TRENDS

1. Review

The high GDP growth of 4.8% in Q3 prompted state officials to make immoderate estimates in public about Serbia's great economic progress and the success of Serbia's economic policies. However, an objective analysis of the published macroeconomic data shows a slightly different picture. While it is true that with a 4.8% GDP growth, Serbia was the second fastest growing economy in Central and Eastern Europe (after Hungary) in Q3 - it should not be forgotten that in the first half of the year Serbia was (with Albania and BiH) the slowest growing CEE economy. In addition, GDP growth in Q3 accelerated primarily due to the construction of the Turkish Stream and the consequent increase in construction activity growth of as much as 35%, while all other sectors of the economy continued with roughly similar trends as in the first half of the year. This means that relatively high economic growth is likely to be limited in time by the end of this year, when most of the pipeline construction works will be completed. We singled out this example at the beginning of the Review because it is a good illustration of the importance of conducting objective macroeconomic analyzes, as we have done since the first edition of QM in 2005. Namely, it is important for the public, and for the Government itself, to point out objectively not only the successes of economic policy (such as successfully implemented fiscal consolidation and the achieved macroeconomic stability), but also the problems and poor results in order to correct them by appropriate policies. And the biggest failure of economic policies pursued in Serbia in the last decade is precisely insufficient economic growth - and that estimate cannot be changed based on one, temporarily better result, as it was the case in Q3.

The analysis of macroeconomic trends from Q3 points to three most important conclusions that didn't change much compared to the previous quarters: 1) macroeconomic stability is maintained; 2) moderate (insufficient) economic progress continues; and 3) the government's efforts to address the greatest weaknesses present in the domestic economy are largely absent. The achieved macroeconomic stability is primarily a result of the roughly balanced government budget with declining public debt, and the most obvious manifestation of this stability is the extremely low inflation, which dropped to just 1% y-o-y in October. Moderate economic progress is indicated by GDP growth of just over 3.5% as it was in Q3 (excluding the construction of the "Turkish Stream") and as we expect it to be during the whole year. Similarly, in Q3 we continue to see a slight increase in employment (by 0.3% compared to the same period of the previous year according to LFS), with a reduction in the unemployment rate to below 10%, the first time since it has been measured by a comparable methodology. This decrease in unemployment, however, is largely a result of adverse demographic change rather than a modest increase in employment. Finally, the Government still does not face the problems of unreformed public enterprises (primarily EPS), poor economic environment, unregulated system of wages and employment in public administration, and more. Due to the long absence of structural reforms, Serbia's economic growth in 2019 is not satisfactory, both in terms of size and structure. Namely, with the economic growth rate in 2019 of just over 3.5% Serbia will be only on average or slightly below the average of comparable CEE countries, and should grow noticeably faster than them because it is economically underdeveloped. Also, Serbia's economic growth relies too much on domestic demand, rather than the growth of net exports and industrial production, which in 2019 are performing poorly. The result is an increase in the current account deficit, which will be noticeably higher in 2019 than in 2018.

As we have pointed out, the results of economic activity in Q3 are not fully satisfactory, although a relatively high GDP growth rate of 4.8% has been achieved (see Section 2 "Economic activity"). Namely, most of the acceleration of economic activity in Q3 is due to only one major project (construction of the "Turkish Stream") and is therefore not sustainable in the long term, and it is possible that the added value of that project has not been measured reliably enough, i.e. that the economic growth in Q3 was slightly lower than shown. When the construction of the pipeline is excluded from the results of economic activity in Q3, GDP growth in Q3 was slightly above 3.5%, which is at the level of the average of the CEE countries. Because the acceleration of GDP growth came as a result of temporary factors, we expect that in 2020, when most of the pipeline construction work will be completed, GDP growth will again slow down and return to its usual level of around 3.5 %. For now, therefore, we forecast that the GDP growth rate in 2020 is likely to be slightly lower than the official forecasts of 4%, since there is no indication of an acceleration of the core trend of economic activity in 2019 to 4%. If some of the major investments announced (such as investments in new copper mines in Bor) are realized in 2020, economic growth could be slightly above our current forecasts. However, if the slowdown in economic activity in EU countries and the region in 2020 prove to be stronger than current expectations, it would undoubtedly have a negative impact on Serbia's GDP growth, so growth could easily be slightly lower.

Gradual improvements in the labor market continued in Q3, although we need to be cautious in interpreting these trends (see Section 3 "Labor Market"). The unemployment rate as measured by the Labor Force Survey (LFS) in Q3 fell to its lowest level since this survey is in use (2003), and it was 9.5%. It is interesting to note, however, that the relatively strong decrease in the unemployment rate in Q3 was not a result of a large increase in employment, which was modest 0.3% y-o-y according to LFS, but primarily due to demographic changes. These changes present decreases in the number of working age population due to the negative natural increase, but certainly also due to increased emigration of the working age population - although there is still no reliable data on emigration. In Q3, the good trend of formalizing the labor market continues, as the number of informally employed persons was reduced by about 7.8% y-o-y, while the number of formally employed persons by LFS increased by 2.4%. The data on the growth of formally employed of about 2% is confirmed by the movement of registered employment, which is independently and reliably monitored by the SORS on the basis of administrative data (CROCSI). In terms of wage developments in Q3, a rather high real average wage growth is further accelerated, and exceeded 9% y-o-y in the quarter. This increase in wages is much higher than the growth of economic activity as well as the growth of productivity. Higher real wage growth than productivity growth has negative effects on the competitiveness of the Serbian economy, that is, contributes to the deterioration of trade and cannot be sustained over a longer period. Unlike in previous years, when similar trends were the result of non-market mechanisms (excessive wage increases in the public sector, high minimum wage growth), in Q3, as well as throughout 2019, private sector wages also grew faster than productivity. Although it is too early to conclude, it is possible that this is one of the consequences of a large emigration of the working population, that is, the appearance of a deficit of skilled and productive workforce in the country.

Due to a slightly faster rise in imports than exports, the current account deficit continued to worsen in Q3, with a slightly less visible worsening compared to the first half of the year (see Section 4, "Balance of Payments and Foreign Trade"). The current account deficit in Q3 amounted to 5.4% of GDP (EUR 640 million), which is around EUR 80 million higher than the deficit achieved in the same period last year. The main reasons for further exacerbation of the foreign trade deficit, that is, the current account deficit, were the faster growth of domestic demand than the growth of production, followed with an exaggerate strengthening of the dinar exchange rate. Although the latest available data for October show some improvements in Serbia's foreign trade, the current account deficit in 2019 will undoubtedly be significantly higher than in 2018, i.e. it could amount to around 2.8 billion euros compared to 2.2 billion euros in 2018. On the capital inflows side, it is important to point out that the current account deficit in Q3 was fully covered by large foreign direct investments (FDI) inflows, which exceeded 7.5% of GDP in this quarter (EUR 912 million) - a marked increase compared to the same period of the previous year when they were EUR 600 million. Although the current account deficit will certainly be covered by the net FDI inflows in 2019, the growth of external imbalances could pose a future risk, especially in the event of a more pronounced slowdown in European countries, and should be addressed by appropriate economic policies to reduce it - primarily by a policy of gradual weakening of the dinar, but also the growth of public sector wages and minimum wages in line with the productivity growth.

Inflation continued to slow down and declined to just 1% year-on-year at the end of October (see Section 5 "Prices and the Exchange Rate"). For some time now inflation has been below the NBS target level (3 ± 1.5%) and was lower than in the Eurozone from July to October (the latest available data), which is an unusual occurrence for Serbia. Consumer prices in Serbia decreased by 0.6% between July and October, while prices in the Eurozone remained unchanged in the same period. Due to such trend in inflation, there was a certain curiosity, i.e. the dinar in these four months in real terms even slightly weakened against the euro, although in July the average exchange rate was 117.8 dinars per one euro, and in October 117.5 dinars per one euro. This unusual trend of real weakening of the dinar without its nominal depreciation, however, cannot last for a long period and cannot have major effects on improving the price competitiveness of the domestic economy, which has been deteriorating over a longer period. We expect average annual inflation to be around 1.8% in 2019, and we expect a similar, low inflation of about 2% in 2020.

The relatively strong slowdown in inflation, as well as international circumstances (notably the easing of the monetary policy of the ECB and the Fed), encouraged the NBS to reduce its key policy rate by 25 basis points three times from July - from 3% to 2.25% (see Section 7 "Monetary Flows and Policy"). In addition, the NBS responded to strong foreign exchange inflows during Q3 (and October) by buying around 1.4 billion euros in the interbank foreign exchange market, thus preventing a stronger strengthening of the dinar. We consider such a policy of the NBS justified, because excessive strengthening of the dinar would be bad for Serbian economy. On the other hand, we have less understanding of NBS interventions that stopped the dinar from weakening, and which (to a lesser extent) happen at the end of November and the beginning of December. A slight weakening of the dinar would have a positive impact on the price competitiveness of the Serbian economy, and inflation is below the NBS target corridor, so there is no economic reason not to use the rare depressive pressures for a controlled weakening of the dinar.

Lending activity continues to intensify. The total net placements of commercial banks in Q3 increased significantly due to the combined effect of increased placements on all grounds. Net placements to both the corporate and household sectors recorded an increase compared to the previous quarters, while the overall growth in lending activity was further enhanced by an increase in net cross-border placements taken by the economy abroad in Q3. Along with the growth in lending activity, a record increase was also noted in sources for new placements. The growth of credit potential in Q3 was driven by growth in domestic deposits by the economy and households, but also by borrowing from domestic banks abroad, as well as by an increase in capital and reserves accounts. The share of non-performing loans in total placements decreased by the end of November to a relatively low level of about 6.5%. Write-offs of bad loans and sales to individuals outside the banking sector directly from the bank's balance sheet continued in Q3, but further decline in the share of bad loans was more affected by the growth of total lending activity. Increased supply of capital in the domestic market, accompanied by a fall in inflation, led to a decrease in interest rates on indexed loans and loans in dinars, which are likely to remain at a similar level in the coming period.

Public revenues were slightly higher than public expenditures in Q3 and October, and a fiscal surplus of about 20 billion dinars was achieved during this period (see Section 6 "Fiscal Flows and Policy"). By the end of October, the fiscal surplus reached nearly 50 billion dinars. Although there is a relatively strong deficit at the end of the year, such trends in public revenues and public expenditures suggest that fiscal 2019 will still end with a roughly balanced government budget (although a rebalance from October planned a deficit of about 25 billion dinars, i.e. 0.5% of GDP).

The most important news regarding fiscal policy, however, is that, at the end of November, the budget for 2020 was adopted, which forecasts a slight fiscal deficit of 0.5% of GDP, which we consider to be a good target. Such a low deficit will allow further reduction of public debt relative to GDP in 2020, so we expect that public debt could drop to below 50% of GDP at the end of that year. Budget has made some positive developments in the structure of public revenues and public expenditures, as gradual fiscal relief of labor continued and investments in infrastructure increased. Total government spending on investments in 2020 is planned at around 4.5% of GDP, which is actually similar to the expected 2019 realization. However, the structure of these expenditures is economically more favorable as more funds are planned for the construction of infrastructure and slightly less for military and police equipment. The improvement in the budget structure could have been even greater if the Government had not opted for an oversized and economically unfounded increase in the wages of general government employees, which averages about 9.5% and is faster than expected nominal GDP growth in the next year. Excessive wage increase has reduced funds available for greater corporate tax reductions and stronger public investment increases. The downside of the planned fiscal policy in 2020 is that the adoption of the pay system for general government employees is postponed for another year, but there is also an extension of the ban on employment in public sector, which has been going on for too long (originally planned to be abolished by the end of 2015) and is economically damaging, because it leads to staff shortages in important public administration jobs (large deficiencies already exist in healthcare, inspection services and more).

Serbia: Selected Macroeconomic Indicators, 2010 - 2019

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2018				2019		
										Q1	Q2	Q3	Q4	Q1	Q2	Q3
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	5,068.6	…	…	…	…	…	…	
GDP	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2	4.4	5.0	5.0	4.2	3.5	2.7	2.9	4.8
Non-agricultural GVA	1.1	2.2	0.8	2.5	-2.2	2.3	3.4	3.3	3.7	4.8	4.6	3.2	2.5	2.8	3.1	5.6
Industrial production	1.2	2.5	-2.6	6.1	-7.4	7.3	4.9	4.2	1.4	6.9	1.7	-1.4	-1.1	-2.1	-2.3	1.6
Manufacturing	2.5	-0.2	-1.3	5.5	-4.9	5.7	5.6	6.6	2	5.9	1.6	1.0	0.3	-2.3	-3	1.6
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	49,089	49,573	48,965	50,943	53,739	54,553	54,285
Registered Employment (in millions)	1.805	1,866	1,865	1,864	1,845	1,990	1989	2,112	2,131	2092	2127	2147	2159	2148	2162	2180
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	8.4	2.5	4.4
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	7.3	5.7
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	11.9	7.0	16.2
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	-5,205	-5,599	-5,523
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	3,866	4,277	4,174
Current account5[)]	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,223	-724	-354	-556	-589	-893	-744	-639
in % GDP[5)]	*-6.5*	*-10.3*	*-10.9*	*-5.8*	-6	-3	-3	-5	*-5.2*	-7	-3	-5	-5	-8.8	-6.6	-5.4
Capital account[5)]	1,553	3,340	3,351	1,630	1,705	920	535	1,648	1,683	568	268	384	463	772	607	276
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	801	995	912
NBS gross reserves																
(increase +)	-929	1,801	-1,137	697	-1,797	166	-302	228	1,123	398	674	105	-55	79	685	921
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	1,081,169	1,188,918
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	8098.204557	8,166	9,167	10,110
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	2261981.23	2,282,988	2,325,531	2,392,787
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	1,186,319	1,207,760
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	9.7	12.0
Credit to the non-government sector	13.9	0.5	-2.1	-8.3	1.2	1.4	0.9						7.8			8.6
(y-o-y, real growth, in %)								4.0		4.6	4.7	5.2		8.0	7.5	
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	44.4	44.4	45.0
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	2.2	1.5
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	85.7	85.9
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	117.97	117.7

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.