Effects of Fiscal Policy on the Maintenance of Macroeconomic Stability in Serbia in the 2001-2007. Period

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This paper presents the research conducted to find out the effects of fiscal policy in Serbia over the 2001-2007 period. A dominantly procyclical fiscal policy had an unfavourable impact upon both external and internal balances. Larger budgetary revenues were followed by equally increased budgetary expenditures, which in terms of inadequately flexible aggregate supply created adverse pressures on the macroeconomic stability maintenance.

1. Introduction

The key effect upon the maintenance of macroeconomic stability during the observed 2001-2007 transition period in Serbia was that of the fiscal policy measures. This research will describe the analysis of the effects of fiscal policy upon the internal and the external balances. The analysis of the level of budgetary balance, the amount of public debt and the fiscal policy effects upon inflation and the foreign exchange rate allows for the identification of the Serbian fiscal policy transmission channels as well as of its impact on the macroeconomic stability.

2. Effects of fiscal policy in the 2001-2007 period

The budgetary deficit was continually reduced during the 2001-2006 period, which had a favourable effect upon the reduction of the level of public debt, of the balance of payments current account[1] deficit reduction and of the inflation rate. We will examine here the effects of fiscal policy upon macroeconomic stability via the analysis of the effects of fiscal policy upon the change in the economic liquidity. A particular problem in identifying the effects of fiscal policy was the result of the different levels of budgetary balance calculated on the basis of different methodologies (the National Bank of Serbia – NBS – methodology, the International Monetary

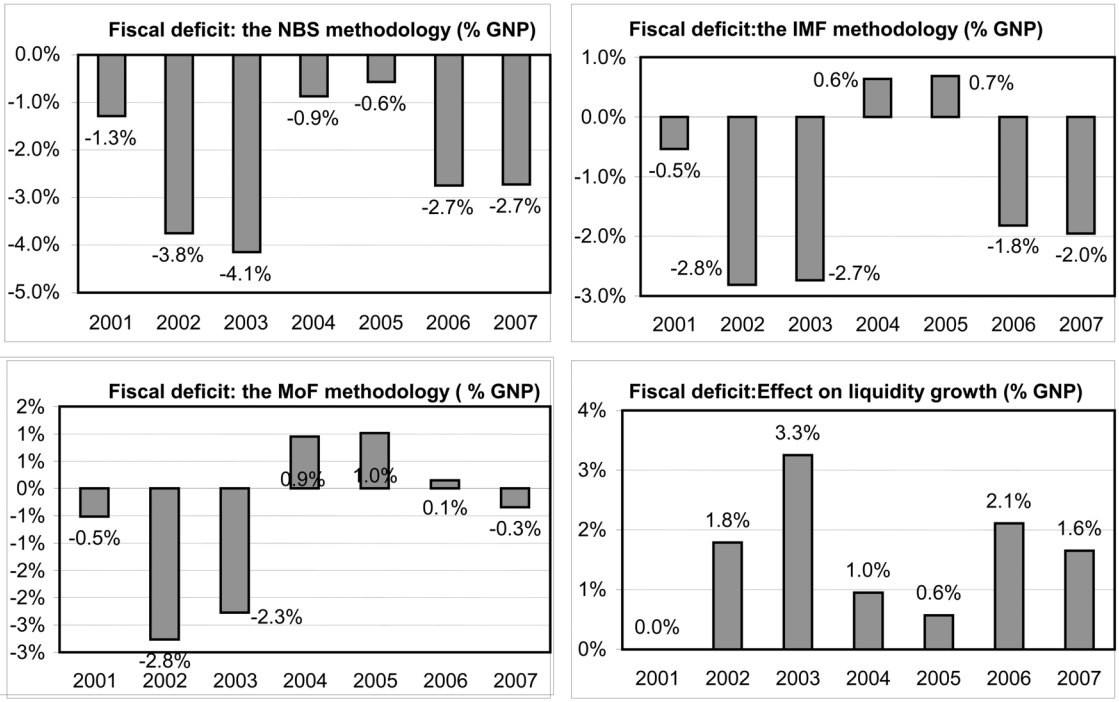

Chart 1. (Dragutinović, 2007)

[1] **The balance of payments current account deteriorated in 2004, however the reduction trend continued in 2005.**

Fund – IMF – methodology, the Ministry of Finance – MoF – methodology) – chart 1[2]

Therefore it is quite possible that, according to one methodology, the budgetary balance may be balanced and even in surplus, whereas according to another, it may show a deficit of 2-3% GNP. The effect of fiscal policy upon the liquidity growth was expansive since 2002; however, the chart shows that the restrictive fiscal policy in 2004 and 2005 resulted in the fall in liquidity, which further resulted into a lower pressure upon aggregate demand. It is for this reason that the measures of fiscal policy produced countercyclical effects.

Since the 2006[3] budget revision the fiscal policy measures have been expansive and procyclic. The expansive quality of the fiscal policy measures is based on the increase in the wages in the public sector and the commencement of the National Investment Plan implementation.

The 2006 budgetary balance (-1.5% GNP) in Serbia is comparable to the average balance in the European Union member countries (EU 27) (www.ec.europa.eu/eurostat) which was -1.6% GNP in 2006. Among the transition countries now the member countries of the EU, the budget surpluce was accumulated only in Bulgaria (3.2% GNP) and in Estonia (3.6% GNP). In the majority of countries the budgetary balance showed a deficit: the Czeck Republic (-2.9% GNP), Hungary (-9.3% GNP), Romania (-1.8% GNP), Slovenia (-1.2% GNP), Slovakia (-3.8%GNP), Latvia (-0.2% GNP), Lithuania (-0.6% GNP), Poland (-3.8% GNP). It is also important to identify the share of both public revenues and public expenditures in the countries that became members of the EU upon the completion of their transition processes.

The share of public expenditures in the GNP of the three observed countries is 35% GNP or lower, which makes the lowest level of public expenditure in the EU: Romania (35% GNP), Lithuania (34% GNP) and Estonia (33% GNP) compared to all the other EU member countries. In as many as 5 EU countries the share of of public expenditure exceeds 50% GNP: Sweden (57.9% GNP), France (53.4% GNP), Hungary (51.9% GNP), Denmark (51.5% GNP), Italy (50.1% GNP). It is only Ireland, one of the EU member countries that did not undergo the transition process, that is comparable with the abovequoted countries, with the public expenditure level of 34% GNP.

The public revenues share in Romania (33.2% GNP), Lithuania (33.4% GNP) and Slovakia (33.9% GNP) is considerably lower compared to the countries with the highest share levels: Sweden (57.9% GNP), Denmark (56.2% GNP) and Finland (52.5% GNP).

The 2006 public revenues in Serbia rose by 0.9% percentage points compared to the year 2005 (from 41.3% GNP to 42.4% GNP), however the amount of public expenditure rose simultaneously by 3.3% percentage points (from 40.6% GNP to 43.9% GNP). The sustainability of the growth in public expenditure is based on the parallel growth of public revenues, predominantly due to a steady growth of the GNP. Although the budgetary deficit of 1.5% GNP is sustainable, the increase in the public revenue and the public expenditure shares in the GNP results in the fiscal policy measures becoming more redistributive. An increased participation of the state in the economic activities generally shrinks the area for an optimal decision making in the private sector. The expansive fiscal policy measures did have an impact upon the maintenance of a high level of public expenditure within the GNP.

In case of Serbia, the study (the World Bank, 2004) analysed two scenarios of economic development. The effects of the first scenario, besed on high fiscal adjustment[4], would provide for a steady economic growth and a 17% higher GNP[5] in comparison to the latter (the public expenditure level and structure remain steady). The Serbian fiscal policy being predominantly cyclic did not produce an unfavourable impact upon the growth of public debt; on the contrary, the share of the public debt in the GNP continually decreased (by the debt repayments made possible due to the high level of inflow in the capital balance and the debt release by the foreign creditors), therefore, measured by the Mastricht criteria, the condition of public finances is absolutely stable. Besides the public debt reduction in an absolute amount, there was an additional factor of continuaous GNP growth, which further reduced the share of public debts in the GNP. The public debt share in the GNP was reduced from 102.2% GNP at the end of 2001 to 29.4% GNP at the end of 2007 (www.mfin.sr.gov.rs).

With the creation of an additional pressure upon the aggregate demand, the expansive nature of the fiscal policy proved to be a further problem to the National Bank of Serbia implementation of the disinflation policy. The

[2] The Ministry of Finance did not apply the internationally comparable GFS methodology used by the IMF.

[3] The fiscal policy measures in Serbia will, due to their effects upon the trends of macroeconomic variables in 2007 and 2008, be based on the data for 2006, which will be supplemented by a comparative analysis of fiscal policies in other countries.

[4] With a faster productivity growth as a result of structural reforms, improvement of exports realization and high external capital inflows .

[5] A steady economic growth projected at the time amounted to 5% annually, therefore the projected effects in case of inclusion of the realized, higher economic growth rates would certainly be higher.

inflation reduction trend in the 2001-2007 period was not steady. The inflation rate was reduced from 40.7% in 2001 to 7.7% in 2003, however, in 2004 it rose to 13.7%, with a further growth to 17.7% in 2005. In 2006 it was again reduced to 6.6%, but in 2007 it rose again to 10.1%. The rise in the public sector earnings, a result of the budget readjustment in 2006 (third quarter) may prove to be a strong pressure towards the rise in the inflation rate in 2007, due to the delay in the functioning of the transmission channel. In the conditions where the inflation trend is affected by the factors which are not related to the fiscal policy implementation (raising the state controlled prices, the trends in the prices of food and fuels on world market, etc.) it is not possible to accurately define the extent to which the implementation of expansive fiscal policy brought forth the rise in the inflation rate. Nevertheless, the impact of the expansive fiscal policy measures increasing the demand for commercial goods certainly create an inflatory pressure.

The impact of the expansive fiscal policy upon the increase in the foreign trade deficit can be determined with more accuracy. According to the IMF study (IMF, 2008), the budgetary balance has an important impact upon the balance of payments current account in Serbia. The ratio between the budgerary balance level change and the current account level is 1:1, which means the budgetary balance fall by 1% GNP results in the fall of the current balance by 1% GNP. Hence a conclusion can be drawn that an expansive fiscal policy affects the national economic operations to a smaller extent, i.e., that the predominant effect of an expansive fiscal policy is the increase in the imports of commercial goods.

A high level of the current account deficit is characteristic of a country in the first years of transition. The reduction in the current account deficit is possible to accomplish using three channels:

1. Accelerated GNP growth;
2. Reduction in investments;
3. Public expenditures reduction.

Regardless of a steady growth of the GNP in Serbia, the GNP current account experiences a growing deficit from 2001 to 2004; the deficit is reduced from 2004 to 2006, while the rise in the current account deficit is again evident in 2007 and 2008. The periods of the current deficit growth coincide with the implementation of the expansive fiscal policy. Having in mind the need for ever more numerous investments in Serbia in the period to come, the only channel to relax the balance of payments current account is the reduction of the amount of public expenditures.

The next transmission channel with an adverse impact on the balance of payments is the foreign exchange rate appreciation. In the observed period in Serbia, the foreign exchange rate appreciation was predominantly the consequence of a high capital inflow, which is characteristic of a large number of transition countries. The capital inflow had a favourable impact upon the Serbian economic growth; on the other side, it created the currency appreciation effect which has a negative impact upon the balance of payments.

The study of the appreciation spiral will be based on two aspects: the impact of the combination of fiscal and of monetary policies measures upon the foreign exchange and the effects of money transfers/remittances from abroad in the conditions of currency appreciation.

In case the maintenence od macroeconomic stability is set as an objective in economy, it can be clearly inferred that the optimal combination is that of restrictive fiscal policy and restrictive monetary policy. The implementation of such a combination of economic policy measures could, however, have an adverse effect upon the economic growth. The optimal combination in a transition country, such as Serbia, will therefore be: one policy measures are expansive, while the other policy measures are restrictive. The fiscal policy in Serbia was predominantly expansive, therefore the monetary policy measures had to be restrictive, in order that the price stability – the basic objective of the monetary policy – should be maintained. It was only in the 2004-2006 period, the period of restrictive fiscal policy, that the monetary policy measures were expansive and that they affected the business cycle trend in Serbia by controlling the money offer. In 2006 and 2007, the fiscal policy measures are expansive, which, aided by the restrictive monetary policy, they additionally created an appreciation pressure.

A considerable portion of Serbia's balance of payments are the money transfers from the Serbian citizens working abroad. These make an additional source of foreign currency that has a favourable effect upon the country's balance of payments and allows that the economy spends more than it produces. The effects of the transfers depend on the structure of the demand for commercial goods formed in the circumstances: in case the demand is larger, the imports will increase, while in case the demand for non-commercial goods rises, the consequence will be the rise in prices. Theoretically, the effects of remittances will be favourable in accordance with the government's willingness to create an economic environment in which productive activities will be financed (Glytsos, 1997); however, the transfers may produce adverse effects if the economy becomes dependent on their continual inflow (Boone, 1995).

In 2007, the total net inflow of current transfers amounted to $ 4,250,000, the major portion being the remittances (www.nbs.org.rs). In the conditions of the exchange rate appreciation in Serbia, the citizens receiving the transfers from abroad are forced to sell large amounts of foreign currency to purchase an adequate quantity of products. The effect of the process is an appreciation spiral creating an additional appreciation pressure in that it increases the offer of foreign currency, thus reducing the potential level of savings. In time, an increasing number of transfers/remittances is used for the purpose of consumption, whereas the savings decrease, which to a certain extent may cause the rise of the interest rate and the fall in investments.

In conclusion, in the observed period it is possible to identify a significant correlation between the public revenues and the public expenditures trends. There is a direct ratio between the increase in the trend of public revenues by a generated value added tax and the trends of two largest groups of public expenditures:

a. expenditures for the employees and
b. subsidies and transfers.

Namely, viewed exclusively from a macroeconomic level, the public expenditures can be seen as increasing in accordance with the trend of the rise in public revenues, hence the rise in public revenues was used to improve the economic position of the employed in the public sector, as well as to facilitate the work of the pension plan.

Essentially, the subsidies, the transfers and the rise in the public sector employees' earnings serve to perform a redistributive role of the fiscal policy. The principal quality of the redistributive role is the increase in the current budgetary expenditure which results into the reduction of the funds otherwise available for capital investments. This reduction of the available capital investment funds endangers the maintenance of economy and a steady economic growth.

4. Conclusion

A predominantly expansive, procyclic fiscal policy in the 2001-2007 period had adverse effects upon the maintemance of macroeconomic policy in Serbia. Therefore, the implementation of the policy of budgetary deficit during the major part of the period failed to generate enough public savings to allow for the optimal countercyclic fiscal policy followings the beginning of the world economic crisis in 2008.

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