voters. The specifics of the economic policy manipulation in political purposes in Serbia are related to extreme political instability that characterized the period of democratic changes 2000`s, which included frequent political elections for different levels of government, unstable coalition governments consisting of parties with different ideological orientations, and therefore with different economic goals, with under-developed democratic system, which since 2003 in Serbia has been designated as a semi-consolidated democracy (Freedom House).

However, the analysis of macroeconomic policy in Serbia shows that the lack of consensus on the allocation of transition costs, as well as the absence of clear transition strategies and models of economic growth that would be implemented, led to the unstructured economic developments, which the government tried to influence during election campaigns, but without significant long-term results. The greatest constraint for political manipulation of economic policy in Serbia was the need to maintain macroeconomic stability, primarily through the goal of maintaining low inflation. In Serbia, due to the experience with very high rates of inflation in the recent past (hyperinflation of 1993), this goal represented not only a prerequisite for economic development and investment, as is the case in all the economies in the world, but also a particularly important goal, given the public preferences, the non-existence of any form of "money illusion" and the permanent presence of inflationary expectations at a mere indication of potential inflation.

Limited by require to maintain price stability, the policymakers in Serbia have not significantly abused monetary policy for political purposes, relying on a single monetary policy objective - low and stable inflation rate. Although this goal was not always successfully implemented, the monetary authorities were aware that in the situation of absence of clear fiscal responsibilities, in an economy characterized by market rigidities and monopolies, such as Serbian economy, a necessary condition for keeping inflation under control was - the acceptance of monetary conservatism (Adam and Billi, 2008). Therefore, political influence in the monetary sphere was primarily concerned with the area of controlling monetary policy, financial and banking system, rather than direct abuse of monetary policy through monetary expansion. The policymakers, thus, focused on fiscal policy, where in the past there had been no clear responsibilities, except those imposed by international financial organizations, such as the IMF.

As in other countries of "new democracy" with the so called political budget cycles resulting from a manipulation with fiscal policy, it is possible to track changes in the level and structure of public expenditure according to the electoral cycle or the pre-election periods in Serbia as well, with discretionary use of privatization revenues for government expenditures. In these circumstances of unfinished economic reforms, constant threats of macroeconomic instability because of fiscal and trade deficits, with the non-restructured economy and incomplete privatization, which had not led to greater economic efficiency, with monopolized markets, high unemployment rate, widespread poverty and wealth of a small number of individuals who participate in the privatization process without checking the origin of their property, Serbia was hit by the effects of the global economic crisis in 2008. The policymakers were faced with the need to respond to the crisis with economic policy, mostly by well-known Keynesian measures to stimulate economic activity. These, countercyclical measures, were primarily related to fiscal policy.

The fiscal policy in the fight against economic recession recommended by the IMF to all the economies whose fiscal systems were able to survive it included a fiscal package of measures that would be sufficiently large, diversified, collective and sustainable, with the aim to use fiscal expansion in all the countries where it was possible to offset the decline in global aggregate demand (Spilimbergo et al., 2008). The fiscal measures to boost aggregate demand and economic activity in Serbia were primarily limited by the need to maintain macroeconomic stability – low and stable inflation rate, not to deepen the trade deficit, not to jeopardize fiscal stability – to maintain control of the government budget deficit, as well as not to endanger the financial stability, which implied debts of the economy and the households.

The constraints of fiscal stimulus in Serbia were significant and implied both the demand for its medium term sustainability, and elimination of risks of high inflation or negative effects on interest rates, personal consumption and level of indebtedness. However, despite these limitations, the suggested fiscal policy level had one common and important feature at the global level: it was the return of *discretionary* fiscal policy, which meant rejection of the rules of firm budget constraints and inevitably opened the door to politically motivated measures of policymakers. In

Serbia, this shift in the direction of discretion had the characteristics of fiscal manipulation causing economic and political consequences, which were not always justified by the global economic crisis.

2. The Effects of Global Economic Crisis on Serbian Economy

Economic recession in the United States officially started in December 2007, although the signs of economic slowdown and financial crisis were noticeable even in the early autumn of 2007. It soon became clear that from the financial sector in which it had occurred, the crisis would spill over into the real sector, affecting European economy both those strong ones and the economies in transition and with emerging markets. In the autumn of 2008, the IMF warned that the global economy had slowed down, and that financial markets were recording quakes that could only be compared with those during the Great Depression of the 1930s.

The policymakers in advanced economies were facing the request to maintain financial stability, prevent the collapse of the financial and banking sectors, to provide additional liquidity, primarily through monetary policy measures, and to restore confidence in the financial and economic systems, as well as to use fiscal measures in their attempt to stimulate economic activity – by encouraging the components of aggregate demand (personal consumption, investments, government spending and net exports). The expansionary monetary policy measures were immediately introduced, and soon even the rate of inflation was no longer a significant threat to the expansive economic policies (inflation rate is a variable that is behind the cycle); on the contrary, they were trying to avoid deflation, so the Federal Reserve preferred low, but positive rate of inflation, as protection against the start of a deflationary spiral.

In transition economies, such as Serbian economy, the tasks facing the policymakers were even more complex. This complexity was primarily related to higher limitations that were imposed on them, the most prominent being the problem of foreign capital inflow into these countries, which was questionable due to the reduction of global liquidity and the developments in financial markets, which policymakers could not affect directly. At the same time, export demand decreased, because of the slowdown in global economy and the reduction of global aggregate demand. Policymakers were able to partially react to this through the depreciation of the exchange rate, although it was limited by the regime of monetary policy which the transition economies had opted for (some of them had directly linked their currencies to euro through a currency board), and the fact that the reduction in global aggregate demand reduces the efficiency of the exchange rate as a means of boosting exports as it is limited by the lack of demand for products in the world market.

The influence of global economic crisis on Serbian economy is observed through two main channels:

- Reduction of capital inflows, including the reduction of direct foreign investments, which has lead to problems of offsetting current account deficit, maintaining a stable exchange rate, limiting the growth of the GDP and the recessionary trends as well as rising inflation;
- Reduction of export demand due to global reduction in demand, given the recession present in most economies, including key export markets for Serbian economy (although the share of exports in Serbian GDP is only 30%).

In the beginning of the crisis spillover, in late 2008, there was also the fear of a possible significant impact of the crisis on the banking sector, due to repeated bankruptcies of financial institutions in the world, which led to short-term effect of withdrawal of savings from the banks in Serbia (in October 2008, around 1 billion euros were withdrawn) as a result of psychological factors. However, there were no significant effects and the banking sector remained stable. All this, combined with the fact that the state guaranteed for the deposits up to a certain amount, resulted in the stabilization of the deposits and the return of savings into banks. The banking sector in Serbia proved to be more stable and resilient to shocks in the crisis than those in the region, primarily because it was excluded from trade in risky securities, the presence of substantial capitalization and significant reserves for less liquid claims.

For Serbian economy and the impact of the global economic crisis on it, the decisive period was the second half of 2008 with the occurrence of a drop in economic activity and a slowdown of economic growth with the strongest effect present in 2009. Namely, in the period between 2001 and 2008, Serbia had annual growth rates by an average of about 5.5%. While this is a high growth rate, still, especially considering the economic lag in the 1990s in Serbia, this rate meant insufficiently dynamic development. The key factor for this growth was the aggregate demand, particularly its component related to domestic demand (Stamenkovic et al., 2009, p. 40). Thus generated growth resulted in internal and external imbalances which were even more evident if we take into account the sectored structure of growth in which the three sectors (trade, transport and telecommunications, financial intermediation), the non-exchangeable goods, contributed to the overall economic growth with up to about 75%.

The economic growth which was not based on a clear strategy of economic development, but was a result of spontaneous developments, did not provide a productive basis for involvement of Serbian economy in the international exchange, and thus the potential increase in essential exports. It still had low export share in gross domestic product (GDP) of only 31% in 2008, which was significantly lower than in the successful transition countries of Central Europe (Slovakia: 78%, Hungary: 81%, Czech Republic: 77%), but it was also among the lower ones among the countries of Southeast Europe, which in general have low share (Bulgaria: 61% Croatia: 42%, FYR Macedonia: 56%, Montenegro: 41%). This is why Serbian economy had a significant problem with the foreign trade imbalance and fiscal deficit even before the global economic crisis.

Small share of agriculture and industry in the GDP and their low growth rates – agriculture (0.3% per year), industry (1.6% per year), did not provide export products. On the contrary, it was because of the rise in domestic demand that the demand for imported commodities increased, current account deficit also increased (from 13 to 17.5% in the period between 2006 and 2008) as well as Serbian foreign debt to 64% in 2008.

At the same time, the inflow of capital caused the appreciation of RSD, which further encouraged imports of goods, investments in non-exchangeable sectors and increase in unit labor costs due to increases in salaries denominated in EUR, especially in the period between 2006 and 2008, which additionally diminished the competitiveness of Serbian economy. Insufficient investment, both from abroad, directed primarily to the financial sector, and domestic, also not directed at exchangeable sectors (significantly lagged behind the growth in total domestic demand) did not provide the basis for stable economic growth.

Bad sectored structure of economy and unfavorable structure of development were accompanied by a significant problem of public finance reflected in the government budget deficit, which was the result of expansionary fiscal policy in the period before the start of the 2006-2008 crisis, which just coincided with a politically motivated manipulation of economic policies and slowdown in economic reforms in Serbia. Consequently, the budget surplus of about 1% of GDP, achieved in 2005, transformed into a deficit of about 2% of GDP, while the structural deficit was as high as 3%. In such adverse conditions Serbia became involved in the global economic crisis, when it could be justifiably presumed that there would be a drop in GDP, which would lead to more budget deficit if fiscal strictness or tax growth measures were not taken. At the same time, it could be assumed that the restrictive fiscal policy would be difficult to implement in times of crisis when there is the inevitable decline in tax revenues due to economic downturn, while it could also be assumed that there would be even greater pressure to increase budgetary expenditures resulting from the need for the state to encourage economic activity, through various forms of stimulation of the economy and consumers, as well as the deterioration of the social status of the population and the inevitable rise in unemployment. Therefore, the forecast said that the budget deficit might have reached even 6-7% of GDP (Arsic and Petrovic, 2009, p. 75).

The strongest impact of the crisis on Serbian economy was recorded in 2009 when, for the first time since the changes in 2000, it recorded the decline of GDP (Table 1). Significant slowdown in economic activity was recorded in the second half of 2008 (Table 2) as a consequence of a decline in aggregate demand in both components - domestic and export demand (Table 3), which can be attributed to the effects of the global economic crisis. Although the fall in export demand was greater, due to greater participation of domestic demand in aggregate demand of about 80%, its reduction influenced the slowdown in economic activity more significantly since the decline in exports (Table 4). It is also possible to notice that in 2009 the fall in aggregate demand was higher than economic activity. Such developments were encouraged by a slowdown in real wages due to their freeze in the public sector and reduced employment in the private sector, the depreciation of the RSD, reduction of the inflow of foreign capital for financing domestic demand, reduction in privatization revenues and reduced lending.

Unfavorable trends were recorded in 2009 in the labor market as well, although these culminated in 2010, given the fact that changes in the amount of employment and unemployment rates lag behind cyclical fluctuations in economic activity. A chronic problem of Serbian economy - high unemployment rate, as expected, became particularly relevant in the time of the global economic crisis. In late 2008 and early 2009 the employment rate began to decline significantly (in April 2009 compared to October 2008 it fell by 2.5%) so that it was 50.8% for the population in active working age. The unemployment rate in the same period rose to 16.4% for the working population. The negative trends continued throughout the 2009 and 2010, when a recovery in economic activity could be noted, but not in employment trends (Table 5).

The effects of the global economic crisis caused a decrease in Serbian trade deficit in 2009, compared to 2008. This, however, was not a result of a turning point in the form of increased exports, but the effect of reducing the total trade between Serbia and other countries during the crisis. Yet, as in the end of 2009, the economic activity recovered, so was the tendency of faster growth of imports relative to exports repeated (approximately 6% versus 4%).

In 2009, the inflation, although high, was not a significant problem, and in the second half of the year it even showed a decreasing tendency. These trends can be linked to the effects of the fall in aggregate demand present in 2009. However, the rate of inflation in the period of slight recovery, recorded in Serbia in 2010, would prove to be an important constraint for economic policy. Its growth would be characterized by both external and internal imbalances present in Serbian economy. In 2010, the inflation rate trends resulted from the economic policy measures taken in order to overcome the effects of the global economic crisis.

Serbian economic development in the period from 2001 was based on consumption, whose growth exceeded the GDP growth, while the funds from privatization and borrowing were also directed to consumption. In the period of global economic crisis, the problem of its debt, originating from a growing trade deficit, financed by borrowings, also become acute. While the debt was accompanied by the growth of foreign exchange reserves, the reduction in external debt in exports of goods and services and the share of external debt in GDP, the indebtedness did not pose a significant problem. However, just before the onset of the global crisis, the share of debt service to exports of goods and services started to increase, which was why an ever increasing share of export revenues was used to pay annuities, thus leaving less space to finance the trade deficit. At the same time, in 2009 the share of debt in the GDP increased to 10% imposing additional restrictions on economic policy, which had to count on additional indebtedness more carefully, which actualized the requirement to balance the production and consumption and to adopt a new growth model that would not be based on consumption.

Table 1: Serbian GDP – year-on-year indexes, 2002-2010 (at constant prices of 2002)

	2003	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*
Total	**102,4**	**109,3**	**105,6**	**105,2**	**106,9**	**105,5**	**96,9**	**101,8**
Taxes minus subsidies	109,5	109,3	110,2	99,8	109,5	103,8	94,3	102,4
Gross value added	101,1	109,4	105,0	106,4	106,5	105,9	97,4	101,6
Agriculture	93,0	119,0	95,1	99,8	92,2	108,6	100,7	98,7
Manufacturing	94,0	108,8	99,9	105,6	104,8	101,2	84,7	102,6
Construction	110,8	103,5	102,0	107,7	110,8	101,5	85,7	88,6
Transport, storage and telecommunications	109,5	115,6	123,4	129,3	120,1	112,5	106,5	107,1
Wholesale and retail trade	111,5	117,0	122,0	110,3	119,9	106,8	91,1	102,0
Financial intermediation	109,0	109,8	111,9	112,2	115,6	113,5	104,3	107,3
Other	101,7	101,3	102,1	100,6	101,5	103,6	101,2	100,1

Source: Statistical Office of Serbia, QM no. 23, 2010

Table 2: Serbian GDP – year-on-year indexes in quarters, 2008 and 2009
(at constant prices of 2002)

	2008				*2009*			
	Q1	*Q2*	*Q3*	*Q4*	*Q1*	*Q2*	*Q3*	*Q4*
Total	**108,5**	**106,0**	**104,9**	**102,8**	**95,7**	**95,5**	**97,8**	**98,3**
Taxes minus subsidies	109,9	104,4	102,1	101,7	92,0	90,4	96,4	97,8
Gross value added	108,3	106,5	105,6	103,2	96,4	96,5	98,1	98,3
Agriculture	109,0	108,3	109,8	109,0	99,9	101,4	100,8	100,6
Manufacturing	104,7	104,6	101,0	95,6	79,3	79,9	86,0	93,0
Construction	104,8	105,7	99,8	96,6	90,0	86,4	83,6	82,7
Transport, storage and telecommunications	118,0	115,7	110,8	108,4	103,8	106,7	107,8	107,4
Wholesale and retail trade	111,6	105,8	107,6	104,3	92,6	90,8	91,7	89,5
Financial intermediation	114,3	110,1	108,9	108,3	105,3	105,3	103,7	103,0
Other	104,6	102,8	103,2	102,1	101,3	101,3	101,7	100,5

Source: Statistical Office of Serbia, QM no. 19, 2009

Table 3: Growth of aggregate demand in Serbia, 2006-2010

	2006	*2007*	*2008*	*2009*	*2010*
Total demand	**109,3**	**110,3**	**107,1**	**91,9**	**104,1**
Domestic demand	106,0	106,9	105,6	94,0	100,9
Export demand	125,1	125,6	113,3	83,3	117,5

Source: QM, no.23 (October-December 2010, p.11)

Table 4: Growth of aggregate demand in Serbia in quarters, 2008 and 2009

	2008				*2009*			
	Q1	*Q2*	*Q3*	*Q4*	*Q1*	*Q2*	*Q3*	*Q4*
Total demand	**109,9**	**112,0**	**107,6**	**101,3**	**93,0**	**87,7**	**89,3**	**97,4**
Domestic demand	107,4	110,4	106,2	101,2	96,8	89,1	91,6	98,4
Export demand	120,4	118,2	113,2	101,6	78,4	81,8	79,8	93,3

Source: QM, no.19 (October-December 2009, p.12)

Table 5: Employment and unemployment rate in Serbia, 2004-2010

	Employment rate age 15-64	*Total number of employed age 15-64*	*Unemployment rate age 15-64*
Oct. 2004	53,4	2.735.977	19,5
Oct. 2005	51,0	2.574.139	21,8
Oct. 2006	49,8	2.516.794	21,6
Oct. 2007	51,5	2.525.570	18,8
Oct. 2008	53,3	2.646.215	14,7
Oct. 2009	50,0	2.450.643	17,4
Oct. 2010	47,1	2.269.565	20,0

Source: Labour Force Survey, Statistical Office of Serbia

3. The Response of Monetary Policy in Serbia to the Global Economic Crisis

In late 2008, the monetary response to the global economic crisis, was related to the attempts of the monetary authorities to restrain sudden depreciation of RSD by restrictive monetary policy and, initially, by raising interest rates. This measure was supposed to have a restrictive effect on inflation, whose trend at the beginning of the crisis spillover of in late 2008 and early 2009, was still worrying, but was stabilized by 2009, only to become actualized again in the recovery period, during 2010, which concurs with the fact that the rate of inflation is a delayed indicator (Table 6). However, since the expected effects of the depreciation of RSD failed, and there were significant effects in the form of an "escape" from RSD into foreign currency, the National Bank of Serbia (NBS) took measures of direct intervention in the foreign exchange market and the implicit targeting of exchange rate, to ensure a controlled depreciation of RSD. The depreciation of RSD had a stimulating effect on economic activity primarily by encouraging exports and restricting imports, but due to the fear of inflation, it insisted on a limited depreciation which implied monetary contraction.

Table 6: Consumer Price Index – cumulative

	2007	*2008*	*2009*	*2010*	*Jan 2011*
Consumer Price Index (cummulative)	11,0	8,6	6,6	10,2	11,2

Source: Statistical Office of Serbia

In addition to preventing a significant depreciation of the exchange rate and its significant fluctuations that would further aggravate the uncertainty regarding future developments causing a deterioration of psychological factors that would have resulted in strong inflation expectations, and also an even greater slowdown in economic activity, the monetary authorities were faced with a problem of reduced liquidity. However, this problem was not primarily solved by the NBS for the well known reasons of inflationary pressures and the inability to depreciate interest rates, but was left to fiscal policy.

The monetary policy taken was restrictive and based on the withdrawal of RSD through the sale of foreign currency, thus causing a decrease in foreign exchange reserves. The monetary policy was not used for countercyclical purposes, but primarily for the maintenance of macroeconomic stability - price stability and to reduce exchange rate fluctuations. Such choice of the monetary authorities was not surprising if we take into account fiscal constraints and other factors related to the previous character of the economic growth in Serbia. The monetary response was largely conditioned by the fiscal imbalance and the inability to address the fiscal imbalances that had existed in Serbia even before the crisis, which had political origins. Therefore, monetary policy remained the guarantor of macroeconomic stability, which led to the conclusion on insufficient coordination between the monetary and fiscal policies, which were implemented to overcome the effects of the global economic crisis.

4. Politically Manipulated Fiscal Policy in Serbia

The global economic crisis has globally reaffirmed countercyclical economic policy whose backbone was a well-known Keynesian concept of aggregate demand, fiscal policy primarily, because of the insufficient efficiency of monetary policy. However, the fiscal stimulus in Serbia, as a way to minimize the effects of the global economic crisis and promoting economic activity, was limited by multiple factors:

- Unfavorable ratio of the amount of public revenue and expenditure in the previous period;
- Reduction of fiscal revenues as a consequence of economic activity;
- Demands for increased fiscal expenditure as a consequence of the global economic crisis;
- Political factors, primarily the factor of political instability, which dictated both the scope and the architecture of government expenditure, in the past, and in time of crisis as well.

The above factors limited the ability to use the effects of fiscal expansion to compensate for the fall in aggregate demand - domestic and export, through increased public sector demand. Nevertheless, the period until the start of the global economic crisis was characterized by exceptionally expansive fiscal policy in Serbia, so that in the period between 2006 and 2008 it acted pro-cyclical. The reasons for this can be found in the extreme political instability that dictated the use of fiscal policy for political purposes, that is fiscal manipulation whose costs were to be charged in the most difficult moment for Serbia – the time of the global economic crisis.

In Serbia, the economic policy, fiscal policy especially, was determined by a significant political instability, which was reflected in:

- Frequent elections at various levels (table 7);
- Differences in economic and even more, in political goals among the participants in the elections – the political parties that can gain power and become policymakers.

As in most other "new democracy" countries and transition economies, Serbia too, was dominated by opportunistic motives of policymakers - to stay in power, and to a much lesser degree, by partisan or ideological motives - the realization of a particular ideology related to the implementation of specific economic goals that would improve the position of a certain segment of the society – the members or supporters of a particular party. The reason for this primarily lay in the indistinct ideological profiles of the parties in Serbia, especially in the area related to economic goals. However, the lack of clear differences in the economic objectives of the political parties in Serbia was compensated by significant differences in their political objectives, particularly prominent in 2008, when, after the latest parliamentary elections there were changes in the political arena and changes in the political goals of some of the important political parties (splitting the largest opposition party and the acceptance of EU goals by the dominant, detached part of the party; political reconciliation and the formation of joint government by key political rivals in the period prior to 05/10/2000).

In addition to the parliamentary elections in Serbia, as many as four in the period between December 2000 and May 2008, frequent presidential elections also contributed to political instability. In the past 11 years, only four years were not pre-electoral or electoral (2001, 2005, 2009 and 2010) which says enough about the extreme political instability and political tensions that accompanied economic reforms in Serbia.

Table 7: Electoral years

Year	*Elections*
2000	Parliamentary
2002	Presidential (failed twice)
2003	Presidential (failed)
2003	Parliamentary
2004	Presidential (successful)
2007	Parliamentary
2008	Presidential
2008	Parliamentary

Macroeconomic instability in the pre-electoral period originates not only from the manipulation of macroeconomic policy, but also from the uncertainty with which economic agents are faced, and which is related to the question of who will win the elections and how they will form a coalition government (Alesina, Roubini and Cohen, 1997). These issues were present during the formation of the past three, out of four governments in total. This slows down economic activity, delays investments, hinders the formation of expectations and discourages foreign investments.

The shifts in fiscal policy precisely coincided with electoral cycles in Serbia in the period before the start of the crisis (parliamentary elections announced in November 2006, Parliamentary elections in January 2007, new government formed in May 2007, Parliamentary elections announced in March 2008, and parliamentary elections in May 2008, new government in July 2008). Expansive fiscal policy in the previous period was related precisely to those elements of fiscal expenditures which prove the hypothesis of political budget cycles. In 2006 the implementation of the *National Investment Plan* (*NIP*) started, which included a growth in public investments, which should have, in the medium term, led to positive results for the production potential of the country, and thus for future budget revenues. These effects, however, did not occur, but evidently there was high current consumption. High domestic aggregate demand exerted considerable pressure on inflation, and the external balance.

During the election periods, there were also significant growths in the so-called discretionary public spending - public investments, subsidies, budget loans and the like. This only proves the claims developed in the models of political budget cycles, according to which the height of public debt is positively correlated with the degree of political polarization between different governments, the length of the mandate of the government and the prospects that the government is not re-elected (Alesina and Tabellini, 1990). This means that the governments in unstable and polarized political systems, such as those in Serbia, are prone to high deficits. Fiscal developments in Serbia prove this (Prascevic, 2009). The indisputable political polarization, not primarily related to economic objectives, but indirectly precisely these objectives were at stake, had led Serbia to a situation where budget deficit was the *strategic variable*, by which the current government affects the future government's fiscal policy, because the manipulation of the current fiscal policy affects the choice of fiscal policy to be implemented by future policymakers, although they may have different party preferences. This means that policymakers fail to fully internalize the current scope of the budget deficit. According to this approach, the deficit in Serbia extended with the following:

- Increase in the degree of polarization;
- Increase in the degree of uncertainty.

The budget deficit was used in Serbia as a strategic variable that affects the election results since deficits affects the structure of financial assets of economic agents, and thus their political preferences. Similar can be said for the overall fiscal policy - both for the revenue, and for the expenditure side of the budget. The period between 2006 and 2008 showed some important phenomena related to expenditures, and revenues, which were rooted in politics:

- A noticeable increase in the salaries in public sector during the electoral year 2006, which continued in 2007, based on the realization of the agreements between the trade unions and the government in pre-election period in 2006;
- Launch of the National Investment Plan in 2006;
- Subsidy programs for enterprises (small, medium and those that were being restructured) in 2006;
- Reduction of income tax and the introduction of non-taxable earnings in 2007;
- Reduction of some tax rates - tax on transfer, VAT for certain products, total exemption from payment of VAT for first time home buyers in 2007.

An especially important segment of possible fiscal manipulation was related to the budget revenues from privatization revenues, which also became one of the sources of financing the budget of the Republic of Serbia with good motives - social and developmental. The Privatization Law provides that the revenues from the sale of companies after settlement of liabilities shall flow into the budget of the Republic of Serbia and be used for social and development purposes:

- State Pension Fund - 10%;
- Restructuring and Development of Serbian economy - 50% (50% for the autonomous province of Vojvodina, if the company is in the territory of Vojvodina);
- Compensation to the persons whose property was nationalized - 5%;
- Financing local infrastructure development - 5%.

In the period from 2002 until the end of 2008, privatization revenues in the budget of the Republic of Serbia amounted to 1,542,007,000 EUR. This amount does not include revenues from sales of assets not made through the Privatization Agency that is from the following: "Mobi

63" - EUR 1.5 billion, six state banks - EUR 780.5 million, the Oil Industry of Serbia (NIS) - EUR 400 million and Insurance Society DDOR – EUR 220 million. In the period of 2005-08, the state had revenues from privatization, bypassing the Privatization Law and the Privatization Agency, of EUR 2.9 billion. Thus, the state had total income of about EUR 4.4 billion over 7 years (2002-2008). In 2009, privatization slowed down significantly, and the income dropped partly due to the impact of the global economic crisis as well. In 2009, the income from privatization amounted to only 82.09 million (compared to 250 million in 2008). At the same time, the number of broken agreements in the privatization process increased, so that in 2009, 78 privatization agreements were broken.

High privatization revenues, particularly from 2005/06 represented a significant financial injection for the budget of the Republic of Serbia, and thus in the policymakers. It is particularly important that the use of these revenues was determined by the discretionary rights of the policymakers, because only the part of that income realized in compliance with the Law on Privatization had a clearly defined purpose, whereas the other part was the subject of the so-called National Investment Plan - NIP (2006-2011), which defined a number of priorities in the areas of infrastructure, regional development, but also in education, health and culture.

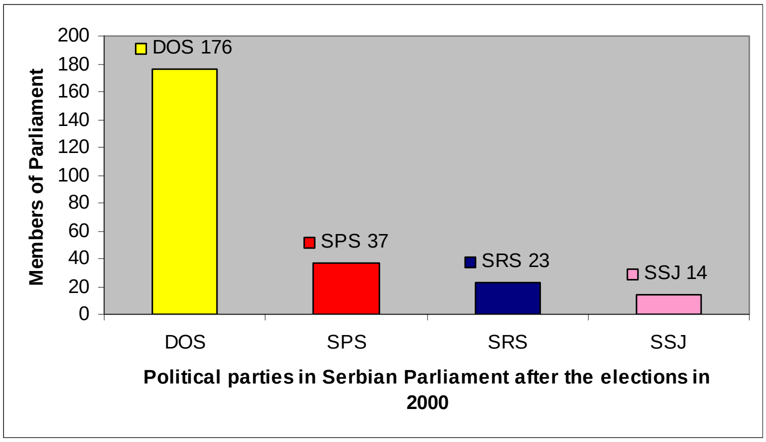
Initially, NIP was announced in April 2006, immediately before the sale "Mobi 63" as a plan that would allow planned state investments in four sectors - education, health, infrastructure and economy. It was announced that the NIP funds, which would amount to EUR 1.5 billion – the amount of the privatization revenues, would be used to renovate schools and hospitals, build highways, bridges (two bridges in Belgrade simultaneously), for gasification and other projects.

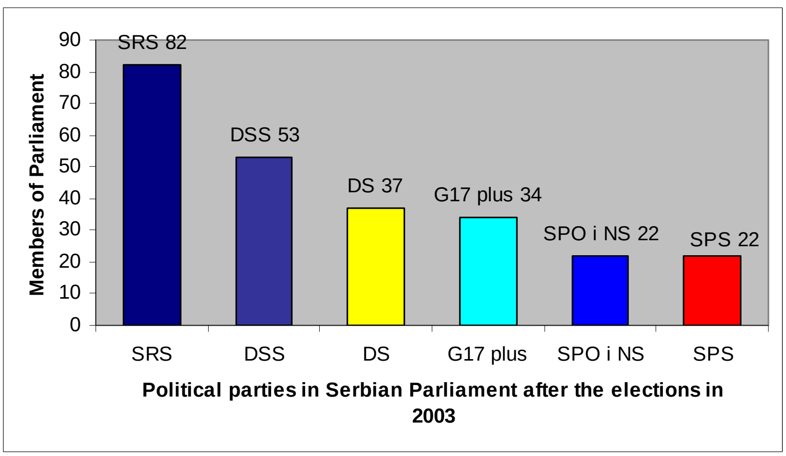
Nevertheless, despite good intentions for the use of funds stemming from the sale of "Mobi 63", the year 2006 recorded significant fiscal expansion, as well as a distinct growth of fiscal expenditures for employees resulting from the growth of salaries in several important sectors (education, culture, military). In December 2006, the expenditures for salaries were 40% higher than the expenditures in December 2005. It was also in 2006 (July) that the second part of the debt to pensioners was paid, subsidizing housing loans continued, and there also were daily bidding with the money from the NIP that was directed to different municipalities and regions in Serbia, for infrastructure projects (paving roads, repairing schools and hospitals, and rehabilitation of cultural and religious sites).

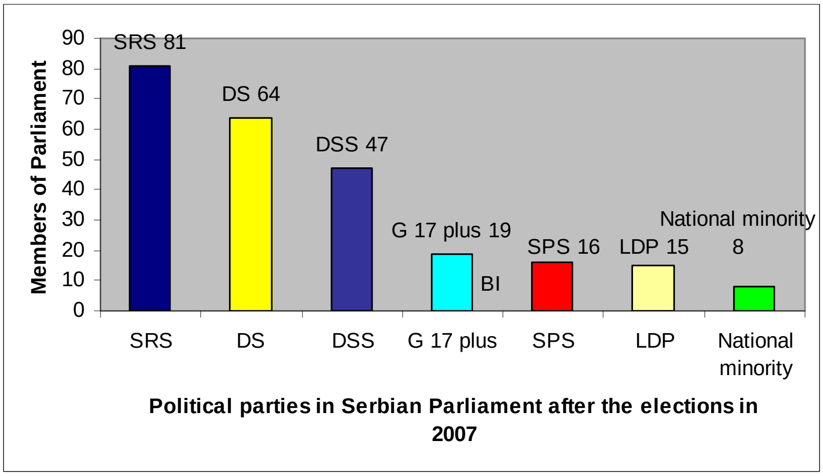
The right question to be asked in the context of political cycles is: what was the important event that happened in 2006? That year was a pre-electoral year for the elections which took place on 21st January 2007, and which were announced on 10th November 2006. It was preceded by the spring frictions within the ruling coalition, whose motive was freezing the talks on the Stabilization and Association Agreement with the EU for political reasons. This freeze happened in May 2006 when it became clear that the coalition would disintegrate and split into the unconditionally pro-European part around the *G17 plus* (the then Minister of Finance) and the part around the *DSS*. Therefore, we can say that the election campaign had been conducted since May 2006. The trends in macroeconomic sizes, as well as in salaries, provide evidence of strong political pre-electoral cycle that had its support in a large financial injection in the form of revenues from the privatization of "Mobi 63".

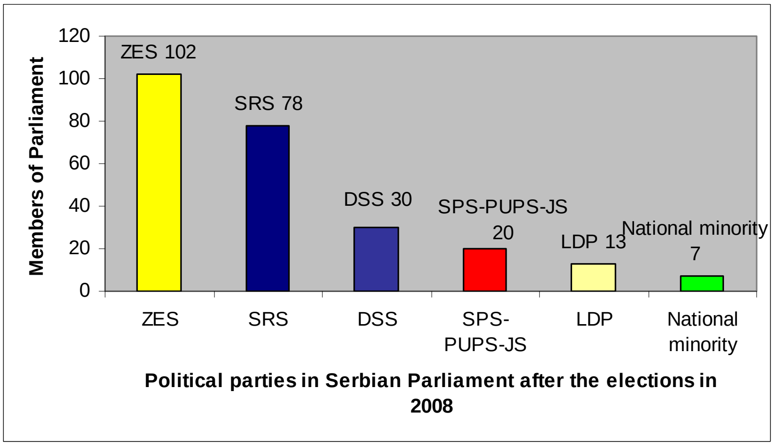
A significant abuse of fiscal policy that was present in the period before the start of the crisis had, in addition to the politically opportunistic motives, its justification in the attempts of the political elite to keep the country on the pro-reform and pro-European course, which became questionable with the reduced support for reforms by the voters, as the election results indicated. These results indicated ever decreasing voters' support for economic reforms, or at least for the main protagonists of these reforms – the political parties that after the political changes in October 2000 emerged as their key drivers. The results of the political elections conducted in Serbia from 2002, at different levels, reflected the ever-decreasing voters' support for the pro-reform and pro-European forces (table 8, figure 1), thus imposing a significant fear of a return to earlier policy. The reasons for such political developments originate to a substantial degree in economics, and are related to the costs imposed to the society by the transition, especially to certain segments of the society, the uneven distribution of these costs, distinctly impoverished segments on one hand, and distinctly rich individuals, on the other hand, along with the majority of the population who felt that their expectations from political and economic changes had been betrayed. These were the reasons why over time the political elite abandoned the most significant reforms, using economic policies, primarily fiscal policy, in order to "purchase" the support of the voters in elections, which can already be seen in the work of the second government (from 2004). So the funds raised were used for spending and temporary purchases of social peace, electoral victories and the like, instead of improving the production structure of the society, raising the competitiveness of Serbian economy in the world market, which would provide a long term basis for economic development, marketing and pro-European political orientation of the country (Prascevic, 2008).

Figure 1: Serbian Parliament after the elections (2000, 2003, 2007, 2008)









Source: Republic Electoral Commission - Election results

Table 8: Serbian governments (2000 - 2011)

Period	*Prime Minister*	*Political Parties in Government (Members of Coalition)*	*Number of months*
25/01/2001 – 03/03/2004	Zoran Đinđić	DOS (until August, 2001)	7
	Zoran Đinđić (until March, 2003)	DOS without DSS	18
	Zoran Živković (from March, 2003)	DOS without DSS	12
03/03/2004 – 16/05/2007	Vojislav Koštunica	DSS, G 17 plus, SPO i NS (manjinska vlada, podrška SPS)	37,5
16/05/2007 – 07/07/2008	Vojislav Koštunica	DS, DSS, G 17 plus	13,5
07/07/2008 –	Mirko Cvetković	ZES, SPS, PUPS i JS	

Source: Jaksic and Prascevic, 2010, pp. 310-311

With this in mind, it was essential that economic reforms be conducted in order to consolidate the democratic system, which includes the construction, implementation and development of specific democratic institutions (Acemoglu and Robinson, 2006). It is well known that the citizens are more pro-democratically oriented than the elite, for one simple reason - democracy provides citizens with much greater benefits than non-democracy. The elite, however, can be encouraged to support undemocratic processes and forces that will increase its economic prosperity.

5. Fiscal Stimulus and Fiscal Manipulation in Overcoming Recession in Serbia

Serbia expected the main impact of the global economic crisis in late 2008 with high government budget deficit of about 2%, with an estimated structural deficit of at least 3% of the GDP. Taking into account the fact that the expectations were that there would be a slowdown and decline in economic activity and thus tax revenues, the forecasts were that without restrictive fiscal policy steps, we could be facing record deficit values of as much as 6-7% of the GDP, which would jeopardize the country's macroeconomic stability. Therefore, instead of fiscal expansion measures recommended in other countries to stimulate economic activities, in Serbia, the policymakers were faced with attempts to reduce the deficit and implement austerity measures which, by definition, result in a recession. In late 2008, an agreement with the IMF fixed the budget deficit for 2009 at 1.5% of the GDP, which was revised in May 2009 due to unfavorable trends in the amount of GDP and fiscal income to 4.5% of the GDP.

However, these fiscal severity measures that were proclaimed and implemented in some areas were preceded by fiscal expansion as one of the first measures of the new government elected in July 2008, which was partly a consequence of the relations of political power on the political scene in Serbia, as well as the relations within the ruling coalition. The new government was elected after the elections held in May 2008, as a "socially responsible government", whose key objectives in addition to joining the EU, were also faster economic growth, reducing unemployment and improving living standards, poverty reduction and equitable distribution of costs of economic reforms and transition.

The composition of the coalition government incorporating parties with different political orientations, and especially with different economic objectives, as well as the coalition agreement on the manner in which the government and the ruling majority would function, how it would manage public enterprises and the like, significantly impeded the implementation of fiscal stabilization.

All three major coalition partners had their share in the requirements for continued fiscal expansion, originating from the campaign promises and party-ideological agenda that determined their behavior to a greater extent than was the case in the past:

- The *Democratic Party (DS)* as the largest party in the government coalition and the backbone of *ZES (ZES - For the European Serbia)* promoted the pro-European course, but it tried to present itself as a center-left party, being a member of the Socialist International, as well as to make a shift from the previously proclaimed economic policy firmly based on liberalism and market, and particularly in relation to the privatization whose negative effects become apparent in late 2008. Apart from that, this party was not only the backbone of the political elite in the country, but also of the economic elite that had certain expectations in terms of state assistance to business and capital owners. On the other hand, the party was in the past the choice of those structures of the society whose economic position improved in the transition process (whose standard of living increased), and these were mostly public sector employees whose salaries had unduly grown in the past and who expected such trends to continue in the future. It turned out that the DS did not want to give up the reduction and elimination of tariffs on imports from the EU, even though these measures resulted in a decrease in customs revenues, which had been estimated at as much as 1.5% of the GDP.

- The coalition *SPS-PUPS-JS* preferred and promised increased social spending and greater social equality, and the first visible demand related to the growth and maintenance of the real level of pensions (a request that they be in the amount of 70% of the average salary in Serbia).
- *G17 plus* insisted on greater government support for economy and the households (by granting subsidized loans), as well as the support for foreign investments, and as was the case with previous governments, in the new government it continued to manage the *National Investment Plan* funds, which was a major source of discretionary spending for by the state. With the program of financial support to the investment FIAT in "Zastava Kragujevac", this party also played a role in creating the budget deficit in 2009. At the same time, it raised the issue of regional economic development, creating the basis for later political profile that proclaimed balanced regional development, now present in the form of a highly populist political movement of the *United Regions of Serbia* (URS), whose backbone is G17.

These characteristics were observed in the significant post-electoral fiscal expansion in the last quarter of 2008, which can only be compared with previous pre-electoral expansions. The budget deficit in the last quarter of 2008 was even 6.5% of the GDP of that period, which in absolute terms about equals to 4/5 of the total deficit achieved in 2008, and the total deficit for the whole of the 2008 amounted to 2% of the GDP. The recessionary economic trends in this period led to a reduction in public revenues. At the same time, there was a decline in real public spending, but slower than the fall in revenues. Within the expenses, the expenditures for salaries of public sector employees continued to increase, while the highest growth was recorded for spending on pensions by as much as 20% compared to the same period in the previous year (due to regular adjustment of pensions, as well as two extraordinary adjustments). The capital expenditures in this period were reduced, partly because of the distinct expansiveness of other elements in order to limit excessive deficit, partly due to lack of a well designed plan of the state to use fiscal policy in order to reduce the recessionary trends.

The government was immediately faced with the need to reduce the realization of some of the campaign promises to a reasonable extent. This primarily related to the commitments on expansion of the "social state". However, there was a manifestation of the problem known in political models of macroeconomics as a *distributional conflict*, which focuses on the conflict of objectives among coalition partners, members of the coalition government, which affect the fiscal policy (Alesina and Drazen, 1991). In such cases, after the initial fiscal shock (which had occurred even before the crisis), there is a delay in fiscal stabilization because the decisions on stabilization depend on the agreement between political parties that form the government, but have different, party motivated preferences in terms of budgetary policy with their consequences on the distribution, so that each of the coalition partners is trying to transfer the burden of the stabilization on the other partner, or that segment of the society that supports them. Stabilization is therefore postponed until one party agrees to accept a disproportionately larger share of the burden of the stabilization. (Alesina and Drazen, 1991, p. 1170). Of course, delaying fiscal stabilization carries additional costs related primarily to an increase in inflation rate to be faced by the economy.

Resolving conflicts between the objectives of fiscal policy in Serbia could be done in the following ways:

- To reduce the extent of political polarization;
- To insist on full implementation of stabilization.

There is a significant political dispersion in Serbia, so that the *index of political power* defined by Roubini and Sachs (Roubini and Sachs, 1989) as a measure of political dispersion is 2 - a coalition government with four or more coalition partners, and only a minority government has a greater dispersal. The way to implement fiscal stabilization in Serbia would imply political consolidation, where one political side would become politically dominant over the other, so that it would shift a part of the stabilization burden on the other. Successful stabilization is often preceded by several unsuccessful attempts for its realization. In terms of economic developments in Serbia, the key cost of the delay in fiscal stabilization would be that of increased inflation, which is why it could be expected that the government would implement measures of fiscal stabilization. One way to solve the problem of the distribution of the burden of the fiscal stabilization, which has been used in Serbia, is to use the help of the IMF. Namely, the IMF programs allow domestic policymakers to pass responsibility and the costs that it brings to external factors, such as the IMF. The IMF demands (to reduce the deficit to 1.5% of the GDP) in this case, were welcomed by the policymakers in Serbia, because these were used to explain to the public the reasons for the abandonment of campaign promises, and to resolve mutual conflicts in the economic objectives between the coalition partners.

During the recession year 2009, fiscal policy recorded significant decrease in fiscal revenues (by 8.7% compared to 2008) and expenditures (3% compared to 2008). The anti-recession measures that the government adopted in early 2009 were supposed to: help the functioning of the financial sector and ensure its safety (ensuring retail deposits up to EUR 50,000, the abolition of tax on interest income and capital gains from trade in securities), to encourage bank lending (interest subsidies for certain loans – consumer loans for buying domestic products and investment loans) and lending to small and medium size enterprises through foreign borrowings. A particularly important role in the states measures belonged to public investments related to intensifying the construction of the road and rail “Corridor 10”, which required investment of minimum EUR 200 million and a maximum of EUR 700 million. The measures taken by the state had positive effects (Arsic, 2008, p. 67). From subsidized loans the banks approved RSD 102.3 billion (RSD 86.6 billion – business, and 15.7 billion – retail), which partly increased the liquidity of real sector, but low liquidity and credit rating of companies remained as one of the key issues. During 2009, there also was a pronounced effect of crowding out as a consequence of the high state budget deficit, on one hand and a large credit risks to the economy, which is why the banks preferred investing in government bonds, not the economy. The greatest reduction in government expenditure was recorded in capital expenditures at a real rate of 53%, indicating significant recessionary trends.

It is important to state that the fiscal deficit in Serbia in 2009 was financed primarily by borrowings, because the sources of privatization revenues had dried up, which led to the growth of public debt for 7% of the GDP, compared to the previous year. An important support to economic policy in 2009 was an arrangement with the IMF, which encompassed the financial support of EUR 2.9 billion. The program stipulated a reduction of public and private sector consumption, since it could no longer count on substantial inflows of foreign capital (in the period 2005-07 the inflow of foreign loans amounted to approximately 3.4 billion per year, foreign direct investments were an average of 2.5 billion per year) (Arsic, 2008, p. 68). Because of the reduction of fiscal revenues derived primarily from a slowdown in economic activity, the Program stipulated freezing public sector salaries and pensions, which remained valid during 2010 as well, and reduced discretionary spending on goods and services, subsidies, loans to all levels of government. At the same time, it should ensure that fiscal policy has no additional recession effects on economic trends in Serbia, which is why it approved a deficit of 4.5% of the GDP.

The arrangement with the IMF had both political and psychological connotations related to blaming the "guilt" for the unpopular measures in terms of reducing public spending and especially freezing wages and pensions on the IMF. Due to the devaluation of the RSD by 20% this freezing meant their real reduction, the same as if we take into account the inflation (in 2006-07 there was a real growth of average earnings by an average of 13% per year, which is two times faster than the GDP growth). The implementation of the program was successful - in 2009, the state recorded a deficit of about 4.1 of the GDP, which was less than the agreed. At the same time, in the last quarter of 2009, certain recovery economic activity was noticeable, which continued in 2010.

In 2010, there was the GDP growth of around 1.8%, which was significantly lower than the rates that had existed before the crisis, but showed a reverse in the trends, providing some hope regarding future economic developments. At the same time, there was a recovery of aggregate demand and a significant growth in export demand which can simply be explained by the fact that salaries and pensions remained frozen, and that the problem of high unemployment rate was still present, which is why it was unrealistic to expect significant growth in domestic demand.

Labor market trends in 2010, however, were not encouraging, partly because the indicators of employment and unemployment are the delayed indicators. This is why in 2010 they continued to record negative trends, which were stabilized in the last quarter of 2010. The unemployment rate of the working population was at a record high level of 20%, while the percentage of unemployed persons aged 15-24 was even 46.1%, and for those between 25 and 34 this percentage was 27.5%. The employment rate of working population is only 47.1%, while we have an increasing the number of the so called discouraged workers. It should also be stated that the number of persons who are losing their jobs does not apply to the public sector, precisely because of the effects of the global economic crisis and negative economic developments in the country, the needed for the public sector reform that will inevitably involve layoffs in the sector and growth of unemployment in this respect has been postponed.

In 2010, salaries increased by 1.2%, in real terms, which gave rise to the growth in the private sector, while those in the public sector declined in real terms because of the freeze in 2010. Average net salary in 2010 decreased and amounted to EUR 332 (compared to EUR 357 in 2008 and EUR 337 in 2009). These figures speak enough of a difficult economic position for most of the population in Serbia in 2010. This position, as well as the whole economic situation was further complicated with a marked increase in prices, so that the inflation in 2010 exceeded the value determined by targeted inflation rate corridor, continuing the upward trend in 2011. Total inflation in 2010 amounted to 10.3% and it was mostly due the rise in the prices of food and agricultural products. At the same time, after a long period of the RSD exchange rate depreciation, in 2010, at the end of the year saw its mild appreciation and stabilization, which contributed to the stabilization of living standards, bringing primarily positive psychological effects.

Fiscal policy in 2010 remained the backbone of the overall economic policy. It continued with the implementation of the arrangements with the IMF, and the total government deficit amounted to about 4.4% of the GDP, which is within the agreed limits. Public debt, however, continued to grow and in late 2010 it was about 41.5% of the GDP. The success of fiscal policy pursued in Serbia was primarily related to the persistence on the reduction of items of current spending, especially on keeping the salaries in the public sector and pensions frozen. However, political factors and the difficult economic situation for a large part of Serbian citizens, as well as the indications that came from the government in the end of 2010, encouraged the expectations of imminent thaw on the salaries and pensions freeze. Such expectations were also fueled by the claims of the policymakers that the country had come out of the recession. Considering the fact that there will parliamentary elections in Serbia not later than in 2012, 2011 is probably the preelectoral, so it can be expected that the abuse of economic policies will be repeated, primarily of the fiscal policy for political purposes, which has often been used in the past. This is particularly obvious from the characteristics of political and economic life in Serbia:

- There is still considerable political dispersion;
- Rise of the popularity of the opposition, which reduces the probability that the ruling parties will stay in power, which may further motivate the use of fiscal manipulation;

- Change in political goals of the most important opposition party, which has increased the chances of it coming into power (the acceptance of pro-European political orientation);
- Very poor economic trends - high unemployment rate and inflation.

The main limitation of such a manipulation could be limited funds at disposal for fiscal manipulation.

6. Conclusion

In the period of the global economic crisis, Serbia had to "pay" for its mistakes from the past, and it could not count on any previously accumulated reserves, while the economic policy was burdened by restrictions imposed not only by the global economic crisis but also by economic policy measures taken in the past, reforms that had not been implemented and inappropriate production structure of the country.

The responsibility of the fiscal elite for the abuse and manipulation was decisive, because it has failed to solve the problem of public support for a broader process of building a democratic society based on individual liberties, liberalism and democratic institutions, and also for the economic reforms that carried economic costs that had to be paid, but not always equally and in proportion to the economic strength of the individuals, which is why the reforms were faced with the opposition from those structures of the society that were called “transitional losers”. This sequence of events led to the conclusion that the democratic process can occur as a limiting factor for the development of a new market system. What also contributed to this were the initially promoted and unsubstantiated glorified effects of the market mechanism in the circumstances of underdeveloped and very rigid markets, so it was necessary to secure public support for the changes that implied temporary deterioration in the relative positions of many individuals. In this framework, the premises of the theory of political macroeconomics that involve abuse of economic policy for political purposes become apparent. The nature of this abuse is primarily political in terms of improving the political position of the policymakers.

Overcoming the effects of the global economics crisis by using fiscal policy in Serbia was limited by previous fiscal expansion and fiscal manipulation which was also politically motivated. In spite of the limitations, fiscal policy was formulated with the aim of overcoming the recession movements and in compliance with the arrangement established with the IMF. The recovery detected in the Serbian economy is very weak, accompanied by an escalation of economic problems reflected in high inflation rate, high unemployment rate, as well as an increasing public dissatisfaction due to the fall in life standard caused by the salaries and pensions freeze. The political motives from the past are still present in Serbia as a background for the fiscal policy choice of the policymakers, which leads us to expect that in the future pre-election period the fiscal policy, will be misused for opportunistic goals - staying in power.

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