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.