TRENDS

1. Review

The previous year, 2017, was marked by the combination of positive and negative macroeconomic trends. On the positive side, the most important improvements in 2017 relate to public finances, low and stable inflation of around 3%, which was throughout the year within the NBS target band, and a moderate increase in employment of 2.5-3%. The main negative trends in 2017 were a weak economic growth of only 1.9%, which was practically the lowest in Central and Eastern Europe (CEE), strong deterioration of the foreign trade deficit and the delay in the implementation of structural reforms. Although in 2018 we expect some improvements in macroeconomic results, primarily concerning the increase in economic growth (we expect GDP growth of around 4%), all three negative trends from 2017 (low growth trend, rising external deficit and failure to implement reforms) will be present in 2018. Thus, the 4% economic growth expected in 2018 is not yet sufficient to reduce Serbia's lag behind the comparable CEE countries, as these countries are growing even faster – for example in 2017 they recorded a GDP growth of 4,5%. In addition, the 4% economic growth expected in Serbia in 2018 is not fully sustainable because it is based on the recovery of agriculture from the effects of drought form 2017. Also, the first January data point to further expansion of the foreign trade deficit, while the Government's readiness to accelerate structural reforms in 2018 is still under a question mark.

The observed macroeconomic weaknesses impose the need for the Government and the NBS to respond to these challenges with adequate economic policies and acceleration of reforms. Regarding low economic growth, for some time now we have been pointing out that the direct reason why Serbia is lagging behind the comparable countries in the long run is - a lack of investments. Therefore, we believe that the Government should implement the following policies to increase investment share in GDP and permanently accelerate economic growth: 1) to increase public investments, 2) reform public enterprises in order to invest more, 3) privatize the remaining state -owned enterprises such as RTB Bor and Petrohemija and 4) improve the business environment, above all in the area of the rule of law, reduction of corruption and increase of the efficiency of state administration, in order to increase private investments. For the second macroeconomic problem, a strong expansion of the foreign trade deficit, it is necessary for NBS to stop the excessive strengthening of the dinar which negatively affects net exports, but also to give up on the announced faster growth of demand compared to GDP growth. Finally, regarding the halt in the implementation of structural reforms, it is important to sign a new agreement with the IMF, but also to make a political decision that would lead to the implementation of the reforms beyond the short-term political interests of the authorities and the special interests of the privileged groups.

Economic growth in 2017 was 1.9%, which is in line with our expectations from the middle of the previous year (see section 2 "Economic activity" in previous QM issues). GDP growth of 1.9% was unsatisfactory since it was the lowest in the entire CEE (excluding Macedonia which had a political crisis). The poor performance of Serbia's economy in 2017 was partially under the influence of one-off factors - drought and a sharp fall in EPS production in the first part of the year. These two factors combined lowered economic growth by about one percentage point. However, even without such temporary factors, Serbia's GDP growth would still be relatively low, i.e. slightly below 3%. With GDP growth of 3%,' Serbia would still be the country with the lowest economic growth in the entire CEE (Table T2-1).

In 2018 we expect GDP growth of about 4%. Such estimate is led by the current GDP trends and the analysis of economic activities that recorded a major decline in 2017. Namely, economic trends in the last two quarters of 2017 indicate that the GDP growth trend with which enter 2018 is about 3%. Since in 2018 we expect a recovery of agriculture from drought from 2017 and its growth of about 10%, as well as a relatively high growth in electricity production, which will be compared with a sharp decline from the first half of 2017 - this will add to the existing growth trend of the economy another percentage point. Thus, the growth trend of around 3% with one-off contribution from agriculture and electricity production should in the aggregate result in GDP growth of about 4% in 2018. Due to poor achieved results in the first quarter of last year, the growth rate of 4% in this year is in line with GDP growth in the first quarter of this year of around 4.5%. Therefore, the high growth in the first quarter of this year should not be interpreted as the growth prognosis for the whole year.

Labor market trends in 2017 were in principle favorable. Employment rate increased by just over 2.5%, and wages increased by 0.9% (see section 3 “Labor market”). In addition to a number of indicators of employment trends, some of which we consider to be insufficiently reliable (Labor Force Survey), as the best indicator of real employment growth in Serbia we single out the movement in the registered employment. Registered employment is monitored on the basis of administrative data from the Central Registry of Compulsory Social Insurance (CROCSI) and this data shows a growth of registered employment in 2017 of 2.6%. Although at first glance data on employment growth (2.6%) and real wages growth of 0.9% are not fully consistent with somewhat lower economic growth (1.9%), it should be noted that low economic growth was affected by drought and poor EPS management, which do not have much impact on employment and wages. For this reason, for the assessment of the sustainability of the current growth of employment and wages, it is better to compare the growth of the wage mass with the growth of the underlying GDP (from which we exclude the effects of drought and poor results of the energy sector) - which is around 3% and is relatively close to the real growth of the wage mass.

In 2018 we expect similar employment trends as in 2017, i.e. employment will continue to grow at a rate of 2-3%. The growth of wages could accelerate, since at the beginning of the year the average wage in the general state (about 500,000 employees) increased by around 9% in average, and also the decision was made to increase the minimum wage by 10%, which applies to both the public and the private sector. Of these two measures, the more problematic is the wage increase to employees in the general government, which is higher than the expected growth of the nominal GDP, but also higher than private sector wage growth (which was below 4.5% in 2017). Higher growth of wages than the GDP growth, which the state is planning for its employees can have a negative impact on the increase of macroeconomic imbalances, and the accelerated growth in public sector wages unduly favors it in relation to the private sector in which the job security is smaller. The second measure of the Government, increasing the minimum wage by 10%, is not so questionable as it was made together with the increase of the non-taxable part of salary from 11,790 dinars to 15,000 dinars. Due to the simultaneous tax relief of labor, this increase in minimum wage will not pose an additional burden on employers. However, we also point out that the available fiscal space in 2018 actually allowed for a greater tax burden relief on all employees, but the government decided to spend this on the above-average increase in public sector wages.

Movements in the balance of payments in 2017 were unfavorable as the current account deficit increased from 3.1% of GDP (1.1bn euros) in 2016 to 5.7% of GDP (2, 1 billion euros) in 2017 (see section 4 “Balance of Payments and Foreign Trade”). Behind this deterioration is the largely faster growth of imports than exports which led to an increase in a foreign trade deficit of 820 million euros. The increase in the level of the foreign trade deficit in 2017 was a result of 1) unfavorable terms of trade, 2) reduction of the surplus in the trade of agricultural products, and 3) the strengthening of the dinar. Since the first two causes of the deficit growth are the consequences of external circumstances (the change in world oil prices, unfavorable weather conditions for agriculture), which cannot be influenced by domestic policies, it is crucial that the NBS more decisively prevents excessive strengthening of the dinar in order to at least stop the influence of that channel on the increase in external imbalances.

The capital inflow from abroad in 2017 also increased significantly, a good part as a result of the rise in foreign direct investments (FDI). Net FDIs increased from 5.5% of GDP (201 billion euros) from 2016 to 6.5% of GDP (2.4 billion euros) in 2017. Although this trend is basically positive, not only the level but also the structure of the FDIs should be taken into account. Available data on FDIs structure for the first three quarters of 2017 indicate a decline in foreign investments in the manufacturing industry for over 150 mln euros, while at the same time investments in real estate and trade increased for more than 200 mln euros. Although it is still early to make long-term conclusions, the NBS should take very seriously deterioration of the trade exchange and the change in the structure of FDIs. Serbia already had a strong dinar experience, a strong increase of the current account deficit, and orientation of the economy on services and consumption instead of exports in the period 2005-2008. Such trends proved to be unsustainable and costly with the outbreak of the crisis in the second half of 2008, so Serbia should not repeat the same mistake twice.

As we already pointed out, 2017 was marked with a relatively strong strengthening of the dinar (see section 5 “Prices and the Exchange Rate”). The dinar nominally strengthened against the euro by 4% and against the US dollar by as much as 15.4%. Since inflation in Serbia in 2017 was higher than in the Eurozone and the USA the real appreciation of the dinar in the previous year was even more pronounced than the nominal. Strengthening of the dinar often has positive connotations in the public, as it increases the purchasing power of the population and reduces the indebtedness of foreign debtors (it also led to a strong reduction in public debt). However, the long-term consequences of excessive strengthening of the dinar are damaging because they seriously undermine the price competitiveness of the Serbian economy, encourage rebalance of the economy towards domestic consumption and nonexchangeable services rather than towards exports, and send wrong signals to investors.

In 2017 inflation was 3% (see section 5 “Prices and the Exchange Rate”), which is also the middle of the NBS target band (3 ± 1.5%). The rise in prices in 2017 was marked by two different periods. At the beginning of 2017 inflation was somewhat higher - from January to April inflation increased by 3%, same as the total annual inflation rate. This means that from May to December the price increase was completely stopped. As a result, we entered 2018 with the trend of very low inflation, which now due to the high base effect reflects in a relatively strong decline of the y-o-y inflation in the first two months of 2018. Y-o-y inflation in February dropped to the bottom of the NBS target band (1.5%) and there is a high probability that it will leave it in the coming months. It would desirable that the NBS uses the monetary measures for keeping inflation in the target band more boldly, as the price increases near the center of the target band is desirable not only for economic growth but also for the credibility of the National Bank.

In response to low inflation, in the second half of 2017 and at the beginning of 2018 NBS reduced the key policy rate (see section 7 “Monetary Flows and Policy”). In October 2017, the key policy rate was reduced from 3.75% to 3.5%, and in March 2018 it was again reduced to 3.25%. In 2017 credit activity grew solidly, although this was not apparent at first sight due to the significant write-offs of non-performing loans. The problem of non-performing (bad) loans had been rapidly reduced in 2017, so at the end of December, the share of bad loans fell to 11%, which is their lowest share since 2009, i.e. the number halved compared to their record level of 23% from the middle of 2015. Interest rates are still at a record low level, the banking sector is in good shape so in 2018 we expect the further increase in credit activity in Serbia.

Fiscal trends in 2017 were favorable (see section 6 “Fiscal Flows and Policy”). After more than a decade the budget was again in a surplus of over 50bn RSD (1.2% of GDP). This result was due to the widespread growth in tax revenues which increased by 4% in real terms compared to 2016, while public expenditures decreased in real terms by almost 2%. On the public revenue side, much higher than the planed were revenues from the income tax due to the extraordinary growth of the profitability of the economy in 2016, as well as revenues from contributions due to the higher employment growth in 2017 than expected. On public expenditures side, the largest decrease compared to the plan was on interest expenses (dinar appreciation and interest rate cuts) as well as with the (undesirable) decrease in public investments which were by 6.7% lower in 2017 than 2016 in real terms, although the plan was to increase them by 6% in real terms.

The achieved fiscal result in 2017 is undeniably good, especially when compared to the fiscal deficit of 2.2 billion euros (6.6% of GDP) from just three years ago. Also, the achieved budget surplus in 2017 positively influences the sustainability of public finances and the relatively strong reduction in public debt. However, Serbia should not aim to achieve fiscal surpluses in 2018 and the following years, especially in conditions of a slow economic growth. Instead, efforts should be increased to more effectively implement public investments, so that they increase from the current level of around 3% of GDP to over 4.5% of GDP, which, we estimate, instead of the budget surplus would result in a smaller fiscal deficit of 0,5 - 1% of GDP. Another economically desirable solution in the event that the fiscal surplus continues to be achieved in 2018 is the increase in public investments and abandoning the practice of taking dividends from public enterprises. If even after that there is a fiscal space it could be used for a certain fiscal easing of wages. The announced use of the expected fiscal surplus for a larger increase in public sector wages and pensions (above GDP growth) would be a big mistake, which would not only have any significant impact on the increase in economic activity, but such a policy would rapidly start to topple public finances, but also the relations between wages in the public and private sector. An additional increase in wages in the public sector in the current year would also mean the violation of the legislation on the maximum share of wage costs in the general government sector of 7% of GDP. After experiencing the immediate danger of the outbreak of a deep public debt crisis only three years ago, and the inevitable reduction in pensions and public sector wages that followed, we hope that the public and political elites in Serbia are sufficiently matured not to repeat identical mistakes which exactly led to these problems.

Serbia: Selected Macroeconomic Indicators, 2006–2017

Annual Data

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
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
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
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
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
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
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
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
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
									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
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
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
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
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
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
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
NBS gross reserves (increase +)	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,797	166	-302	228
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
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
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
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
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
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
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
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
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
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

	2015				2016				2017			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Economic Growth												
GDP (in billions of dinars)	…	…	…	…	…	…	…	…	…	…	…	…
GDP	-1.7	1.2	2.3	1.1	4.0	2.0	2.8	2.5	1.2	1.5	2.2	2.5
Non-agricultural GVA	-1.9	2.7	3.7	2.2	4.3	1.9	2.3	2.2	1.5	2.4	4.1	4.0
Industrial production	-2.0	11.1	13.2	10.2	10.5	2.4	3.7	2.8	0.7	3.1	6.3	3.5
Manufacturing	4.2	7.3	6.4	3.2	6.5	5.9	4.4	5.3	7.3	5.1	7.7	4.9
Average net wage (per month, in dinars)[2]	41,718	44,717	44,719	46,592	43,588	46,450	46041	48168	45437	48670	47844	49599
Registered Employment (in millions)	1,983	1,985	1,998	1,989	1,978	2,008	2,023	2,030	2,024	2,061	2,073	2,087
Fiscal data												
Public Revenues	6.9	3.5	4.5	-1.4	7.4	7.8	9.2	5.6	5.3	5.5	1.3	3.5
Public Expenditures	-5.4	-3.8	-1.3	-2.6	5.7	4.9	2.3	-3.7	-1.3	-1.7	-3.6	-0.6
Overall fiscal balance (GFS definition)[3]	-21.2	-14.2	-15.8	-98.0	-16.0	-2.1	13.8	-52.8	11.8	32.4	37.8	-29.8
Balance of Payments												
Imports of goods[4]	-3,648	-3,869	-3,777	-4,057	-3,701	-4,230	-3,939	-4,339 0	-4,204	-4,576	-4,383	-4,912
Exports of goods[4]	2,601	2,997	2,882	2,877	2,956	3,294	3,131	3,351	3,277	3,693	3,559	3,560
Current account5[)]	-511	-279	-343	-445	-378	-309	-293	-390	-694	-333	-384	-678
in % GDP[5]	*-6.7*	*-3.2*	*-3.9*	*-5.2*	*-4.8*	*-3.6*	*-3.3*	*-4.5*	-8	-4	-4	-7
Capital account[5]	427	139	243	396	184	197	127	282 0	486	328	266	610
Foreign direct investments	339	441	510	514	480	404	492	485 0	558	626	660	571
NBS gross reserves (increase +)	111	-32	300	-213	-836	-317	332	519	-455	222	1,061	-600
Monetary data												
NBS net own reserves[6]	854,636	858,972	902,526	931,320	884,093	846,969	899,959	923,966	894,102	881,125	936,542	891,349
NBS net own reserves[6], in mn of euros	7,094	7,125	7,509	7,649	7,180	6,864	7,303	7,486	7,217	7,221	7,851	7,482
Credit to the non-government sector	1,919,958	1,918,917	1929573	1,982,974	1,961,626	2,009,537	2,044,160	2,031,825	2,042,971	2,050,579	2,057,675	2,067,826
FX deposits of households	1,004,948	1,010,179	995123	1,014,260	1,027,439	1,048,123	1,053,841	1,070,944	1,087,084	1,067,142	1,069,094	1,074,424
M2 (y-o-y, real growth, in %)	6.4	5.8	2.6	5.5	7.2	7.3	9.4	8	6.4	4.8	2.3	0.6
Credit to the non-government sector (y-o-y, real growth, in %)	3.7	2	0.7	1.4	1.6	4.2	5.2	0.9	0.5	2.7	2.4	4.0
Credit to the non-government sector, in % GDP	47.4	47.0	46.9	47.8	46.8	47.6	48.0	47.2	40.4	47.7	46.6	45.4
Prices and the Exchange Rate												
Consumer Prices Index[7]	1.8	1.9	1.4	1.6	0.6	0.3	0.6	1.5	3.5	3.6	3.2	3.0
Real exchange rate dinar/euro (average 2005=100)[8]	91.3	90.5	90.0	90.7	91.0	91.9	91.6	91.8	90.6	89.9	87.7	87.4
Nominal exchange rate dinar/euro[8]	121.6	120.4	120.2	120.8	122.85	123.01	123.3	123.26	123.88	122.91	119.8	119.1

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.