TRENDS

1. Review

Although year-on-year GDP growth accelerated to 4.6% in Q1, basic macroeconomic trends are in fact very similar as in the previous year. Namely, the acceleration of economic growth at the beginning of the year was influenced by temporarily good results of agriculture, construction and electricity production, which were compared with a poor first quarter of the previous year. Except for the mentioned sectors, most of the economy continued with a similar growth of around 3% which ended 2017. This growth trend of the largest part of the economy, of 3%, is considerably lower than in other comparable countries of Central and Eastern Europe, and consequently Serbia's economy continues to lag behind comparable countries in 2018. At the beginning of 2018, inflation remained low and relatively stable (at the lower limit or slightly below the NBS target band), and the trend of deterioration of Serbia's foreign trade exchange continued. The relatively low growth of the largest part of the economy and the increase in the foreign trade imbalance are sufficient indicators for the Government and the NBS to respond with measures of economic policy, to accelerate structural reforms, to work on improving the business environment and to revise the policy of strengthening of the Dinar. However, for now there are no indications that this will happen. Economic policy makers are still satisfied with the macroeconomic stability achieved through the successful implementation of the fiscal consolidation, and, instead of the necessary reforms there is an announcement of some fiscally irresponsible and economically inefficient measures, such as excessive increase in public sector wages and pensions. Negotiations on a new arrangement with the IMF are about to begin, but good fiscal and economic policies in Serbia should not depend only on the presence of the IMF.

Economic growth in Q1 amounted to 4.6%, which is the highest y-o-y growth of GDP in the past ten years (since the outbreak of the crisis in the second half of 2008). As we expect a gradual slowdown in economic activity in the coming quarters, in relation to Q1, we keep our prediction from previous issues of QM that the GDP growth will amount to about 4% at the entire level of 2018. Serbia's economic growth of about 4%, which we expect to be reached in 2018, is at the level of the predicted average economic growth of other CEE countries (see section 2 "Economic activity").

Despite relatively high growth of GDP in Q1 of 4.6%, we cannot assess the current economic trends as completely favorable. As we already indicated, the achieved economic growth in Q1 is not entirely sustainable as it relies largely on a strong one-off growth of a limited number of sectors, which were compared with poor results from the previous year. Most of the Serbian economy continues to record growth rates of around 3%, as was the case in 2017, which is significantly lower than in the comparable countries. Also, the GDP growth structure continues to deteriorate at the beginning of 2018, as domestic demand rises considerably faster than GDP growth, and one can notice that the investments in the production of tradable products redirected to the investments in non-tradable sectors (trade, banking, construction). Serbia already had an experiance with a similar model of economic growth based on domestic demand in the period 2005-2008 which did not prove to be sustainable (it couldn't have lasted even if there hadn't been a global economic crisis). Therefore, it would be bad for Serbia to go through the same mistakes again, i.e. the Government and the NBS should not ignore these indicators.

A strong deterioration of the foreign trade deficit continues in early 2018. Serbia's deficit in trade of goods with other countries increased in the first four months of 2018 by 450 million euros (from 1,250 million euros to 1,700 million euros). The increase in the goods trade deficit was a result of almost two times higher growth of imports than growth of exports (imports of goods in the first four months of 2018 increased by 13.5% and exports by 7.5%). These trends in imports and exports can be partly explained by objective circumstances. Due to a bad agricultural season of 2017, the exports of agricultural products in the first four months of 2018 had a strong y-o-y decline of over 30%, which reduced the surplus that Serbia has in exchange of agricultural goods with the world for 100 million euros, when compared to the previous year. Also, global growth in energy prices contributed to the deterioration of Serbia's trade deficit by about 50 million euros. However, when objective factors are excluded it is evident that the deterioration of the foreign trade is still a lasting trend, caused by the increase in domestic demand and excessive strengthening of the Dinar.

Despite the significant deterioration in foreign trade, the current account deficit in Q1 amounted to 650 million euros (7% of GDP), i.e. it was slightly lower than in the same period of the previous year (680 million euros, 8.2% of GDP). The improvement in the current account deficit in Q1 is a result of the reduction of the deficit in the primary income account and mild surplus in secondary income account (see Section 4, "Balance of Payments and Foreign Trade"). On this occasion, we emphasize that the deterioration of trends in trade exchange seems to be more durable, and that improvements in primary and secondary income are the result of their volatility, i.e. we cannot count on their improvement in a longer period of time. Therefore, we assess the improvement of the current account deficit in Q1 as temporary, i.e. with the current foreign trade trends we do not expect the improvement of the current account deficit to continue until the end of the year. In Q1, the net FDI amounted to around 570 million euros and were not sufficient to cover the current account deficit.

In the first half of 2018, the dinar continued to strengthen in real terms against the euro (see section 5 "Prices and the Exchange rate"). From the beginning of the year until the middle of June, the dinar strengthened slightly in nominal terms against the euro by about 0.8%. Due to the differences in inflation in Serbia and the Eurozone the real strengthening of the dinar in the first five months of 2018 was about 1.5%. At first glance, such strengthening of the dinar at the beginning of 2018 does not seem to be significant. However, taking into account that the trend of real strengthening of the dinar in 2018 is connected with the strong appreciation of the dinar from the second half of 2017, this estimate is somewhat different. Namely, the average exchange rate in the first five months of 2017 was 123.6 dinars per euro, and in the first five months of 2018 the average exchange rate was 118.3 dinars per euro. This means that only in one year the dinar strengthened in real terms against the euro by around 5%. Such strong appreciation of the dinar in real terms in the past year was not in line with the movement of the productivity of the domestic economy and seriously undermined Serbia's price competitiveness, which reflects on the growth of the foreign trade deficit. We think that NBS, when deciding on monetary policy and interventions on the interbank foreign exchange market, should in future pay more attention to economically unfavorable trend of the real dinar exchange rate, which continues in 2018.

The price increase in the first five months of 2018 was 1.7%, which is the appropriate inflation trend for Serbia (see section 5 "Prices and the Exchange rate"). During this period, the y-o-y inflation was mainly at the lower limit of the NBS target band (3 ± 1.5%), and in March and April it was temporarily below the lower limit due to the high base from the previous year. The rise in prices in first five months of 2018 was a result of an increase in food prices, but we estimate that this is a seasonal increase. The acceleration of energy prices, due to a global increase in oil prices and recent strengthening of the dollar exchange rate, could be somewhat more durable. Alongside these two factors, the acceleration of inflation at the beginning of 2018 was influenced by the growth of domestic demand and relaxation of the NBS monetary policy. On the other hand, the rise in prices was slowed down by the appreciation of the dinar. Taking all of this into account, we still estimate that inflation in Serbia is stable, low and under control, and we do not expect any significant changes in the coming months.

Labor market saw undeniable improvements in Q1 2018 (see section 3 "Labor Market"). According to the Labor Force Survey (LFS), employment growth compared to the same period of the last year amounted to 1.1% and was (in line with economic expectations) lower than GDP growth. Also, formal employment (without agriculture) according to ARS recorded a growth consistent with the movement of comparable registered employment, which is independently monitored on the basis of the data from the Central Register of Compulsory Social Insurance

(CROCSI) - both indicators show registered/formal employment growth (without agriculture) of just over 3% y-o-y. In addition to improvements of the labor market trends, very important news is that LFS for the first time after a long time provided economically expected data that is consistent with other, independent, sources. This could be a good sign of improving the quality of data from this important Survey.

The average net wage in the first three months of 2018 recorded a nominal growth of 5.5% (3.8% in real terms). The increase in average net wage in 2018 was influenced by several different factors, some of which are not market-based. For example, somewhat higher average wage growth was influenced by wages of employees in the general government, which increased by 9% (on average) in 2018, which is well above the nominal GDP growth, as well as above wage growth in the private sector. Also, the Government introduced a relatively high (by 10%) increase of the minimum wage in 2018, which also affected the acceleration of the average wage growth. Despite a solid increase in average wage in the first three months of 2018, it is not realistic to expect that by the end of the year the average salary will reach the level of 500 euros (as announced in the public). Namely, with the current exchange rate of around 118 dinar per euro, this would mean that in December 2018 the average wage would increase by about 20% y-o-y, for which there is no economic basis, nor there is any indication that this could happen (nominal wage growth in the first three months was 5.5%). Even if this, very unlikely, increase in the average net wage to 500 euros by the end of the year happens, it would be economically very harmful. Namely, due to the appreciation of the dinar, the average net wage in the first three months of 2018 already increased in euros compared to the previous year by around 10% (it reached the level of 415 euros). Labor is the most important non-tradable good in the economy, and this high increase in wages in euros (significantly above productivity growth) has considerably worsened the international competitiveness of the Serbian economy, and further continuation and strengthening of this trend would be very economically dangerous.

Low inflation, with the balanced state budget, provided NBS with the opportunity to continue with the easing of monetary policy (see section 7, “Monetary Trends and Policy”). The key interest rate in 2018 was reduced twice, so it is now at a record low of 3% (which is also the midpoint of the inflation target corridor). We see this as the correct policy of the NBS. In addition, the banking sector is on the upward track. For the time being this is best seen by the increase in credit placements to households, while data on the real credit activity of the economy are still blurred by the write-offs and sales of bad loans which were in the balance sheets of banks. The percentage of bad loans for the first time since the outbreak of the crisis in 2008 was reduced to a one-digit value. Since the banking sector in Serbia is now consolidated, in principle healthy (a relatively low share of non-performing loans), there is no risk of macroeconomic instability after the implementation of fiscal consolidation, and interest rates are still very low - by the end of the year a gradual expansion of credit activity can be expected in Serbia.

Fiscal trends in the first four months of 2018 are in principle similar to those in the previous year (see section 6, “Fiscal Trends and Policy”). Namely, both public revenues and public expenditures have relatively similar growth as in the same period of the previous year (5.5% and 8%), so that the fiscal result remained in a mild surplus (around 7 billion dinars, about 0.4% of comparable GDP). On the public revenues side, a strong growth was recorded by the income tax, excise taxes and contributions, while the collection of net VAT slightly decreased compared to the previous year. On the public expenditures side, the strongest growth was in capital expenditures (primarily due to the comparisons with a low base from the previous year), procurement of goods and services and wage expenses. Public expenditures on interest rates (reduction of public debt, decrease in interest rates, appreciation of the dinar), and expenditures for the repayment of guaranteed debt of public companies (most of the Srbijagas’s debt, which was paid for by the state instead this company, was repaid by the end of 2017) were considerably lower, compared to the previous year.

Successful completion of fiscal consolidation opens the possibility for the Government to abolish temporary austerity measures - first of all the Law on Temporary Reduction of Pensions. However, the thing that is not good is that with the abolition of this temporary Law, an additional increase of only below-average pensions is announced. Such an approach is economically wrong, since it would violate the link between paid pensions and paid contributions. Therefore, it is far better to equally allocate the remaining fiscal space (after the abolition of the Law on Temporary Reduction of Pensions) to all pensioners. The pension system in Serbia, just like in other European countries, is regulated on the basis of clear and objective parameters, and this is a part of public finances that should not be arbitrarily (and permanently) violated depending on political priorities.

Public debt at the end of April amounted to 23.6 billion. (61.5% of GDP), which represents an increase of nearly half a billion euros in relation to the end of 2017. The growth of public debt in the first four months of 2018 was influenced by the government borrowing to finance the future liabilities, while the continuation of the dinar appreciation had the opposite effect. The increase in public debt at the beginning of 2018 is temporary, as the budget is basically balanced (a slight surplus is also likely in 2018) - and the balanced budget leads to a more durable trend of public debt reduction in relation to GDP. The downward trend of public debt to GDP ratio, i.e. low fiscal deficit, is necessary in the long run, since the current public debt level of about 60%, for countries like Serbia, is still too high.

Serbia: Selected Macroeconomic Indicators, 2006–2018

	Annual Data												2016				2017				2018
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Economic Growth							y-o-y, real growth[1]														
GDP (in billions of dinars)	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3908.5	4043.5	4261.9	4479.0	…	…	…	…	…	…	…	…	…
GDP	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	0.8	2.8	1.9	4.0	2.0	2.8	2.5	1.1	1.4	2.1	2.4	4.6
Non-agricultural GVA	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.5	1.9	2.7	3.1	4.3	1.9	2.3	2.2	1.6	2.4	3.9	3.8	4.9
Industrial production	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	8.2	4.7	3.5	10.5	2.4	3.7	2.8	0.7	3.1	6.3	3.5	5.9
Manufacturing	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	5.3	5.3	6.4	6.5	5.9	4.4	5.3	7.3	5.1	7.7	4.9	5.0
Average net wage (per month, in dinars)[2]	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	44,437	46,087	47,888	43,588	46,450	46041	48168	45437	48670	47844	49599	49089
Registered Employment (in millions)	2.028	1.998	1.997	1.901	1.805	1,866	1,865	1,864	1,845	1,990	1,989	2,061	1,978	2,008	2,023	2,030	2024	2061	2073	2087	2092
Fiscal data							in % of GDP														
Public Revenues	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	3.2	3.1	7.5	4.0	7.4	7.8	9.2	5.6	5.3	5.5	0.3	3.5	3.6
Public Expenditures	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.2	-3.2	1.9	-1.7	5.7	4.9	2.3	-3.7	-1.3	-1.8	-4.5	-0.6	5.6
							in billions of dinars														
Overall fiscal balance (GFS definition)[3]	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-258.1	-149.1	-57.1	52.3	-16.0	-2.1	13.8	-52.8	11.8	32.5	37.8	-29.8	3.7
Balance of Payments							in millions of euros, flows[1]														
Imports of goods[4]	-10,093	-12,858	-15,917	-11,096	-11,575	-13,614	-14,011	-14,674	-14,752	-15,350	-15,933	-18,076	-3,638	-4,159	-3,878	-4,258 0	-4,204	-4,576	-4,383	-4,912	-4,704
Exports of goods[4]	5,111	6,444	7,416	5,978	6,856	8,118	8,376	10,515	10,641	11,357	12,814	14,090	2,976	3,310	3,160	3,369	3,277	3,693	3,559	3,560	3,571
Current account5)	-3,137	-4,994	-7,054	-2,084	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-1,075	-2,090	-305	-284	-239	-247	-694	-333	-384	-678	-650
in % GDP[5]	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-6.8*	*-10.9*	*-11.6*	*-6.1*	*-5.9*	*-4.7*	-3	-6	-4	-3	-3	-3	-8	-4	-4	-7	*-7.0*
Capital account[5]	7,635	6,126	7,133	2,207	1,553	3,340	3,351	1,630	1,705	1,205	535	1,690	99	180	95	162 0	486	328	266	610	460
Foreign direct investments	4,348	1,942	1,824	1,372	1,133	3,320	753	1,298	1,236	1,804	1,899	2,415	470	454	533	443 0	558	626	660	571	569
NBS gross reserves (increase +)	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,797	166	-302	228	-836	-317	332	519	-455	222	1,061	-600	398
Monetary data							in millions of dinars, e.o.p. stock[1]														
NBS net own reserves[6]	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	931,320	923,966	891,349	884,093	846,969	899,959	923,966	894,102	881,125	936,542	891,349	866,515
NBS net own reserves[6], in mn of euros	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,486	7,649	7,486	7,482	7,180	6,864	7,303	7,486	7,217	7,221	7,851	7,482	7,327
Credit to the non-government sector	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,870,916	1,927,668	1,982,974	2,031,825	2,067,826	1,961,626	2,009,537	2,044,160	2,031,825	2,042,971	2,050,579	2,057,675	2,067,826	2,081,211
FX deposits of households	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	1,014,260	1,070,944	1,074,424	1,027,439	1,048,123	1,053,841	1,070,944	1,087,084	1,067,142	1,069,094	1,074,424	1,095,018
M2 (y-o-y, real growth, in %)	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	6.7	5.5	8	0.6	7.2	7.3	9.4	8	6.4	4.8	2.3	0.6	2
Credit to the non-government sector (y-o-y, real growth, in %)	10.3	24.9	25.2 5,2		13.9	0.5	-2.1	-8.3	1.2	1.4	0.9	4.0	1.6	4.2	5.2	0.9	0.5	2.7	2.4	4.0	4.6
Credit to the non-government sector, in % GDP	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	48.4	47.2	45.4	46.7	47.2	47.4	46.6	46.4	46.0	45.7	45.4	44.9
Prices and the Exchange Rate							Y-o-y growth[1]														
Consumer Prices Index[7]	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	1.6	1.5	3.0	0.6	0.3	0.6	1.5	3.5	3.6	3.2	3.0	1.4
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	91.2	85.4	91.3	95.8	87.7	92.9	87.4	89.2	90.6	91.6	88.9	91.0	91.9	91.6	91.8	90.6	89.9	87.7	87.4	86.3
Nominal exchange rate dinar/euro[8]	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	120.8	123.26	121.4	122.85	123.01	123.3	123.26	123.88	122.91	119.8	119.1	118.4

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.