From the Editor

The results achieved by the Serbian economy this year are basically a continuation of trends from the previous two to three years. The economic growth is slower than in the previous year, but will be slightly above the average for the previous three years. Most indicators of macroeconomic stability are good, although there are imbalances that, if they persist in the coming years, could cause instability. Restructuring of public enterprises and the state sector is still slow, while reforms to improve the economic environment have remained absent this year. The international circumstances for the growth of the Serbian economy have been less favorable than in the past few years, which is manifested through the slowdown in the growth of European economies.

We estimate that the growth of Serbian economy in 2019 will be about 3.5%, which is slightly below the weighted average of the countries of Central and Eastern Europe. When observed by activity, the construction and services sectors (trade, transport, tourism, telecommunications and financial services) recorded a strong growth, while industry and agriculture were stagnant. Thus, strong growth was achieved by activities that generate most of their revenues in domestic market, while economic activity stagnated in sectors that are crucial for exports. Stagnation in sectors producing tradable goods is partly the result of a slowdown in demand growth in the main export markets, and partly the result of a strong dinar, which directs investors to non-tradable sectors. The poor performance in the industry is partly due to external constraints such as the introduction of prohibitive tariffs on exports to Kosovo and Metohija and restriction on steel exports to the EU. The most important driver of economic growth this year was domestic demand, and high investment growth was achieved within it. Strong investment growth, which is likely to be around 15%, is in principle a good result, but its impact on economic growth in the coming years will be modest, since most of the investments were made in construction (residential construction, "Turkish Stream"), while investments in equipment increased by only 4%. Private and government consumption grew at a similar rate as GDP, while net exports had a negative impact on growth as imports grew faster than exports.

Year-over-year growth of about 3.5% is an average of slow growth of 2.8% in the first half of the year and significantly faster growth of about 4.5% in the second half of the year. The acceleration of growth in the second half of the year is almost entirely the result of the growth of construction activity and to a much lesser extent the acceleration of industry growth, while other activities had relatively uniform growth throughout the year. According to statistics, value added in construction increased in the third quarter as a result of the construction of the Turkish Stream pipeline by as much as 34.7% y-o-y, which is an enormous acceleration compared to 9.8% growth in the first quarter and increase of 18,1% in the second quarter. The growth of value added in construction is far outstripping the growth of gross wage mass in this sector, which increased by about 22% in real terms over the same period. Given that gross wages account for 60% of construction value added, this implies that other parts of gross value added in construction (gross profit, depreciation, etc.) increased by over 50%! The big difference in the growth of wage mass and value added raises the question of whether the statistics overestimated the growth of value added in construction, and thus the growth of total GDP, in the third quarter of this year?

Based on current trends and adopted economic policies, we expect GDP growth to be 3.5% - 4% in 2020. A much lower construction growth rate and moderate industrial production growth are expected in the coming year, while other activities will have similar growth as in this year. Due to high wage growth in public and private sectors, rising pensions and strong growth in bank lending, we expect the private consumption to be a key driver of economic growth, while slowing construction activity will slow down the investments. Due to a strong growth in domestic demand and a further decline in price competitiveness of the Serbian economy, it is expected that imports will grow faster than exports in the coming year, meaning that net exports will negatively affect GDP growth. The previous forecast is based on the assumption that the next year's growth of European economies would be in line with current projections, and that the agricultural season in Serbia would be average.

Serbia has made significant progress over the past few years towards establishing macroeconomic stability - inflation is low and stable, the dinar exchange rate is stable, interest rates are low, while the country's balance sheets are roughly in balance. However, for the third year in a row, external deficits have been growing and the current account deficit will reach 6% of GDP this year, which is above the long-term sustainable level. The key driver of the foreign trade deficit growth, which then spilled over to the current account deficit growth, was an increase in the real value of the dinar by about 7%, which had no basis in the productivity growth of the Serbian economy. Another factor that influenced the growth of external deficits, and whose impact will be present in the next year, is faster wage growth than productivity growth, that is, unit labor costs growth. The fiscal surplus achieved by the state over the last two years has influenced the reduction of the foreign trade and current account deficit.

The high wage growth in the last year and this year also was generated by the high increase in public sector wages, which in 2019 was accompanied by high wage growth in private sector. The high wage growth in private sector is a part of a broader trend that has existed in Central and Eastern European countries for two to three years, and which has been generated by labor shortages due to the emigration of workers to developed European countries. The negative impact of rising unit labor costs on the competitiveness of the Serbian economy over the last three years has been largely mitigated by a decrease in the cost of lending interest to the economy, which was caused by a fall in interest rates. The fall in interest costs and rise in real value of the dinar are key factors that prevented the rise in unit labor costs to affect a rise of inflation. In the coming period, we cannot count on an additional significant fall in interest rates, and it is unlikely that the dinar will further strengthen. Therefore, the growth of unit labor costs in the coming years would affect the decrease in price competitiveness of the Serbian economy, the growth of external deficits, but also the growth of inflation. An increase in external deficits would worsen Serbia's net asset position, which would increase the outflow of interest and dividend income in the future. A high external deficit would make a country overly dependent on foreign capital and vulnerable in the event of a sudden halt in its inflow. Due to balance of payments risks, the growth of external deficits should not be ignored, and it would be good for economic policy measures to halt further deterioration of the price competitiveness of the economy.

A moderate increase in employment and a further reduction in unemployment are expected in the coming year. We expect that the registered employment will increase by about 2% in the coming year, that is, it will increase by about 40 thousand. Given that the redundancies in enterprises inherited from the 1990s have been eliminated, GDP growth will be accompanied by employment growth in the future but, due to productivity growth, employment growth will be slower than GDP growth. The growth of registered employment in the coming year will also be affected by termination of employment in the public sector. Unemployment is expected to decrease in the coming year, both as a result of rising employment and the departure of workers abroad.

Next year, a high average wage growth is expected, which will amount to 9.6% in public sector, while private sector wages will rise by about 10%. While public sector wage growth is the result of a political decision, wage growth in the private sector will continue to be under intense pressure of workers leaving abroad (labor migration) and shortage in certain categories of workforce. Real wage growth in the coming year is likely to be around 8%, which is significantly higher than the growth expected in production and productivity. As a consequence of a faster growth of real wages than productivity growth, unit labor costs will increase by about 6% in the next year, which will lead to additional growth in external deficits, but also to a certain acceleration of inflation.

Inflation is expected to accelerate in 2020, but it will remain in the lower half of the target corridor (below 3%). The main driver of inflation growth on the cost side is the rise in unit labor costs, which is unlikely to be amortized by the fall in some other costs. The rise in inflation will be influenced by the growth in demand due to the growth of citizens' incomes, but also due to the lending activity of banks.

In addition to the standard analyzes of economic trends and economic policy, this issue of the Quarterly Monitor contains the Spotlight On text "Real Estate Market in Serbia Price Analysis", by Aleksandar Radivojevic and the Highlights text "Wages, Productivity and International Price Competitiveness", by Milojko Arsić.