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Analytical and Notation Conventions

Values

The data is shown in the currency we believe best reflects relevant economic processes, regardless of the currency in which it is published or is in official use in the cited transactions. For example, the balance of payments is shown in euros as most flows in Serbia's international trade are valued in euros and because this comes closest to the measurement of real flows. Banks' credit activity is also shown in euros as it is thus indexed in the majority of cases, but is shown in dinars in analyses of monetary flows as the aim is to describe the generation of dinar aggregates.

Definitions of Aggregates and Indices

When local use and international conventions differ, we attempt to use international definitions wherever applicable to facilitate comparison.

Flows – In monetary accounts, the original data is stocks. Flows are taken as balance changes between two periods.

New Economy – Enterprises formed through private initiative

Traditional Economy - Enterprises that are/were state-owned or public companies

Y-O-Y Indices – We are more inclined to use this index (growth rate) than is the case in local practice. Comparison with the same period in the previous year informs about the process absorbing the effect of all seasonal variations which occurred over the previous year, especially in the observed seasons, and raises the change measure to the annual level.

Notations

CPI – Consumer Price Index

Cumulative – Refers to incremental changes of an aggregate in several periods within one year, from the beginning of that year.

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

M2 in dinars – In accordance with IMF definition: cash in circulation, sight and time deposits in both dinars and foreign currency. The same as M2 in the accepted methodology in Serbia

M2 – Cash in circulation, sight and time deposits in both dinars and foreign currency (in accordance with the IMF definition; the same as M3 in accepted methodology in Serbia)

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

y-o-y - Index or growth relative to the same period of the previous year

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

MAT – *Macroeconomic Analyses and Trends*, publication of the Belgrade Institute of Economics

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

Q1, Q2, Q4, Q4 – 1st, 2nd, 3rd, and 4th quarters of the year

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

Over the last four years, Serbia has made significant progress towards establishing macroeconomic stability, but despite this growth, the Serbian economy is among the slowest in the region of Central and Eastern Europe. Key reasons for the slow growth don't lie in fiscal or monetary policies, but in bad economic environment i.e. in weak institutions. One of the important causes of the bad economic environment in Serbia is an inefficient state that burdens the economy with high costs and risks, whose services are of low quality and the price of these services, collected through taxes, is relatively high.

EU member states, on average, collect through taxes from citizens and the economy about 45% of GDP and then spend that on financing a number of functions. Serbia, after fiscal consolidation, spends around 42% of GDP, which is above the average of the EU member states from Central and Eastern Europe (CEE), which spend 40% of GDP. Modern states perform numerous and varied functions, some of which exist since the formation of first states, while the others were created during the second half of the 19th and 20th century. Functions such as judiciary, internal and external security, building of infrastructure, and maintaining macroeconomic stability are under the responsibility of states since their formation. Modern states spend less than 10% of GDP, or just over a fifth of their expenditures on these classical functions. For functions that they have began to carry out only since the second half of the 19th century, such as pension insurance, health care, education, the protection of the poor, ecology, fundamental scientific research and other, modern states spend almost 80% of total expenditures.

The state provides important services for citizens and economy, without which there would be no civilized society, nor longer lasting economic and social progress. It is therefore important for the overall functioning and progress of the society how efficiently the state performs its functions. The Efficient State provides legal certainty, social stability, good relations with the world, macroeconomic stability, good infrastructure, educated workforce, encourages innovation, whereby all these activities are financed by moderate taxes. Such a state reduces the costs and risks for the private sector and promotes private activities that are crucial to economic and social progress, such as diligence, honesty, education, savings and investment, innovation, and the like.

Efficiency of the state is measured in such a way that its results are compared to the resources it engages when achieving those results. The state is efficient in performing a function if it achieves a certain result with minimal costs. It is therefore important to question the effectiveness of the Serbian state, how does it affect economic and social progress and what can be done to improve this?

For now, there is no comprehensive analysis of the efficiency of the Serbian state in performing the most important functions. Nevertheless, based on the comparison of placement on ranking lists which assess results of the state in relation to resources used, we can make approximate estimates of efficiency of the Serbian state. On the World Bank ranking list which measures quality of governance Serbia is ranked among the 3-4 weakest countries in Europe. Only three countries from Europe are ranked worse than Serbia on the ranking list of the World Economic Forum according to the quality of institutions, while based on the quality of infrastructure, training of the workforce and the quality of health services Serbia is positioned better, but still below the CEE average. Given that the results of Serbia in the performance of most of the functions are weaker than the average of the CEE countries, and that the share of public spending in GDP is above the average of this group of countries, it can be concluded with a significant level of certainty that Serbia's efficiency is lower than the CEE average. This result was confirmed in one study (Mitrović et al. 2016) on the effectiveness of health services, where the results of health services (infant mortality, mortality of people younger than 64 years of age) were compared with resources used (number of doctors and nurses per 100,000 inhabitants, health care costs per capita). According to this study, Serbia is ranked 15th in the group of 21 countries of Europe and Central Asia, based on the efficiency in providing health services.

The low efficiency of the Serbian state in different fields is confirmed by numerous individual examples. In performing judicial functions, low efficiency is manifested through lengthy and expensive court proceedings. An additional problem is that the outcome of court proceedings is often determined by corruptive activities and political influences, which leads to legal uncertainty. In performing administrative affairs, citizens and businessmen are often faced with lengthy and expensive procedures, and their ending is often conditioned by bribery. The level of gray economy in Serbia has been among the highest in Europe for a long period, indicating the inefficiency of the tax and customs administrations, as well as other state organs such as the judiciary and police. Serbia has been late with construction of key highways for many years now, and similar delays have also been present in the realization of public utility projects. State's inefficiency in infrastructure construction is manifested at all stages, starting with project selection, project documentation, contracting companies, quality control of works, etc. The consequence is that projects that are not objectively considered a priority or which are not economically justified, are being implemented, as well as that the costs of implementing a justified project are larger than it is economically necessary. One of the visible manifestations of ineffective and weak state over a long period of time is the absence of urbanistic order, which for the consequence has a growth in non-planned and wild construction. The state's ineffectiveness is also manifested in the fact that it imposes unnecessarily high costs for its citizens and economy in the form of time spent in carrying out the administrative work and money spent in order to exercise their legal rights.

Inefficient state has a negative impact on economic growth in many ways. Generally, it inefficiently uses funds collected through taxes, which could be more efficiently used in the private sector. The inefficient state provides citizens with judicial, administrative, educational and other services of poor quality, and these services are financed by high taxes. Given that many of the activities the state provides are by nature monopolistic (judicial, administrative, security), citizens and companies do not have the opportunity to avoid paying the low-quality services at high prices, except to turn to gray economy. The inefficient state is one of the important factors supporting a high level of gray economy in Serbia. Inefficiency of the state is, as a rule, associated with pronounced corruption, which causes citizens and the economy to deal with non-productive activities such as lobbying, bargaining, bribing, etc., rather than dealing with productive activities such as education, work, savings, investment and innovation.

Fundamental conditions for establishing an efficient state are not only good laws that are strictly implemented, but also building of a competent, dedicated and fair administration. These fundamental conditions for a more efficient state could be differently presented as a requirement for improvement of institutions. An efficient state implies its departisation, in order for it to be in function of social interest rather than the interest of political parties.

The second measure to improve the country's efficiency is to reduce public spending to around 40% of GDP, while keeping the fiscal deficit at a low level. If Serbia could succeed in reducing the level of public spending to 40% of GDP, while maintaining or even increasing the quality of public services, it would mean a direct increase of the efficiency of the state. The state could further boost the economy if the reduction in consumption is followed by a reduction in labor taxes, due to the negative impact of these taxes on economic activity.

In addition to general reforms, increasing the country's efficiency requires reforms in specific areas. The example in investments illustrates which decision-making procedure should be used in order to diminish the unnecessary waste of taxpayers' funds. The decision on the realization of a particular project in democratic societies is based on a detailed analysis of economic and social justification, rather than the influence of privileged interest groups or the subjective assessment of politicians as to whether a particular project is justified. For each proposed investment, government representatives should present a detailed study on justification of its realization to the public. A justification study should, for example, prove that it is more economically beneficial for the state to finance the construction of a national stadium than to modernize one of the existing stadiums or build a new national stadium together with first league teams from Belgrade. Similarly, the state should demonstrate that the suggested routes of the Belgrade metro are optimal in relation to alternative solutions or that it is economically justified to build a ski resort at Avala Mountain, which is about 500 meters high. Professional debates should check whether the assumptions and projections that justify the realization of a project are realistic or pre-ordered in order to confirm the previously made political decision. Even if construction of a national stadium is justified, under the conditions of a limited budget, it is necessary to decide whether it is more important to build a national stadium or, for example, a wastewater treatment system or to build or renovate a number of kindergartens and student homes. The fundamental assessment of the justification for the realization of a particular project and choosing of the best way to realize it are only the first steps leading to the efficient realization of the project. After these steps, it is necessary to organize fair tenders for making of project documentation and choosing the project contractor, and then select an independent expert supervision and provide the most favorable financing method. Only if these conditions are cumulatively provided can it be expected that public projects would be carried out efficiently, and this means in the best interest of the society.

In this issue of the Quarterly Monitor, apart from regular research devoted to macroeconomic trends and economic policy, there is a Highlights section text by Milutin Živanović, which analyses the profitability of the Serbian economy in the last few years.

TRENDS

1. Review

The main characteristics of economic trends in Serbia at the beginning of 2019 are a strong slowdown in economic activity growth and solid result in the area of macroeconomic stability. In the first quarter, Serbia's GDP grew by only 2.5%, which is the lowest growth recorded in all 11 Central and Eastern European countries (CEEs) - the EU members. In the coming months we expect acceleration of GDP growth, so we estimate that this year will achieve a growth of about 3%. Improvements in the labor market continued in the first quarter - employment rate and wages grew, while unemployment rate declined. However, labor market improvements partly exceed economic possibilities, because for a longer period of time it is not sustainable that aggregate growth of wages and employment are faster than the growth of production. At the beginning of the year, the growth of foreign trade and current account deficits continued, as well as the strong inflow of foreign capital. Serbia's current account deficit has been worsening for more than two years, indicating that it is the result of systemic factors such as the economically unfounded strengthening of dinar, faster growth of domestic demand than the GDP growth, and the growth of unit labor costs. In this year we expect that due to the pressures of the mentioned systemic factors, the deficit of the current account of the balance of payments will amount to 5.5%-6% of GDP. Inflation accelerated in the first quarter, but we estimate that this is mainly the result of seasonal and other temporary factors, while the increase in core inflation is still very mild. Therefore, we estimate that this year's inflation will be between 2.5% and 3%. The results of fiscal policy at the beginning of 2019 are generally good - in the first quarter a surplus of 0.9% of GDP was achieved, while public debt growth was temporary. By the end of this year with unchanged fiscal policy we expect a fiscal surplus of about 0.5% of GDP. However, given the slow growth of the economy, the fiscal surplus policy is assessed as inadequate. The monetary policy outcomes are also generally good, interest rates are low and relatively stable, the percentage of bad loans continues to decline. Nevertheless, monetary policy continues to support an economically unfounded strong dinar exchange rate.

The slowdown in economic activity, which began in the middle of the previous year, was enhanced in the first quarter of 2019. Serbia achieved GDP growth of only 2.5% in the first quarter, which is the lowest growth rate among the CEE countries (see section 2 "Economic Activity"). CEE countries, including neighboring countries (Croatia 3.9%, Northern Macedonia 4.1%, Bulgaria 4.8%, Romania 5%, Hungary 5.3%), experienced strong growth in the first quarter of this year, indicating that general international circumstances were favorable. Industrial production has contributed the most to the slowdown of GDP growth in Serbia, falling by 1.5% in the first quarter, which is contrary to the industrial production growth in the CEE countries of 3.2% on average.

The low GDP growth rate in the first quarter is the aggregate result of the already existing slow growth trend and a series of unfavorable extraordinary circumstances. There has been a low growth trend in Serbia for several years now and it is a consequence of the unfavorable economic environment for the majority of domestic companies, but also of the economic policy which weakens the market competitiveness of the Serbian economy (strong dinar exchange rate, unit labor costs growth, etc.). The special benefits that the state has created for foreign investors and privileged domestic companies are not sufficient to generate a strong growth of the economy. For a strong growth of the economy it is necessary to create equal and good conditions for all companies and entrepreneurs, not just for the privileged ones. The unfavorable extraordinary circumstances that slowed down the growth of Serbia's economy in the first quarter are the result of temporary internal problems (EPS cutbacks, NIS overhaul), which are not expected to adversely affect the economy in the coming quarters. The long-term decline in the production of the company FIAT Serbia affects the slowdown in economy and this negative impact will, on the basis of the announcements from the company, be present throughout this year. The introduction of prohibitive taxes on exports to Kosovo and Metohia had the negative impact on the slowdown of Serbia's economy as well, but the magnitude of this impact cannot be estimated because it is unknown how many products are delivered through illegal channels or through other countries. The introduction of quota on steel exports to the EU for the time being did not significantly affect production decline, but prevented the realization of Hestil Serbia's plans to increase production in this year. In the coming quarters, we expect the recovery of economic activity in Serbia, as the effects of some unfavorable factors (EPS, NIS) will be excluded, so at the level of the year we expect GDP growth of about 3%, which is likely to be one of the lowest rates of growth in the CEE region.

The deterioration of the foreign and current account of the balance of payments, which began in 2017, continued in the first quarter of 2019. Foreign trade deficit amounted to 10.8% of GDP, which is by 1.4 percentage points higher than in the same quarter of the previous year, while the current account deficit amounted to 9.2% of GDP, which is by 1.8 percentage points above the last year's value (see section 4. "Balance of Payments and Foreign Trade"). In the first quarter, a strong influx of foreign capital continued - the net inflow amounted to nearly 850 million euros, while foreign direct investments amounted close to 800 million euros. The unfavorable trends in foreign trade, which last for more than two years, triggered by the strengthening of the dinar and the excessive growth of domestic demand, were further boosted at the beginning of this year by the growth of unit labor costs, the introduction of prohibitive taxes on exports of products to Kosovo and Metohia, the introduction of quotas for steel exports to the EU and worsening of the terms of trade. The growth of the foreign trade deficit and current account deficit is not necessary a consequence of the growth of the economy, as most CEE countries, whose growth has significantly exceeded Serbian, have experienced a surplus in the current account or a very low deficit during the previous years (see section 4). On the basis of the results achieved and the announced economic policy, we estimate that the current account deficit will be higher this year than in the previous one and amount to 5.5%-6% of GDP. Possible additional increase in domestic demand in the election year or strengthening of the dinar would impact the additional increase in the current account deficit. We also expect a high inflow of foreign capital, as a result of the delay in increase of the ECB and FED interest rates, but also the result of continued policy of granting special benefits to foreign investors.

In the first quarter, the improvement of all labor market indicators in Serbia continued - employment rates and growth rates rose, unemployment decreased, while real earnings increased significantly (see section 3 "Labor Market"). The employment rate reached 47.4%, which is by 2.4 percentage points more than in the same period last year, while the rate of activity reached 53.9%, which is 1 percentage point more than a year ago. The unemployment rate was 12.1% and was lower by 2.7 percentage points than in the first quarter of the previous year. Although the labor market situation in Serbia has improved, it is still significantly worse than in other CIE countries, where the average employment rate is 55.1%, while the average unemployment rate is 5.1%. Real earnings increased by 6.9% in the first quarter, while earnings in Euro increased by 9.7% in really terms. The improvement of the labor market situation in Serbia over the past 2-3 years is a result of the relatively modest growth of the economy, the large labor migration in the EU, but also the economic policies characterized by high growth of minimum wage and salaries in the public sector. Significantly faster growth in earnings than productivity growth directly affects the growth of unit labor costs and fall in price competitiveness of the Serbian economy, which has the consequence of a long-term unsustainable rise in external deficits. Strong growth in economic activity and productivity is the only long-term sustainable source of earnings growth. The growth of average and minimum earnings should be the result of economic growth, not its driver.

Inflation amounted cumulatively by 2.3% in the first four months of the year and reached 3% y-o-y in April. However, in May, deflation by -0.3% was recorded, so year-on-year inflation fell to 2.2%. Significant inflation acceleration in the first four months is a result of mild growth in core inflation and significant seasonal rise in the price of a number of food and energy products (see section 5 "Prices and Foreign Exchange Rate"), and similar trends were achieved in other CEE countries. Inflation growth was affected by a faster growth in domestic demand than the GDP and unit labor cost growth, while strengthening of the dinar had an impact on the slowdown in inflation. We estimate that core inflation in this year will be between 1.5%-2% while total inflation will be between 2.5%-3%. In the first five months of 2019, the dinar slightly nominally strengthened against the euro (0.2%), with its value stable over the whole period. At the same time, the nominal value of CEE countries' currencies declined by 0.6% on average, although their economies grew faster, while their external position was considerably better. In the first four months of this year, the dinar strengthened by 1.5% against the euro in real terms, so the cumulative real growth since the end of 2016 has amounted to 7.5%. The long-term sustainable real value of the dinar should be in line with Serbia's production, productivity and foreign trade position, rather than its value is formed to allow temporary, unsustainable in long-term, growth of consumption and standard of citizens.

In the previous part of the year, relatively good results were achieved in the area of fiscal policy. In the first quarter, the fiscal surplus was 0.9% of GDP, with 8.3% higher public revenues compared to the same period of the last year, while public expenditures increased by 6.8%. In the same period, public debt temporarily increased by 380 million euros (see section 6 "Fiscal Flows and Policies"). All types of public revenues, except for excise revenues, recorded a solid real growth. The faster growth of tax revenues than GDP growth is a consequence of the high growth of the most important tax bases, consumption and wages, while keeping the gray economy at almost unchanged level (see section 6). The fastest growth within public expenditures was achieved by public investments (22.2%), but for now it is unknown how much of this growth was invested in infrastructure, and how much was invested in weapons and equipment for the military and police. Expenditures for public sector employees and pensions increased in real terms in the first quarter by 4.3% and 6.6% respectively, which means that they will grow significantly faster, not only than the GDP growth in the first quarter, but also than the expected GDP growth in all 12 months of 2019. On the basis of the existing trends and unchanged fiscal policy, we estimate that Serbia could achieve a fiscal surplus of about 0.5% of GDP in this year and that the public debt at the end of the year could be around 50% of GDP. Achieving fiscal surplus in a country with slow economic growth and declining public debt is not an optimal fiscal policy. In the circumstances in which Serbia currently is, we estimate that it would be optimal to realize a fiscal deficit of 0.5-1% of GDP, which means that there is a fiscal space of about 1% of GDP in order to increase fiscal policy expansion, i.e. to increase some expenditures and tax reductions. From the point of view of the faster growth of the economy and standard of citizens in the long run, it would be best to use the existing fiscal space to reduce the fiscal burden on labor and increase public investments in national and municipal infrastructure.

In the first quarter the key policy rate remained the same, while the NBS strongly intervened in the foreign exchange market to maintain a nominal exchange rate on a nearly fixed level. Keeping the key policy rate at the level of 3% is expected and justified, as the acceleration of inflation in the first quarter was the result of temporary factors, and the core inflation only reached the lower level of the target corridor (see section 7 "Monetary Flows and Policy"). Due to the growth of external deficits, we estimate that the NBS interventions on the foreign exchange market should be asymmetrical, i.e. that NBS should not prevent a moderate weakening of the dinar but should prevent its strengthening. Strong growth of bank loans to households continued in the first quarter, by EUR 174 million. Bank loans to companies, including cross-border loans, and taking into account loan write-offs, increased by 218 million euros, which is a good result if you consider that credit activity in the first quarter is seasonally low. The growth of corporate lending is one of the signs of a certain acceleration of the growth of the economy in the coming period. The unexpected growth of inflation reduced the ex-post real interest rates on dinar loans, while interest rates on indexed loans rose slightly. We expect that with stabilization of inflation there will be a moderate growth of real interest rates on dinar loans, while interest rates on indexed loans will remain at the current low level due to a late growth of ECB and FED interest rates.

Serbia: Selected Macroeconomic Indicators, 2010 - 2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018				2019
										Q1	Q2	Q3	Q4	Q1
Economic Growth														
GDP (in billions of dinars)	3,250.6	3,612.3	3,810.1	4,121.2	4,160.5	4,312.0	4,521.3	4,754.4	5,059.7	…	…	…	…	…
GDP	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2	4.3	4.8	4.9	3.8	3.4	2.5
Non-agricultural GVA	1.1	2.2	0.8	2.5	-2.2	2.3	3.4	3.3	3.6	4.7	4.5	2.8	2.4	2.7
Industrial production	2.5	2.2	-2.9	5.5	-6.5	8.2	4.7	3.5	1.3	6.1	2.1	-1.5	-0.9	-1.9
Manufacturing	3.9	-0.4	-1.8	4.8	-1.4	5.3	5.3	6.4	2	5.0	1.9	1.0	0.5	-1.9
Average net wage (per month, in dinars)[2]	34,159	37,976	41,377	43,932	44,530	44,437	46,087	47,888	49,643	49089	49573	48965	50943	53739
Registered Employment (in millions)	1.805	1,866	1,865	1,864	1,845	1,990	1989	2,061	2,131	2092	2127	2147	2159	2148
Fiscal data														
Public Revenues	-1.5	-4.6	0.6	-3.0	3.2	3.1	7.5	4.0	4.6	3.6	2.7	5.4	6.5	8.3
Public Expenditures	-1.7	3.3	3.6	-5.7	5.2	-3.2	1.9	-1.7	5.8	5.6	3.7	9.5	4.9	6.8
Overall fiscal balance (GFS definition)[3]	-136.4	-158.2	-217.4	-178.7	-258.1	-149.1	-57.1	52.3	32.2	3.7	30.1	21.4	-23.0	11.2
Balance of Payments														
Imports of goods[4]	-11,575	-13,614	-14,011	-14,674	-14,752	-15,099	-15,933	-18,064	-20,483	-4,714	-5,084	-5,090	-5,596	-5,180
Exports of goods[4]	6,856	8,118	8,376	10,515	10,641	11,454	12,814	14,066	15,238	3,576	3,927	3,850	3,885	3,857
Current account5[)]	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-724	-354	-556	-589	-937
in % GDP[5]	*-6.5*	*-10.3*	*-10.9*	*-5.8*	*-5.6*	*-3.4*	*-2.9*	*-5.2*	*-5.2*	*-7.5*	*-3.3*	*-5.1*	*-5.2*	*-9.2*
Capital account[5]	1,553	3,340	3,351	1,630	1,705	920	535	1,648	1,683	568	268	384	463	776
Foreign direct investments	1,133	3,320	753	1,298	1,236	1,804	1,899	2,418	3,188	723	682	598	1,184	797
NBS gross reserves (increase +)	-929	1,801	-1,137	697	-1,797	166	-302	228	1,123	398	674	105	-55	79
Monetary data														
NBS net own reserves[6]	489,847	606,834	656,347	757,689	788,293	931,320	923,966	891,349		866,515	961,084	949,638	957832.96	963,944
NBS net own reserves[6], in mn of euros	4,609	5,895	5,781	6,605	6,486	7,649	7,486	7,482		7,327	8,135	8,029	8098.20	8,166
Credit to the non-government sector	1,660,870	1,784,237	1,958,084	1,870,916	1,927,668	1,982,974	2,031,825	2,067,826		2,081,211	2,132,166	2,179,194	2,261,981.23	2,282,988
FX deposits of households	730,846	775,600	909912	933,839	998,277	1,014,260	1,070,944	1,074,424		1,095,018	1,106,253	1,120,870	1139750.01	1,167,846
M2 (y-o-y, real growth, in %)	1.3	2.7	-2.2	2.3	6.7	5.5	8	0.6		2	5.6	6.1	12.3	11.8
Credit to the non-government sector (y-o-y, real growth, in %)	13.9	0.5	-2.1	-8.3	1.2	1.4	0.9	4.0		4.6	4.7	5.2	7.8	8.0
Credit to the non-government sector, in % GDP	54.0	52.4	54.7	48.3	49.5	48.4	47.2	45.4		44.9	45.4	43.1	44.2	43.6
Prices and the Exchange Rate														
Consumer Prices Index[7]	10.2	7.0	12.2	2.2	1.8	1.6	1.5	3.0	2.0	1.4	2.3	2.1	2.0	2.8
Real exchange rate dinar/euro (average 2005=100)[8]	95.8	87.7	92.9	87.4	89.2	90.6	91.6	88.9	86.6	86.3	86.5	86.6	86.8	85.3
Nominal exchange rate dinar/euro[8]	102.90	101.88	113.03	113.09	117.25	120.8	123.26	121.4	118.27	118.43	118.17	118.14	118.35	118.23

Source: FREN.

1) Unless indicated otherwise.

2) Data for 2008 represent adjusted figures based on a wider sample for calculating the average wage. Thus, the nominal wages for 2008 are comparable with nominal wages for 2009 and 2010, but are not comparable with previous years.

3) We monitor the overall fiscal result (overall fiscal balance according to GFS 2001) – Consolidated surplus/deficit adjusted for "budgetary lending" (lending minus repayment according to the old GFS).

4) The Statistical Office of the Republic of Serbia has changed its methodology for calculating foreign trade. As from 01/01/2010, in line with recommendations from the UN Statistics Department,
Serbia started applying the general system of trade, which is a broader concept that the previous one, in order to better adjust to criteria given in the Balance of Payments and the System of National Accounts. A more detailed explanation is given in *QM* no. 20, Section 4, "Balance of Payments and Foreign Trade".

5) The National Bank of Serbia changed its methodology for compiling the balance of payments in Q1 2008. This change in methodology has led to a lower current account deficit, and to a smaller capital account balance. A more detailed explanation is given in *QM* no. 12, Section 6, "Balance of Payments and Foreign Trade".

6) The NBS net own reserves represent the difference between the NBS net foreign currency reserves and the sum of foreign currency deposits of commercial banks and of the foreign currency deposits of the government. More detailed explanations are given in the Section Monetary Flows and Policy.

7) Data for 2004, 2005 and 2006 are based on the Retail Prices Index. SORS has transferred to the calculation of the Consumer Price Index from 2007.

8) The calculation is based on 12-m averages for annual data, and the quarterly averages for quarterly data.

2. Economic activity

Economic trends in Q1 were not generally favorable. A relatively modest y-o-y GDP growth of 2.5% was recorded, the lowest in Central and Eastern Europe (CEE), and seasonally adjusted growth was only 0.3% compared with the previous quarter (1.2% annually). The reduction in y-o-y growth rate of GDP at the beginning of 2019 was expected because the effect of high growth of agriculture was exhausted, which led to somewhat higher growth rates in 2018 (agriculture in 2018 had a high growth of over 15% because it was compared with the drought from 2017). However, even when we exclude agriculture, GDP growth in Q1 2019 was slower (by about 1 pp) compared with the average of 2018. This additional slowdown in economic activity was primarily a result of domestic weaknesses, and not adverse changes in the international environment. This is confirmed by the fact that other Central and Eastern European (CEE) countries maintained a steady growth in 2018 in Q1, i.e. in Q1 they had a year-on-year GDP growth of 4.3% on average. More specifically, the countries closest to Serbia (for which data are available) in Q1 accelerated rather than slowed down their economic growth - Croatia had a year-on-year GDP growth of 3.9%, Northern Macedonia 4.1% Bulgaria 4.8%, Romania 5% and Hungary 5.3%. The slowdown of economic growth in Serbia (without agriculture) is primarily the result of industrial production movements, which in Q1 had a year-on-year fall of about 1.5%. Several factors lie behind the fall of industrial production : 1) temporary decline in individual activities (overhaul of NIS facilities, unstable production of unreformed EPS), 2) continuation of long-term unfavorable trends in specific areas (e.g. motor vehicle production), and 3) broader trend of slowdown in a large number of activities that could be the result of the fall in price competitiveness of the domestic economy – which can also be seen from another angle in systematic growth of trade deficit. By the end of the year, we expect a gradual acceleration of economic activity because temporary negative factors will cease to exist, but the rate of economic growth in 2019 will most likely amount to about 3%, instead of the previously predicted 3.5%, which will again be among the lowest in the CEE. This indicates that the economic policies in Serbia are unsuccessful in terms of creating conditions for successful business operations and private sector investment and the fast economic growth of the country.

Gross Domestic Product

Year-on-year GDP growth in Q1 fell to 2.5%

After a solid GDP growth of 4.3% in 2018, in the first few months of 2019, there was a significant decline in y-o-y growth rate of Serbian economy. According to recent data from the SORS, the y-o-y growth of GDP in Q1 was only 2.5% and was the lowest in the entire CEE (among the countries for which data are currently available). The reduction of Serbia's GDP y-o-y growth was partially expected and we announced it in the previous QM issues. Namely, the relatively good results of economic activity in 2018 were under significant influence of high, but one-off, growth of agriculture, as it was compared with the dry 2017 and therefore the results were temporary. As the one-off effect of agriculture has been exhausted since the beginning of 2019, it has been expected that economic growth in 2019 would be somewhat lower than in 2018 (about 1 pp). However, the achieved GDP growth in Q1 of 2.5% was, not for 1 pp, but for almost 2 pp. lower than in 2018, suggesting even worse economic performance than expected - i.e. the slowdown in the GDP growth trend.

Table T2-1 shows two indicators that are very important for the assessment of economic trends in Serbia. The first is presented in the second row of the Table (Serbia – Underlying Economic Growth) in which Serbia's GDP growth rate excludes one-off factors (droughts, floods and some other incidental changes in the industry). This line shows us the "underlying" trend of Serbia's economy, which is often blurred by one-off factors. Thus, Table T2-1 clearly shows that in the last three years there have been no major changes in the "underlying" economic growth of Serbia, although realized GDP growth rates have differed significantly. For example, although

GDP growth in 2017 was only 2%, and in 2018 it was twice as high (4.3%), there were no major changes in the trend of economic activity - only in 2017 drought temporarily reduced GDP growth, and in 2018 it temporarily accelerated as a result of the recovery from drought. Another important indicator from Table T2-1 that we use to assess Serbia's economic trend is how different it is from the comparable CEE countries. The table shows that for some time now Serbia's economic growth (excluding one-off factors) has been systematically slower than the average economic growth of comparable countries, and this continued in Q1 2019, with this difference increasing even more.

Table T2-1. Serbia and countries in the CEE region: GDP growth a, 2014-2019

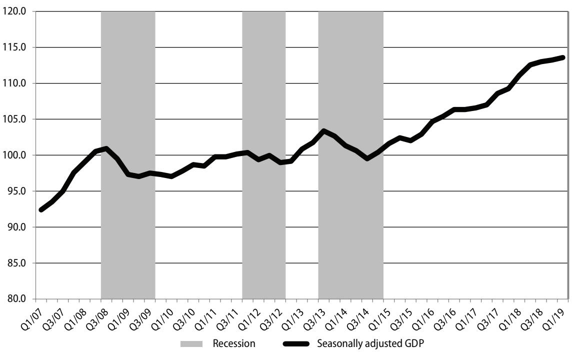
	2016	2017	2018	2018				2019
				Q1	Q2	Q3	Q4	Q1
Serbia	3.3	2.0	4.3	4.9	4.9	4.1	3.4	2.5
Serbia – underlying growth [1)]	2.9	3.3	3.4	3.7	3.8	3.5	2.7	2.8
CEE (weighted average)	3.2	4.7	4.3	4.3	4.3	4.5	4.1	4.3
Albania	3.4	3.9	4.1	4.3	4.2	4.7	3.1	-
Bosnia and Herzegovina	3.1	3.1	3.1	3.2	3.4	2.7	3.0	-
Bulgaria	3.9	3.6	3.1	3.5	3.2	2.7	3.0	4.8
Montenegro	2.9	4.4	4.8	4.5	4.9	5.0	4.8	3.0
Czech Republic	2.6	4.4	3.0	3.5	2.6	2.5	3.0	2.6
Estonia	2.1	4.9	3.9	3.3	3.9	4.0	4.3	4.5
Croatia	3.2	2.8	2.6	2.5	2.9	2.8	2.3	3.9
Latvia	2.2	4.5	4.7	4.0	5.3	4.5	5.1	3.0
Lithuania	2.3	3.8	3.5	3.7	3.8	2.6	3.8	4.0
Hungary	2.2	4.0	4.9	4.6	4.9	5.1	5.1	5.3
Macedonia	2.9	0.0	2.3	0.9	3.0	3.0	3.7	4.1
Poland	3.0	4.6	5.2	5.2	5.4	5.7	4.4	4.7
Romania	4.8	6.9	4.1	4.0	4.1	4.2	4.1	5.0
Slovakia	3.3	3.4	4.1	3.7	4.5	4.6	3.6	3.7
Slovenia	3.1	5.0	4.5	4.8	4.1	5.0	4.1	3.2

Excluded one-off factors (droughts, floods, temporary EPS issues and more)
Note: data for Q1 2019 have not yet been published for three countries: Albania, Bosnia and Herzegovina, and Montenegro
Source: Eurostat *QM* estimates on the basis of SORS data and Statistical Offices for BiH and Montenegro

In CEE countries there was no noticeable economic growth slowdown as in Serbia

Table T2-1 shows that not only is Serbia's economic growth systematically, permanently, lower than in other comparable countries, but also that the short-term trends in Serbia are more unfavorable. The underlying trend of Serbia's economic growth (second row in T2-2) slowed down noticeably in the second half of 2018, and similar developments continued in Q1 2019. Thus, irrespective of the effects of changing agricultural seasons on GDP, Serbia's economic growth was reduced by about 1 pp. compared to the first half of 2018. The Table shows us that similar economic slowdown did not exist in other CEE countries which in the second half of 2018 and the beginning of 2019 maintained virtually unchanged rates of economic growth from the first half of 2018. This clearly indicates that the main reason for the slowdown of economic activity in Serbia is the internal weakness, and not the unfavorable external conditions. Systematic lagging but also short-term unfavorable economic trends in Serbia, when compared to other comparable countries, indicate that the economic policies in Serbia are inadequate in terms of the economic growth.

Graph T2-2. Serbia: Seasonally adjusted GDP growth, 2002-2019 (2008 = 100)



Source: *QM* estimates based on SORS

Seasonally adjusted GDP growth Q1, compared to the previous quarter, was only 0.3%

Graph T2-2 shows the series of seasonally adjusted GDP growth which shows short-term trends in economic activity compared to the year-on-year indices from a different angle and more reliably (the shaded periods represent a recession, according to the Bry-Boschan procedure). Seasonally adjusted GDP growth in Q1, compared with a previous quarter, was 0.3%, which would, on an annual basis, represent a GDP growth of around only 1.2%. Seasonally adjusted indices confirm previous assessment that a short-term economic slowdown occurred in the second half of 2018, when the slope of the line indicating the growth of seasonally adjusted GDP declined noticeably.[1]

In the achieved growth of GDP in Q1, construction activity and services have the greatest influence, while the industry is in decline

Table T2-3 shows data on the y-o-y GDP growth by activity, i.e. by individual sectors of the economy. The fastest y-o-y growth of 12.3% was recorded by the construction activity. Although Q1 is generally not the most reliable period for estimating the movement in construction activity, as full construction season has not yet started - we believe that the strong growth of this sector of about 10% is sustainable in 2019 and is in line with our expectations. Construction data from Q1 also confirm our assessment from previous QM issues that a strong slowdown in construction activity in the second half of 2018 (Table T2-3) was primarily due to uncertainty in the statistical monitoring of this sector, rather than the actual unfavorable trends. In addition to construction activity, solid growth in Q1 was recorded by all kinds of services, especially Trade, Transport and Tourism, which had a real growth of about 6% over the same period of the previous year. On the other hand, the biggest y-o-y decline in Q1 of about 3% was recorded by agriculture, but this data does not really have any analytical significance because it is not yet known what the agriculture season will be like, and these first estimates of SORS are still preliminary (based on the assumption that in 2019 agricultural production would be average). As far as agriculture is concerned, for the time being it is only certain that it will not continue with its exceptionally high growth from 2018 of over 15%, as the base is now increased. Industrial production had essentially the worst trend of all analyzed sectors, and in Q1 was in third consecutive quarter with a year-on-year decline. Although the industry accounts for less than 25% of Serbia's GVA, this sector produces the largest share of traded products, and this structure of GDP growth by activity - a relatively high growth in services with a fall in industrial production - indicates that GDP growth is currently not in balance and is primarily based on domestic demand.

Table T2-3. Serbia: Gross Domestic Product by Activity, 2008- 2019[1]

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018				2019	Share
											Q1	Q2	Q3	Q4	Q1	2017
Total	97.3	100.7	102.0	99.3	102.9	98.4	101.8	103.3	102.0	104.3	104.9	104.9	104.1	103.4	102.5	100.0
Taxes minus subsidies	94.7	99.6	101.8	99.0	98.7	100.2	99.1	101.0	101.7	103.5	103.4	103.7	103.5	103.4	103.3	15.1
Value Added at basic prices	97.8	101.0	102.1	99.4	103.7	98.1	102.3	103.8	102.1	104.5	105.2	105.1	104.3	103.4	102.3	84.9
Non agricultural Value Added	97.5	101.1	102.2	100.8	102.5	97.8	102.3	103.4	103.3	103.6	104.7	104.4	103.1	102.4	102.7	92.8[2)]
Agriculture	100.8	99.6	100.9	83.0	121.0	102.0	102.0	108.3	88.8	115.6	112.6	115.9	117.2	115.6	96.9	7.2[2)]
Industry	90.7	100.3	103.8	100.6	106.6	92.1	104.2	103.5	102.8	101.0	105.5	102.4	99.0	97.5	98.4	23.6[2)]
Construction	87.2	92.6	114.8	101.2	82.5	101.4	116.8	107.9	105.7	112.7	126.7	120.4	109.9	102.7	112.3	4.7[2)]
Trade, transport and tourism	99.8	102.5	98.2	98.4	99.3	98.9	103.0	104.6	105.5	106.0	105.4	105.8	106.2	106.5	105.8	18.4[2)]
Informations and communications	106.5	102.9	108.2	113.7	104.3	102.8	102.6	103.7	103.8	105.0	104.4	105.3	105.1	105.1	104.9	6.0[2)]
Financial sector and insurance	106.2	106.6	100.9	104.6	101.1	99.6	101.2	105.4	100.9	101.8	100.2	102.6	100.4	104.0	103.4	3,6[2)]
Other	101.6	101.1	101.0	100.5	102.8	100.5	98.9	101.6	102.2	102.7	102.0	103.0	102.8	102.9	102.3	33.3[2)]

Source: SORS
1) In prices from the previous year
2) Share in GVA

Q1 net exports continues to deteriorates

The structure of the achieved GDP growth by expenditure is shown in Table T2-4. The table shows that investments had a relatively high growth of around 8% in Q1, which is similar to the average growth of investments in 2018 and is in line with high growth in construction activity. Unlike investments, net exports continued to deteriorate in 2018 as growth in imports was faster than export growth (Table T2-4). These trends of deterioration of net exports have lasted for more than two years and cannot be explained only by the poor agricultural season in 2017 or the purchase of investment equipment - which would be temporary (agriculture) or economically desirable (in the case of a strong growth in investment equipment imports). These trends of net exports decrease are more permanent, widespread in all types of products, and are consistent with the deterioration of industrial production (which produces the dominant part of tradable products). The Government and the NBS should therefore pay special attention to them. The

1 As one of the reasons for a slowdown in Serbia's economic growth the introduction of a 100% tax on exports of goods to KiM was often mentioned in public. Taxes certainly had a certain negative impact on economic activity, but it could not be so big and it was not the decisive reason for the slowdown in economic activity, which is implicitly shown in Graph T2-2. Namely, the Graph shows that the slowdown in the Serbian economy started well before the introduction of the mentioned tax, but also that the seasonally adjusted GDP growth index for the last three quarters was low but very stable - the effect of tax introduction would reflect on seasonally adjusted indices as a one-time deterioration and not as a permanent trend change.

government should take into account whether its policies encourage spending too much instead of production and exports, and the NBS should consider whether the current dinar exchange rate is more incentive to imports or exports, i.e. whether more robust measures are needed to prevent excessive strengthening of the dinar.

Table T2-4. GDP by expenditure method, 2009-2019

	Y-o-y indices															
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1	Share 2017
GDP	97.3	100.7	102.0	99.3	102.9	98.4	101.8	103.3	102.0	104.3	104.9	104.9	104.1	103.4	102.5	100.0
Private consumption	96.7	99.4	101.4	98.3	98.3	99.9	99.7	101.3	101.9	103.3	103.1	103.4	103.3	103.2	103.2	70.8
State consumption	98.3	100.0	101.6	100.4	97.9	100.9	96.3	101.2	103.3	103.6	102.1	104.8	104.0	103.3	102.5	16.2
Investment	77.5	93.5	104.7	113.9	88.0	96.6	104.9	105.4	107.3	109.2	116.3	111.6	108.3	103.2	108.4	17.7
Export	88.5	116.9	105.6	102.9	118.0	104.3	109.4	111.9	108.2	108.9	109.2	106.6	109.3	110.6	109.3	50.5
Import	78.1	99.9	107.2	99.4	106.5	105.1	104.0	106.7	111.1	111.1	113.2	109.4	111.4	110.9	109.4	57.1

Source: SORS

Private consumption in Q1 has a faster growth than production

The real growth of the largest expenditure component of GDP, private consumption, was slower than GDP growth virtually from the outbreak of the crisis in the second half of 2009 to 2018. This was one of the main reasons for the systematic reduction in inflation and current account deficit compared to the pre-crisis levels. Since 2018, however, this trend has been reversed. Private consumption growth throughout 2018 was roughly equal to the trend growth of GDP (excluding one-off factors - Table T2-1), and at the beginning of 2019 private consumption growth began to be higher than GDP growth. We believe this is not a favorable economic trend. The Serbian economy still has a pronounced structural imbalance resulting from considerably higher consumption than production (a current account deficit) and a high share of private consumption in GDP (private consumption accounts for about 70% of GDP in Serbia, while the average share of this component of GDP in other CEE countries is below 60%). For Serbia, therefore, it would be optimal that in a longer period of time private consumption grows at least one percentage point slower than the long-term GDP growth - which did not happen in 2018 and early 2019.

GDP growth in 2019 probably about 3%

When analyzing more closely what lies behind the slowdown in economic growth that started in the second half of 2018 (Graph T2-2), we see that, in addition to more permanent trends, there are some temporary factors that will be exhausted in the coming quarters. For example, NIS had large plant overhauls in Q1, leading to a drop in oil derivatives production by as much as 90% in March (and 60% in April). Also, somewhat better results in electricity production in March and April and a relatively favorable hydrological situation point to future EPS production growth (which is declining from the second half of 2018). Due to all this, we expect that in the second half of the year there will be a certain acceleration of economic activity compared to Q1, but it is likely that GDP growth in 2019 will still be around 3% instead of the previously projected 3.5%. The important fact to point out, however, is that the data for Q1 indicate that the average economic growth of CEE countries in 2019 will be over 4%, as in the previous two years, and that Serbia's lagging behind in economic growth will be deeper - even if Serbia achieves the projected GDP growth rate of 3.5%.

Industrial production

Industrial trends in 2019 are unfavorable

Industrial production in Q1 recorded a year-on-year fall of 1.9% (Table T2-5). All three sectors of industrial production declined in relation to the same period of the previous year. Mining by 3.1%, manufacturing industry by 1.9%, and electricity production by 1.4%. When we compare Q1 results with previous quarters, Q3 and Q4 2018, we see that the y-o-y decline in mining and electricity production is decreasing, and is deepening in the manufacturing industry (Table T2-5). Movements in mining and electricity production are a direct consequence of problems in EPS operations[2]. The latest results of these industrial production sectors are somewhat more favorable, suggesting that EPS has managed to stabilize its production and announce that these

2 The movement of mining is influenced by EPS through the area of "Coal exploitation" where this company is the dominant producer. We have written about EPS issues in more detail in previous issues of QM.

sectors may move into a positive growth zone in the second half of the year, compared to a low base from 2018. Unlike these two sectors, the manufacturing industry is far more heterogeneous and its bad results better reflect market trends in industrial production.

Table T2-5. Serbia: Industrial Production Indices, 2009-2019

	Y-o-y indices															Share
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018				2019	2017
											Q1	Q2	Q3	Q4	Q1	
Total	87.4	101.2	102.5	97.7	105.6	92.6	107.3	105.2	103.9	101.3	106.1	102.1	98.5	99.1	98.1	100.0
Mining and quarrying	96.2	103.9	109.8	100.0	105.3	84.2	112.2	103.2	102.2	95.2	103.1	98.0	87.1	94.5	96.9	9.4
Manufacturing	83.9	102.7	99.8	99.1	104.7	95.3	105.7	106.0	106.3	102.0	105.0	101.9	101.0	100.5	98.1	72.7
Electricity, gas, and water supply	100.8	95.7	109.7	92.8	108.2	85.1	112.5	102.7	93.9	101.1	111.3	105.9	93.2	94.8	98.6	18.0

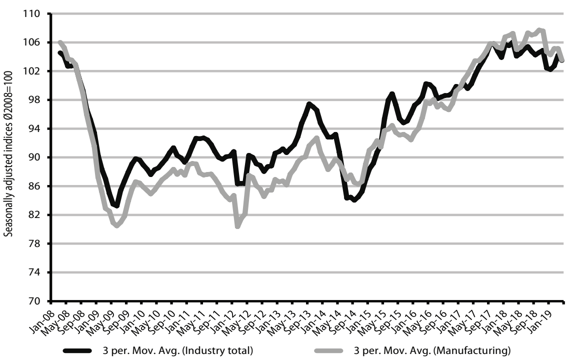
Source: SORS

Unfavorable movements can not be explained only by temporary factors

In fact, the main question we put into the analysis of industrial production in Q1 is whether the unfavorable trends are the consequence of temporary circumstances and therefore short-lived or part of widespread and, consequently, more prolonged and dangerous deterioration? The answer to this question is that there are short-term and permanent negative factors, but the permanent factors are, by all means, more dominant. Namely, it is indisputable that the bad results of industrial production in Q1 were considerably caused by one-off factors (overhauls in NIS and the consequent huge fall in oil derivatives production, and EPS problems), but they did not have a crucial impact on the bad results. Even without the fall in mentioned areas, the industrial production growth, i.e. processing industry growth, would be barely positive. An additional indication that poor industrial output is structural rather than temporary in nature is the medium-term trend[3] in the manufacturing industry over the last few years (Table T2-5). Between 2015 and 2017, the manufacturing industry had a relatively high and stable growth of about 6%, and then the year-on-year growth began to slow down throughout quarters in 2018, which was finally completed in Q1 2019 when it entered a negative y-o-y growth zone. Such stable deterioration of results for more than a year additionally confirms that individual negative factors didn' play a decisive role in the deterioration of total industrial production, but that it is a more widespread trend.

Seasonally adjusted industrial production data confirm broader trends of the slowdown in economic activity

Graph T2-6. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2019



Source: SORS

We can also make an estimate of industrial production trends from another angle, based on the seasonally adjusted indices we have shown in Graph T2-6. The graph shows the seasonally adjusted trend of manufacturing industry and the total industrial production. As can be seen from the Graph, from the beginning of 2015 until the first half of 2018, industrial production (with normal oscillations) was in a relatively strong rise. However, since the first half of 2018, there has been a systematic halt and stagnation, if not the fall of industrial production.

Comparative analysis shows that a similar slowdown in industrial production did not occur in other CEE countries

Table T2-7 shows the year-on-year indices of industrial production growth in comparable CEE countries. The table shows that the substantial deterioration of the trend is in principle specific to Serbia[4], while other CEE countries in Q1 continued with relatively normal, solid growth rates of industrial production. All this points to the fact that the decline in industrial production, as well as the slowdown of total GDP in Serbia, is a consequence of internal factors, and that the Government and NBS need to take these indicators into consideration and consider possible corrections of current economic policies.

3 As we have already mentioned, the manufacturing industry is more reliable for assessing trends in the industry, since the total industrial output was under the relatively strong influence of fluctuations in EPS production.

4 Only Bosnia and Herzegovina had a strong deterioration of the industrial production trend that was even more pronounced than in Serbia

Table T2-7.Serbia and the CEE countries: the y-o-y growth of industrial production, 2018-2019

	2018				2019
	Q1	Q2	Q3	Q4	Q1
Serbia	6.1	2.0	-1.5	-0.9	-1.9
CEE (weighted average)	5.0	4.9	4.4	3.0	4.3
Bosnia and Herzegovina	5.3	1.6	0.7	-0.5	-5.1
Bulgaria	1.8	1.4	1.1	0.0	4.1
Czech Republic	4.3	2.5	3.9	2.3	0.3
Estonia	4.7	3.1	3.8	5.2	3.5
Croatia	0.6	0.5	-1.6	-3.3	2.8
Latvia	4.7	0.2	3.0	0.9	-0.9
Lithuania	7.1	5.2	2.9	5.7	4.5
Hungary	4.8	3.3	3.6	4.3	6.3
Macedonia	5.4	4.9	5.0	6.4	8.9
Poland	5.9	7.1	5.9	4.3	6.9
Romania	5.9	5.4	4.6	1.6	1.1
Slovakia	1.3	5.7	5.9	4.5	6.7
Slovenia	8.9	6.9	3.8	0.7	4.4

Source: Eurostat and SORS

Increase in production of investment goods is positive

Observed by purpose of industrial products (Table T2-8), there was a divergence in the trends of industrial production of individual groups in Q1. One of the few positive trends in industrial production is a solid growth of investment products, which in Q1 amounted to about 5%. This result is particularly significant considering that this product category also includes the production of motor vehicles which in Q1 fell by 13% due to reduced demand for the model produced by FAS. All other special purpose product groups had a y-o-y drop, ranging from 4.6% (in energy production) to 1.3% (in the production of intermediate products).

Table T2-8. Serbia: Industrial Production by Purpose, 2009-2019

	Y-o-y indices														
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018				2019
											Q1	Q2	Q3	Q4	Q1
Total	87.4	101.2	102.5	97.7	105.6	92.6	107.3	105.2	103.9	101.3	106.1	102.1	98.5	99.1	98.1
Energy	98.8	97.7	106.2	93.6	113.2	82.6	116.9	101.9	98.3	101.2	108.4	103.9	95.6	97.6	95.4
Investment goods	79.3	93.6	103.2	103.8	127.6	95.9	103.0	101.6	107.1	102.0	98.0	104.4	104.1	101.6	104.9
Intermediate goods	78.4	109.2	102.2	91.2	99.0	96.8	105.3	109.5	109.7	103.5	111.3	101.4	101.6	102.2	98.7
Consumer goods	86.8	102.1	95.4	103.2	100.7	100.7	104.0	105.6	102.5	99.5	103.8	100.7	97.3	97.2	97.3

Source: SORS

By the end of the year we expect a slight recovery of industrial production

As we have already pointed out, the poor output of industrial production in Q1 was affected by temporary factors, such as the overhaul of NIS production facilities, EPS manufacturing problems, etc. In the coming quarters, therefore, we expect a certain recovery of industrial production and a move to a mild positive growth zone. This recovery will likely be sufficient for industrial production to avoid the decline on annual level (in the first four months of 2019 the decline in industrial production was 1.5% compared to the same period last year). In any case we can now conclude with certainty that since the middle of 2018 there have been structural changes and that, unlike the period 2015-2017, industrial production no longer triggers GDP growth, but rather follows it.

Construction

Construction activity in Q1 grew by more than 10%

According to the SORS estimates, construction activity in Q1 recorded a strong real y-o-y growth of 12.3% (Table T2-2). SORS estimates this growth relying primarily on the Index of the value of construction works in the country, which in real terms recorded a real y-o-y growth of 13.6% in Q1. The analyzes that we regularly implement in the QM indicate, however, that the SORS estimates of the movements in the construction activity are systematically more unreliable than for other sectors of the economy. The problem with monitoring this sector of economy is that a large number of small private companies that are quickly established and closed, operate within it, which official statistics monitors with difficulty, and a good part of the activity is carried out in the gray zone, out of sight of the SORS. Therefore, along with the official data from the construction statistics, we always monitor a series of additional indicators through which, indirectly and not completely precisely, but with relative reliability, we follow the basic trends in this sector of the economy. For example, in the course of 2018, these additional indicators pointed to a much different (and more probable) movement of construction activity than that of official statistics.[5] In Q1, however, all additional indicators were consistent with the official estimates of the SORS. Therefore, we conclude that construction activity in Q1 indeed had a high, two-digit y-o-y growth of between 10% and 15%.

Additional indicators that we used for a more reliable assessment of trends in construction activity are the movement of employees and salaries of employees in construction activity and cement production. As for the trends in the labor market - the number of registered employees, as well as the number of employees in the construction industry, including the informal sector (measured by the Labor Force Survey), shows a y-o-y growth of around 10% in Q1, while real gross wage growth in construction was 4.5%. Thus, the movement in the mass of wages within construction activity is indisputably consistent with the high y-o-y growth of construction activity of over 10%.

Table T2-8. Serbia: Cement Production, 2001-2019

	Y-o-y indices														
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1
Total	87.4	101.2	102.5	97.7	105.6	92.6	107.3	105.2	103.9	101.3	106.1	102.1	98.5	99.1	98.1
Energy	98.8	97.7	106.2	93.6	113.2	82.6	116.9	101.9	98.3	101.2	108.4	103.9	95.6	97.6	95.4
Investment goods	79.3	93.6	103.2	103.8	127.6	95.9	103.0	101.6	107.1	102.0	98.0	104.4	104.1	101.6	104.9
Intermediate goods	78.4	109.2	102.2	91.2	99.0	96.8	105.3	109.5	109.7	103.5	111.3	101.4	101.6	102.2	98.7
Consumer goods	86.8	102.1	95.4	103.2	100.7	100.7	104.0	105.6	102.5	99.5	103.8	100.7	97.3	97.2	97.3

Source: *QM* based on SORS data

Cement production recorded a year-on-year increase of 12.2%

As the most reliable additional indicator describing the movement of construction activity, we single out the cement production. Namely, cement is used in virtually all types of construction works, its production can be followed relatively easy and reliably (only few cement production companies), and cement consumption is approximately equal to its production, as long-distance transport by land is not economically justified, i.e. foreign trade of this product is relatively small. Cement production in Q1 recorded a year-on-year increase of 12.2% (Table T2-9).

In 2019 we expect growth of construction activity of around 10%

Table T2-9. Serbia: Cement Production, 2001-2018

	Y-o-y indices				
	Q1	Q2	Q3	Q4	Total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	81.4	86.0	75.3	74.4
2010	160.7	96.9	96.0	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	88.3	58.2	84.9	79.6
2013	83.5	78.7	127.6	93.5	94.9
2014	136.2	90.3	96.2	104.7	101.5
2015	77.9	112.4	104.5	108.7	103.1
2016	120.2	109.8	109.9	100.4	108.9
2017	110.4	104.1	96.4	118.7	105.9
2018	107.5	110.6	112.8	106.3	109.7
2019	112.2	-	-	-	-

Source: *QM* based on SORS data

Construction activity in Q1 is not representative for the assessment of annual trends of this sector of the economy, because it is under the great influence of meteorological conditions and the construction season is not in full swing. For example, a slightly warmer winter, with more working days, is sufficient, for y-o-y indices to show high growth, which can easily prove unsustainable in the coming quarters. The QM analysis, however, shows that this was not the case in Q1 2019 and that the high growth in construction activity will likely be extended by the end of the year. Namely, the winter of 2019 was not significantly different from the previous year, and there are economic arguments supporting the assessment that the growth of construction activity throughout 2019 will be high - the credit activity of the population and the economy has a solid growth, interest rates are still historically very low and the state continues to increase investment in the infrastructure.

5 For more details, see *QM*55 or some of the *QM* issues from 2018.

Trends

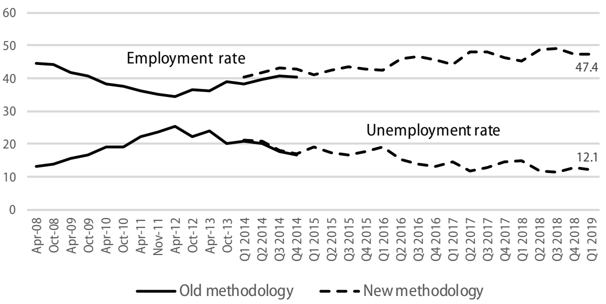
3. Labour Market

According to the Labour Force Survey (LFS), the basic labour market indicators in Q1 2019 recorded moderate improvements compared to the same quarter of the previous year. Activity and employment rates have increased, and the unemployment rate has been reduced. The activity rate was 53.9%, higher by 1 percentage point (pp) compared to the same quarter of the previous year. The employment rate was 47.4% in Q1 2019, and the unemployment rate was 12.1%. The number of unemployed persons according to the LFS decreased by 81,600, or 17.4% yoy. Reduction of the number of unemployed persons was the result of the growth of economic activity, but also of mass emigration of the population. The number of employed persons increased by 4.5%, with formal employment increasing by 6.4%, and informal decreasing by 3.6% in Q1 2019 compared to the same quarter of the previous year. The informal employment rate was 17.1%. Total and formal employment in Q1 grew at a higher rate than real growth of gross value added (GVA), which was 2.3%. On the other hand, the yoy growth of registered employment (CROCSI) was 2.7%, which was in line with the movement of economic activity. Employment increased in all activities, with the highest yoy growth of 13.3% in construction. Employment achieved 5% yoy growth in the private sector and 1.3% in the public sector. The increase in registered employment in the private sector was the result of the growth of economic activity, as well as the suppression of the grey economy. On the other hand, the reduction in public sector employment, although considered a positive trend, was probably less a result of public sector restructuring, and more of other factors (retirement, privatisation of remaining state enterprises, bankruptcy, etc.). Year-on-year wage growth in Q1 was 9.5% in nominal terms and 6.9% in real terms. Real wage growth was much higher than the real yoy growth of GVA. High wage growth with almost unchanged productivity (CROCSI employment) leads to a considerable real increase in unit labour costs. Real unit labour costs increased by 7.3% yoy. The biggest wages are still in public enterprises, followed by the public sector (public enterprises and the general government sector). Wages in public enterprises in Q1 2019 were 28% higher than in the private sector, while they were almost 20% higher in the public sector than in the private one. The nominal yoy growth of wages was around 10% in both the public and private sectors, as well as in public enterprises. The increase in wages in the private sector was the result of higher demand for labour in relation to labour supply and emigration of the population. Mass emigration of workers of different profiles gives local people higher negotiating power and the ability to negotiate higher wages. As of January 1, 2019, unemployment contributions at the expense of the employer have been abolished, which reduced the total fiscal burden of labour from 63% to 62%. Average net wages amounted to 455 euros, while the employer's costs amounted to 735 euros in Q1 2019. Due to the unchanged exchange rate of the dinar in Q1 2019 compared to Q1 2018, the yoy growth of earnings in euros corresponded to the increase in earnings in dinars.

The employment rate has increased compared to the same quarter of the previous year, while the unemployment rate has been reduced…

The reduction in unemployment was the result of the growth of economic activity and mass emigration

Graph 3.1 Trends in Employment and Unemployment Rates, 15+, 2008-Q1 2019



Note: Break in the series in 2014.
Source: LFS, SORS.

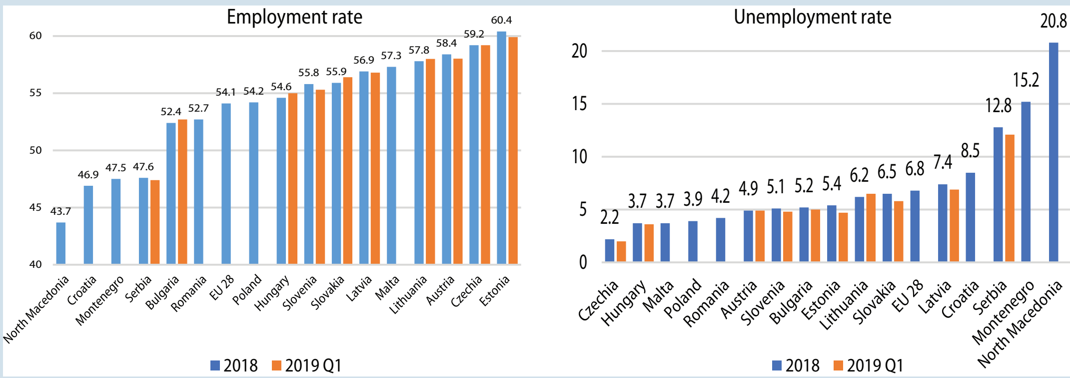
Employment and Unemployment

The employment rate in Q1 2019 was 47.4%, and the unemployment rate was 12.1%. Compared to the same quarter of the previous year, the employment rate increased by 2.3 pp, while the unemployment rate decreased by 2.7 pp. Graph 3.1 shows the trends in employment and unemployment rates since 2008.

Highlight 1. Comparison of the Employment and Unemployment Rates in Serbia and the Countries of Central and Eastern Europe

Although the unemployment rate has been significantly reduced, it remains high, much higher than the Central and Eastern European countries (CEE). Graph 3.2 shows the movement of the employment and unemployment rates in 2018 and the first quarter of 2019 for selected countries (Northern Macedonia, Croatia, Montenegro, Serbia, Bulgaria, Romania, Poland, Hungary, Slovenia, Slovakia, Latvia, Malta, Lithuania , Austria, Czech Republic and Estonia). Data for Q1 2019 are not yet available for all countries surveyed. The unemployment rate at the EU28 level was 6.8% in 2018. The lowest rate was in the Czech Republic - 2.2%, while the highest rate was in the Balkan countries. Unemployment rate was as high as 20.8% in Northern Macedonia and 15.2% in Montenegro. Although Croatia has a much lower unemployment rate than Serbia - 8.5%, it has a higher unemployment rate than other selected EU countries. The employment rate was the lowest in Northern Macedonia, followed by Croatia, Montenegro and Serbia. On the other hand, Serbia had a significantly lower employment rate compared to Estonia and the Czech Republic, which had an employment rate of 60%. Compared to the EU28 average, Serbia had 6 pp lower employment rate in 2018. Basic labour market data (employment and unemployment rates) show that Serbia is still far behind the countries of Central and Eastern Europe.

Graph 3.2 Employment and Unemployment Rates in European Countries, 15+, in %, 2018 and Q1 2019



Source: Eurostat, for Q1 2019 for Serbia, Czech Republic and Austria – national statistical offices.

Total employment (LFS) increased by 4.5% year-on-year, while the growth of registered employment (CROCSI) was 2.7%

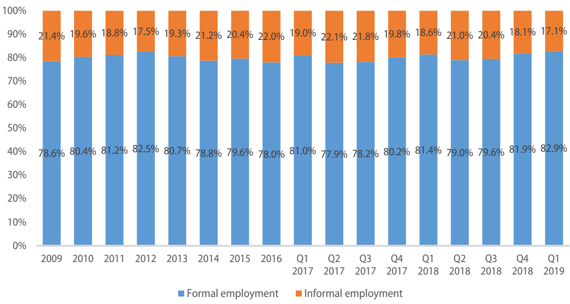
The number of unemployed persons according to the LFS was 387 thousand in Q1 2019 and it was lower by 81.6 thousand compared to the same quarter of the previous year, i.e. the relative decrease was 17.4%. The number of unemployed persons was significantly reduced partly as a result of the growth of economic activity, but mostly due to the mass emigration of the population. The number of active persons increased by 1.3% compared to the same quarter of the previous year. A significant drop in the number of unemployed and a small increase in the number of active persons led to a decrease in the unemployment rate in the observed period.

The growth of registered employment is in line with the movement of real GVA growth rate of 2.3%

Informal employment has been reduced. The informal employment rate was 17.1%.

The number of formally and informally employed persons amounted to about 2 million 811 thousand persons in Q1 2019, which is 122 thousand more than in the same quarter of 2018. Relative growth was 4.5%. The number of persons in formal employment amounted to 2 million and 329 thousand persons, while the number of informal employees amounted to 482 thousand in Q1 2019. Formal employment increased by 6.4%, while informal employment decreased by 3.6%, yoy. The informal employment rate was 17.1%, which is 1.5 pp less compared to the same quarter of the previous year. The SORS has published data on the number of formally employed according to a more rigorous definition (in addition to the employment contract, the criterion of compulsory social security of the employee is taken). That number is 2.181 thousand and it corresponds to the number of registered employees according to the CROCSI source. Registered employment according to CROCSI was 2 million 148 thousand persons. Registered employment increased by 2.7% compared to the same quarter of the previous year. The increase in registered

Graph 3.3 Formal and Informal Employment (15+) in % of total employment, 2009-Q1 2019



Note: Break in the 2014 series.
Source: LFS, SORS

employment was in line with the trend of real GVA growth of 2.3% yoy. On the other hand, total and formal employment is growing much faster than the real GVA growth rate in the observed period. We see that the employment structure changes in favour of formal employment (Graph 3.3). In Q1 2019, share of formally employed persons in total employment was 82.9%, while share of informally employed was 17.1%.

Employment increased in Q1 2019 compared to the same quarter of the previous year in all activities, in agriculture, industry, construction and services. Employment growth in agriculture was 5.4%, while in the previous quarter, in each quarter (from Q4 2016 to Q4 2018), agriculture recorded a yoy decline in the number of employees. The largest yoy growth in the number of employees was recorded by construction companies - 13.3%. The yoy real growth of GVA in construction was 12.3%. Table 3.1 shows the movement in the number of employees and GVA by sectors in the period 2016 – Q1 2019.

Table 3.1 Movement in the number of employees (15+) and real GVA by sectors, year-on-year change in %

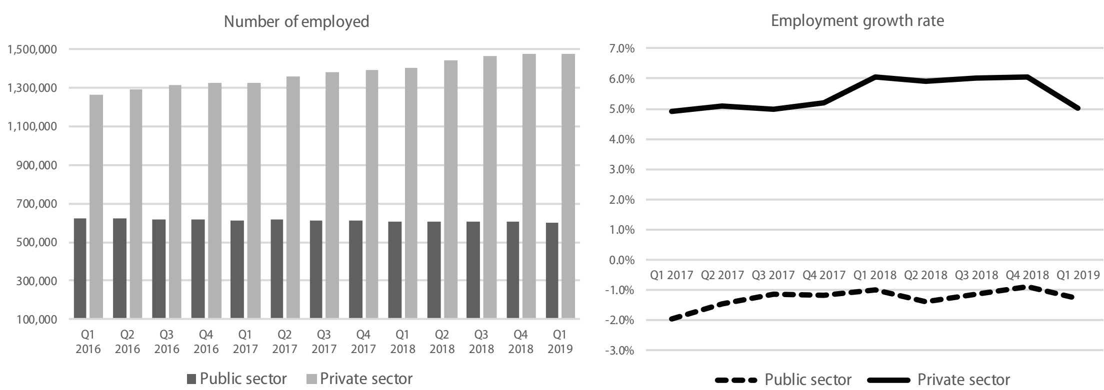
	2016				2017				2018				2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Total employment CROCSI	-0.3	1.2	1.3	2.1	2.3	2.6	2.7	2.8	3.3	3.2	3.3	3.4	2.7
Formal employment LFS	1.9	2.7	3.8	5.2	4.9	5.1	5.5	2.6	1.9	2.1	3.4	4.1	6.4
Total employment LFS	2.7	6.7	7.2	5.8	3.2	4.3	2.4	1.2	1.4	0.5	1.6	1.9	4.5
Total GVA	4.2	3.5	4.4	3.2	1.8	2.0	2.3	2.4	5.2	5.1	4.3	3.4	2.3
Employment- agriculture	-3.7	6.0	6.1	-3.4	-8.0	-1.6	-2.9	-7.8	-7.1	-8.6	-7.6	-1.2	5.4
GVA-agriculture	7.5	4.6	11.8	8.1	-7.7	-10.6	-13.7	-11.4	12.6	15.9	17.2	15.6	-3.1
Employment-industry	4.2	7.8	7.9	7.6	9.3	8.4	7.7	6.3	12.0	12.3	6.1	0.9	3.9
GVA-industry	6.1	2.1	3.2	2.8	0.1	2.9	5.6	2.8	5.5	2.4	-1.0	-2.5	-1.6
Employment-construction	-2.9	4.0	-2.1	-1.8	-12.6	8.2	-0.6	2.5	20.5	0.5	6.8	10.4	13.3
GVA-construction	16.9	10.0	12.4	-2.0	-0.5	-0.4	4.1	16.0	26.7	20.4	9.9	2.7	12.3
Employment-services	4.7	6.8	8.2	9.1	5.7	4.6	2.7	2.0	-1.2	-0.8	2.6	2.6	3.9
GVA-services	2.3	3.3	2.9	3.0	3.5	3.2	3.3	2.9	3.1	4.0	3.9	4.3	3.7

Note: Source for employment was LFS, except for total employment for which we used both LFS and CROCSI. GVA data is revised data for 2015 and 2016, while for 2018 and 2019 we used prior data.
Source: SORS (LFS, SNA and CROCSI)

Employment is increasing in the private sector and decreasing in the public sector

Employment has been reduced in all parts of the public sector compared to the same period of the previous year, with the biggest decrease of 4.1% recorded in public enterprises.

Graph 3.4 Employment trends in public and private sectors, number of the employed (left chart) and growth rate (right chart), Q1 2016 – Q1 2019



Note: Data for Q1 2019 is prior data.
Source: CROCSI, SORS

The total number of employees in the public sector was 598,493, of which the number of employees in public enterprises was 144,154 in Q1 2019. The number of employees in the general government sector was 454,339 (budget users). The number of employees in the private sector was 1,475,044. The number of employees in the public sector was down by 7.851 yoy, or 1.3% yoy. The number of employees in the private sector increased by 70,313 yoy, which is a 5% growth. Compared to the first quarter of 2016, in the first quarter of 2019, the number of employees in the public sector decreased by 4.2%, while in the private sector it increased by 16.8%. Continuous decrease in the number of employees in the public sector and increase in the private sector is a positive trend. Although the administration at the level of local self-government records a year-on-year decrease in the number of employees (Q1 2019 / Q1 2018), in Q1 2019, compared to Q1 2016, the number of employees increased significantly (by 4.7%). Health and social work recorded a decrease in the number of employees in Q1 2019 compared to Q1 2016 by 2.8%, which we estimate as a negative trend. The number of employees in the public and private sector, as well as the yoy change in the number of employees in the public and private sector, are shown in Graph 3.4.

Wages

Net wages in Q1 2019 were around 54,000 dinars, realising a year-on-year growth of 9.5% in nominal and 6.9% in real terms

In Q1 2019, the average nominal net wages amounted to 53,739 RSD. Nominal net wages increased by 9.5%, while real growth was 6.9%. Growth of wages was much higher than real GDP growth (2.3%). The number of registered employees increased by 2.7%, which means that productivity was somewhat reduced (-0.4%). High growth in real wages with a smaller decline in productivity leads to a significant increase in real unit labour costs of 7.3% yoy. If we used LFS data on the number of employees, the productivity would be lower by 2.1% yoy, while real unit labour costs would have increased by 9.2%. Real wage growth of 6.9% in the period when economic activity increased by 2.3% is not justified nor sustainable in the long term. As of January 1, 2019, contributions for unemployment borne by the employer (0.75%) have been abolished, resulting in the reduction of the total fiscal burden on wages from 63% to 62%. The total contribution rate on wages has been reduced from 37.8% to 37.05%.

Real growth of wages was higher than the real growth of GVA, which is estimated as a negative trend

Labour productivity has slightly decreased in Q1 2019 (CROCSI) compared to Q1 2018, while unit labour cost significantly increased (by 7.3%)

Faster growth of real wages than the growth of GDP in Serbia over the past two years is part of a wider trend that has affected the countries of Central and Eastern Europe. The main driver of strong growth of wages in CEE countries are movements in the labour market, and above all the mass emigration of workers from CEE countries to developed EU countries. However, faster wage growth from productivity growth reduces price competitiveness of the CEE countries, which may result in an increase in foreign deficits, less investment and ultimately slower growth in the future. The negative effects of such policies over a longer period of time have manifested in recent history in the countries of southern Europe, and especially in Greece. The negative consequences of the faster growth of wages than of productivity in the long run could be particularly strong in Serbia, as before this trend began, it had a high foreign deficit, high current consumption and low investment compared to GDP, high unemployment, etc. From the point of view of Serbian economy's price competitiveness, it is particularly unfavourable that, along with faster growth of wages than productivity, the policy of strong dinar is conducted.

If LFS data on the number of the employed is used, the real growth of unit labour cost was even higher and was 9.2% year-on-year

The high share of private consumption in Serbia's GDP (around 70% compared to the usual 60% in CEE countries) leaves no room for faster growth of wages than of productivity over a longer period of time

Average wages were the highest in public enterprises and amounted to 64,858 RSD, followed by the public sector[1] (60,528 RSD), while significantly lower in the private sector 50,519 RSD. We see that wages in public enterprises are on average around 15,000 RSD higher than in the private sector, or 28.4% higher in Q1 2019. The difference between the average wages in the public and private sector were around 10,000 RSD, that is, public sector wages in Q1 2019 were higher by 19.8% than private sector ones. General government wages recorded a year-on-year

1 The public sector is a part of the national economy that includes the general level of the state, as well as non-financial enterprises controlled by the state (public and other state enterprises) primarily engaged in commercial activities (Law on Budget System, "Official Gazette of the Republic of Serbia" No. 54/2009, 73/2010, 101/2010, 101/2011, 93/2012, 62/2013, 63/2013, 108/2013, 142/2014, 68/2015 and 103/2015). Accordingly, the public sector includes users of budgetary funds in the activities of education, culture, healthcare and social work and state administration, as well as public enterprises founded by the state or units of local self-government, and performing activities of general interest (Law on Public Enterprises and Performance of Activities of general interest, "Official Gazette of the Republic of Serbia", No. 119/2012, 116/2013 and 44/2014). In addition to public enterprises, the state also owns some of the non-privatised former social enterprises. The public sector is classified into the following subgroups: public state enterprises, public local enterprises, administration - state level, administration - level of the autonomous province, administration - local self-government level, healthcare and social work, education and culture.

Trends

Average wages are the highest in public enterprises and are around 65,000 RSD.

Average wages in the public sector are around 60,000 RSD, which in the private sector they are around 50,000 RSD

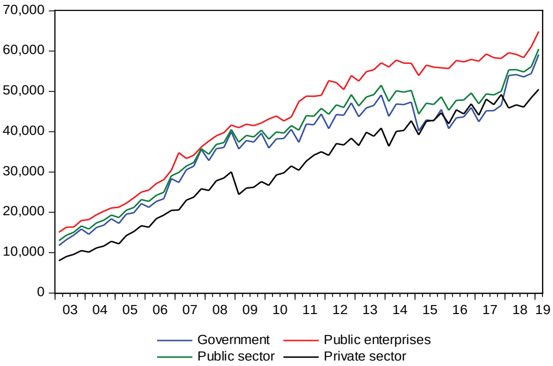
The difference in wages between public enterprises and the private sector is 28.4%, while the difference in wages between the public and private sector is 19.8%

Year-on-year nominal growth rate of wages in the public sector, public enterprises and the private sector was around 10%

Year-on-year growth of wages in euros corresponds to the increase in wages in dinars in Q1 2019, due to the unchanged exchange rate

Year-on-year growth of wages in euros was 9.7%

Graph 3.5 Movement of average net wages, public sector, public enterprises, general government sector, and private sector, Q1 2003-Q1 2019



Note: Break in the 2009 and 2018 series.
Source: SORS

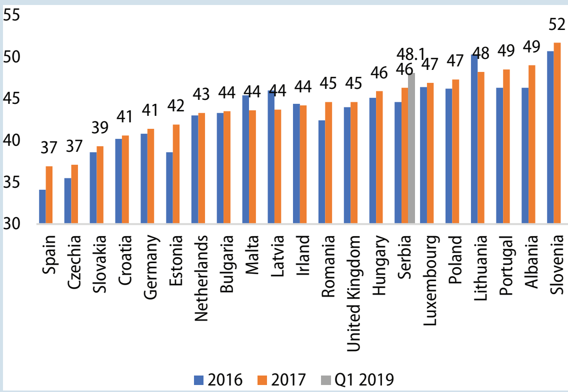
nominal growth of 9.6% in Q1 2019 compared to the same quarter of the previous year. In the public sector, yoy nominal wage growth was 9.4%. The growth of wages in public enterprises was 8.8%. Growth of wages in the private sector was slightly higher than in the public sector and its sections, amounting to 10.1%. The yoy rate of inflation was 2.4%, so the real wage growth in the public and private sector was about 6-7%, yoy. Graph 3.5 shows the movement of average net wages in the public and private sectors, as well as in sections of the public sector (public enterprises and the general government sector).

Due to the massive emigration of workers abroad, there have been significant changes in the labour market. The relationship between labour supply and demand has changed, which affects the better negotiating position of workers and the growth of private sector wages.

Highlight 2. The Ratio of Minimum and Average Wages in Europe

In 2018, the minimum net wage per hour was 143 RSD and it increased to 155.3 RSD in 2019. The nominal growth of the minimum net labour cost per hour was 8.6%. The average price increase in the first 5 months of 2019 compared to the same period of the previous year was 2.5%. Real growth in the minimum net labour cost per hour for the first 5 months of 2019 compared to the same period of the previous year was 5.9%. According to Eurostat, the ratio of minimum and average wage[1] in 2017 was 46.3% in Serbia, which was slightly above the EU average[2] of 44.1%. However, in the next two years the minimum wage significantly increased, so in the first three months of this year the ratio of minimum and average wage was 48.1%. The increase in the ratio of minimum and average wage in Serbia over the last two years, similar to other CEE countries, is an attempt to slow down labour migration through the increase of wages. However, the flip side of the faster growth of minimum and average wages than productivity growth is the reduced price competitiveness of these countries. Spain had the lowest ratio of 36.9%, while Slovenia had the highest ratio of 51.7% in 2017. In 2017, compared to 2016, the ratio of minimum and average wages had increased in most countries, while in some countries this ratio declined. The largest decrease was in Latvia and Lithuania, 2.3 pp and 2.1 pp, respectively. Estonia had the highest growth, 3.3 pp, followed by Spain 2.8 pp, Albania 2.7 pp. In Serbia, this growth was 1.7 pp. Graph 3.6 shows the ratio of minimum and average wages in EU countries and candidate countries in 2016 and 2017.

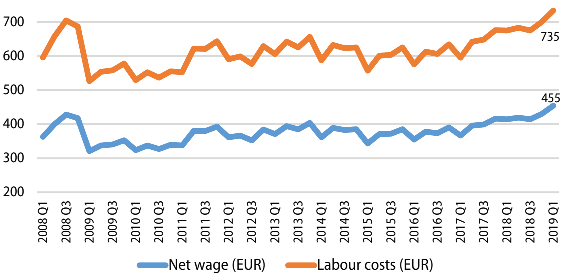
Graph 3.6 Ratio of minimum and average wages in EU countries and candidate countries in %, 2016 and 2017.



Note: Q1 2019 data on minimum wage is Socioeconomic Council, and for average wage SORS.
Source: Eurostat

1 Average earnings include B-S activities (NACE Rev.2) except for extra-territorial organisations and bodies and activities of households as employers. The average wages are gross wages.
2 Minimum wages exist in 22 out of the 28 EU countries. There is no national minimum wage in 6 EU countries and EFTA countries. Countries that do not have the national minimum wage are: Denmark, Italy, Cyprus, Austria, Finland, Sweden, Iceland, Norway and Switzerland. The candidates for EU membership with minimum wage are: Albania, Northern Macedonia, Montenegro, Turkey and Serbia.

Graph 3.7 Movement of average net wages and cost of labour in EUR



Note: Break in the 2009 and 2018 series.
Source: Author's calculations based on SORS and NBS data.

Average net wages in euros were 455 euros, while the employer's costs amounted to 735 euros. The yoy growth of wages in euros was 9.7%, while the costs of the employer increased by 8.7%. The increase in wages in euros after a long time equals the increase in wages in dinars (Q1 2019 compared to Q1 2018). The exchange rate in Q1 2019 and in Q1 2018 was almost unchanged, 118.2 and 118.4, respectively. Therefore, the increase in wages in euros was not due to the change in the exchange rate, but due to the higher nominal wage growth in dinars of 9.5%. Graph 3.7 shows the movement of average net wages in euros and costs of employers in euros.

Appendix

Table D 3.1 Basic labour market indicators according to LFS and CROCSI, Q1 2014- Q4 2019

	2014				2015				2016				2017				2018				2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Activity rate (%)	51.0	52.6	52.5	51.6	50.8	51.5	52.0	51.9	52.6	54.1	54.3	52.3	51.8	54.5	55.3	54.2	52.9	55.2	55.5	54.4	53.9
Employment rate (%)	40.2	41.8	43.1	42.9	41.2	42.6	43.4	42.7	42.6	45.9	46.8	45.5	44.2	48.1	48.2	46.3	45.1	48.6	49.2	47.4	47.4
Unemployment rate (%)	21.3	20.7	17.9	17.0	19.0	17.3	16.6	17.7	19.0	15.2	13.8	13.0	14.6	11.8	12.9	14.7	14.8	11.9	11.3	12.9	12.1
Informal employment rate (%)	19.7	20.4	22.8	21.8	19.7	19.7	21.5	20.4	20.3	22.7	24.1	20.9	19.0	22.1	21.8	19.8	18.6	21.0	20.4	18.1	17.1
Employment in 000, (LFS)	2453.6	2548.3	2626.8	2609.0	2504.1	2587.8	2623.9	2580.8	2570.7	2761.5	2814.0	2731.4	2652.2	2881.0	2881.9	2763.6	2688.3	2896.8	2929.3	2817.4	2810.5
Employment, index, (2014=100), (LFS)	95.9	99.6	102.6	101.9	97.8	101.1	102.5	100.8	100.4	107.9	109.9	106.7	103.6	112.6	112.6	108.0	105.0	113.2	114.5	110.1	109.8
Formal employment in 000, (LFS)	1969.3	2029.5	2027.6	2041.4	2010.5	2078.3	2058.6	2053.5	2048.7	2134.9	2136.6	2160.7	2148.1	2243.0	2253.5	2217.2	2188.2	2289.6	2330.4	2308.2	2328.5
Formal employment, index, (2014=100), (LFS)	97.6	100.6	100.5	101.2	99.7	103.0	102.1	101.8	101.6	105.9	105.9	107.1	106.5	111.2	111.7	109.9	108.5	113.5	115.5	114.4	115.4
Total employment in 000, (CROCSI)	1835.8	1844.9	1850.3	1851.0	1977.0	1982.0	1993.7	1994.0	1978.0	2008.3	2023.0	2030.3	2024.3	2061.5	2077.7	2086.7	2092.2	2126.6	2146.8	2158.7	2147.9
Total employment, index, (2014=100), (CROCSI)	99.5	100.0	100.3	100.3	107.1	107.4	108.0	108.0	107.2	108.8	109.6	110.0	109.7	111.7	112.6	113.1	113.4	115.2	116.3	117.0	116.4

Source: Author's calculations using SORS data.

Table D 3.2 Real net wages and costs of employers in EUR, Q1 2014- Q4 2019

	2014				2015				2016				2017				2018				2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Average net wages, total, (€)	361	389	383	386	343	371	372	386	355	378	373	391	367	399	398	416	415	419	414	430	455
Average net wages, industry, (€)	359	382	378	378	351	376	379	389	369	391	382	399	376	417	411	429	404	416	405	425	439
Labour costs, total (€)	588	633	623	626	557	601	603	626	576	613	607	635	596	648	647	677	676	684	676	701	735
Labour costs, industry (€)	582	622	617	615	570	611	617	632	599	635	623	649	611	677	669	699	658	678	660	692	709

Note: The industry includes B, C and D activities, weighted average wages. Dinar exchange rate against the euro, period average (NBS).
Source: Author's calculations using SORS and NBS data.

Trends

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4. Balance of Payment and Foreign Trade

In Q1 2019, the current account deficit amounted to 937 million euros, i.e. 9.2% of GDP. Thus, the current deficit was at a relatively higher level than the previous quarterly values, due to a more pronounced increase in trade deficit. Since the beginning of the year, both imports and exports have decelerated their growth, with a somewhat faster growth of imports of goods than the growth of exports (yoy 9.9% and 7.9%, respectively). This has led to further growth of trade deficit in the observed period. Seasonally adjusted data for Q1 2019 show an increase in exports and a slight decrease in imports compared to the previous quarter, while the April data show almost unchanged dynamics in the growth in imports as during the first three months, while exports slightly accelerated their growth. Adverse trends in foreign trade, which have lasted for more than two years, initiated by the strengthening of the dinar and excessive growth in domestic demand, at the beginning of this year were further enhanced by the introduction of prohibitive customs duties on the sale of products in Kosovo and Metohija, introducing a steel export quota to the EU and worsening trade relations. In Q1, a net inflow of capital of 850 million euros was recorded, and foreign exchange reserves increased by about 80 million euros in this period. Significant FDI inflows (EUR 797 million, or 7.8% of GDP) were realised with additional borrowing from other investments - growth of government and other sectors' loans. In 2019, we expect additional growth of foreign trade and current deficit due to faster growth of domestic demand than production growth and reduction of price competitiveness of the Serbian economy due to the increase of unit labour costs and strong dinar. The external balance sheets in the past year were adversely affected by the rise in energy prices, as well as the deterioration of the international status of Serbia, which is manifested through introduced customs duties on the sale of goods to Kosovo and Metohija and the introduction of steel export quotas for the EU. Possible introduction of additional protectionist measures by the EU or the retrogression of European economies after the recovery in the first quarter, would adversely affect Serbia's foreign trade results.

Current deficit in Q1 2019 was 937 million euros, i.e. 9.2% of GDP and significantly above previous quarterly values

The current account deficit in Q1 2019 amounted to 937 million euros (Table T4-1), and was significantly higher than the previous quarterly values. The share of the current deficit in GDP in the first three months of 2019 was 9.2% of GDP, which is 1.8 pp of GDP above the level from the same period of 2018. This increase in the current deficit is mainly due to the growth of trade deficit (which was higher by 1.3 pp of GDP compared to the one in Q1 2018). The share of Primary Income account and services deficit[1] in GDP remained at almost unchanged level compared to Q1 of the previous year, while the share of net income on the Secondary Income account[2] in GDP was somewhat lower (by 0.4 pp of GDP).

Trade deficit recorded a significant growth, partially due to extraordinary factors

During Q1 2019, exports amounted to 3.857 million euros, while imports were 5.180 million euros[3], so in Q1, the trade deficit was 1.324 million euros. The trade deficit accounted for 13.0% of GDP, and it was 1.3 percentage points of GDP higher than the share realised in Q1 2018. This percentage increase in the trade deficit was the result of the 2.5 pp increase in the share of imports in GDP (reaching 50.9%) and the 1.2 pp growth of the share of exports in GDP (amounting to 37.9%). The foreign trade deficit also recorded a year-on-year increase to 1.09 billion euros, and in Q1 2019, this deficit was 10.8% of GDP and 1.4 percentage points higher than the reported level in Q1 2018 (Graph T4-2 and Table T4-1).

The deterioration of foreign trade results at the beginning of 2019 was the result of a continued unfavourable trend that has been in place since the beginning of 2017, driven by a faster growth of domestic demand than GDP growth and a reduction in the price competitiveness of the Serbian

1 This item in the balance of payments includes employee benefits, dividends, reinvested earnings, interest and other income from factors of production.

2 This item in the balance of payments includes remittances, donations and other types of transfers.

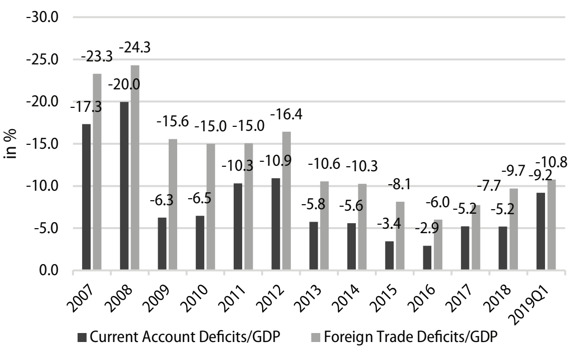
3 NBS data on import and export of goods, as well as on trade balance, differ from SORS data (which we use in the following sections of the article: *Export and Import*) because they do not include finishing goods (see Highlight 1 on changing the calculation methodology of Balance of Payments in *QM*37). Therefore, there is a certain difference in the levels of exports and imports, as well as the growth rates, depending on whether the data source was NBS or SORS.

Table T4-1. Serbia: Balance of Payments

	2016	2017	2018	2018				2019
				Q1	Q2	Q3	Q4	Q1
				mil. euros				
CURRENT ACCOUNT	-1,075	-2,051	-2,223	-724	-354	-556	-589	-937
Goods	-3,119	-3,997	-5,245	-1,138	-1,157	-1,240	-1,710	-1,324
Credit	12,814	14,066	15,238	3,576	3,927	3,850	3,885	3,857
Debit	15,933	18,064	20,483	4,714	5,084	5,090	5,596	5,180
Services	907	966	1,092	226	247	289	329	230
Credit	4,571	5,246	6,000	1,274	1,409	1,659	1,659	1,497
Debit	3,664	4,280	4,909	1,048	1,162	1,370	1,329	1,267
Primary income	-2,022	-2,533	-2,207	-622	-534	-641	-410	-653
Credit	630	568	564	113	159	139	153	125
Debit	2,653	3,101	2,771	736	692	780	563	777
Secondary income	3,159	3,514	4,137	810	1,090	1,036	1,201	810
Credit	3,635	4,097	4,740	951	1,237	1,185	1,368	959
Debit	476	583	602	141	147	149	166	150
Personal transfers, net [1]	2,510	2,758	3,222	633	913	854	823	649
Of which: Workers' remittances	1,874	2,049	2,531	480	741	687	623	470
CAPITAL ACCOUNT - NET	-10	5	-7	6	-3	-7	-2	-2
FINANCIAL ACCOUNT	-535	-1,648	-1,683	-568	-268	-384	-463	-776
Direct investment - net	-1,899	-2,418	-3,188	-723	-682	-598	-1,184	-797
Portfolio investment	917	827	913	-328	181	32	1,028	49
Financial derivatives	9	-21	21	16	-10	12	2	5
Other investment	740	-265	-552	70	-432	64	-254	-111
Other equity	-1	-1	-1	0	-1	-1	1	0
Currency and deposits	220	-623	404	21	-317	79	621	-274
Loans	303	-159	-1,303	30	-359	-202	-772	-112
Central banks	23	9	8	4	0	4	0	4
Deposit-taking corporations,	279	-235	-603	95	-80	-290	-328	272
General government	-308	9	-198	-103	-69	114	-141	-192
Other sectors	309	58	-510	34	-210	-30	-303	-196
Insurance, pension, and standardized	8	15	0	0	0	0	0	0
Trade credit and advances	209	504	347	18	245	188	-104	275
Other accounts receivable/payable	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0
Reserve assets	-302	228	1,123	398	674	105	-55	79
ERRORS AND OMISSIONS, net	549	398	546	150	89	179	128	163
PRO MEMORIA				in % of GDP				
Current account	-2.9	-5.2	-5.2	-7.4	-3.3	-5.0	-5.2	-9.2
Balance of goods	-8.5	-10.2	-12.3	-11.7	-10.9	-11.3	-15.0	-13.0
Exports of goods	34.9	35.9	35.6	36.8	36.8	35.0	34.1	37.9
Imports of goods	43.4	46.1	47.9	48.5	47.7	46.2	49.2	50.9
Balance of goods and services	-6.0	-7.7	-9.7	-9.4	-8.5	-8.6	-12.1	-10.8
Personal transfers, net	6.8	7.0	7.5	6.5	8.6	7.7	7.2	6.4
GDP in euros[2]	36,724	39,206	42,782	9,726	10,660	11,014	11,383	10,171

Note: Balance of Payments of the Republic of Serbia is in line with the international guidelines contained in the IMF Balance of Payments Manual no. 6 (BPM6).
Source: NBS
1) Personal transfers represent current transfers between resident and non-resident households.
2) Quarterly values. The annual GDP conversion to the euro was made at the average annual rate (average official daily middle exchange rates of the NBS).

Graph T4-2. Serbia: Current and Foreign Trade Deficit, 2007- Q1 2019



Source: NBS, *QM*

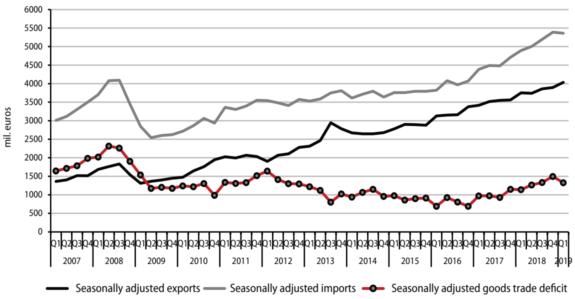
The growth of exports in 2019 will be adversely affected by the possible strengthening of protectionist measures... further growth of domestic demand in the pre-election year or strengthening of the dinar would encourage the acceleration of imports and decelerated growth of exports

economy due to economically unjustified strengthening of the dinar and the increase in unit labour costs. The deterioration of the foreign trade deficit was also affected by the worsening of the trade relations between the previous and the beginning of this year, as well as the deterioration of the international economic position of Serbia, which was manifested through the introduction of taxes on the delivery of products to Kosovo and Metohija and the introduction of steel export quotas for the EU. The decline in FIAT's production, the largest single exporter in Serbia, has further exacerbated the deterioration of the foreign trade balance.

In Q1 2019, the import of goods registered a relatively faster yoy growth (9.9%) than the growth of export of goods (7.9%), which led to further growth of trade deficit in the observed period. On the other hand, according to seasonally adjusted values, exports increased by 3.6% in Q1 2019 compared to Q4 2018, while imports decreased by 0.5% (Graph T4-3). SORS April data indicate that the growth rate of exports was slightly below the growth rate of imports of goods (8.0% and 8.8%, respectively). The possible strengthening of protectionist measures and

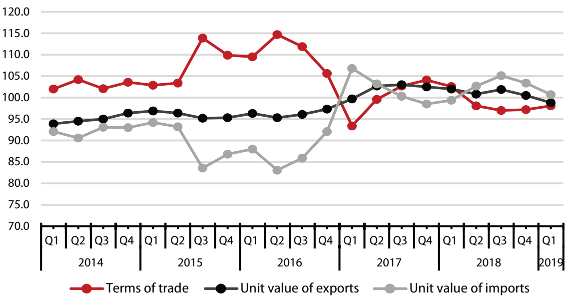
Trends

Graph T4-3. Serbia: Seasonally Adjusted Exports and Imports, Quarterly, 2007 – Q1 2019



Source: NBS, SORS, *QM*

Graph T4-4. Year-on-Year Trade Ratio Indices, 2014 – Q1 2019



Source: SORS, *QM*

continued prohibitive customs duties on the delivery of products from Serbia to Kosovo and Metohija will adversely affect Serbia's exports. A possible retrogression of European economies, following solid results in the first quarter, would have an adverse impact on exports, while an additional increase in domestic demand and the strengthening of the dinar in the pre-election year would boost imports and slow down exports.

Graph T4-4 shows the exchange rate index, which was 98.1 in Q1 2019. This was slightly above the level from the previous two quarters (in Q3 and Q4 2018 it was about 97). However, the value below 100 indicates that the quotient of export and import prices in Q1 2019 was below the Q1 2018 level. The movement of the exchange ratio was largely influenced by the movement of prices of oil derivatives on the global market (as we have written in previous issues of QM). From the beginning of the year the price of oil has increased again after it declined at the end of 2018. The uncertainty regarding its further movement makes it hard to assess the impact of the exchange ratio on the level of foreign trade and current deficit in 2019.

Inflow on Secondary Income Account of 8.0% of GDP

The net inflow on Secondary Income account in Q1 2019 was 810 million euros, i.e. 8.0% of GDP. Of that, 649 million euros, i.e. 6.4% of GDP was from personal transfers. Although the inflow on Secondary Income account and Personal Transfers was at last year's level in absolute terms, expressed in GDP, it was 0.4 and 0.1 pp lower than in Q1 2018, respectively (Table T4-1).

Instead of the planned reduction of current account balance of payments deficit, there will be an increase in 2019

Introduction of numerous protectionist measures in the world, specific problems in certain countries, predicted this year's modest growth in the countries that are the most important domestic foreign trade partners, etc. with the expected increase in domestic demand and the retention of strong dinar, will almost certainly lead to further increase in the trade deficit. In 2019, there will be no planned reduction of the current deficit, and it is almost certain that the deficit in relation to GDP will be slightly higher than in the previous year. In a situation where a number of external factors (protectionist measures, high energy prices, customs duties on Kosovo and Metohija, a slowdown in European economy) deteriorated, possible additional growth of domestic demand in the pre-election year would worsen the foreign trade and current balance of payments.

Net inflow of capital in Q1...

A net inflow of capital of 852 million euros was recorded in Q1[4], which resulted in forex reserves at the end of Q1 being by 79 million euros higher compared to the level recorded three months earlier (Table T4-1).

...was thanks to the inflow of FDI and other investments, on the one hand, and smaller outflow of portfolio investments on the other

The FDI inflow remained at a significant level in Q1 2019, but below the level of the current deficit. Net inflow of FDI amounted to 797 million euros, which makes 7.8% of GDP. Also, capital inflows were recorded due to additional borrowing of EUR 111 million from other investments. Within other investments, net borrowing from loans of 112 million euros was recorded, where the state and other sectors increased borrowing, while the banks deleveraged by 272 million euros. At the same time, there was an increase by the same amount on the *Cash and Deposit* account, while *Trade Loans and Advances* account had a decrease by the same amount.

4 Inflow of 1.015 million euros, including the *Errors and Omittances* account.

Highlight 1. The level of current account balance of payments in Serbia compared to the European countries in transition

Based on the latest NBS data, the current account deficit in Serbia is on the rise. The lowest level of the current deficit was recorded in 2016, when it was 2.9%. After that, for two consecutive years the current deficit was at the level of 5.2%, and from the beginning of 2019 it was as high as 9.2%. Such a trend suggests that at the level of 2019 there will be no desirable reduction of the current account deficit, i.e. that the external imbalance, despite the desirable reduction, will be maintained at a significant level.

Table T4-4 shows the share of deficit in GDP in Central and Eastern European countries, together with some countries in the region, for the last four years. According to the levels shown, Albania had a high and negative current account balance, which was above the deficit in Serbia. Compared to all other selected countries, Serbia is significantly ahead of the deficit level in relation to Romania, Slovakia and North Macedonia, which also had a deficit in all four years observed. Romania also recorded a certain increase in the level of deficit in GDP, but in 2018 it was 4.5%, which was below the level achieved in Serbia in the same year (5.2%). Slovakia has recorded a negative outcome in the current balance over the past four years, but it has been at a stable level of about 2% of GDP all the time. Northern Macedonia, in addition to Albania, Serbia, Romania and Slovakia, also recorded a deficit in the observed four-year period, but it has a declining trend, so that in 2018 it was only 0.3% of GDP.

Poland, Latvia and Lithuania periodically realised current account deficits, but they were at a much lower level and very close to equilibrium (0). Other observed countries have had a positive balance on the current account over the past four years. Particularly high levels were achieved by Slovenia, which in 2018 recorded a current surplus of 7% of GDP. We should particularly mention the result in this field recorded by Bulgaria. According to the data, there was a rapid trend of surplus growth in Bulgaria. Namely, Bulgaria had a balanced current account in 2015. In 2016 and 2017, its surplus reached and surpassed 3% of GDP, and in 2018 it was as high as 4.6% of GDP (Table T4-4).

Tabela T4-5. Share of Current Balance in GDP, 2015-2018

	2015	2016	2017	2018
Slovenia	4.5	5.5	7.2	7.0
Bulgaria	0.0	2.6	3.1	4.6
Croatia	4.4	2.5	3.9	2.6
Estonia	1.8	2.0	3.2	1.7
Lithuania	-2.3	-0.8	0.9	1.6
Hungary	2.7	6.1	2.8	0.4
Czechia	0.2	1.6	1.7	0.3
North Macedonia	-2.0	-2.9	-1.0	-0.3
Poland	-0.6	-0.5	0.2	-0.7
Latvia	-0.5	1.6	0.7	-1.0
Slovakia	-1.7	-2.2	-2.0	-2.5
Romania	-1.2	-2.1	-3.2	-4.5
Serbia*	-3.4	-2.9	-5.2	-5.2
Albania	-8.6	-7.6	-7.5	-

Source: Eurostat; NBS and *QM* for Serbia

In fact, based on these data, we can conclude that in other countries there is no trend of deteriorating the external balance, and that the trend of the current account deficit in Serbia is largely a systemic problem. Also, the observed decrease in the current deficit in Serbia in certain years in the previous period is not the result of any permanent improvement. Therefore, all this indicates that the problem of the external imbalance of the domestic economy in previous years was only mitigated at a certain time by favourable external circumstances (improving trade ratios) and certain temporary political measures (fiscal consolidation), but that it still exists.

Exports

Exports decelerated growth during Q1 2019, only to slightly accelerate again in April

In the first three months, exports amounted to 4.08 billion euros, which was by 6.5% above the value of exports from Q1 of the previous year (Table T4-6). Thus, exports slowed down their growth compared to the previous quarter (yoy growth rate of exports in Q4 2018 was 8.8%). The primary reasons for this slowdown in exports were the slow growth of the Serbian economy (supply) and weakening of its price competitiveness (strong dinar, increase in unit labour costs). Contributing factors were also the slow growth of Italy and Germany, which are our most important trading partners, as well as taxes on products delivered to Kosovo and Metohija and the introduction of steel export quotas. In April, there was a slight acceleration of exports, when

Table T4-6. Serbia: Exports, Year-on-Year Growth Rates, 2017 – April 2019

	Exports share in 2018	2017	2018	2018		2019		2018		2019	
				Q3	Q4	Q1	April	Q3	Q4	Q1	April
	in %	in mil. euros						in %			
Total	100.0	15,051	16,271	4,068	4,132	4,083	1,412	7.5	8.8	6.6	8.0
Total excluding road vehicles	93.4	13,801	15,203	3,857	3,932	3,869	1,099	8.8	11.6	10.1	9.6
Energy	3.0	382	485	161	118	90	20	49.9	-1.7	8.6	-43.1
Intermediate products	39.4	5,743	6,410	1,598	1,612	1,640	563	6.9	11.3	5.4	10.5
Capital products	24.2	3,633	3,933	910	1,011	977	348	10.8	3.3	2.3	3.8
Capital products excluding road vehicles	17.6	2,383	2,864	699	811	762	250	20.7	15.3	18.8	9.8
Durable consumer goods	5.3	811	857	210	224	213	79	3.3	8.1	8.3	9.1
Non-durable consumer goods	21.4	3,358	3,480	897	889	852	301	0.9	3.4	4.8	11.8
Other	6.8	1,124	1,107	293	278	312	100	8.2	49.3	37.6	18.7

Source: SORS

yoy growth of 8.0% was recorded. The value of road vehicle exports was 32% below last year's level in Q1 2019 and 9% in April. Thus, the yoy growth of total exports, after excluding road vehicles, in Q1 was 10.1%, and in April, 9.6%, which is a solid result.

During Q1 all export components except Energy, Durable and Non-Durable Consumer Goods decelerated their growth

During Q1, exports of the two biggest export groups: *Intermediate* and *Capital Goods* decelerated their growth. Exports of these two product groups combined make 2/3 of total export value (see Table T4-6). The export value of *Intermediate Goods* in Q1 recorded a yoy increase of 5.4%, after a yoy growth rate of 11.3% in Q4 2018. On the other hand, consumer goods (durable and non-durable) slightly accelerated their yoy growth in Q1 2019 compared to the growth from the previous quarter.

Export value of energy products varies significantly. In Q3 2018, it had a yoy increase of around 50%. In Q4 2018, it was by 1.7% below the value of Q4 2017, and in Q1 2019, it recorded a yoy growth of 8.6%, only to be 43% ahead of the last year's value in April. The movements in export value significantly reflects the movements of global oil prices, which increased since the beginning of 2018, then slightly declined in Q4 2018, only to record growth again in the beginning of 2019[5]. Still, as the energy exports make only 3% of total exports, the trends in the value of energy exports, despite its pronounced fluctuations, do not have a considerable impact on the total export dynamic.

In April, accelerated exports were mostly the result of accelerated growth of *Intermediate Goods, Capital Goods* and *Non-Durable Consumer Goods* (which also represent the biggest export groups, with a share of 2/5, 1/4 and 1/5, respectively, see Table T4-6), while *Energy* exports are significantly below last year's. In addition to the pronounced decline of *Energy* export value, in April there was an accelerated growth of exports in all export components, except in non-classified exports (group *Other* decelerated its growth from 37.6% in Q1 to 18.7% in April, Table T4-6).

We expect a solid growth of exports in 2019 despite certain unfavourable circumstances

In the coming period, we can expect a negative impact on the growth of exports due to the downward trend in the economic activity of the eurozone countries and the delayed effect of real appreciation of the domestic currency. The dynamics of export growth in the coming period will also be determined by further local and global moves regarding the barrier to foreign trade, to what extent the adverse weather conditions to date will be reflected in agricultural production in the country, as well as the movement of prices of primary goods on the global market.

Imports

Total imports in Q1 2019 amounted to 5.529 million euros. Thus, imports decelerated growth and in Q1 recorded a year-on-year growth rate of 8.9%, followed by 8.8% in April, after 13.3% in Q4 2018 (see Table T4-7). The slowdown in imports growth during Q1 was due to the slowdown in the growth of all import components (even negative rates in Durable Consumer Goods), with the exception of unclassified imports (*Other*[6] in Table T4-7).

5 In the analysis, we used World Bank data on the price of oil, type Brent.
6 This group includes predominantly warehoused goods.

Since the beginning of 2019, there has been a decelerated growth of imports…

Imports of energy products recorded significant variation in the levels and thus in yoy growth rates as well. In the second half of 2018 (Table T4-6), there was a very high yoy increase in *Energy* imports (predominantly due to the high growth of energy prices since mid-2018), followed by a slowdown in growth in the first quarter of 2019, only to achieve a year-on-year decrease in the value of imports in April 2019.

...and in the coming period, the level of imports will be determined by the global energy prices and domestic demand

The highest growth rate of imports during Q1 was recorded in products classified in the group *Other* - which grew by 20% yoy, followed by *Energy* goods (11.2%) and *Intermediate Goods* (10.1%). Other imports accelerated compared to the previous quarter (yoy growth of 20% in Q1 2019 and 13.4% in Q4 2018), while imports of *Energy* and *Intermediate Goods* decelerated (the yoy growth in Q4 2018 of 41.1% and 12, 0%, respectively).

At the same time, imports of *Non-Durable Consumer Goods* decelerated their growth in Q1 and accelerate in April. *Capital Goods* in Q1 recorded a very low growth of 0.7% yoy, and slightly faster growth of 1.5% yoy in April. On the other hand, *Durable Consumer Goods*, following a year-on-year decline in imports of 0.6% in Q1, recorded a significant recovery and yoy growth of 11.0% in April. However, the movement of imports of *Durable Consumer Goods* does not significantly affect total imports, as they make only 2% of the total imported value.

In April 2019, the growth rate of imports remained almost unchanged as in Q1. In April, imports of all production components slightly accelerated growth. The exception was *Other Imports* that slowed down and *Energy* - where a year-on-year drop in the imported value of 15% was recorded. Significant yoy growth in April was recorded in *Intermediate Goods*, as well as in *Durable* and *Non-Durable Consumer Goods*.

Table T4-7. Serbia: Imports, Year-on-Year Growth Rates, 2017 - April 2019

	Imports share in 2018	2017	2018	2018		2019		2018		2019	
				Q3	Q4	Q1	April	Q3	Q4	Q1	April
	in %	in mil. euros						in %			
Total	100.0	19,396	21,918	5,402	5,961	5,529	1,912	14.8	13.3	8.9	8.8
Energy	11.6	2,026	2,541	655	777	586	171	34.3	41.1	11.2	-15.0
Intermediate products	35.6	6,913	7,810	1,929	2,050	2,021	724	9.5	12.0	10.1	16.3
Capital products	21.0	4,186	4,593	1,099	1,199	1,107	384	14.7	3.3	0.7	1.5
Durable consumer goods	2.0	405	436	102	127	103	38	3.1	10.9	-0.6	11.0
Non-durable consumer goods	14.9	2,930	3,269	786	925	836	300	8.5	11.7	7.3	15.4
Other	14.9	2,936	3,269	832	882	875	297	23.0	13.4	19.8	13.2
Imports excluding energy	88.4	17,370	19,377	4,747	5,184	4,942	1,742	12.5	10.0	8.7	11.9

Source: SORS

Accelerated growth of imports in the coming period will be affected by the expected increase in domestic demand, as well as the delayed effect of real appreciation of the dinar. In addition, the growth dynamics of imports will in part be determined by the trend of global energy prices.

Foreign Debt

Foreign debt at the end of 2018 was 26.9 billion euros

At the end of 2018, Serbia's foreign debt was 26.901 million euros, i.e. 62.9% of GDP (Table T4-8)[7].

During Q4 2018, the foreign debt increased by 377 million euros and during entire 2018, it increased by 1.3 billion euros

During Q4 2018, the foreign debt increased by 377 million euros. Expressed as a share of GDP (due to GDP growth), the foreign debt at the end of December was at the same level as three months earlier (62.9% of GDP). In Q4 2018, private sector borrowing significantly increased, so private debt grew by 951 million euros, while at the same time public sector's debt fell by 574 million euros. The increase in the private sector's foreign debt was due to the increase in the long-term debt (primarily of the business sector) and the higher level of short-term debt (primarily due to increased short-term debt of banks). Banks increased their short-term debt by 279 million euros, and the business sector by 45 million euros. Additional borrowing on the business sector's long-term foreign debt amounted to 545 million euros, while banks borrowed on this basis another 82 million euros (see Table T4-8).

7 The source of data for foreign debt and international investment position is NBS, and the latest available data refer to the end of 2018.

Table T4-8. Serbia: Foreign Debt Trend Dynamic, 2015–2018

	2015	2016	2017				2018			
			Mar.	Jun	Sep.	Dec.	Mar.	Jun	Sep.	Dec.
	stocks, in EUR millions, end of the period									
Total foreign debt	26,234	26,494	26,091	25,389	25,999	25,578	25,392	26,101	26,524	26,901
(in % of GDP) [4]	*73.3*	*72.1*	*70.4*	*67.6*	*67.8*	*65.2*	*63.1*	*63.2*	*62.9*	*62.9*
Public debt[1]	15,295	15,680	15,508	14,592	14,653	13,910	13,767	14,096	13,997	13,423
(in % of GDP)[4]	*42.7*	*42.7*	*41.8*	*38.9*	*38.2*	*35.5*	*34.2*	*34.1*	*33.2*	*31.4*
Long term	15,295	15,680	15,508	14,592	14,653	13,910	13,767	14,096	13,997	13,423
o/w: to IMF	15	0	0	0	0	0	0	0	0	0
o/w: Government obligation under IMF SDR allocation	493	494	495	472	465	462	458	468	468	472
Short term	0	0	0	0	0	0	0	0	0	0
Private debt[2]	10,939	10,815	10,584	10,797	11,346	11,667	11,625	12,005	12,527	13,478
(in % of GDP) [4]	*30.6*	*29.4*	*28.5*	*28.8*	*29.6*	*29.8*	*28.9*	*29.1*	*29.7*	*31.5*
Long term	10,636	10,138	10,067	10,114	10,622	10,769	10,779	11,074	11,351	11,978
o/w: Banks debt	2,057	1,408	1,345	1,390	1,412	1,519	1,506	1,555	1,639	1,721
o/w: Enterprises debt	8,576	8,725	8,714	8,717	9,200	9,241	9,263	9,510	9,701	10,246
o/w: Others	4	6	7	8	9	9	10	10	11	11
Short term	303	676	517	683	724	898	846	931	1,176	1,500
o/w: Banks debt	186	590	382	602	641	817	761	833	1,067	1,346
o/w: Enterprises debt	116	86	135	81	82	81	85	98	109	153
Foreign debt, net [3], (in% of GDP) [4]	44.3	44.4	44.1	41.9	40.1	39.8	37.7	36.3	36.4	36.6

Note: Republic of Serbia's foreign debt is calculated according to the principle of "maturing debt", which includes the amount of debt per principal and the amount of accrued interest not paid at the moment of the agreed maturity.
Source: NBS, QM
The foreign debt of the Republic of Serbia's public sector includes the debt of the state (which includes the debt of Kosovo and Metohija for loans concluded before the arrival of the KFOR mission, unregulated debt to Libya and clearing debt to the former Czechoslovakia), of the National Bank of Serbia, local self-government units, funds and agencies founded by the state and the debt for which the state guarantee was issued.
The foreign debt of the Republic of Serbia's private sector includes the debt of banks, enterprises and other sectors, for which a state guarantee has not been issued. Private sector's foreign debt does not include loans concluded before December 20, 2000 for which no payments are made (EUR 968.8 million, of which EUR 419.3 million refers to domestic banks, and EUR 549.5 million to domestic enterprises).
Total foreign debt reduced by NBS forex reserves.
The sum of the GDP of the observed quarter and the previous three quarterly GDP values is used.

During 2018, private sector borrowing abroad had a fast growth

At the end of 2018, compared to the end of 2015, total foreign debt was higher by 1.323 million euros, but at the same time, its share in GDP was reduced (from 65.2% to 62.9%). During this period, the private sector significantly increased its foreign borrowing by 1.8 billion euros, while the total public sector debt was 487 million euros. In 2018, banks borrowed EUR 202 million for long-term debt, and the business sector borrowed as much as one billion euros. Short-term debt of banks in the observed period was higher by 530 million euros, while the short-term debt of the business sector recorded an increase of 72 million euros (Table T4-7).

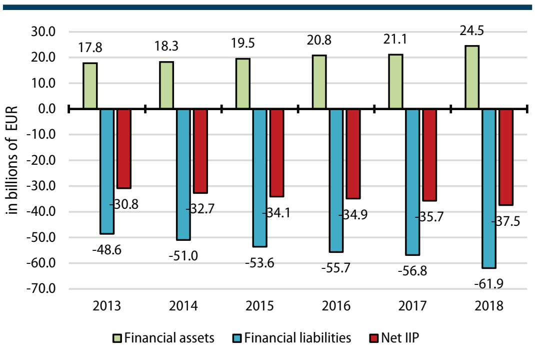
International Investment Position

In 2018, Serbia's IIP recorded a 1.7 billion euro increase…

…At the end of the year, it was 37.5 billion euros

At the end of 2018, Serbia's International Investment Position (IIP)[8] was 37.5 billion euros, where Serbia's receivables abroad were 24.5 billion euros, and liabilities were 61.9 billion euros (Graph T4-9).

Graph T4-9. Serbia: Net International Investment Position, in billions of EUR



Source: NBS
Note: Net financial liabilities are expressed as negative values in the graph.

During 2018, there was a growth in both financial assets - by 3.4 billion euros, and financial liabilities - by 5.1 billion euros. Thus, during this period, IIP increased by 1.7 billion euros.

A more detailed analysis of the position of net financial liabilities indicates that at the end of 2018, FDI reached 34.8 billion euros, that the loans were at the level of 17.75 billion euros, and that the level of portfolio investments was 4.75 billion euros. Thus, during 2018, there was a significant increase in FDI liabilities of 3.5 billion euros, as well as loans of 1.6 billion euros, while on the other hand there was a decrease in liabilities from portfolio investments of 0.7 billion euros.

8 The International Investment Position of the country (MIP) includes financial assets and liabilities of international character. It represents the difference between foreign financial assets in our possession (foreign reserves, our direct and portfolio investments abroad, approved loans abroad, etc.) and foreign financial liabilities in Serbia (foreign direct and portfolio investments, debts abroad, etc.). The country is a net creditor if its claims and assets abroad are higher than foreign assets in the country and its foreign debts.

5. Prices and The Exchange Rate

There was a modest price growth of 0.1% in the last quarter of 2018, but the first two months of this year saw a slight acceleration in inflation. Year-on-year December and average inflation have stopped at the level of 2%. Last year's inflation was largely caused by the increase in the prices of food, oil and tobacco products, which means that inflationary pressures in the economy are still weak. This is confirmed by low and stable underlying inflation (measured by the consumer price index excluding food, alcoholic beverage, tobacco and energy), which was moving within a narrow interval of about 1% throughout 2018. In the first two months of 2019, year-on-year inflation accelerated to 2.4%, primarily thanks to a rise in food prices that was higher than usual seasonal and tobacco products due to a January increase in excise taxes, whereas the underlying inflation reached 1.3% in February. A gradual acceleration of inflation this year is in line with our expectations, given that there is a prediction of further growth in private consumption (partly due to a strong growth in public sector wages and pensions) and exhaustion of disinflationary impact of dinar appreciation in the previous period. However, we estimate that in the most of 2019 inflation will continue to move in the lower half of the NBS target interval (3 ± 1.5%) - slightly above last year's 2% on average- which is why we should not expect a correction of the key policy rates, at least in the first half of the year. In the whole 2018, despite strong appreciations pressures, the Dinar only slightly strengthened against the Euro (by 0.2%), due to frequent NBS interventions in the interbank foreign exchange market. Although the prevention of excessive strengthening of the dinar in 2018 by a net purchase of 1.580 million euros was a good policy, the fact that NBS intervines at first signs of depreciation pressures is problematic - as happened in January of this year, when 130 million euros were sold. By doing this, NBS continues to implement a firm foreign exchange rate policy and partly contributes to the economically unfavorable trend of real appreciation of the domestic currency, which has been present since Q4 2016. Such a policy would be justified if the exchange rate of the dinar was at equilibrium level, that is, if the external balance was in balance, but that is not the case. In 2018, the dinar realistically strengthened against the euro by 1.2%, and by an additional 1.8% in the first two months of this year - which negatively affects the competitiveness of domestic economy, and this extended period of real dinar appreciation is one of the important factors standing behind the worsening of deficit in foreign trade exchange over the past year.

Prices

The prices in Q4 slightly increased on average, thus both December and average inflation amounted to the expected 2% in 2018

The last quarter of 2018 recorded a modest increases in a small number of products, which, along with the decline in the prices of petroleum products due to a recent drop in world oil prices, led to inflation of only 0.1% in Q4. In accordance with our previous expectations, total inflation in December stopped at a level of 2%, as was the amount of average inflation in 2018 (Table T5-1). When groups of products are observed, the increase in prices in the previous year was mainly driven by the price increase of food products (by 2.7%, contribution of 0.8 pp), transport services (by 4%, contribution of 0.5 pp) and alcoholic beverages and tobacco by (5.2%, contribution 0.4 pp). The fact that total inflation in 2018 was largely conditioned by the movement in food prices, petroleum products and legal adjustment of excise taxes on tobacco products clearly suggests that domestic inflationary pressures are still relatively weak. This is confirmed by low underlying inflation (measured by the consumer prices index excluding food, alcoholic beverages, tobacco and energy), which was fairly stable throughout the entire year and was moving in a narrow interval of around 1%.

Inflation was slightly increasing in the first two months of 2019

In the first two months of 2019 prices increased by 1.1% on average, which is why year-on-year inflation accelerated slightly to 2.4%. Although this is, to a large extent, the result of a more noticeable increase in the prices of food than it is seasonally usual and increase in the prices of tobacco products due to a January increase in excise duties, it is also possible to expect moderate

Table T5-1. Serbia: Consumer Price Index, 2011-2019

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2011					
dec	154.3	7.0	7.0	-0.7	2.5
2012					
dec	173.1	12.2	12.2	-0.4	9.9
2013					
dec	176.9	2.2	2.2	0.2	-0.9
2014					
dec	180.0	1.8	1.8	-0.4	-2.4
2015					
dec	182.8	1.6	1.6	-0.2	-1.9
2016					
dec	185.6	1.5	1.5	-0.2	1.8
2017					
mar	190.0	3.5	2.4	0.2	9.8
jun	191.0	3.6	2.9	0.2	2.1
sep	190.7	3.2	2.7	0.1	-0.6
dec	191.2	3.0	3.0	0.1	1.1
2018					
jan	191.8	1.9	0.3	0.3	1.3
feb	192.4	1.5	0.6	0.3	2.7
mar	192.7	1.4	0.8	0.2	3.2
apr	193.5	1.0	1.2	0.4	3.6
maj	194.7	2.2	1.8	0.6	4.9
jun	195.4	2.3	2.2	0.4	5.7
jul	194.8	2.4	1.9	-0.3	2.7
avg	195.4	2.6	2.2	0.3	1.5
sep	194.8	2.1	1.9	-0.3	-1.2
oct	195.4	2.2	2.2	0.3	1.2
nov	194.8	1.9	1.9	-0.3	-1.2
dec	195.0	2.0	2.0	0.1	0.4
2019					
jan	195.7	2.0	0.4	0.4	0.6
feb	197.1	2.4	1.1	0.7	4.8

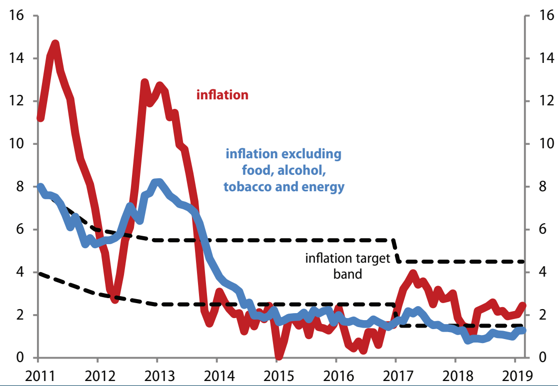
Source: SORS.

acceleration of total inflation this year. The key inflationary factors in 2019 should be a continuation of domestic demand growth (which will be partly contributed by a significant increase in salaries in public sector and pensions) and depletion of a strong disinflationary impact of the dinar appreciation in the previous period. Faster demand growth than production growth largely led to the growth of foreign trade deficit, but with a certain time shift also influenced the increase in inflation. On the other hand, a sharp decline in world oil prices at the end of 2018 and last year's good agricultural season will probably slow down total inflation through base effect. Taking these factors into account, we estimate that, in most of 2019, inflation will nevertheless move within the lower half of the NBS target interval (3 ± 1.5%), but on average slightly above last year's 2%.

Due to prevailing weak inflationary pressures, underlying inflation remained at a record low level of about 1% in Q4

Underlying inflation (measured by the consumer price index excluding food, alcohol, tobacco and energy products) was very stable standing at the level of about 1% (Graph T5-2). As we have already mentioned, last year's total inflation was largely conditioned by the increase in price of a limited number of products that are excluded from the calculation of underlying inflation - fruits and vegetables, petroleum products and regulated prices (tobacco products) - which confirmed the fact that general inflationary pressures were still weak in the past year. Although private consumption in 2018 increased by 3.3% in real terms, it still represents the growth in accordance with the trend of non-agricultural GDP and therefore insufficient to generate stronger inflationary pressures. The exchange rate was highly stable over the past year (the dinar actually nominally strengthened against the euro by 0.2%), following a strong appreciation in 2017, which also contributed to underlying inflation standing at a record low level throughout the year. In January of this year, underlying inflation slightly accelerated to 1.3%, which agrees with our expectations

Graph T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2011-2019

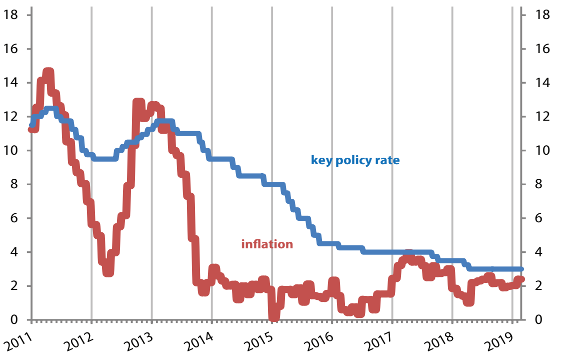


Source: NBS and *QM* estimates

for 2019. Namely, further growth in private consumption is expected this year, which should be contributed by fiscal policy measures (noticeable increase of wages in budget sector by 9% on average and pensions) and full effect of relaxation of monetary policy in 2018 (through the growth of credit activity). In 2019, we also expect exhaustion of disinflationary impact of strong dinar appreciation from the previous period, which as a result would have a greater impact of import prices on the underlying inflation movement. The final impact on the movement of underlying inflation will also depend on factors on the supply side (such as the movement of the price of petroleum or electricity for the economy) that determine the costs of production, but this year it is certainly possible to expect its gradual approach to the NBS target interval (3 ± 1.5%).

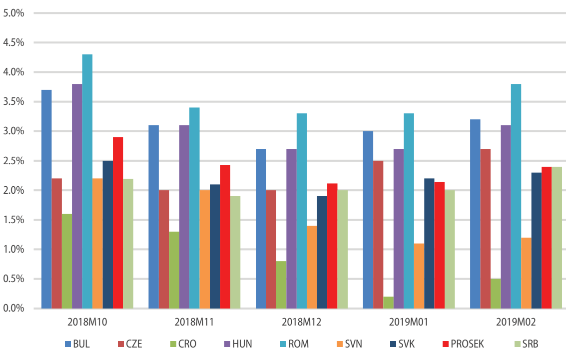
Following the relaxation of monetary policy in March and April, the NBS retained the key policy rate at 3% until the end of 2018

Graph T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2011-2019



Source: NBS

Graph T5-4. Inflation in Serbia and selected countries in Central and Eastern Europe



Source: Eurostat, SORS and *QM* calculations

Sharp slowdown in underlying inflation and appreciation pressures on the dinar encouraged the National Bank of Serbia that last year twice cut its benchmark interest (in both March and April by 0.25 basis points) - from 3.5% to 3% (Graph T5-3). In remaining months of past year and at the beginning of 2019, there was no further relaxation of monetary policy, as inflation ranged within the target interval, and there was a moderate recovery in the credit activity of the economy. We estimate it is unlikely that there will be additional correction in key policy rate in the first half of 2019 - inflation will continue to move in the lower half of the targeted interval, while possible pressures on the dinar exchange rate, as in 2018, are likely to be neutralized by NBS interventions in the interbank foreign exchange market. Namely, in the past year, the NBS prevented excessive strengthening of the dinar against the euro by net purchase of 1,580 million, and similar practice continued in January when it eased depreciation pressures on the dinar by selling 130 million euros. Possible changes in key policy rate will significantly depend on developments in international environment, primarily decisions of leading central banks - the US Fed and the European Central Bank. The initial statements of FED representatives that 2019 will be followed by more noticeable monetary policy tightening are now somewhat softened, while the effects of quantitative incentives of the ECB (although formally completed in December 2018) are likely to be felt in the greater part of this year. It also suggests that the key policy rate could remain unchanged (3%) at least in the first half of 2019.

Inflation in Serbia reached the average price increase in the countries of Central and Eastern Europe by the end of 2018

After a relatively strong acceleration of inflation in the CEE region in the first half of last year (from 2.2% in January to 3.1% in June), over the second part of 2018, inflation slowed down steadily to December's 2.1% (Graph T5-4). When individual countries are observed, at the end of 2018 inflation was the highest in Romania (3.3%), and lowest in Croatia (0.8%) - while Serbia's December inflation rate of 2% is approximately the average of the region. Another common thing for the whole region is that the key contribution to inflation in previous year was made by the increase in prices of petroleum (due to a rise in world oil prices at the beginning of 2018) and food products. In addition, in some countries domestic factors also generated higher inflationary factors - such as stronger growth in private consumption, very favorable trends in the labor market (the unemployment rate is in many countries at the historically lowest level), but also depreciation of national currencies. Consequently, several central banks was already forced to tighten monetary policy in the past year. For example, in the Czech Republic, the key policy rate was increased five times by 0.25 b.p. (from 0.5% to 1.75%), while in Romania the key policy rate increased from 2% to 2.5% in 2018. On the contrary, the economic recovery in Serbia was lagging behind the region, so the inflation was much lower during the greater part of 2018, which is why the intensification of domestic monetary policy is likely to be delayed when compared to the region.

Table T5-5. Serbia: Consumer Price Index: Contribution to Growth by Selected Components

	Share in CPI (in %)	price increase in Q4 2018.	Contribution to overall CPI increase (in p.p.)	price increase in january 2019.	Contribution to overall CPI increase (in p.p.)	price increase in febraury 2018.	Contribution to overall CPI increase (in p.p.)
Total	100.0	0.1	-0.3	0.4	0.4	0.7	0.7
Food and non-alcoholic beverages	31.7	0.3	0.1	1.3	0.4	2.0	0.6
Food	28.1	0.2	0.1	1.4	0.4	2.3	0.6
Alcoholic beverages and tobacco	6.9	-0.2	0.0	0.0	0.0	2.6	0.2
Tobacco	4.4	0.0	0.0	0.0	0.0	3.8	0.2
Clothing and footwear	4.7	2.2	0.1	-1.3	-0.1	-1.5	-0.1
Housing, water, electricity and other fuels	13.8	0.2	0.0	0.1	0.0	0.0	0.0
Electricity	5.1	0.0	0.0	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.9	0.1	0.0	0.3	0.0	0.1	0.0
Health	4.9	0.6	0.0	0.2	0.0	0.2	0.0
Transport	12.4	-1.0	-0.1	-0.8	-0.1	0.0	0.0
Oil products	5.9	-3.4	-0.2	-2.2	-0.1	0.1	0.0
Communications	5.0	-0.4	0.0	0.3	0.0	-0.2	0.0
Other items	15.9		0.0		0.1		0.0

Source: SORS and *QM* estimates

In Q4 2018, there was a slight change in the price of a limited number of products and services, therefore it recorded a low inflation of 0.1%

The last quarter of 2018 continued with the low inflation trend that was set in the second half of the year and prices increased by only 0.1% on average (Table T5-5). When individual months are observed, October inflation was 0.3%, then in November we saw the average consumer basket decrease by the same amount (-0.3%), whereas December prices increased by an average of 0.1 %. The highest contribution to inflation in Q4 was made by a seasonally usual price increase of food products (by 0.3%, contribution of 0.1 p.p.) and clothing and footwear (by 2.2%, contribution of 0.1 p.p.). Decrease in the prices of goods and services in transport sector by about 1% worked in opposite direction (contribution -0.1 pp). Namely, during the last quarter of 2018, there was a sharp drop in oil prices on the world market (by around 30%), which also affected the reduction in domestic prices of petroleum products to a lesser extent (on average by 3.4%). Changes in the prices of other products and services were negligible in Q4, and their contribution to total inflation is mainly annuled. At the end of Q4, year-on-year inflation stopped at the level of 2% in accordance with our expectations.

At the beginning of 2019, inflation accelerated slightly, mainly due to increases in the prices of food and tobacco products

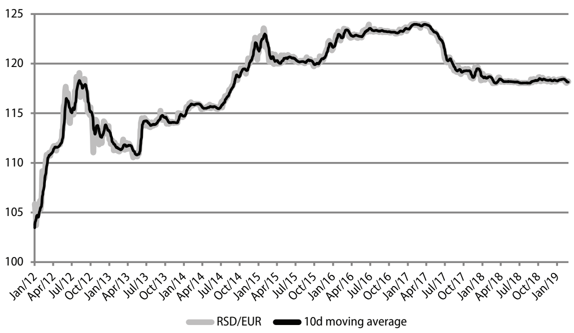
January recorded inflation of 0.4% (Table T5-5), largely due to a seasonally usual increase in food prices by 1.3% (contribution of 0.4 p.p.). The increase in food prices in this month is almost entirely the result of the increase in fresh vegetables prices by 8.4%. Also, the prices of goods and services from the group of recreation and culture increased by 1.3% (contribution of 0.1 p.p.), primarily due to the increase in the price of tourist package packages by 7.6%. A seasonal decline in the prices of clothing and footwear by about 1.3% (contribution of -0.1 p.p.), i.e. decline in the prices of petroleum products by an additional 2.2% (contribution of -0.1 pp), which is actually transferred effect of a sharp drop in world oil prices that happened at the end of last year, had a disinflationary effect. Prices of other products and services slightly increased, and their cumulative contribution to January inflation amounted to 0.1 p.p. In February, prices increased by 0.7% on average, again primarily due to a food price increase by about 2% (contribution of 0.6 p.p.). In this month, prices of tobacco products also increased by 3.8% (contribution of 0.2 p.p.) due to a regular increase in excise duties in January. In the end, the seasonal decline in the prices of clothing and footwear continued by an additional 1.5%, which slowed down the inflation by 0.1 p.p. in this month. The increase in the prices in the first two months of 2019 was more noticeable than in the same period of previous year, which is why year-on-year inflation slightly accelerated - from 2% in December to 2.4% in February.

The Exchange Rate

During Q4, the dinar weakened slightly against the euro with minimal intervention by the National Bank of Serbia

The appreciation pressures on the dinar, which were present in the greater part of 2018, weakened in Q4, and the exchange rate was mostly stable and without major intervention by the NBS on the interbank foreign exchange market. During Q4, the dinar nominally strengthened against the euro by 0.2% (i.e. weakened by 0.2% when compared to the quarter average), while the NBS appeared on IFEM both as a buyer (45 million euros) and seller (60 million euro) to prevent excessive daily fluctuations in foreign exchange rate. The seasonal growth in demand for foreign currency at the beginning of 2019 caused depreciation pressures on the dinar, but the domestic currency weakened by only 0.2% in January, thanks to the NBS selling 130 million in the IFEM. The NBS thus continued to implement the firm foreign exchange rate policy from last year, when it successfully maintained the exchange rate in the narrow interval of 118-118.5 dinars per euro with its frequent interventions (Graph T5-6). At the end of the year, the dinar nominally appreciated by 0.2% when compared to the end of 2017, i.e by 2.6% if we observe average annual foreign exchange rates. The dinar weakened by 1.7% against the US dollar in Q4, ie by 2.1% when compared to the quarter average. Thanks to the strengthening of the US currency against the euro in 2018, the dinar weakened against the dollar by 4.3% annually. Similar trends are recorded in the dinar exchange rate against the Swiss franc, as the domestic currency weakened by 0.8% in Q4 (by 0.9% when compared to the quarter average), while the dinar depreciated by 3.6% annually.

Graph T5-6. Serbia: Daily RSD/EUR Exchange Rate, 2012-2019

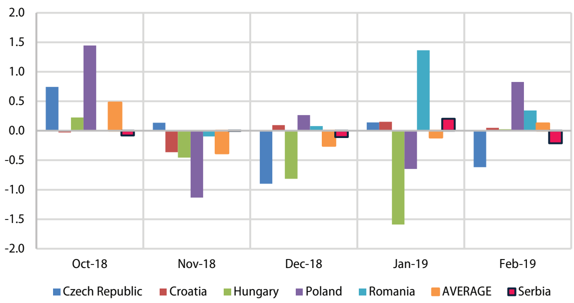


Source: NBS

In spite of the strong appreciation pressures in 2018, the Dinar was one of the most stable currencies in the region, but the growth of the external deficit indicates that it was not stabilized at the equilibrium level

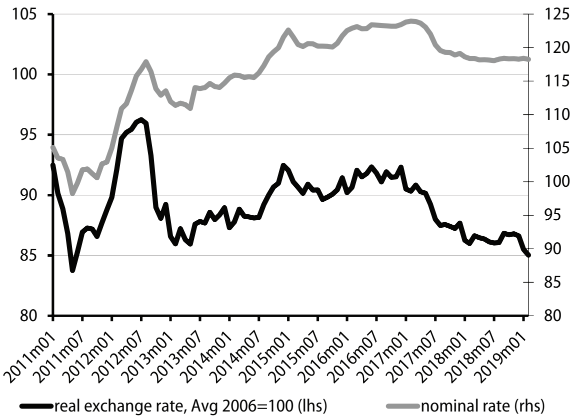
In 2018, the dinar strengthened slightly against the euro by 0.2% in nominal terms, while monthly volatility of the dinar exchange rate was generally less pronounced compared to the currencies of other CEE countries with the same exchange rate regime (Graph T5-7) . On the other hand, the basket of currency of the observed countries in 2018 nominally weakened against the euro by 1.4% (Hungarian Forint and Polish Zloty by over 3%), while, in addition to the dinar, only the Croatian kuna nominally strengthened against the European currency (by 0.4%). Although several factors generated strong appreciation pressures on the dinar (increased FDI inflows, eurobond refinancing with government borrowing in the domestic financial market, and others), monthly oscillations of the exchange rate were, as a rule, within a narrow interval of ± 0.2% (except in February). This was mainly contributed by the NBS consistently implementing its policy of de facto targeting the exchange rate level, although the official commitment is to manage the exchange rate by floating. Thus, in order to ease the appreciation pressures on the dinar, in 2018 the NBS bought a total of EUR 1,835 million, i.e. sold EUR 285 million to prevent the weakening of the domestic currency (mainly

Graph T5-7. Nominal exchange rate change (in %) in selected countries



Source: Eurostat, NBS and *QM* calculations
Note: an increase represents depreciation

Graph T5-8. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2011-2019



Source: NBS, SORS, Eurostat and QM estimates
Note: an increase represents depreciation

at the beginning and at the end of 2018). Economically speaking, the prevention of excessive dinar strengthening is currently a good policy, given that the prolonged period of unfoundedly strong dinar (since 2016) already adversely affects the price competitiveness of the economy and growth of Serbia's trade deficit. The problem is, however, in the fact that the NBS responds to the first signs of depreciation pressures on the dinar, because it is not in line with the policy of directing the exchange rate towards a level that balances the country's external balance. To that end, coordination between fiscal and monetary policy needs to be improved.

There was a slight real appreciation of the dinar against the euro by 0.5% in Q4, a total of 1.2% in 2018

In the last quarter of 2018, the dinar appreciated in real terms against the euro by 0.5%, or by 1.2%, if we observe the whole last year (Graph T5-8). Although the trend of real appreciation of the dinar is slowed down when compared to 2017, due to the real appreciation in the previous two years, the dinar exchange rate is excessively strong when compared to the competitiveness of the Serbian economy. The Croatian and Romanian currencies appreciated to about the same extent, while the currencies of the remaining CEE countries with a similar exchange rate regime weakened against the euro in real terms during 2018 - Polish zloty by 2.7%, Hungarian forint by 1.8% and Czech crown by 0.6%. In addition, the real dinar strengthening continued in the beginning of 2019 - by1.8% in total during the first two months. Historically, in February, the dinar reached the highest real value in relation to the euro since mid-2011. The problem with this trend of the real foreign exchange rate is that it does not have a strong foothold in macroeconomic fundamentals (labor productivity is actually reduced), which then adversely affects the competitiveness of the domestic economy when compared to the EU countries and other important trading partners. We estimate that this is one of the important factors (together with growth of world oil prices and domestic demand) which led to an increase in Serbia's foreign trade deficit in 2018 by about 2 p.p. of GDP. On the other hand, we have economies such as the Czech Republic, Hungary or Poland, whose currencies weakened in real terms against the euro in the past year, which, along with notable increase in productivity over the past few years, significantly improved their competitiveness and export performance. Although stable nominal exchange rate of the dinar against the euro has its advantages, we believe that slight real depreciation would have significantly more positive effects on the domestic economy and that the NBS should take this into account when formulating its exchange rate management policy.

6. Fiscal Trends and Policy

In Q1, a consolidated fiscal surplus of 11.2 billion dinars was achieved (0.9% of the quarterly GDP), due to continued solid growth of public revenues (both tax and non-tax), which was somewhat faster (8.3%) than the growth of public spending (6.8%). Tax revenue in Q1 registered a significant growth (6.8%), which was due to the growth of almost all types of tax revenue, excluding revenue from excises, with the highest relative growth recorded in corporate income tax. Growth in tax revenues can mostly be explained by the movement of appropriate tax bases, except for VAT, where revenue growth was faster, which may be the result of deliberate transfer by the state of a portion of revenue from the previous to the current year. The strong growth of revenue from income tax can be partly explained by the growth of the economy's net profit (before taxes), as well as the low base effect, since in 2018 revenue growth from this tax was slower than expected, taking into account the profitability dynamics. On the side of public spending, the increase was recorded for all types of expenditures, and the highest relative growth was recorded in subsidies and capital spending. Spending on pensions and wages grows faster than economic activity, which is assessed as inadequate. The realised fiscal result in Q1 was higher than planned by around 20 billion dinars. If such trends continue, Serbia could again achieve a surplus of 0.5-1% of GDP in 2019. In conditions of slow economic growth, it would be optimal to run a fiscal deficit policy of around 0.5% of GDP. Fiscal space of around 1% of GDP should, above all, be used to increase investment in infrastructure and reduce fiscal burden on labour. Public debt at the end of Q1 amounted to 23.4 billion euros (about 54% of GDP), which is around 380 million euros more than at the end of 2018, primarily due to government borrowing in order to repay debts that will soon mature. If existing trends continue, public debt at the end of the year could amount to around 50% of GDP.

Fiscal Tendencies and Macroeconomic Implications

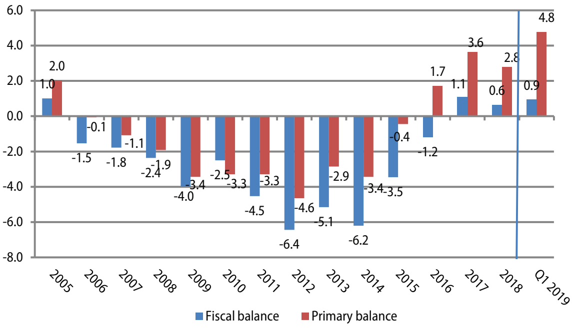
In Q1, a fiscal deficit of 11.2 billion dinars (0.9% of GDP) was realised...

In Q1, year-on-year growth in public revenues as well as public spending continued, with revenue growth being somewhat faster, resulting in a consolidated fiscal surplus of 11.2 billion dinar (0.9% of quarterly GDP). When excluding interest expenses, the primary surplus was about 57.4 billion dinar (about 4.8% of quarterly GDP).

…which is by 20 billion dinars above the plan

Starting from the usual intra-annual dynamics of public revenues and public spending in previous years, as well as from the plan for 2019 and its realisation in the period January-March, it is estimated that the fiscal result achieved in Q1 was higher than planned by around 20 billion dinars. This was mostly due to better realisation of public revenues compared to the plan, both tax and non-tax. In the first quarter, there was a higher collection based on almost all types of taxes, whereby a positive deviation in relation to the plan was especially evident in corporate income tax. On the other hand, public spending in Q1 was also realised in a higher amount compared to the expected dynamics, with the biggest deviation in the payment of interest and capital spending. In addition, in the remaining part of the year, there will also be extraordinary expenses of about 11 billion dinars on government subsidies in order to resolve issues of those who borrowed in Swiss francs. Adoption of the law by which private currency risks are collectivised, i.e. financed at the expense of all taxpayers is assessed as economically and ethically unjustified, since it rewards risky and punishes cautious behaviour.

Graph T6-1. Serbia: Consolidated Fiscal Balance and Primary Balance Sheet (% of GDP)



Source: *QM* calculations

Trends

Public revenue accelerated its growth in Q1

In Q1 2019, public revenues continued a real yoy growth of 8.3%, which was a continuation of the trend of accelerated growth from the previous quarters. This is supported by the fact that real seasonally adjusted growth of public revenues was achieved in Q1, as well as in relation to the previous quarter (by 3.3%), which was the result of the growth of both tax and non-tax revenues.[1]

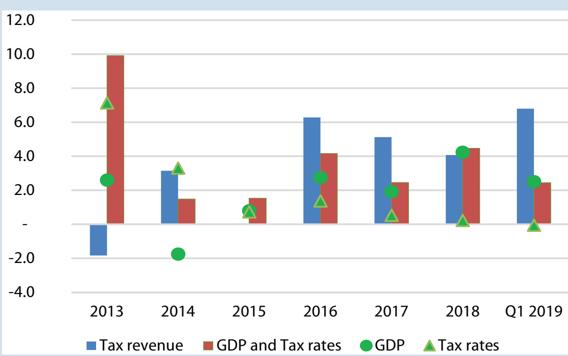
All types of tax revenue recorded a growth, except excise tax

In Q1, the trend of accelerated yoy real growth of tax revenues continued, so they were higher in real terms by 6.8% compared to the same period last year, while a significant increase (of 3.2%) was also achieved compared to the previous quarter. The dynamics of total tax revenues in Q1 was mostly influenced by the strong yoy growth of VAT revenues (by 13.9%) and corporate income tax (by 41.8%), but also by contributions (by 4.3%), personal income tax (by 8.3%) and customs (by 6%). Excise revenues, however, recorded a yoy decline in Q1 (by 11.4%). Intra-annual dynamics of excise revenues is often influenced by extraordinary and specific factors, which is why trends can only be assessed after examining data for a longer period of time. The dynamics of VAT revenues can partly be explained by trends in consumption. However, the double-digit rate of yoy growth in VAT revenues achieved in Q1, followed after their real decline in Q4, which could suggest that at the end of the year there was an intentional transfer of a part of the revenues from the previous to the next calendar year, as it was estimated that the fiscal balance in 2018 will certainly be positive. The trends in customs revenues can be explained by the strong growth of imports, whose effects are partially reduced due to the real appreciation of the exchange rate of the dinar. The strong growth in income from corporate income tax is, among other things, a result of the growth of economy's profitability in 2018 (see: Highlight 1), but also the effect of a low base, since in 2018 growth of revenue from income tax was slower than expected, having in mind the profitability of the economy in 2017. The dynamics of revenue from income taxes and contributions can mostly be explained by the movement of formal employment and earnings.

Box 1. Grey Economy Trends in Serbia

Solid collection of tax revenues, which in some periods was above the plan, can be the result of faster growth of relevant tax bases (income, profit, consumption, etc.), Increase of tax rates or the suppression of the grey economy. With unchanged tax rates and a constant level of grey economy, the dynamics of tax revenues should correspond to the dynamics of tax bases.* In 2016 and 2017, tax revenues in Serbia grew in real terms faster than the cumulative growth of tax bases, while tax rates were generally stable, which could be a sign of a reduction in the informal economy. This trend was halted in 2018, as real growth in tax revenues was approximate to the growth of bases and rates, so it is estimated that there was no further progress in the fight against the grey economy in the past year, but that it stagnated. In the first quarter of 2019, tax revenue growth was faster than the change in bases and rates, but data for the next quarters need to be taken into account in assessing the dynamics of the grey economy, given the specificity of the seasonal dynamics of some types of tax revenues.

Graph T6-2. Tax Revenue Growth Rates, GDP and Average Tax Rates (in%)



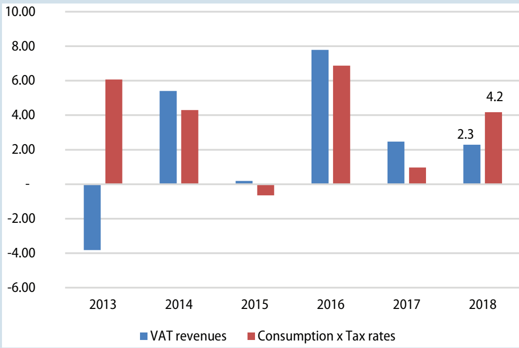
Source: Author's calculations

The efficiency of collecting the most important types of taxes (VAT, contributions and wage taxes) is similar to the dynamics of the efficiency of collection of total tax revenues. VAT revenues in 2018 grew in real terms slower than consumption, with tax rates being constant, indicating that there was a decline in billing efficiency, as indicated by a move in the C-efficiency coefficient. Nevertheless, it is estimated that this is the consequence of the transfer of part of tax revenues from 2018 to 2019, which could mean that the efficiency of VAT collection in 2018 was at about the same level as in 2017.

* For more details, see: Arsić, M., Ranđelović, S. i N. Altiparmakov (2019) *Gde je nestala siva ekonomija?,* Ekonomske ideje i praksa, br. 31.

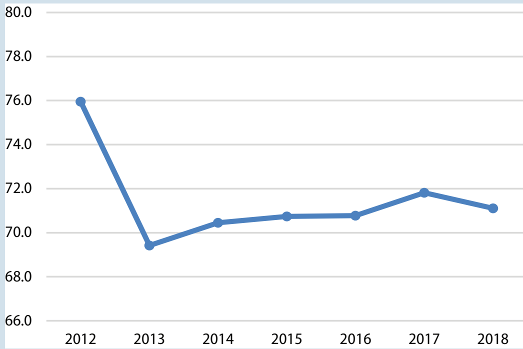
1 The real growth rates of all variables compared to the previous quarter of the current year are calculated on the basis of seasonally adjusted data.

Graph T6-3. Real growth rates of VAT revenue, consumption and tax rates



Source: Author's calculations

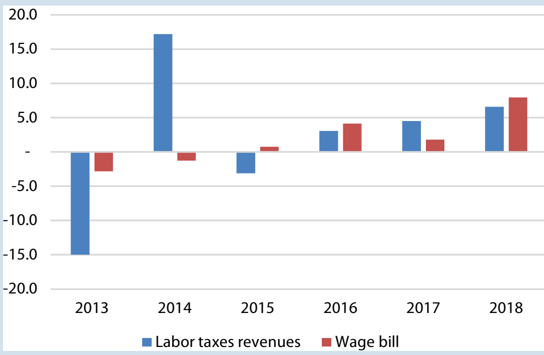
Graph T6-4. C-efficiency of VAT collection



Source: Author's calculations

Regarding taxes and contributions paid on wages, it is estimated that the collection efficiency in 2018 has stagnated, as real growth in revenues is only slightly lower than the increase in the wage mass. There was a more substantial increase in 2018 in the non-taxable part of earnings, which had a negative effect on the movement of tax revenues.

Graph T6-5. Real revenue growth rates from taxes on wages and contributions, wage mass and tax rates

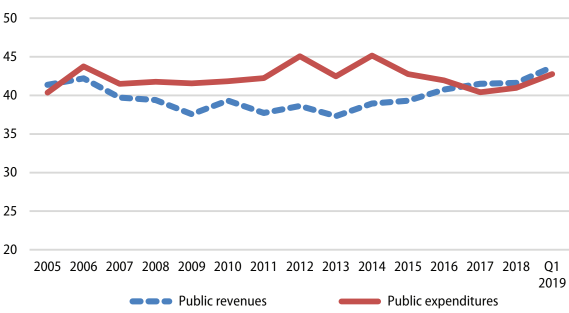


Source: Author's calculations

The lack of further progress in curbing the grey economy, even though it is still relatively high, is the result of the Government's lack of commitment to implement a systemic approach to improving tax collection efficiency through the reform of inspection services, as well as the country's tolerance to certain forms of grey economy. In addition, the negative trends regarding trust in the state and the quality of public services, and often the rewarding of those who do not respect the general rules (through tax amnesties, extraordinary subsidies, as in the case of Swiss francs, etc.) also adversely affect the willingness of taxpayers to fulfil their obligations towards the state on time and in full.

In Q1, non-tax revenue continued to grow

Graph T6-6. Serbia: Consolidated Public Revenues and Public Spending (% of GDP)



Source: *QM* calculations using MF data

In Q1, real year-on-year growth of non-tax revenues (by 19.9%) was achieved, which was consistent with high growth compared to the previous quarter (by 5%).[2] Out of a total of 64.4 billion dinars of non-tax revenues realised in Q1, about 9.4 billion refers to collected dividends, primarily from the National Bank of Serbia (9.3 billion dinars). The fiscal strategy for 2019 anticipates a reduction of non-tax revenues by about 15% (from 5.1% of GDP to 4.3% of GDP). In order for this result to be achieved, it is necessary for the state to gradually abandon the policy of aggressive dividend collection and thereby free the funds for investments of public and state enterprises.

2 Inflows from the concession fee were realised in April 2019, of which 2.5 billion dinar were expressed as non-tax revenues, and 42.2 billion as an inflow based on the source of funding ("below the line"), and so the non-tax revenue growth in Q1 can not be attributed to this transaction.

Public spending – both current and capital, is growing

In Q1 there was an acceleration in the growth of public spending, which in real terms rose by 6.8% yoy compared to the same period of the previous year. The strong growth of spending was also recorded compared to the previous quarter (by 4%). Growth was recorded in all categories of public spending, with the highest relative growth in subsidies (26.4%) and capital spending (22.2%), which in Q1 amounted to around 3% of GDP. Growth of capital spending in Q1 represents a continuation of the trend from the previous three quarters, which is considered favourable to the extent to which it is the result of major investments in infrastructure. Since it was mainly for the procurement of equipment from abroad, the growth of capital spending in Q1 will not have significant positive effects on the growth of the economy. In Q1, spending on employees and pensions, as the two most significant categories of public spending, recorded a significant yoy growth (by 4.3% and 6.6%, respectively), which was primarily due to the increase in nominal salaries and pensions at the beginning of the year. Real growth in employee and pension spending in Q1 was above the upper limit of sustainability, as it was faster than the growth of economic activity.

Box 2. Wages and Employment Policy in the Public Sector and Pension Policy

In 2018, total spending on employees and pensions (9.3% of GDP and 10.4% of GDP) converged towards a long-term sustainable level, although these expenditures in Serbia are still slightly higher than the average amount of the comparable countries from Central and Eastern Europe. In order to keep it at that level, the growth of total spending on wages and pensions in the coming period should not be higher than the GDP growth. Therefore, it is necessary to introduce the practice of increasing wages and pensions once a year (at the beginning of the year), according to pre-determined criteria, and abandon the practice of announcing extraordinary increases in income already at the beginning of the year, of which there is a particularly high risk in the pre-election period. In terms of indexing earnings, it is necessary to introduce the principle of "same salary for the same job", through the application of salary grades, as well as the introduction of rules that would lead to the increase in earnings not faster than the growth of economic activity. For the indexation of pensions, it is justified to use the so-called "Swiss formula", which was announced during the last visit of the IMF delegation. Any extraordinary fiscal space, which would result from a better collection of public revenues, should not be used for the extraordinary increase in wages and pensions, but for productive spending - on infrastructure, education and science.

Total spending, in addition to the amount of wages and pensions, is also affected by the number of employees and pensioners. The implementation of the freezing policy in the past five years had limited effects on the total number of employees in the public sector, which was reduced by less than 30,000 in that period, although the number of those who left the work place as part of a natural outflow was several times higher. At the same time, the implementation of this rule led to the centralisation of decision-making on employment at the level of the Commission of the RS Government. This indicates that the space for abuse of power has increased, primarily in terms of party employment in the public sector. Consequently, in the upcoming period, a general ban on employment in the public sector should be abolished and the systemic regulation of employment policy by sectors introduced, based on objectively defined parameters and criteria, while respecting the prescribed quotas would be monitored at the central government level. With regard to pension insurance, it is necessary to continue with the application of existing rules, including the application of penalties for early retirement. In this regard, greater efforts should be made to clarify the reasons for applying these penalties and their economic and ethical justification, in order to reduce the pressure of abolishing them in the future, which will especially be pronounced after the expiration of the IMF arrangement.

Similar trends continued in April, when public revenues recorded a yoy growth of 6.1%, due to the growth of both tax and non-tax revenue. In that month, there was a further acceleration in the growth of spending by around 10%. Accordingly, a consolidated fiscal deficit of 3.5 billion dinars was achieved in April.

Fiscal policy is not in line with the state of economy

The growth of Serbia's economy in 2018, when excluding the impact of one-off factors (agriculture, energy), was moderate, while in Q1 2019 there was an additional slowdown, so according to the results so far, Serbia's economy in the current year is among the slowest growing in the region (see: Economic activity). Even though fiscal policy's expansiveness increased due to the change in the spending structure, running the fiscal surplus policy under the conditions of slow growth of the economy is assessed as inadequate. Bearing in mind the dynamics of economic activity and the state of public finances, the general framework for fiscal policy management should include a fiscal deficit of around 0.5% of GDP, with changes in the structure of public spending, from current to productive spending. If the trends from Q1 continue, in 2019, there will likely be a consolidated fiscal surplus of around 0.5-1% of GDP.

The fiscals pace of around 1% of GDP should be used to invest in infrastructure, education and science, as well as to ease fiscal earnings

Since the growth rate will be moderate (close to the potential one), a cyclically-adjusted surplus will be close to the real one. This means that there is a fiscal space of about 1% of GDP in Serbia, which can be used for the implementation of discretionary fiscal policy measures. In order to raise the potential rate of economic growth, it is justified to use this fiscal space primarily to increase the investment in infrastructure (road, rail, ecology), as well as in education and science, with the improvement of the allocation criteria. In addition, part of the fiscal space should also be used to further reduce the fiscal burden on labour.

Public Debt Trend Analysis

Public debt at the end of Q1 was 23.4 billion euros (54% of GDP)...

At the end of Q1 2019, Serbia's public debt amounted to 23.4 billion euros (54% of GDP). If we include the non-guaranteed debt of local governments, it was about 54.9% of GDP, which is about 380 million euros more than at the end of 2018. Relative growth of the public debt during Q1 (by around 0.2 % of GDP) was slower than the growth of absolute debt, due to a slight increase in GDP, as well as the real appreciation of the dinar exchange rate.

The debt increased by 380 million euros due to additional borrowing in order to pay the debts that will soon mature

The growth of public debt in Q1 was primarily from the state borrowing abroad, in order to create the reserves necessary for the repayment of debts maturing in the coming period. At the same time, the trend of a slight decrease in indirect debt continued (by about 20 million euros), as there was no need for a significant borrowing of public and state enterprises, with state guarantee.

Real appreciation of dinar had a minor effect on the reduction of debt

During Q1 2019, dinar exchange rate against the euro increased by 1.7% in real terms, and against the US dollar it stagnating in real terms, so observed in total, the exchange rate influenced a slight decrease of debt in this period. However, the real appreciation of the dinar negatively affects the future growth of the economy, which can negatively affect the long-term sustainability of the debt.

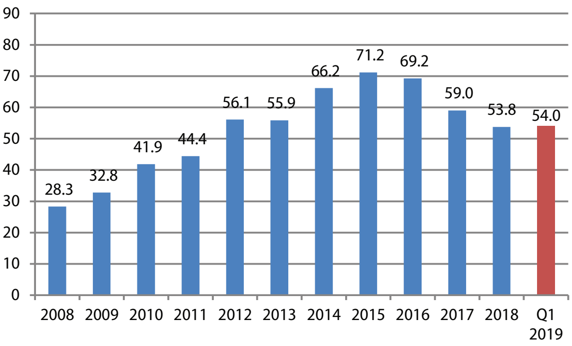
Tabela T6-7. Serbia: Public debt dynamics 2000-2019 (bn. of dinars)

	2000	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Q1 2019
I. Total direct debt	14.2	7.9	8.5	10.5	12.4	15.1	17.3	20.2	22.4	22.7	21.4	21.5	21.9
Domestic debt	4.1	3.2	4.1	4.6	5.1	6.5	7.0	8.2	9.1	8.8	9.1	9.4	9.5
Foreign debt	10.1	4.7	4.4	5.9	7.2	8.6	10.2	12.0	13.4	13.9	12.4	12.1	12.4
II. Indirect debt	-	0.9	1.4	1.7	2.1	2.6	2.81	2.5	2.4	2.1	1.8	1.5	1.5
III. Total debt (I+II)	**14.2**	**8.8**	**9.8**	**12.2**	**14.5**	**17.7**	**20.1**	**22.8**	**24.8**	**24.8**	**23.2**	**23.0**	**23.4**
Public debt / GDP (QM)[3]	**169.3%**	**28.3%**	**32.8%**	**41.9%**	**44.4%**	**56.1%**	**55.9%**	**66.2%**	**70.0%**	**68.0%**	**57.8%**	**53.8%**	**54.0%**

1) According to the Public Debt Law, public debt includes debt of the Republic related to the contracts concluded by the Republic, debt from issuance of the t-bills and bonds, debt arising from the agreement on reprogramming of liabilities undertaken by the Republic under previously concluded contracts, as well as the debt arising from securities issued under separate laws, debt arising from warranties issued by the Republic or counterwarranties as well as the debt of the local governments, guaranteed by the Republic.
2) Estimate of the Ministry of Finance of the Republic of Serbia
3) QM estimate (Estimated GDP equals the sum of nominal GDP in the current quarter and three previous quarters)
Source: QM calculations based on the MoF data

Public debt could reach 50% of GDP by the end of the year

Graph T 6-8 Serbia's Public Debt Trend (% of GDP)



Source: *QM* calculations[3]

If there are no major fluctuations in the exchange rate in real terms, the fiscal surplus is between 0.5% and 1% of GDP, the growth of the economy is about 3%, and the inflows from concession fee and privatisation (e.g. Komercijalna bank) are used for repayment of old debts that will soon mature, the public debt at the end of the year could amount to around 50% of GDP. If the appreciation trends continue, the level of debt at the end of the year could be somewhat lower.

Annexes

Annex 1. Serbia: Consolidated General Government Fiscal Operations, 2010-2019 (bn RSD)

	2010	2011	2012	2013	2014	2015	2016	2017	2018					2019
									Q1	Q2	Q3	Q4	*Q1-Q4*	Q1
I PUBLIC REVENUES	**1,278.4**	**1,362.6**	**1,472.1**	**1,538.1**	**1,620.8**	**1,694.8**	**1,842.7**	**1,973.4**	**473.8**	**526.9**	**536.9**	**567.7**	**2,105.3**	**525.4**
1. Current revenues	1,215.7	1,297.9	1,393.8	1,461.3	1,540.8	1687.6	*1833.3*	1964.9	472.5	525.1	534.3	558.7	2090.6	523.8
Tax revenue	1,056.5	1,131.0	1,225.9	1,296.4	1,369.9	1463.6	*1585.8*	1717.9	420.0	456.4	465.3	480.5	1822.2	459.4
Personal income taxes	139.1	150.8	35.3	156.1	146.5	146.8	*155.1*	167.9	40.1	40.6	48.2	50.5	179.4	44.5
Corporate income taxes	32.6	37.8	54.8	60.7	72.7	62.7	*80.4*	111.8	22.9	44.6	22.9	22.1	112.5	33.3
VAT and retail sales tax	319.4	342.4	367.5	380.6	409.6	416.1	*453.5*	479.3	110.3	125.6	139.7	124.2	499.8	128.7
Excises	152.4	170.9	181.1	204.8	212.5	235.8	*265.6*	279.9	76.9	62.2	71.5	79.4	290.0	69.8
Custom duties	44.3	38.8	35.8	32.5	31.2	33.3	*36.4*	39.7	10.0	10.4	10.9	12.4	43.6	10.8
Social contributions	323.0	346.6	378.9	418.3	440.3	505.7	*527.5*	71.9	142.5	153.5	153.8	170.0	619.7	1.6
Other taxes	46.0	43.5	42.6	43.5	57.3	63.3	*67.3*	567.4	17.2	19.5	18.4	22.1	77.1	20.1
Non-tax revenue	159.2	36.9	37.9	34.9	170.9	224.0	*247.5*	247.0	52.4	68.7	69.1	78.2	268.4	64.4
II TOTAL EXPENDITURE	**-1,419.5**	**-1,526.1**	**-1,717.3**	**-1,750.2**	**-1,878.9**	**-1,844.0**	**-1,899.7**	**1,921.1**	**470.1**	**496.8**	**515.5**	**590.7**	**2,073.0**	**514.1**
1. Current expenditures	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-1,628.0	-1696.6	*-1,717.9*	1745.3	434.8	451.6	453.9	507.0	1847.2	475.0
Wages and salaries	-308.1	-342.5	-374.7	-392.7	-388.6	-419.2	*-417.7*	426.3	116.0	117.4	115.9	119.6	468.8	123.9
Expenditure on goods and services	-202.5	-23.3	-235.7	-236.9	-256.8	-257.6	*-283.6*	301.6	66.4	85.0	82.6	109.3	343.4	72.3
Interest payment	-34.2	-44.8	-68.2	-94.5	-115.2	-129.9	*-131.6*	121.2	42.0	22.1	30.8	13.7	108.6	46.1
Subsidies	-77.9	-80.5	-111.5	-101.2	-117.0	-134.7	*-112.7*	113.3	17.9	29.0	23.0	39.7	109.7	23.2
Social transfers	-579.2	-609.0	-652.5	-687.6	-696.8	-710.0	*-716.8*	720.1	180.3	182.8	181.8	201.0	746.0	194.5
o/w: pensions5)	*-394.0*	*-422.8*	-473.7	-498.0	-508.1	-490.2	*-494.2*	497.8	128.6	130.2	129.6	136.9	525.2	140.3
Other current expenditures	-22.9	-31.7	-37.4	-36.9	-53.7	-45.3	*-55.6*	62.7	12.1	15.3	19.7	23.7	70.8	15.0
2. Capital expenditures	-105.1	-111.1	-126.3	-84.0	-96.7	-114.5	*-139.3*	133.9	28.9	39.7	54.0	76.8	199.3	36.1
3. Called guarantees	-2.7	-3.3	-3.7	-7.9	-29.7	-30.1	*-39.1*	28.8	4.0	4.5	7.1	4.1	19.7	2.3
4. Buget lendng	-30.0	-25.0	-38.2	-35.6	-55.4	-2.7	*-3.3*	13.2	2.4	1.1	0.5	2.7	6.8	0.7
CONSOLIDATED BALANCE	**-141.0**	**-163.5**	**-245.2**	**-212.1**	**-258.1**	**-149.1**	**-57.1**	**52.3**	**3.7**	**30.1**	**21.4**	**-23.0**	**32.2**	**11.2**

Source: *QM* calculations based on the MoF data

Annex 2. Serbia: Consolidated General Government Fiscal Operations, 2010-2019 (real growth rates, %)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018					2019
										Q1-Q4	*Q1*	*Q2*	*Q3*	*Q4*	*Q1-Q4*	Q1
I PUBLIC REVENUES	**3.3**	**-8.9**	**-1.5**	**-4.6**	**0.6**	**-2.2**	**3.2**	**3.1**	**7.5**	**4.0**	**3.6**	**2.7**	**5.4**	**6.5**	**4.6**	**8.3**
1. Current revenues	3.5	-9.1	-1.5	-4.4	0.1	-2.6	3.3	*3.3*	*7.4*	*4.1*	*3.3*	*2.4*	*5.1*	*5.7*	*4.3*	*8.3*
Tax revenue	3.7	-8.8	-2.5	-4.1	1.0	-1.7	3.5	*0.3*	*7.2*	*5.2*	7.0	0.8	3.6	5.1	4.0	6.8
Personal income taxes	6.3	-10.8	-3.9	-2.9	2.1	-12.2	-8.1	*-1.2*	*4.5*	*5.1*	5.3	-1.9	8.5	6.8	4.8	8.3
Corporate income taxes	18.5	-27.0	-3.6	3.9	35.1	2.9	17.4	*-15.0*	*26.9*	*35.0*	19.5	-10.6	3.2	-2.7	-1.3	41.8
VAT and retail sales tax	2.5	-10.2	-0.7	-4.0	0.0	-3.8	5.4	*0.2*	*7.8*	*2.6*	-0.9	3.3	7.4	-1.2	2.2	13.9
Excises	0.7	11.6	4.2	0.6	-1.2	5.1	1.6	*9.4*	*11.4*	*2.3*	16.7	-6.2	-10.8	8.7	1.6	-11.4
Custom duties	1.8	-32.4	-14.9	-21.5	-14.0	-15.6	-6.5	*5.9*	*8.1*	*5.8*	5.5	5.9	7.3	12.0	7.8	6.0
Social contributions	4.3	-7.0	-6.5	-3.9	1.9	2.6	3.1	*-2.1*	*3.2*	*3.8*	8.2	5.9	6.8	7.6	7.1	4.3
Other taxes	-2.3	-4.9	14.5	-15.2	-8.8	-5.2	29.2	*8.9*	*5.1*	*4.4*	2.0	3.6	1.1	13.5	5.2	13.8
Non-tax revenue	2.6	-11.3	5.8	-6.1	-6.2	-8.7	1.5	*27.9*	*9.3*	*-3.1*	-16.3	17.3	16.9	9.4	6.5	19.9
II TOTAL EXPENDITURE	**5.0**	**-4.8**	**-1.7**	**3.3**	**4.3**	**-0.3**	**5.2**	**-3.2**	**1.9**	**-1.7**	**5.6**	**3.7**	**9.5**	**4.9**	**5.8**	**6.8**
1. Current expenditures	6.9	-3.3	-2.2	3.1	4.1	-2.7	2.9	*-1.4*	*0.2*	*-1.2*	*2.7*	*1.1*	*5.5*	*2.6*	*3.8*	*6.7*
Wages and salaries	10.9	-6.0	-5.9	0.4	2.0	-2.6	-3.1	*-9.7*	*-1.4*	*-0.9*	*11.4*	*6.6*	*6.4*	*7.3*	*7.8*	*4.3*
Expenditure on goods and services		-5.7	-0.3	4.3	1.5	-6.6	6.2	*-1.1*	*8.9*	*3.3*	*8.1*	*14.9*	*11.8*	*11.2*	*11.6*	*6.3*
Interest payment	-2.8	-5.7	-0.3	17.4	41.9	28.8	19.3	*11.2*	*0.2*	*-10.6*	*-12.8*	*-14.5*	*-3.7*	*-21.8*	*-12.1*	*7.2*
Subsidies	-13.3	19.0	40.6	7.4	29.1	-15.6	13.2	*13.6*	*-17.3*	*-2.3*	*-6.6*	*6.7*	*2.3*	*-15.0*	*-5.1*	*26.4*
Social transfers	10.1	-26.0	13.9	5.8	-0.1	-2.1	-0.7	*0.5*	*-0.1*	*-2.1*	*1.7*	*0.6*	*2.5*	*1.5*	*1.6*	*5.3*
o/w: pensions5)	*9.5*	2.2	-3.9	3.9	*4.4*	*-2.3*	*-0.1*	*-4.8*	*-0.3*	*-2.2*	*2.8*	*2.7*	*2.1*	*6.2*	*3.4*	*6.6*
Other current expenditures	14.9	6.7	-6.1	23.9	9.9	-8.4	42.6	*-16.7*	*21.4*	*9.6*	*-10.1*	*10.6*	*26.8*	*5.5*	*10.7*	*21.4*
2. Capital expenditures	-4.3	-6.7	-11.8	5.3	6.0	-38.2	12.7	*16.8*	*20.3*	*-6.7*	*136.8*	*9.6*	*77.5*	*32.9*	*45.9*	*22.2*
3. Called guarantees	283.5	-2.2	-2.7	-3.3	-3.7	248.7	267.8	0.1	28.5	-28.5	-52.3	-23.4	4.7	-50.5	-32.9	-44.2
4. Buget lending	13.3	-24.0	-30.0	-25.0	-38.2	44.2	52.2	-95.1	20.8	283.9	62.2	-61.0	-83.7	1.8	-49.3	195.0

Source: *QM* calculations based on the MoF data

[3] Including the non-guaranteed debt of the local governments

7. Monetary Trends and Policy

Despite the fact that inflation rose at a faster rate in Q1 its value at the end of March was still below the target level of 3% which, along with the expected slowing down in May when the effects of the seasonal rise in vegetable prices was exhausted, caused the National Bank of Serbia (NBS) to keep its key policy rate unchanged. The depreciation pressure at the end of 2018 soon turned into strong pressure to strengthen the Dinar which is ongoing. NBS interventions on the FX market were intended to defend the Dinar exchange rate both in terms of offer and demand for hard currency with the net effect standing at just 30 million Euro of hard currency bought. The NBS continued its interventions and was a net buyer of hard currency to the tune of more than 550 million Euro by the first week in June. The NBS net own reserves recorded a rise in Q1 by 68 million Euro which, along with the withdrawal of banks from REPO placements, had an effect on the creating of primary money but those effects were neutralized with the rise in the deposits in state accounts. Compared to the value in the same period a year earlier, the money mass continued to grow at a nominal rate of 14.6% which was mainly stimulated by a rise in credit activity among both households and the economy. The net new placements by banks since the start of the year were negative primarily because of negative net placements to the state but the positive trend of placements to households and the economy following a correction to write off NPLs continues. Along with the rise in net new placements to the economy from abroad, the overall net placements to households and the economy in Q1 stood at some 400 million Euro. Although the net deposits by the population increased, the overall sources for new placements by banks dropped in Q1 because of the seasonal withdrawal of deposits by the economy and the repayment of loans taken by banks from their home offices abroad. The share of NPLs has dropped slightly since the start of the year mainly because of the rise of the level of loans overall while the level of NPLs recorded a slight drop. Interest rates in real terms on Dinar loans caused by slightly higher inflation in Q1 recorded a drop while indexed housing loans and current asset loans recorded a growth compared to the end of 2018.

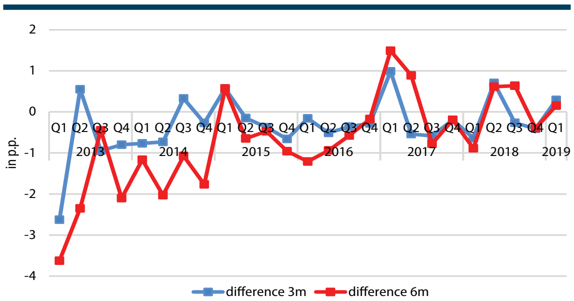
Central Bank: Balances and Monetary Policy

No changes to key policy rate in Q1 …

…because inflation remains in target framework

Despite the fact that inflation speeded up from the start of the year, the NBS did not change the level of its key policy rate to the latest session of its executive board early in June. The key policy rate has remained unchanged for more than a year which was certainly justified in the case of inflation which stood near the lower limit of the target framework in 2018. Inflationary pressure increased from the start of the year because of the seasonal rise in the prices of fresh fruit and vegetables to the end of April when inflation reached 3.1 percent and returned to the level of 2.2 percent y.o.y. in May after those effects of the inflation were exhausted. The elements which will act for the rest of the year such as the growth of domestic demand on the basis of increased salaries in the public sector and potential rise in fuel prices due to geopolitical instability can cause inflation to move around the middle of the target corridor of 3±1,5% to the end of the year. Depending on the implementation of those elements, the NBS will probably keep the key policy rate at its current level in the coming period with the possibility of a correction in the case of greater pressure on prices. Inflation in Q1 went past the expectation that the NBS had three and six months earlier (Graph T7-1) which shows that the short-term fluctuation in this period was significantly stronger than expected while the base inflation of the y.o.y. rate showed somewhat smaller changes which remained at a level of around 1.5%. Bearing in mind that representatives of the European Central Bank and the FED are

Graph T7-1. Deviation from the planned inflation 3 and 6 months in advance of the actual 2013-2018



Source: NBS

thinking about postponing the announced policy of gradually increasing monetary strictness or even re-introducing some monetary easing, we can expect those elements to raise prices on the capital inflow side towards the end of the current or in next year. Even though credit activity in the economy was significantly lower once we take out the effects of the writing off of NPLs compared to the previous quarter, in Q2 and in the rest of the year we can expect a faster pace if there is no deterioration in the loan conditions which, based on current indicators, is very unlikely. We will probably see stronger NBS interventions on the FX market by the end of summer, directed at maintaining the target level of the Dinar exchange rate which has drawn closer to the level of 2014 with the latest reinforcement. Despite NBS statements that the trust of serious foreign investors is strengthening the national currency, the Dinar's trends run counter to Serbia's base macro-economic positions. Although this can have positive effects on the export-oriented part of the economy, in the long term it causes more damage because of the deterioration in the position of domestic producers who are increasingly exposed to lower prices of imports. That additionally burdens the economy which has shown the first signs of its recovery slowing down.

Table T7-2. NBS interventions and foreign currency reserves 2015-2018

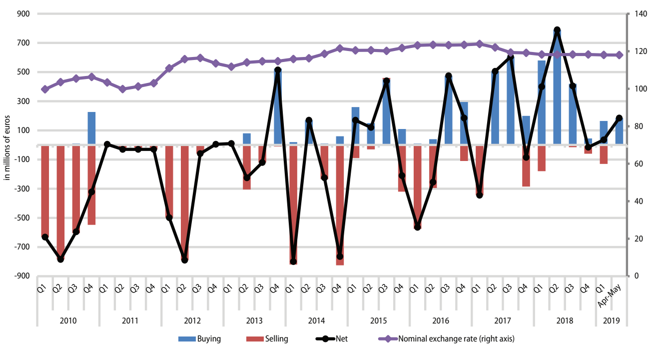
	2016				2017				2018				2019
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in milions of euros)	246.50	239.12	325.82	279.23	480.53	572.42	634.74	384.53	348.00	562.51	339.53	142.95	139.16
NBS interest rate	4.25	4.25	4.00	4.00	4.00	4.00	3.75	3.50	3.25	3.00	3.00	3.00	3.00
NBS interest rate	2.60	1.78	3.17	1.94	-5.11	1.94	4.17	2.68	0.40	-2.60	4.24	2.59	-2.98
NBS interest rate	-0.34	3.35	4.57	3.37	4.48	15.71	7.77	3.50	4.75	3.50	1.65	3.10	3.00
NBS interventions on FX market (in milions of euros)	-555.00	-820.00	-345.00	-160.00	-345.00	160.00	765.00	680.00	400.00	1190.00	1595.00	1580.00	35.00
INCREASE	**in millions of euros, cumulative from the beginning of the year**												
NBS own resreves[1)]	-469.43	-785.86	-346.46	-163.03	-269.73	-265.22	364.16	-4.87	-154.90	653.92	547.26	616.64	67.93
NDA	45.62	395.60	-99.67	94.92	-171.42	-248.75	-704.00	137.47	-264.65	-845.34	-649.45	-142.59	-199.62
Government, dinar deposits[2)]	41.52	275.36	35.00	195.73	-41.59	-358.48	-755.64	-247.10	-376.19	-567.19	-612.17	-153.41	-158.73
Repo transactions[3)]	5.09	19.53	-279.20	-25.66	-207.38	-285.41	-346.27	-95.49	43.47	-168.83	42.95	241.88	12.74
Other items , net[4)]	-0.99	100.71	144.53	-75.15	77.56	395.14	397.91	480.06	68.07	-109.33	-80.23	-231.06	-53.63
H	-423.81	-390.27	-446.13	-68.11	-441.15	-513.96	-339.84	132.60	-419.56	-191.42	-102.19	474.05	-131.69
o/w: currency in circulation	-68.06	-20.21	40.74	157.26	-104.02	-114.39	-103.93	39.59	-102.01	-41.46	60.29	157.82	-37.81
o/w: excess liquidity	-284.91	-319.01	-465.39	-241.74	-351.17	-422.08	-269.15	22.35	-335.18	-200.87	-265.64	185.56	-143.78
	in millions of euros, cumulative from the beginning of the year												
NBS, net	-865.84	-1061.63	-784.51	-137.62	-464.59	-618.87	452.21	-280.73	64.63	915.44	997.16	1069.34	187.71
Gross foreign reserves	-880.04	-1080.32	-807.49	-153.76	-469.25	-632.21	431.51	-302.83	36.47	894.42	977.20	1048.44	181.07
Foreign liabilities	14.21	18.69	22.97	16.14	4.66	13.34	20.70	22.10	28.16	21.03	19.96	20.90	6.64
IMF	8.10	15.09	16.00	14.12	-0.04	5.81	7.68	8.67	9.42	1.44	1.75	0.84	-0.95
Other liabilities	6.10	3.59	6.98	2.02	4.69	7.53	13.02	13.43	18.75	19.59	18.21	20.07	7.59
NBS, NET RESERVES-STRUCTURE													
1. NBS, net	-865.84	-1061.63	-784.51	-137.62	-464.59	-618.87	452.21	-280.73	64.63	915.44	997.16	1069.34	187.71
1.1 Commercial banks deposits	331.11	302.75	339.40	90.80	144.67	156.34	123.17	159.61	47.26	38.80	-33.79	-572.93	-69.13
1.2 Government deposits	65.30	-26.98	98.65	-116.22	50.18	197.32	-211.22	116.25	-271.67	-305.19	-420.98	115.36	-50.65
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	-469.43	-785.86	-346.46	-163.03	-269.73	-265.22	364.16	-4.87	-159.78	649.05	542.39	611.77	67.93

Source: NBS.
1) Definition of net own reserves NBS is given in section 8 Monetary Trends and Policy, Frame 4, *QM* No. 5.
2) State includes all levels of government: republic to local.
3) This category includes NBS Treasury Bonds and repo operations.
4) Other domestic assets include: domestic loans (net bank debts, not including Treasury Bonds and repo transactions; net debts of the economy) along with other assets (capital and reserves; and items on the balance: other assets) and corrected by changes to the exchange rate.

Hard currency purchase on FX has positive effect on growth of own reserves

Depreciation pressure spilled over from the end of the previous year to Q1 which led the NBS to intervene on the FX market to sell hard currency. In February, the direction of the pressure changed leading the NBS to intervene and buy hard currency on the FX market. At quarterly level, those two episodes neutralized each other and the net position of the NBS stood at 35 million Euro bought in Q1 (Graph T7-3). The pressure to strengthen the Dinar continued in April and the NBS bought an additional 75 million Euro on the FX market and partly slowed down the effects on the strengthening of the exchange rate. In May, the NBS bought another 110 million Euro and that tempo continued in the first seven days of June when it bought another 370 million Euro. Despite these interventions the Dinar continued to appreciate nominally and bearing in mind the higher inflation in Serbia

Graph T7-3. NBS interventions on FX market 2010-2018



Source: NBS

compared to the EU zone, the price competitiveness deteriorated further for both the export-oriented part of the economy and the part facing cheaper competitive imports. The NBS net own reserves in Q1 recorded a rise of 68 million Euro with net domestic assets (NDA) dropping by 200 million Euro. The drop in the NDA was caused by a rise in the state deposits of 159 million Euro combined with rise in other domestic assets by 54 million Euro which was just slightly reduced by the withdrawal of banks from REPO operations by 13 million Euro. Because of the strong drop in NDA compared to the rise in net own reserves, primary money recorded a drop of 132 million Euro in Q1 compared to the value at the start of the year.

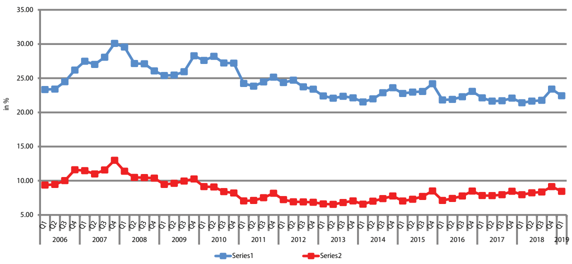
Monetary System: Money Mass Structure and Trends

The growth of the money mass continued in Q1 ...

... because of the rise in credit activity in the household and economy segments

The faster nominal growth of the M2[1] at the end of last year continued in Q1 and the rise in primary money stood at 14.8% y.o.y. at the start of the year (in Q4 2018, the nominal growth of M2 stood at 14.5% y.o.y., Table T7-5). At quarterly level, primary money recorded a drop of –0.7% of the value recorded at the end of December 2018 mainly because of the drop in NSA while at quarterly level the NDA recorded growth. Compared to the level at the end of the previous year, the NSA dropped by 1.6% and the primary money recorded a drop in Q1 which was slightly eased by the increase in NDA of 1% compared to the end of 2018. Following a correction for inflation which in Q1 was somewhat higher, the real growth of the M2 stood at 11.8% y.o.y. which is a slight slowdown compared to the previous quarter but the real growth of loans to the economy and households was somewhat higher and stood at 8% y.o.y. (the real growth of M2 in Q4 2018 stood at 12.4% while the rise in loans stood at 7.8% y.o.y.). The real rate of growth to households by 10% y.o.y. is slightly below the level of the previous quarter while the real rate of growth for loans to the economy continued to speed up to stand at 6.3% y.o.y. (in Q4 2018, the real growth rate of loans to the economy stood at 5.7% y.o.y.).

Graph T7-4. Money mass trends as percentage of GDP, 2005-2018



Source: *QM* calculation

Table T7-5. Growth of money and contributing aggregates, 2015–2018

	2016				2017				2018				2019
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	y-o-y, in %												
M2[1)]	7.9	7.8	10.2	9.9	10.3	7.4	5.6	3.6	3.3	7.9	8.2	14.5	14.8
Credit to the non-government sector[2)]	2.2	4.7	5.9	2.6	4.1	2.0	0.7	1.8	1.9	4.0	5.9	9.4	9.7
Credit to the non-government sector[2)],	0.6	3.1	3.9	1.5	3.5	3.5	2.9	4.7	5.1	5.6	6.5	9.6	10.0
Households	3.8	5.8	8.4	9.4	11.0	11.8	10.8	10.9	10.2	10.6	12.3	12.7	12.4
Enterprises	-1.4	1.4	1.0	-3.3	-1.3	-2.1	-2.4	0.4	1.3	1.8	2.0	7.2	8.0
	real y-o-y, in %												
M2[1)]	7.2	7.3	9.4	8.0	6.4	3.8	2.3	0.6	2.0	5.6	7.2	12.3	11.8
Credit to the non-government sector[2)],	0.2	2.3	2.8	0.9	2.1	2.7	2.4	4.0	4.6	4.7	5.5	7.8	8.0
Households	2.9	4.6	6.6	7.5	8.6	9.7	9.0	9.2	8.9	8.8	10.0	10.4	10.0
Enterprises	-1.5	0.9	0.4	-3.2	-1.7	-2.0	-2.1	0.4	1.5	1.5	1.9	5.8	6.3
	in bilions of dinars, end of period												
M2[1)]	1,979.6	2,023.2	2,087.0	2,196.8	2,182.7	2,173.3	2,204.5	2275.5	2255.1	2345.7	2424.3	2605.3	2588.9
M2[1)] dinars	645.5	685.0	727.1	808.0	772.7	785.2	808.3	872.1	838.6	893.1	924.3	1017.3	974.8
Fx deposits (enterprise and housholds)	1,334.1	1,338.2	1,359.9	1,388.7	1,410.0	1,388.1	1,396.2	1403.4	1416.5	1452.6	1500.0	1588.0	1614.0
	quarterly growth M2[4)] and shares												
M2[1)]	-1.0	2.2	3.2	5.3	-0.6	-0.4	1.4	3.2	-0.9	4.0	3.3	9.2	-0.7
NFA, dinar increase	-2.9	2.0	2.1	3.9	-1.6	0.6	1.1	2.9	-1.5	6.5	1.2	4.2	-1.6
NDA	1.9	0.2	1.1	1.4	1.0	-1.0	0.4	0.3	0.6	2.5	1.8	5.0	1.0

Source: NBS

1) Money mass components – see Analytical and Notation Conventions *QM*.

2) Loans to private sector– loans to the economy (including local government) and households.

3) Trends are corrected by changes to the exchange rate. Corrections are implemented under the assumption that 70% of loans to the private sector (households and companies) are indexed in Euro.

4) Trends are corrected by changes to the exchange rate and inflation. Corrections are implemented under the assumption that 70% of loans to the private sector (households and companies) are indexed in Euro.

1 Monetary aggregate M2 in the section Monetary Trends and Policy includes the lesser aggregate M1, savings and timed deposits in business banks. Because of that the M2 aggregate which we observe is equal to the monetary aggregate M3 in NBS reports

Nominal growth of money mass in Q1 guided by growth of hard currency deposits

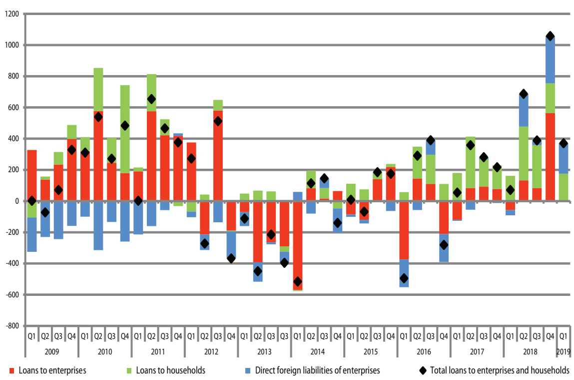
Viewed by individual element, the overall nominal growth of the M2 money mass of 14.8% y.o.y. was achieved mainly thanks to an increase in hard currency deposits. In Q1 the hard currency deposits contributed to the growth of M2 with 8.76 percentage points which accounts for almost 60% of the growth of the money mass. The second largest contribution came from the lesser aggregate M1 whose growth contributed with 4.6 percentage points to the overall growth of M2 in Q1. Savings and timed deposits slightly increased in significance compared to the previous quarter and contributed with 1.44 percentage points to the overall growth of primary money since the start of the year.

Banking Sector: Placements and Sources of Financing

The positive trends in the recovery of credit activity continued in Q1

The overall net placements by business banks since the start of the year were negative, primarily because of the increase in state deposits as the result of a budget surplus in Q1 and because of funds collected by the state for the early redemption of some issued bonds. The rise in state deposits in business bank accounts stood at 259 million Euro and that, combined with the seasonally lower credit activity since the start of the year among both companies and households led to a drop in overall net placements by the banking sector of 89 million Euro (Table T7-7). The withdrawal of banks from REPO placements to the tune of four million Euro in Q1 had a negative effect to a small extent at the level of overall net placements. On the positive side, a growth in placements to companies and households was recorded but it was lower than in other quarters. Net loans to companies suffered a minimal drop of two million Euro compared to the end of 2018 but if we take into consideration the write-off of NPLs to companies in this period, the net placements to the economy actually rose by 22 million Euro. Net loans to households in Q1 saw a rise of 174 million Euro which is higher than in the same quarter of 2018 and, based on data from April, we can expected a faster growth in Q2. Most of the newly-approved loans to companies were for current assets and liquidity accounting for some 51% while investment loans accounted for about 32%. The newly-approved loans to households were mainly cash and re-financing loans which accounted for some 57% while the number of housing loans was higher than in the same period a year earlier.

Graph T7-6. Yield of new loans to the economy and households, 2009-2018



Source: *QM* calculation
See footnote 1 in Table T7-5

Although the net credit activities by banks to the economy was fairly weak in Q1 after the effects of the write-off of NPLs, we get a somewhat better impression if we include the effects of cross-border loans taken out by local companies. This form of financing for the economy was practically non-existent in the first half of last year when the first positive trends were noticed. Although the rise in net cross-border loans of 196 million Euro in Q1 was lower than in the previous quarter, it still indicates a recovery of this form of financing which was dominant in the Serbian economy prior to the global financial crisis (in Q4 2018, net cross-border loans increased by 303 million Euro, Graph T7-6). Take into consideration the increase in net placements to companies and households from domestic and foreign sources and the overall value stands at the level of 370 million Euro in Q1 which is closer to the value of 400 million Euro once the effects of the write-off of NPLs are included. In the rest of the year, the possibility that monetary conditions could be relaxed on the European Union and American markets could be eased will partly neutralize the negative effects through a reduction of the const of financing. Loans to companies and households from domestic and foreign sources currently stand at the level of some 68% of the GDP which is lower compared to similar economies by some 15 percentage points on the average which indicates that there is more room for credit activity to grow.

Table T7-7. Business banks – sources and structure of placements, corrected[1)] trends, 2015-2018

	2016				2017				2018				2019
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
	in millions of euros, cumulative from the beginning of the year												
Funding(-, increase in liabilities)	377	168	-363	-1,130	354	-252	-1,138	-2,185	286	-727	-1,388	-3,641	573
Domestic deposits	223	-235	-708	-1,425	107	-104	-426	-1,032	65	-664	-854	-2,694	80
Households deposits	-16	-235	-362	-625	-69	-164	-258	-517	-166	-411	-646	-1,016	-292
dinar deposits	3	-75	-154	-290	27	-7	25	-121	15	-110	-250	-442	-35
fx deposits	-19	-161	-208	-334	-96	-157	-283	-395	-181	-301	-396	-574	-256
Enterprise deposits	239	0	-346	-800	175	60	-167	-515	231	-253	-208	-1,677	372
dinar deposits	385	222	5	-352	207	142	-30	-307	170	-95	-44	-657	358
fx deposits	-146	-222	-351	-448	-31	-82	-137	-208	61	-158	-164	-1,021	14
Foreign liabilities	181	397	427	335	218	49	-317	-546	-169	-217	-531	-821	136
Capital and reserves	-27	6	-82	-40	29	-198	-395	-607	390	154	-3	-126	357
Gross foreign reserves(-,decline in assets)	214	337	284	244	-35	-153	-286	-261	215	-75	138	625	-54
Credits and Investment[1)]	128	426	1,129	997	255	856	1,162	1,237	219	978	1,227	1,548	-89
Credit to the non-government sector, total	-316	32	329	186	61	474	740	972	105	582	941	1,695	174
Enterprises	-374	-228	-118	-372	-119	-36	58	138	-58	75	159	723	-2
Households	57	260	447	559	180	510	682	833	162	507	781	972	176
Placements with NBS (Repo transactions and treasury bills)	-7	-14	276	27	202	289	341	90	-39	175	-48	-244	-4
Government, net[2)]	452	408	525	784	-8	93	82	176	154	221	334	96	-259
MEMORANDUM ITEMS													
Required reserves and deposits	-598	-864	-859	-565	-161	-94	-83	-30	120	213	287	1,130	1
Other net claims on NBS[3)]	-107	160	6	201	-324	-401	-220	62	-338	-249	-262	-80	-31
o/w: Excess reserves	-102	160	3	187	-326	-415	-223	42	-339	-254	-280	-197	40
Other items[4)]	0	-204	-175	253	-79	18	545	1,176	-514	-152	-8	428	-400
Effective required reserves (in %)[5)]	17	16	15	16	16	15	15	15	15	15	15	17	17

Source: NBS
1) Yield is calculated under the assumption that 70% of loans to the private sector (households and companies) are indexed in Euro. Yield for originally Dinar value deposits are calculated based on the average exchange rate for the period. For hard currency deposits – as the difference of the state calculated based on the exchange rate at the ends of the period. Capital and reserves are calculated on the basis of the Euro exchange rate at the ends of the period and do not include the effects of changes to the exchange rate in calculating the remainder of the balance.
2) NBS bonds includes state and NBS treasury bonds which are sold at repo rate and at rate set by the market for lasting auction sales with a due date longer than 14 days.
3) Net loans to the state: loans approved to the state are lowered by state deposits in business banks; the negative prefix denotes a higher growth of deposits than of loans. State includes all levels of government: republic and local level.
4) Other NBS debts (net): the difference in NBS debts to banks on the basis of cash and free reserves and debts to the NBS.
5) Items on bank balances: other assets, deposits by companies in bankruptcy, inter-bank relations (net) and other assets including capital and reserves.
6) Mandatory cash reserve means the share of the mandatory reserve and deposits in the overall deposits (households and companies) and bank debts abroad. The basis to calculate the mandatory reserve does not include subordinate debts because that data is not available

Despite the rise in private deposits, the credit potential dropped in Q1 …

…because banks repaid loans abroad and capital and reserves were reduced

As in previous year, the credit potential of the domestic banking system was reduced in Q1 by 573 million Euro. That drop was to a lesser extent the result of an 80 million Euro drop in net domestic deposits while the remainder is the consequence of debt repayment by domestic banks to their head offices abroad and the drop in capital and reserves. Net domestic deposits were reduced since the start of the year because of the withdrawal of 372 million Euro in net deposits by companies in Q1. in the same period, households increased their net deposits with business banks by 292 million Euro but that was not enough to cover the withdrawals by companies (Table T7-7). The greatest cause of the reduction in sources for new placements was the reduction of capital and reserves which stood at 357 million Euro in Q1. Although business banks increased their foreign debts all through last year, net repayments of 136 million Euro were recorded in Q1 which additionally reduced the sources for new bank placements.

Table T7-8. Share of NPLs by debtor type, 2008-2018

	2009	2010	2011	2012	2013	2014	2015	2016				2017				2018				2019
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	balance at the end of period																			
Corporate	12.14	14.02	17.07	19.06	27.76	25.5	24.40	26.89	26.26	23.56	19.48	19.92	19.24	16.86	13.83	12.51	12.51	10.37	9.63	9.57
Entrepreneurs	11.21	15.8	17.07	15.92	20.82	43.29	29.92	33.03	30.12	28.44	27.42	26.49	25.02	23.90	16.96	12.60	12.16	9.98	9.07	8.82
Individuals	6.69	6.71	7.24	8.32	8.59	9.97	10.53	10.95	10.63	10.36	9.66	9.21	8.35	7.56	6.43	5.84	5.71	5.15	4.72	4.66
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	3.19	4.09	3.70	3.52	3.76	3.75	3.45	2.83	2.83	2.77	2.63	2.16	9.93	9.80	1.59	1.52	1.51

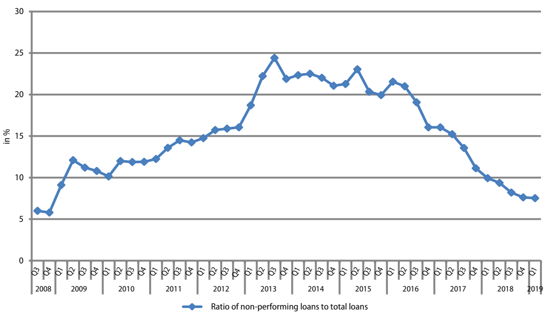
Source: *QM* calculation

Share of NPLs drops slightly

The share of NPLs in the overall placements dropped slightly from the start of the year which is in line with our assessments that future changes of this indicator will mainly be determined by changes in denominator in the overall mass of loans. Credit Bureau data and QM methodology2 showed a drop in the share of NPLs in overall placements at the end of March by 0.1 percentage points which is equal to a level of 7.52%. For a second quarter running, the drop in their share stands at less than 0.5 percentage points which will probably continue to the end of the year

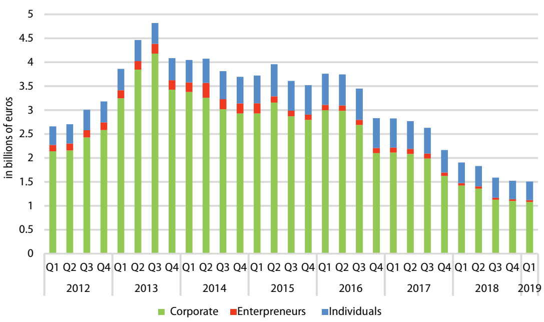
2 For details on manner of calculation share of loans see QM 6 – Spotlight on 1: NPLs in Serbia – What is the true measure?

Graph T7-9. Share of NPLs in overall placement, 2008-2018



Source: *QM* calculation

Graph T7-10. Remainder of debt on loans falling late, 2012-2018



Source: *QM* calculation

(Graph T7-9). Viewed by debtor type, the greatest reduction in relative amounts was recorded among entrepreneurs whose share of NPLs in Q1 dropped by 0.25 percentage points to 8.82%. In absolute terms, that drop had a much lesser effect because of the small overall amount of loans placed to entrepreneurs and the ensuing low absolute amount of NPLs in this group. The biggest absolute reduction was with NPLs to companies which dropped by 0.06 percentage points at the end of March to 9.57% or by some 20 million Euro compared to the situation at the end of December 2018 (Table T7-9). Although the share of NPLs to private individuals recorded a drop of 0.06 percentage points to 4.66%, the source of this drop lies in the rise in credit activity in the households segment while the absolute level of NPLs recorded a slight rise (Graph T7-10). That is also indicated by data from April and May when a rise in the share of NPLs is recorded in the entrepreneurs segment.

Interest Rates: State and Trends

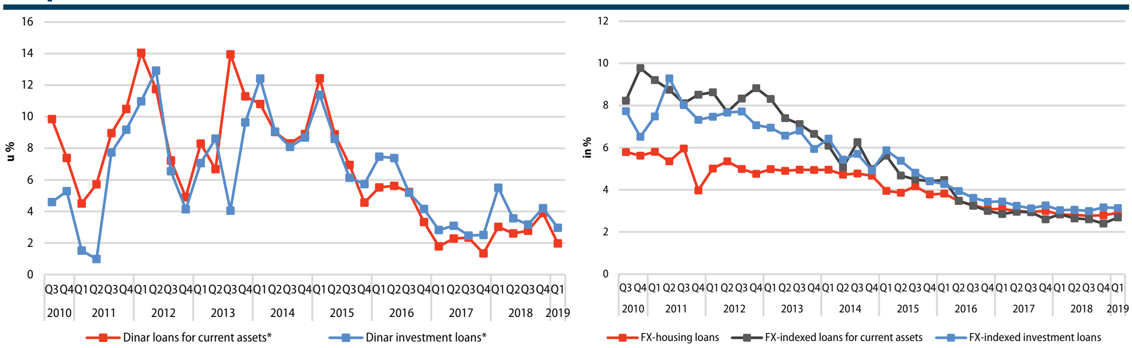
The rise of inflation at the start of the year reduced real Dinar interest rates …

…with indexed rates showing a partial growth

The European Central Bank (ECB) reacted to the danger of recession across the Eurozone by promising to keep interest rates at historic lows for at least the first half of next year. The announced came when the ECB sharply reduced the prediction of Eurozone growth for 2019 from 1.7% to 1.1%. The American Federal Reserve (FED) maintained the target rate at 2.25% at its meeting in May, concluding that economic activity was growing at a solid rate and that the labor market remained strong. FED President Jerome Powell told the latest meeting that the FED will respond in an appropriate manner to the risks presented by a global trade war and other recent events which indicates a possible change in monetary policy towards relaxation in the second half of the year.

The trends in interest rates in Serbia depended on whether their movements were being followed for indexed or loans in Dinars since the start of the year. This is the consequence of a somewhat higher inflation than expected since the start of the year which had a greater effect compared to the previous quarter. The average weighted rate for indexed housing loans increased by 0.11 percentage points compared to the end of 2018 (Graph T7-11b). A somewhat greater increase was

Graph T7-11. Interest rates on Dinar and indexed loans, 2010–2018



Source: *QM* calculation
* real interest rates

recorded with average weighted interest rates on indexed current asset loans of 0.29 percentage points while average weighted interest rates on indexed investment loans dropped slightly by 0.03 percentage points in Q1. Credit conditions measured in real average weighted interest rates on Dinar loans led to lower costs in Q1 because of a drop in nominal interest rates and a slightly faster rise in inflation since the start of the year. The average real weighted interest rate on Dinar loans for current assets showed a drop of almost 2 percentage points compared to the previous quarter and once again dropped below the level of 2% (Graph T7-12a). A similar situation was recorded with average real weighted interest rates on Dinar investment loans which dropped by 1.25 percentage points in Q1 to a level below 3%.

HIGHLIGHTS

Highlights 1. Profitability analysis of the Serbian economy

Milutin Živanović [1]

In 2018, the profitability of the Serbian economy improved slightly, continuing the positive trend present since 2014. Unlike the earlier years, in which companies' profitability was strongly influenced by changes in financial markets and changes in market prices of energy and raw materials, profitability growth in the previous year was primarily determined by the growth of business activities.

Profitability analysis of the overall economy

At the very outset of the analysis of profitability trends of the Serbian economy, it is necessary to study the profitability trends at the level of the overall economy by using, on the one hand, profitability margins, that is, using the operating profit margin and the net profit margin and, on the other hand, using rates of return, such as the Return on Assets (ROA) and the Return on Equity (ROE). In addition, the profitability of the overall economy, and individual economic activities in Serbia are compared with the profitability being achieved globally.

Operating profitability vs. overall profitability

In order for the profitability analysis to be clearer, it is necessary to differentiate the profitability of the core business from the overall profitability of companies, taking into consideration the different relative importance of these two types of profitability, as well as the various factors which affect these two types of profitability.

Improving the *profitability of the core business* of companies in the 2014-2018 period, measured by the *operating profit margin*[2], is stable and can be explained by the cyclical recovery of the Serbian economy within the context of the expansion of European economies. Nevertheless, the growth of operating profit margin was relatively low during this period, which was a result of the modest growth of the local economy. Modest growth of operating profitability does not present a problem for now, and does not put the overall economic profitability at risk, as macroeconomic variables, such as low interest rates and a relatively strong and stable dinar exchange rate against the euro and the dollar, are beneficial for local companies and have a positive impact on overall profitability. However, any potential deterioration of macroeconomic conditions combined with the current relatively low growth rates of operating profitability, could, in the future, endanger the profitability status of the economy.

As opposed to 2017, when a slight drop in operating profitability was recorded, in 2018, it recovered. This resulted in the operating profit margin in 2018 of 5.6%, taking it back up to the level recorded in 2016. Although the reasons for a slight increase in operating profitability will become clearer once we go into a more detailed analysis by sectors, we will present some general conclusions here.

In 2018, unlike 2017, operating income increased at a higher rate (7.1%) compared to operating expenses (6.8%). For the second consecutive year, as part of operating income, income generated from sale of products and services grew at a higher rate (7.6%) compared to income generated from sale of goods (5.2%). These trends can also be a signal of refocusing from growth based on trade in goods to growth based on production of products and services.

On the side of operating expenses, looking at the overall economy, the most significant operating expenses had a relatively uniform growth, 5% - 8%. It is interesting to note that the costs of materials, fuels, and energy in 2018 increased at a significantly lower rate (6.1%) compared to the growth recorded in 2017 (12.4%). Several factors influenced the noticeably slower growth of costs in this category. First of all, unlike 2017, when severe drought saw a decrease in the physical volume of agricultural production of 11.9%, in 2018, there was a 16.3% increase in agricultural production. The increase in supply led to the decline in prices of agricultural products, and producer prices of agricultural products in 2018 were 4.2% lower than the previous year. The drop in the price of agricultural products has affected the reduction in the cost of raw materials for companies from the manufacturing industry which use agricultural products as their main production inputs. Also, according to global market data, in 2018, the prices of almost all industrial metals dropped, which additionally resulted in the reduction of input prices in certain segments of the manufacturing industry. When it comes to energy prices, the price of electricity further increased in 2018, while the price of oil steadily grew until the beginning of the 4th quarter, when it began to drop sharply. Changes in energy prices did not affect any significant increase

1 Faculty of Economics, University of Belgrade

2 The operating profit margin is the ratio of operating profit to operating income. The operating profit is the difference between operating income and operating expenses.

in the cost of materials and fuel and energy at the level of the overall economy but did have a significant impact on the performance of certain sectors. It is interesting to note that in 2018, salary costs grew at a rate of 10.3%, faster than was the case in 2017, as well as in relation to operating expenses and operating income in 2018. The high rise in salary costs in companies is the result of a decline in the labour market supply due to emigration, the increase in salaries in the public sector and a reduction of the informal economy sector.

To form a clearer picture of the level and dynamics of the operating profitability of companies doing business in the local economy, it is necessary to perform appropriate comparisons with other economies. A comparison of the levels of operating profitability is often not very informative, as operating profit margins are strongly influenced by the structure of a particular economy in terms of sectors. However, a comparison of the dynamics of operating profitability can reveal what direction the economic activity of a particular economy is moving in, compared to reference economies, and if, and to what extent, interdependence is present in this respect.

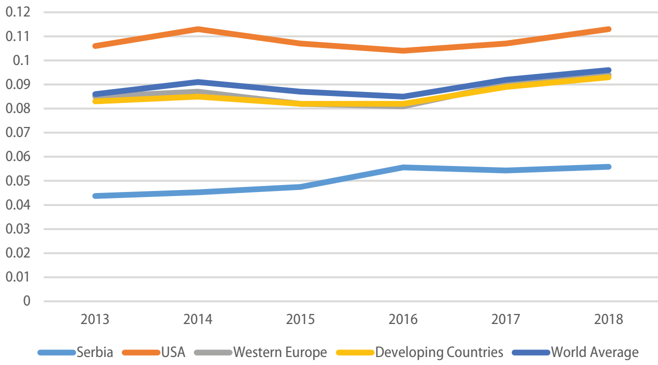
Table 1. Rate of business profit Serbia and the world - comparative analysis, 2013 - 2018

	Serbia	USA	Western Europe	Developing Countries	World Average
2013	4.4%	10.6%	8.5%	8.3%	8.6%
2014	4.5%	11.3%	8.7%	8.5%	9.1%
2015	4.7%	10.7%	8.2%	8.2%	8.7%
2016	5.6%	10.4%	8.1%	8.2%	8.5%
2017	5.4%	10.7%	9.0%	8.9%	9.2%
2018	5.6%	11.3%	9.4%	9.3%	9.6%

Source: Author based on SBA data and http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html

As expected, companies operating in the local economy have lower operating profit margin compared to companies operating in markets in the USA and Western Europe. What may be less expected is that the operating profitability of the local economy also lags significantly behind the profitability of developing countries. What is commendable is the fact that local companies recorded an almost constant increase in the operating profit margin over the analysed period, while globally it fluctuated, corresponding to business cycle trends. Although changes in operating profitability levels of the local economy and economies used as the basis for comparison are generally different from year to year, if we look at the entire period, we can see that the operating profit margin in all economies analysed increased by about 1 percentage point – which means that trends are very similar. This could imply that, within a very short period of time, certain factors have different impacts on the profitability of the local economy and global economies analysed, while in the medium term, this impact is identical. What can be potentially worrying is the fact that, at the global level, there has been a significant increase in operating profitability in the period which includes 2017 and 2018, while operating profitability in Serbia in 2018 is at the same level as it was in 2016, primarily due to the drop in operating profitability in 2017.

Graph 1. Rate of business profit - comparative analysis, 2013 - 2018



Source: Author based on SBA data and http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html

The overall economic profitability, measured by the *net profit margin*[3], after increasing strongly in the 2014 – 2017 period, achieved barely noticeable growth over the past year. The strong growth in overall profitability in the 2014 – 2017 period was dominantly influenced by temporary trends in financial markets, such as strengthening of the real value of the dinar and the drop of real interest rates. In 2018, real interest rates stagnated compared to the previous year, so they did not significantly impact the costs of the economy. Trends of the real exchange rate against the euro and the dollar had moderately positive effects on the profitability of the economy. The real value of the dinar against the euro and the dollar in 2018 was 3.6% higher than in the previous year, which resulted in lower interest costs on foreign currency loans, and consequently, on improving the financial result. However, the value of the dinar against the weighted average euro and dollar at the end of 2018 was unchanged compared to the end of 2017, and this is why the effects of positive exchange rate differences were lower by as much as 83% compared to the previous year. All this has resulted in the fact that local companies in 2018 had a negative financing result[4] which significantly slowed down the growth of the overall economic profitability.

3 The net profit margin illustrates how much of each dinar in revenue translates into profit. The net result, in addition to operating results, is influenced by other elements, such as positive and negative exchange rate differences, interest income and expenses, changes in the value of assets, gains and losses from the sale of assets.

4 The result from financing is the difference between income from financing and financing costs.

What marked 2018, when it comes to the analysis of the overall economic profitability, is the strong growth of other income, which, in 2018, was higher by as many as 108 billion dinars, compared to 2017. The increase in other income was mostly affected by the mining sector, where an unusually large increase in this income category was recorded, in the amount of about 100 billion dinars[5]. Two things should be taken into consideration here. Firstly, the growth of other income is mostly once-off, and cannot be relied on as a permanent source of increase in profitability. Secondly, the increase in other income in 2018 distorted the picture of the overall economic profitability. Had this increase not happened, the overall profitability in 2018, measured by the net profit margin, would be by one percentage point lower than the amount calculated, and by 0.6 percentage points lower than it had been in 2017.

In order to gain a clearer picture of the level and dynamics of the overall profitability of companies operating in the local economy, it is necessary to make appropriate comparisons with other economies.

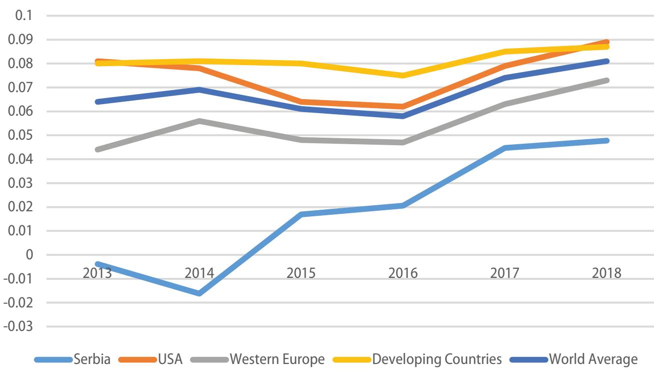
Table 2. Net profit margin - comparative analysis, 2013 - 2018

	Serbia	USA	Western Europe	Developing Countries	World Average
2013	-0.4%	8.1%	4.4%	8.0%	6.4%
2014	-1.6%	7.8%	5.6%	8.1%	6.9%
2015	1.7%	6.4%	4.8%	8.0%	6.1%
2016	2.1%	6.2%	4.7%	7.5%	5.8%
2017	4.5%	7.9%	6.3%	8.5%	7.4%
2018	4.8%	8.9%	7.3%	8.7%	8.1%

Source: Author based on SBA data and http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html

As noted earlier, the Serbian economy significantly improved the overall profitability measured by net profit margin in the period 2013-2018, thus managing to reduce lagging behind observed economies as well as the global average, which is, however, still 40% lower than the global average. We can notice that, during the analysed period, in addition to Serbia and the Western European economies, there has been a significant increase in overall profitability. This could mean that the overall profitability of the local economy and the Western European economies is affected by the same factors.

Graph 2. Net profit margin - comparative analysis, 2013 - 2018



Source: Author based on SBA data and http://people.stern.nyu.edu/adamodar/New_Home_Page/datacurrent.html

As noted earlier, the Serbian economy significantly improved the overall profitability of the measured net profit margin in the 2013 – 2018 period, thus managing to reduce the lag behind economies being analysed and the global average, but is still 40% lower than the global average. We can observe that, in the analysed period, besides Serbia, the Western European economies also recorded a significant increase in overall profitability. This could mean that the overall profitability of the local economy and the Western European economy are impacted by the same factors.

Return on Assets (ROA) vs. Return on Equity (ROE)

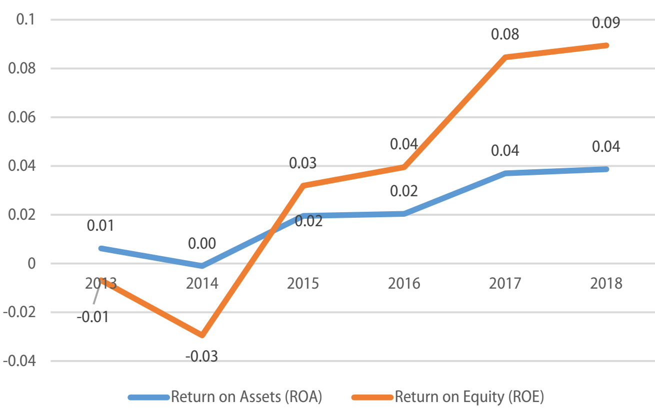
Operating and net profit margins are important indicators of the profitability of companies, but they do not provide us with the information on returns on investments generated by key stakeholders in companies (owners and creditors). For these purposes, Return on Assets (ROA)[6] and Return on Equity (ROE)[7] are used. The ROA and the ROE continued to increase steadily in the 2013 – 2018 period, with the exception of 2014, when these rates recorded a drop and had negative values that could be associated with the consequences of the floods that affected some regions of Serbia during that year. Although the efficiency of asset and equity management over the observed period generally slightly increased, growth of observed rates of return was nevertheless predominantly determined by the increase in net profit. However, we should take into consideration the fact that the key factors leading to the growth of net profit are those on which companies have relatively little influence. This primarily refers to strengthening of the local currency against the euro and the dollar and the constant decline in interest rates, whereby it is relevant that in the future, the dinar may weaken, and

5 It can be assumed that this amount is associated with other income from RTB Bor in 2018, as this is the year when it was privatized. After official publication of financial statements, it will be possible to explain the origin of this amount more precisely.

6 The ROA is the ratio between the net income increased by the cost of interest rates and the company assets.
7 The ROE is the ratio between net income and own equity.

interest rates may start to rise. It can also be noted that in 2013 and 2014, the ROA was higher than the ROE. From 2015, this relation changed and the ROE became higher than the ROA. This relationship between the ROA and the ROE implies that, by 2015, the negative effect of financial leverage was present at the level of the economy, meaning that debts were too large a burden on the economy, resulting in its being less profitable, i.e., the proceeds from total assets of companies were lower than the cost of financing those assets. Since 2015, the positive effect of financial leverage has been present in the economy, meaning that debts had a positive impact on the profitability of equity. This is largely due to the lower relative indebtedness of companies as a result of the strengthening of the local currency, and the continuous decline in interest rates, being actually the price of debt.

Graph 3. Return on Total Assets (ROA) and Equity (ROE), 2013 - 2018



Source: Author based on SBA data

As the database used for the purposes of comparing the profitability of the local economy and economy of selected countries does not contain data on the ROA, the ROE will be used for the purpose of comparing achieved rates of return.

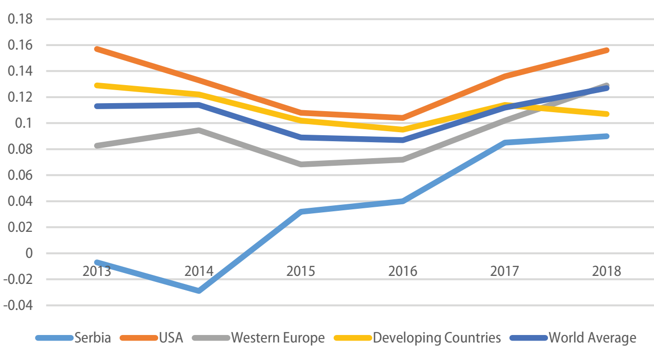
Table 3. Return on Equity - comparative analysis, 2013 - 2018

	Serbia	USA	Western Europe	Developing Countries	World Average
2013	-0.7%	15.7%	8.3%	12.9%	11.3%
2014	-2.9%	13.3%	9.5%	12.2%	11.4%
2015	3.2%	10.8%	6.8%	10.2%	8.9%
2016	4.0%	10.4%	7.2%	9.5%	8.7%
2017	8.5%	13.6%	10.2%	11.4%	11.2%
2018	9.0%	15.6%	12.9%	10.7%	12.7%

Source: Author based on SBA data

It should be considered that the ROE, similar to the operating profit margin, is significantly influenced by the branch of the economy within which companies operate and therefore by the structure of the economy whose performance is being measured and analysed. This, on the one hand, diminishes the informational power of the ROE when it is being used for comparing the profitability of different countries while on the other hand, it allows comparison between profitability trends measured by this indicator. Although a constant increase in the ROE was present in the local economy, throughout the analysed period, similar to previously analysed indicators, it is below the values identified in the observed economies and is below the global average. In order to analyse the leverage of growth of ROE, it is often decomposed down to: (1) the net profit margin indicating the extent to which companies are able to manage total income and expenditure; and (2) the equity turnover ratio indicating the extent to which companies are capable of managing assets and liabilities. What is interesting is that the local economy, although it has a lower net profit margin than the economies analysed, records greater efficiency in managing its own equity, reducing the lag behind the global average when it comes to ROE. As local companies are characterized by less effective asset management than observed economies, greater efficiency in managing their own equity is likely to be associated with a significant protraction of the time taken to pay suppliers and the use of non-interest-bearing sources of financing. For the sake of comparison, the average time taken to pay suppliers in Serbia is almost twice longer than the global average[8].

Graph 4. Return on Equity - comparative analysis, 2013 - 2018



Source: Author based on SBA data

Profitability analysis per sector

In the second part, the focus is on analysing profitability indicators for individual economic activities. The analysis covered the last two years, 2017 and 2018, taking into account only those activities that have a significant impact on total economic trends (all activities which generated at least 100 billion in total income in 2017).

8 The average time for collection of receivables in the local economy in 2018 was 66 days, while the average time for paying suppliers in the same year was 137 days.

Although there was a slight increase in operating profitability in 2018 at the level of the economy, when the analysis is applied at to the level of individual sectors, it can be noticed that a decline in profitability of the core activity is, in fact, recorded for most sectors. The growth of operating profit margin was recorded in transport and storage, construction, professionals and scientific activities, and clerical support and service sectors. This growth was sufficient to neutralize the decline in operating profitability recorded in other sectors and to result in a slight increase in the profitability of the core business at the level of the economy as a whole.

The greatest growth, by far, in operating profitability was identified in the transport and storage sector where the operating profit margin recorded a significant growth of almost 9 percentage points, from 5.1% in 2017 to as many as 13.8% in 2018. This increase was largely driven by strong growth in operating income of 16% (in 2017, this growth was 7.4%) while operating costs grew at an almost identical rate as they did in 2017 (around 7%). From the data available from the Statistical Office for the first half of 2018[9], it can be concluded that this increase was mainly affected by the increase in the volume of freight transport, since the volume of passenger transport in this period slightly decreased. The construction sector is increasing the profitability of the core business for the second year in a row, with growth in 2018 being significantly higher than that identified in 2017. It can be assumed that the administrative reforms of 2015, which led to simplification of procedures for issuing building permits, and the continuing of the low interest rate trend as well as the absence of alternative sources for placing surplus cash due to the insufficiently developed local financial market, allowed further improvement of the profitability of the core business in the construction sector. According to the Statistical Office, the value of construction works completed in 2018 in Serbia increased by 13.9%, compared to the previous year, i.e., by more than 40 billion dinars. In addition to the construction industry, the operating profit margin has been increasing for the second consecutive year in the sector of expert and scientific activities as well. In 2018 it was 8%, which is one percentage point higher than in 2017, and two percentage points more than in 2016. The fourth sector that generated the profitability of core business is the sector of administrative and service activities. The operating income rate in this sector increased from 5.8% in 2017 to 6.4% in 2018. As the last two analysed sectors are relatively heterogeneous in terms of their structure, it is difficult to identify in more detail the sources of growth of their operating profitability. However, what can certainly be concluded is that companies from these sectors are engaged in the provision of services as their core business, which confirms the narrative of the growth of the economy based on the production of goods and the provision of services as opposed to trading in goods.

By far the most significant drop in operating profitability in 2018, at almost 7 percentage points, was recorded in the mining sector, which is particularly interesting, considering that this is the sector which recorded the most significant increase in operating profitability in 2017. This decline in profitability could be linked to the slowdown in business processes in RTB Bor, taking into consideration that 2018 was the year in which the privatization of this company was finalized. It should also be noted that, at the level of the sector, operating income growth of about 20% was achieved, which is higher than the growth recorded in 2017 (18%). However, at the same time, there was a sharp increase in operating expenses (29%), which is far more than the increase experienced in 2017 (12%). Significant income growth could be associated with those companies in the analysed sector which deal with processing and sale of oil and oil derivatives, as there was a significant increase in fuel prices in 2018. Other companies in this sector, especially those engaged in the exploitation of ores and metals, had significantly higher operating expenses due to the increase in the costs of materials, fuel and energy caused by a sudden jump in fuel prices, as well as an increase in the price of electricity for the industry.

In other sectors where operating profitability declined, this drop was between 0.2 and 1.4 percentage points. Similar to 2017 and in 2018, the water supply sector recorded a drop in operating profitability. A fall in operating profitability of 1.2 percentage points was caused by the growth of operating income in 2018 being half of what it was previously, as well as the growth of operating expenses which was higher than the growth of operating income. This is, on the one hand, a consequence of the fact that water consumption decreases from year to year, both in households and in the industry, and that the price of water per cubic meter is often below a cost-effective price, especially with regard to prices for individuals. On the other hand, only 65% of the water consumed is water which generates income, while the remainder is water which is not invoiced and therefore, although it causes an increase in operating expenses, does not generate income. The sector of electricity supply, after the drop in operating profitability in 2017, continues with the same trend in 2018. The main causes of the fall in operating income in these two years are almost the same and are associated with an increase in operating expenses which was not followed by a corresponding increase in operating

9 Data for the entire 2018 is still not available.

income. The growth of operating costs in this sector is primarily due to the decline in the production of electricity, which, with the aim of ensuring a regular and safe supply of customers, is compensated by obtaining electricity on local and foreign stock markets where a significant price jump was observed in the second half of 2018. The agricultural sector, which was the sector with the largest decline in operating profitability in 2017, continues to record a decline in operating profitability in 2018. Unlike 2017 in which a decrease in the physical volume of agricultural production of 11.9% was recorded due to severe drought, in 2018, there was a 16.3% increase in agricultural production. However, the increase in the supply led to a drop in agricultural product prices, and producer prices for agricultural products were therefore 4.2% lower in 2018 than the previous year, which resulted in the growth of income in 2018 to be lower than the growth operating expenses. After a successful 2017 when the growth of operating profitability was achieved, the accommodation and food service sector recorded a decline in the operating profit margin in 2018, taking it back to the 2016 level of 2.7%. Operating expenses growing faster than operating income contributed to a decline in the profitability of the core business. It can be assumed that the operating income growth of 19.3%, which was somewhat lower compared to 2017, contributed to the continuing trend of an increase in the number of tourists, taking into account that according to data from the Statistical Office, the number of tourist arrivals and overnight stays increased in 2018 by 11% compared to the previous year. However, it should be emphasized that the sector of accommodation and food services is characterized by a constant increase in competition, since the growth rate of companies registered for this activity is higher than the overall economy average. This could lead to a decline in service prices and a lower growth in operating income despite the higher demand for this type of service. The increase in operating expenses (20%) was largely due to an increase in intangible costs (51.2%), which are the most significant item of operating expenses for companies in this sector. This category of expenses includes fees which hotels pay to travel agencies and other agents in the process of doing business. In the information and communication sector, core business profitability has been declining since 2016, with the decline in 2018 higher than the one recorded in 2017. Starting from 2013, a vast majority of European Union countries experienced a decline in income in this sector due to the drop in income from voice and fixed telephony services. Although the income from data transmission via the mobile network in total income in the EU market is increasing, it is not sufficient to compensate for the loss of income from voice traffic. According to RATEL's report, in the Serbian market, unlike the EU market, income continues to increase, but it is possible that the trends described are preventing faster growth of income. Operating income in 2018 grew at a higher rate than it did in 2017. It can be assumed that segments related to cable telecommunications, programming,

Table 4. Profitability of selected sectors of the economy of Serbia 2017 - 2018

	Profitability indicators							
	Business Profit Rate		Net gain rate		Return on Assets		Return on Equity (ROE)	
	2017	2018	2017	2018	2017	2018	2017	2018
Agriculture	3,5%	2,5%	3%	-0,3%	1,7%	0,2%	2,2%	-0,2%
Mining	12,4%	5,7%	10,9%	31,9%	6,5%	20,4%	15,7%	42,9%
Manufacturing	6%	5,6%	5,6%	3,8%	5,9%	4,1%	19,4%	11,3%
Supply of el. energy	6,6%	5,5%	5,8%	1,3%	2,3%	0,7%	3,5%	0,7%
Water supply	6,3%	4,9%	3,8%	2,1%	1,8%	0,9%	2,4%	1,6%
Construction	3,8%	5,3%	1,5%	4,1%	1,2%	2,4%	1,6%	4,6%
Wholesale and retail trade	3,6%	3,4%	2,4%	2,3%	4,1%	3,7%	14,4%	12,6%
Traffic and storage	5,1%	13,8%	3,7%	11,5%	3,1%	7,8%	4,7%	14,3%
Accommodation and food services	3,6%	2,7%	2,8%	2,1%	2,2%	1,7%	4,2%	3,5%
Information and communication	11,8%	11,1%	11,4%	9,4%	8,2%	6,9%	23,2%	19,2%
Professional and scientific activities	7,1%	8,0%	6,2%	7,1%	2,5%	3,1%	5,9%	7,1%
Administrative and service parts	5,8%	6,4%	7,2%	4,9%	8,2%	5,0%	28,8%	14,4%

Source: Author based on SBA data

and consulting services in the field of information technology have contributed to this. However, although operating income in this sector increased, this growth was lower than the rise in operating expenses, which led to a drop in operating profitability. Manufacturing and wholesale and retail sectors experienced a slight decline in operating profitability of 0.4 and 0.2 percentage points.

As opposed to 2017, when all sectors recorded increase in net profit margins, primarily due to exogenous factors, in 2018, the trend of overall profitability was the same as the trend of operating profitability in almost all sectors. This should indicate that in 2018 the operating result was what determined the overall profitability of the company. The service and clerical support activities sector was the exception, where the net profit margin was dropping, even though operating profitability grew, and the mining sector where although there was a significant drop in operating profitability, the net profit margin increased by almost 300%[10]. The agricultural sector is the only sector that had a negative net result and consequently a negative net profit margin.

Sectors which recorded increase in ROA and ROE in 2018 are mining, transport and storage, construction, professionals and scientific activities. In the mining sector, significant growth of these indicators is a consequence of the increase in net profits mentioned before, which was the result of the growth of other income, while for the remaining three sectors the growth of these indicators coincided with the growth of operating and the net results. In all other sectors, the decline in the ROA and the ROE was recorded. What could be concluded, by dividing ROE into net profit margin and equity turnover ratio is an enviable efficiency in the management of equity in the manufacturing, wholesale and retail, as well as information and communication sectors. For all these sectors, what is characteristic is the delay in paying suppliers which is above average, which is where the main reasons for the high efficiency of equity management should be sought. The poor efficiency of equity management, which led to the ROE being lower than the net profit margin, is characteristic for the electricity and water supply sector, primarily due to the low efficiency of collection of receivables.

10 This is related to the increase of other income in the amount of RSD 100 billion in the mining sector, which significantly increased the net profit achieved at the level of this sector. See footnote 2.

Table 5. Comparison of the profitability of selected sectors of the Serbian economy with the world average for 2018

	Profitability indicators					
	Business Profit Rate		Net gain rate		Return on Equity (ROE)	
	2018 (Serbia)	2018 (World average)	2018 (Serbia)	2018 (World average)	2018 (Serbia)	2018 (World average)
Agriculture	2,5%	6%	-0,3%	4%	-0,2%	9%
Mining	5,7%	9% - 18%	7,1%	6% - 7%	9,6%	11% - 15%
Manufacturing	5,6%	6% - 21%	3,8%	3% - 13%	11,3%	7% - 22%
Supply of el. energy	5,5%	12%	1,3%	6%	0,7%	8%
Water supply	4,9%	28%	2,1%	16%	1,6%	10%
Construction	5,3%	11%	4,1%	8%	4,6%	15%
Wholesale and retail trade	3,4%	4%	2,3%	3%	12,6%	11%
Traffic and storage	13,8%	5% - 22%	11,5%	15% - 23%	14,3%	19%
Accommodation and food services	2,7%	14%	2,1%	10%	3,5%	27%
Information and communication	11,1%	14% - 24%	9,4%	8% - 17%	19,2%	11% - 34%
Professional and scientific activities	8,0%	10% - 26%	7,1%	6% - 17%	7,1%	10% - 28%
Administrative and service parts.	6,4%	n/a	4,9%	n/a	14,4%	n/a

Source: Author based on SBA data

In previous analyses, we could see that the local economy is lagging behind the global according to all applied indicators. However, in the end, we will still have to compare the performance of selected sectors of the local economy with the success of the same sectors at the average global level in order to determine if, and to what extent, selected sectors of the local economy are more or less profitable compared to the global average. The varying levels of disaggregation of the economy to individual sectors somewhat reduce the informative power of analysis. The classification of sectors applied in Serbia uses a much lower level of disaggregation in some sectors than the international database used in this analysis. Due to this, the values of individual indicators, calculated for comparison purposes, are approximated and presented in appropriate ranges. Also, the ROA and clerical support and service activities sector are left out, since these data are not available in the database which was used.

When it comes to operating profit margin, the biggest lag behind the global average was identified in water supply sector, which should not be surprising, considering that there is a natural monopoly on the local market in this sector, and prices are generally below the cost-effective market prices. Significant lagging also exists in electricity supply sector, which should again be associated with low electricity prices, as well as considerable inefficiency in managing the main electricity producer in the local economy (EPS). Also, there is a noticeable lag in accommodation and food service sector and construction industry. Other sectors record slightly smaller lags in operating profitability. The only sector which achieved operating profitability within the range of the global average in 2018 is transport and storage sector.

When it comes to overall profitability, measured by net profit margin, the situation is drastically better compared to operating profitability, which would indicate that current trends in macroeconomic variables are more in line with the local economy compared to the global average. Several sectors, such as mining, information and communication, professionals and scientific activities and manufacturing industry fit into intervals identified at the global average level. Of course, as noted earlier, caution is advised, because for these sectors, intervals were indicated for which the overall profitability varied within different sub-sectors. Similar to the case of operating profitability, what remains unchanged is that the largest lag is in water supply sector.

In the end, we compare return on equity (ROE) between selected sectors of the local economy and the global average. Wholesale and retail trade sector exceeds the global average, and this is the result of more efficient equity management and a significantly longer delay in paying suppliers, as well as a lower degree of competition. Sectors of information and communication and manufacturing fit into intervals identified at the global average level. In these two sectors, the ROE is even closer to the average than the net profit margin, which indicates more efficient equity management compared to the global average[11]. Again, it is assumed that this is linked to considerably longer delays in payments to suppliers compared to the global average. The biggest lag is present in the sector of accommodation and food service, followed by construction, agriculture, water supply, and electricity supply.

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11 Although it is not possible to state this with certainty until a more detailed analysis and comparison of the efficiency of management and certain categories of assets is performed.

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