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CAN SERBIA AVOID DEBT CRISIS?

Since the beginning of the economic crisis in Europe in 2008 many countries have been confronted with problems concerning public finances. The crisis has led to a drop or stagnation of the national income that was necessary as source of financing state expenditures, which have been higher than usual, due to the very crisis. That is why countries ended up in scissors of lower income and higher state expenditures. During a crisis there is a particular rise of two kinds of expenditures in state budgets – those pertaining to aiding needy population and economic segments. In order to compensate the funds lacking from their budgets, countries usually took on debt. That way, the debt quickly began rising much faster than the national income which, after a while, usually limits or prevents taking on additional debt, thus creating a debt problem[1] in the next step. This is exactly what happened in several European countries.

Stagnant Growth and Fast-Growing Indebtedness

Similar to some other countries, during the last couple of years Serbia, too, has been the scene of increasing debates about the problem of a fast debt growth and the possibility of the country being hit by debt crisis. The possibility of a debt crisis in Serbia is evident in the available data on economic developments, shown in Table 2. Besides the stagnant income, during the last few years Serbia´s performance shows some other negative economic indicators, such as low investment, high unemployment rate, high inflation, high budget deficit and growing deficit in the balance of payment.

[1] Cf. Prokopijević 2011, 2012.

According to most of these indicators, Serbia is either the worst in Europe (budget deficit, inflation) or among the worst-ranked countries.

The fact that income and debt are moving in opposite directions is particularly unfavorable. Serbia's national income at the end of 2013 was smaller than the one in 2008 by around 0.4 percentage points. In that regard, Serbia is somewhere in the middle of the list of Eastern European countries (see Table 1).

Table 1: Real GDP growth 2009-13

Country	**Growth rate**	**Country**	**Growth rate**	**Country**	**Growth rate**
Croatia	-11.4	Czech Repub.	-2.0	Estonia	1.9
Latvia	-5.6	Lithuania	-1.9	Slovakia	5.4
Hungary	-5.5	BiH	-1.2	Macedonia	6.9
Romania	-3.1	***Serbia***	***- 0.4***	Albania	13.9
Bulgaria	-2.1	Montenegro	0.7	Poland	13.9

Source: IMF, Ministry of Finances of the Republic of Serbia.

While the income has stagnated in 2008-13, the public debt has more than doubled in the same period – it grew from 29.2% to 61.4% of the GDP. That is a 110% growth, rendering the movement of income and debt in the case of Serbia one of the least favorable in Eastern Europe.

Table 2: Some basic economic indicators of Serbia 2008-13

	2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014***
GDP, in billion €	33.7	28.9	28.0	31.5	29.6	32.7	34.8
GDP, in billion dinar	2,661	2,720	2,882	3,208	3,348	3,671	4,007
GDP, % of growth	3.8	-3.5	1.0	1.6	-1.5	2.0	1.0
Inflation	8.6	6.6	10.3	7.0	12.2	2.2	5.5
Current account, in % GDP	-21.6	-6.6	-6.7	-9.1	-10.7	-6.0	-
Dir.foreign investments in bil. €	1,824	1,372	860	1,827	232	643	-
Unemployment, %	13.6	16.1	19.2	23.0	23.9	20.1	-
Budget revenue, in bil. dinar	651,3	656,0	712,2	744,8	788,5	812,1	929,9
Budget expenditure, in bil. dinar	702,1	746,5	812,5	877,3	980,5	985,7	1112,3
Budget balance, in bil. dinar	-50.8	-90.5	-100.3	-132.5	-192.0	-173.7	-182.4
Budget balance, in % GDP	-1.9	-3.3	-3.5	-4.1	-5.7	-6.5	-4.5
Interest payment, in bil. dinar	16,3	22,4	34,2	44,8	68,2	94,5	113,9
Public debt, in bil. €	8,8	9,8	12,2	14,5	17,7	20,1	22,7
Public debt, in % GDP	29.2	34.8	44.5	48.2	59.3	61.4	65.2

Source: various statistics of the Ministry of Finances of RS 2009-13. Projection of the 2014 budget, estimate*.

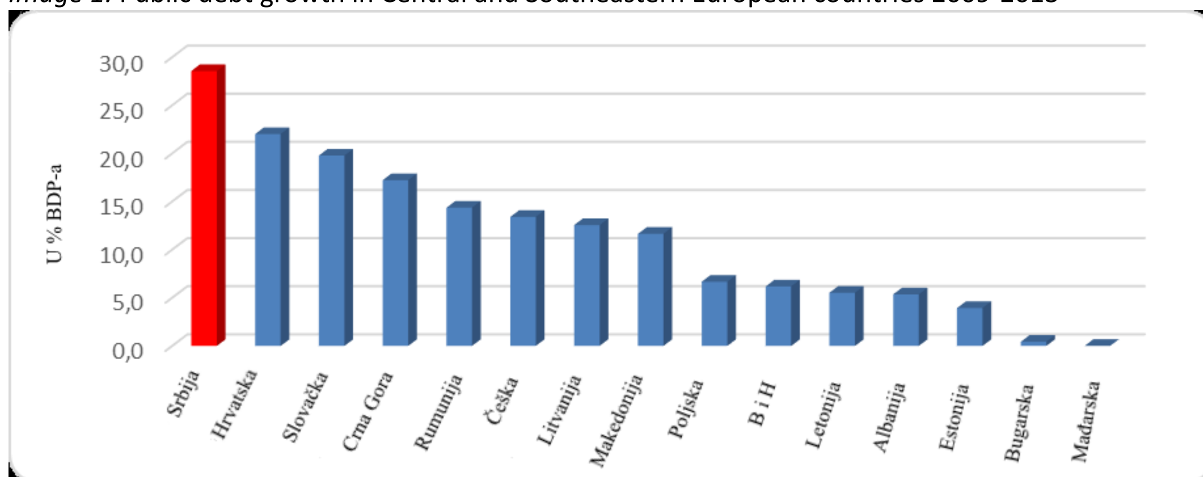
Seen in absolute amounts, the debt has increased even more than as part of the GDP – from 8.8 in 2008 to 20.1 billion euros in 2013 – or 128%. Evidently, the 110% vs.128% difference was caused by the dinar exchange rate. GDP is first calculated in dinars and its growth developed shoulder-to-shoulder with the rise in prices, which increased during the 2008-2013 period by 49 percentage points. The 2013 GDP exceeded the 2008 GDP by 41.3% and the budget grew by 40.3% in the same period. During the same period, the dinar exchange rate dropped only by 29.3% although inflation amounted to 49 percentage points. As a consequence, dinar could have been exchanged for more euros in 2013 than was usually the case. Had the dinar developed parallel to the inflation, in 2013 one euro would not have been worth 114 but 132 dinars. And had the euro exchange rate amounted to 132 dinars, Serbia's GDP in 2013 would not have been 32.7 but 28.5 billion euros. Furthermore, had the 2013 GDP totaled 28.5 billion euros, the share of the public debt in it would have been 70.5%, rather than 61.4%, as was the case (See Table 2). This way, by means of a strong dinar, the share of the public debt in the GDP is decreased which simultaneously points out possible risks. A drop of the dinar value compared to the euro increases the percentage share of the debt in the national income. In other words, the drop of the dinar value increases debt pressure and the possibility of debt crisis.

Serbia is the Country Closest to Debt Crisis in Eastern Europe

Before reaching conclusions on the level of indebtedness of Serbia and the possibility of debt crisis, it is useful to look at some comparative data concerning other countries in the region. It is particularly important to look at 1) speed of debt growth and 2) amount of debt.

Ad 1) According to the analysis by the Fiscal Council of the Republic of Serbia, of all presented Central and Southeastern European countries Serbia is in the worst position when it comes to the pace of the public debt growth during the 2009-13 period, as is illustrated by the image below.

Image 1: Public debt growth in Central and Southeastern European countries 2009-2013



Source: Fiscal Council, p. 62

According to my analysis (column "Growth" in Table 3), Serbia is formally ranked just fifth based on the speed of taking on debt in 2008-2013 (analysis of the Fiscal Council is valid for 2009-13) of all Central and Southeastern European countries, but the ranking is deceptive.

Table 3: Public debt in Central and Southeastern European countries

Country	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**Growth**
Hungary	73.0	79.8	82.2	82.1	79.8	80.2	1.09
Slovenia	22.0	35.2	38.7	47.1	54.4	62.6	2.84
Croatia	-	36.6	44.9	51.6	55.5	61.7	1.68
Serbia	***29.2***	***34.8***	***44.5***	***48.2***	***59.3***	***61.4***	***2.10***
Poland	47.1	50.9	54.9	54.2	55.6	58.0	1.23
Slovakia	27.9	35.6	41.0	43.4	52.4	58.0	2.07
Czech Rep.	28.7	34.6	38.4	41.4	46.2	46.0	1.60
Lithuania	15.5	29.3	37.8	38.3	40.5	39.6	2.55

Romania	13.4	23.6	30.5	34.7	37.9	38.9	2.90
Latvia	19.8	36.9	44.4	41.9	40.6	38.0	1.92
Bulgaria	13.7	14.6	16.2	16.3	18.5	17.3	1.26
Estonia	4.5	7.1	6.7	6.1	9.8	10.0	2.22

Source: Eurostat; Ministry of Finance of RS. Index “Growth” calculated by dividing the debt 2013/2008.

Romania is ranked first with a 2.90 index but its debt is relatively small, as is the case with Estonia where it is negligible. Lithuania is third with a 2.55 index but in the last couple of years its public debt has been stagnate and therefore under control. Only the Slovenian debt is relatively high and quickly growing, which is also the case with Serbia. Accordingly, Serbia is one of two countries in Central and Southeastern Europe with the fastest growing debt. Indebting is not waning in early 2014 and therefore Serbia’s relative position could further worsen. The media reported that in late February 2014 Serbia’s public debt reached 20.4 billion euros, which amounts to 62.9% of the country’s GDP. With this pace, the debt would reach almost 70% of the GDP until the end of 2014 and 78% of the GDP until the end of 2015.

Ad 2) Serbia is one of Central and Southeastern European countries with the highest public debt. As seen in Table 3, it is ranked four according to debt amount (compared with the GDP) out of 12 Central and Southeastern European countries, and comes very close to the third- and second-ranked countries. Thus, one could say that it practically shares second place.

The debt exceeded both the domestic legal limit of 45% and the Maastricht limit of 60% of debt compared with the GDP. Three other Eastern European countries exceeded the Maastricht 60% (Croatia, Hungary, Slovenia). Even though the Serbian law on the limit of indebting had been exceeded three years ago, not only was no one held responsible, but no measures were taken in order to return the debt within the legal framework after a while. Such toying with the law goes to show how irresponsibly it is being perceived in Serbia and how far the country still remains from rule of law.

To conclude, if viewed according to the pace of debt growth and debt amount, Serbia is ranked between first and second among Eastern European countries. The fact that the country with the highest or fastest-growing debt does not necessarily have to be the first who reaches debt crisis is not much of a comfort. Due to circumstances, it could be a country that is ranked worse. Having said that, the risk for the first-ranked country in the list does not diminish, nor does this mean that it will be spared of grim fate. The combination of a stagnant income and fast growth of the debt that is high as it is, only quickens a bad continuation of events.

Further Indebting

At the beginning of the second quarter of 2014 Serbia can still take on debt both on the domestic and international financial market, respectively. But the price of this indebting is very high. One expects Serbia's ten-year bonds on the international market to yield 7.5% annually, which is almost five times higher than equivalent German bonds, twice the amount of Spanish and Italian ones and barely one percentage point less than Greek ten-year bonds[2]. On the domestic market, Serbia's three month to five years bonds, both in dinars and in euros, require extremely high yield – from 4.5% to as much as 14%. We needn't even mention how expensive that is for a country with a stagnate income.

It is impossible to say with certainty how long Serbia could keep on taking on debt like this. The possibility of indebting is facilitated due to relaxed monetary policies by almost all relevant countries in

[2] The fact that on April 10 2014 Greece sold three billion dollars' worth of five-years bonds with a 4,95% interest rate, does not render it credit-worthy again. The markets accepted the Greek covered bond because the market forces were practically suspended in its case by the eurozone leaders' willingness not to let Greece go formally bankrupt. CEP experts also believe that, regardless of the aforementioned sale, „there are neither signs, nor is there hope that Greece could become credit-worthy again in the foreseeable future". Cf. Gerken et al. 2014, p. 3. According to CEP, what Greece lacks the most in order to return independently to the financial market, is economic competitiveness. That is true, but one also needs to bear in mind the debt - currently it amounts to around 180% of the Greek GDP.

the world (especially USA and the eurozone); there is plenty of capital in the market, leaving a possibility of indebting for countries that have long had a so-called non-investment[3] credit rating, as has been the case with Serbia for years. However, the policy of plentiful cheap capital cannot last forever and the return to restrictive monetary policies by USA and the eurozone could lead to higher prices of indebting and thus to non-possibility of taking on debt for many countries.

Besides the rise in cost of capital on the market, other developments may occur which would prevent Serbia from taking on additional debt. For instance, the country could reach a level of indebtedness the creditors would estimate as unsustainable. There is no exact percentage of indebtedness, it is a matter of the creditors' subjective assessment. Or there may be some political changes in Serbia itself, as a result of which the creditors could deem the risk of loans enormous and unprofitable. Or there could be a worsening of international circumstances with unfavorable influence on the global business climate. Any of the abovementioned or their combination can lead either to a great rise in costs of debt service or to lack of possibility for further indebting of Serbia and many other problem-stricken countries. Even though one cannot foresee such things, Serbia, if she retains her hitherto behavior and keeps taking on debt with this pace, could relatively quickly (a year or two maximum) find herself in a situation of formal bankruptcy.[4] In some circumstances, bankruptcy could occur sooner or later. "Sooner" implies the manifestation of some of the aforementioned circumstances. "Later" implies diminishing the pace of indebting, selling of state-owned property (*Telekom*, *EPS*, city-owned land), concluding arrangements with the IMF, receiving bigger loans with low interest rates from co-called friendly regimes, etc. With positive outcomes concerning all of the enlisted sources of financing, Serbia could perhaps avoid

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[3] Non-investment rating is differently marked by various agencies, e.g. *Standard & Poor's* marks it as a BB rating and lower. The credit rating of Serbia in March 2014 was marked by *Standard & Poor's* BB- (BB minus) along with so-called negative prospects.

[4] Cf. Arsić 2013, p. 39 ff.

bankruptcy in the next four or five years. But when the funds from selling property and taking new loans, including ones from the IMF, are exhausted, the country would have to declare bankruptcy since it would have no significant sources of financing of the high deficit of state consumption. This is the case even with the presumption that an economic recovery should occur in Serbia and in Europe in the meantime. Therefore, without a change of behavior, bankruptcy of the state of Serbia is inevitable. The question is only what will be the trigger of such events, when will it occur and in what shape. This conclusion arises based on existing facts and situation and it calls for serious considerations and swift action by the government.

Debt Crisis

When reaching a debt crisis and declaring bankruptcy, a country has several options. It can ignore its international commitments, cease debt service and turn its back not only to creditors but to the world, as well. That has been done by some “ugly regimes”; however it is no option for a country that wants to belong to the developed part of the world.

The second option for the bankrupt country is to launch talks with its creditors on the payment of debt. By doing so, different possibilities can be considered, such as a partial write-off, rescheduling the debt or a part thereof, aid by other countries and the IMF, etc. It is impossible to say in advance which mechanisms and to what extent the negotiations will focus on in the case of a specific country, for it depends on many circumstances.

A country’s bankruptcy basically means its inability to service its debts. However, not every bankruptcy is the same and its specific nature is illustrated by measures which have to be taken in order to resolve

the problem.[5] An easier form of bankruptcy is usually accompanied by closure of commercial banks for a few days, moderate limitations to accessing savings accounts, limitation of foreign payments (both capital and current transactions), decrease of state expenditures (most commonly including salaries and pensions), temporary decrease or cessation of credit activities, currency devaluation, etc. Even this milder form of bankruptcy means a great blow for every economy and society.

Harsher forms of bankruptcy imply longer closure of banks (weeks or months), practically total freezing of savings accounts and the possibility to withdraw only very small amounts or even their defrosting years later or subsequent payment of the "old savings", nationalization of a part of the savings, temporary total freezing of the legal credit market, ban on foreign transfers except in the case of a special permit, rationing of basic supplies, a bigger cut on state expenditures, rise of inflation, price controls and many other very painful measures. The recovery from a harsher bankruptcy can last several years.

How to Avoid Debt Crisis?

Debt crisis and state bankruptcy associated with it introduces major, unpleasant and long-lasting changes to the lives of individuals and institutions and therefore it is better to do whatever can be done in order to avoid it. The classic recommendation for countries threatened by state crisis or those who are already experiencing it is – austerity. Austerity is truly necessary and its goal should be harmonizing state expenditures with incomes. If the crisis is already taking place and bankruptcy has occurred, adjusting the expenditures according to the incomes is mandatory and spontaneous. Simply, there are less funds in the budget, so saving is necessary. If bankruptcy has not yet occurred, austerity measures can usually be more relaxed.

[5] Cf. O Broin 2012.

However, experience and analysis show that saving in and of itself is not sufficient for overcoming a crisis. Some countries that carried out austerity measures in the current crisis (Greece, Cyprus, Spain, Portugal, Bulgaria, Italy, Slovenia…) have avoided formal bankruptcy but have yet to achieve economic recovery, after several years have gone by. This points out that austerity is a necessary but not sufficient condition for the return on the trajectory of growth or prosperity. A good example showing that austerity creates results only if accompanied by structural reforms are the countries that combined those two in their reforms from the 1980s onwards (UK, Chile, New Zealand, Australia, Ireland, Finland, Netherlands, Sweden and Germany). Also, an example confirming the success of the "austerity + reforms" program are Eastern European countries – those who initiated harder reforms after the fall of communism (Baltic countries, Czech Republic and Slovakia) returned faster to the trajectory of growth and the growth was speedier than in countries which performed the so-called "gradual reforms", a different term for slower and inconsistent breakup with the communist past. Finally, when the economic crisis spread from the USA to Europe in 2008, it struck each country but only some of them undertook harsh austerity measures and deeper reforms right away. Estonia, Latvia and Lithuania trimmed state expenditure in the 2009-10 period by 20-25% and similar cuts were applied to pensions and salaries in the state sector. This was followed first by a sharp decrease in the economy but within a year and a half all of them returned to a growth trajectory. These countries today have the highest economic growth rates in Europe. Unlike them, countries that applied austerity without carrying out structural reforms, such as Greece, Spain, Portugal or Italy, are still stagnate or in decline of investment and economic activities, along with high or enormous unemployment rates.

So, in order to bring back economic growth – whether as prevention of crisis or following crisis and bankruptcy – it is necessary that austerity measures are accompanied by structural reforms, as well. If a country has suffered from greater disproportion of production and consumption for a longer period,

such as in the case of Serbia, the disturbance, as a rule, is not momentary but a deep, structural one. In that case, it is not possible to improve without removing those problems and limitations. Structural changes imply an alteration in the rules of the game and a change of behavior.

Of course, reforms can have various forms. They can relate to a reform of the state or the business ambience, they can be general and partial, comprehensive and sectoral, deep or superficial, fast or slow, consistent and inconsistent, etc. It is better if they are faster, more consistent, more comprehensive and deeper. These are more painful and more difficult to carry out but provide better results.

a) State reforms should concentrate on decrease of its costs of operation, increase of administration efficiency, eGovernment, decentralization, combating corruption and rent seeking[6], abolishing unnecessary regulations and services, strengthening of fiscal discipline, functioning of the judiciary and, generally, rule of law. The state and public sector should be small, efficient and have a friendly attitude towards citizens and the business sector.

b) Market reforms can also vary but it is better if they are wider, deeper, more consistent and faster compared with other possibilities. The proposed alterations to four laws[7] in late 2013 by the then minister of economy went in a good direction but they should be completed and placed in a context of much wider changes. They should include strengthening of ownership rights and freedom of contract, liberalization of internal and foreign trade, completion of in-kind based denationalization, market deregulation, especially labor and capital markets, liquidation of bankrupt enterprises in order to free up resources for alternative usage, introduction of

[6] *Rent seeking* means seeking profits outside the market, e.g. by receiving subsidies and other forms of state aid.
[7] These are the Laws on Labor, Privatization and the Deposit Insurance Agency, respectively.

tough budget restrictions, liberalization of capital and current transactions (full convertibility), functionality of commercial courts and arbitration, privatization of a part of the public sector. Of course, there is a need to carry out wider reforms of social insurance, healthcare, education, science, infrastructure...

Both goals could be accomplished by carrying out harsher austerity measures and reforms which would begin in mid-2014. Firstly, bankruptcy of the state of Serbia would be avoided, as well as a hard crisis that would be caused by it. Secondly, the country would reach a trajectory of growth along with relatively high rates. Of course, the exit from the “red zone” would not ensue immediately but only after some time, probably between a year and a half and two and a half years. This transitional period would be very painful but it cannot be avoided. If no steps are taken, bankruptcy of the state would ensue as it is, also followed by changes that would be even more painful and last longer than those in the case of undertaken austerity and reforms. Although austerity and reforms are undoubtedly a better option than awaiting a certain bad fate, there are no guarantees that the better option will prevail. Politicians are afraid to launch a policy of austerity and reforms, since they fear that voters would consider them responsible for the troubles that would temporarily arise. That is why they prefer abandoning themselves to “bad fate”, because there is hope that voters will ascribe the troubles to circumstance (“it happens”, “influence from abroad”) rather than to the politicians in power. When a breakdown of state finances occurs, austerity becomes mandatory, so the policy of austerity is easier to sell to the voters. Of course, only time can show whether the Government of Serbia will face the events or lag after them.

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