TRENDS

1. Review

Q2 saw continuation and further deterioration of the adverse macroeconomic trends we have been warning about in the preceding quarters. Economic activity is in recession, inflation is almost at zero, and the positive trends in the current account of the balance of payments have been halted as exports stopped growing. In addition, fiscal position of Serbia is completely unsustainable, and the huge deficit and fast growing public debt pose a threat of public debt crisis. Signs indicating deterioration in macroeconomic trends have appeared few quarters ago, and some of them more than a year ago, and we have pointed them out clearly in previous issues of QM - but economic policies have failed to address them properly. Work of two key government ministries, the Ministry of Economy and the Ministry of Finance, was almost completely halted during the preceding year by a large number of organizational, personnel and even conceptual changes. Monetary policy makers, on the other hand, "play it safe" and carrying out an extremely cautious and restrictive policy. Therefore, ultimately it fails to meet its goals - because inflation has been below the target level for two successive quarters already.

Economic activity is in recession. Decline in economic activity can only partly be attributed to devastating May floods, because Serbia slipped into recession even before the floods (see Section 2 "Economic activity"). The key reasons for the decline in economic activity are unsustainable fiscal position (high and growing public debt and large deficit), years of decrease in investments, and decline in credit activity, joined by a sharp slowdown in exports in Q2. In the preceding period, it was a steep rise in exports that counterbalanced decline in other components of GDP (investment, consumption), so the unfavourable economic trends were not so evident. With the slowdown in exports these negative trends became more prominent and the total GDP shrank. QM analysis shows that the slowdown in exports is lasting because the export of motor vehicles reached its full capacity (FAS), no new investments that would boost exports have been made, and international environment is unfavourable - therefore we do not expect this period of negative economic growth in Serbia to end soon.

On the basis of somewhat less favourable economic trends detected in Q2, we revised the projected decrease in GDP in 2014 up to 1%, instead of the expected 0-0.5%. This issue of QM also offers the first forecasts of a possible level of economic activity in 2015, which we projected at -1%. Since the real causes of recession are fundamental rather than temporary (such as floods), and therefore more difficult to eliminate, we do not expect that these unfavourable trends in economic activity will be reversed sharply in 2015. Additionally, fiscal consolidation will have to be implemented in 2015 (otherwise Serbia will slip into public debt crisis), which will affect medium term economic growth favourably, but will have limited and temporary negative impact on production in 2015. Due to all this, we expect 2015 to be another year of recession with a drop in GDP now estimated at 1%, but it could easily be higher.

Inflation is very low and its y-o-y level was only 1.5% in August. We should however take into account that the y-o-y index incorporates increase in the reduced VAT rate from 8 to 10% in January 2014, and that without that inflation would fall below 1%. In addition, there was no rise in prices in the past six months - meaning that in the period March-August inflation stood at 0%. Causes of low inflation are economic recession accompanied by decline in domestic demand, quite stable exchange rate, low rise in food prices, low imported inflation, and restrictive monetary policy keeping the reference rate at high 8.5% (see Section 5 "Prices and exchange rate").

Although the NBS have been expecting and announcing rebound in inflation to the targeted corridor (4 ± 1.5%), nothing has changed for the last six months, and the NBS, nevertheless, keeps pursuing restrictive monetary policy. We have understanding for this kind of monetary policy to some extent - the last recorded depreciation of dinar exchange rate in early September was not large, but it once again reminded us of how fragile the macroeconomic equilibrium in Serbia is, and that monetary policy makers need to be very cautious. However, we must emphasize that the NBS has not achieved its objectives for 2014, which contributed considerably to deterioration of other macroeconomic aggregates. We also remind that it is the NBS who often and reasonably points out the unsustainability of fiscal policy as the major threat to macroeconomic stability in Serbia, exchange rate and prices. However, we should add, free from bias, that fiscal policy in 2014 would have been much more effective if the NBS had achieved its goals.

Positive trends in the current account of the balance of payments have been halted by a slowdown in exports in Q2 (see Section 4 "Balance of payments and foreign trade"). Current account deficit now stands at about 5% of GDP, which is much lower than two or three years ago when it stood at about 10% of GDP, and we remind you that before the 2008 crisis it reached more than 20% of GDP. However, the circumstances are now much different to those before the crisis, so in spite of being considerably reduced in 2014 this current account deficit is no longer sustainable. There is no large inflow of foreign capital any longer, and there certainly will not be any in the medium term. Companies are discharging their foreign debt, foreign direct investments are small, and the only source of considerable inflow of foreign capital is – huge government borrowing. One such inflow of about EUR 750 million (loan for budget support granted by the United Arab Emirates) was recorded in August solely. So, when we draw the line, in 2014, current account deficit stands at around 5% of GDP, capital inflows (despite the large government borrowing) are slightly below this percentage - which led to a slight decrease in foreign exchange reserves of about EUR 250 million (from the beginning of January to end of August).

Large government borrowing abroad will, however, have to be gradually reduced already in 2015; otherwise public debt crisis will arise. Reduction in government borrowing in 2015 will most probably push down the overall inflow of foreign capital relative to 2014, since it is quite unlikely that any of the other items in financial account will increase notably in the period ahead - FDI or foreign loans to domestic companies and banks. This is exactly why we believe that the existing current account deficit of 5% of GDP is not sustainable. It is, however, the task of economic policy to anticipate such or similar future trends on time and try to find the optimum combination of monetary policy, exchange rate, and acceptable reduction in foreign exchange reserves in the years ahead, taking into account the balances of foreign currency debtors and that fiscal consolidation leads to reduction in inflow of foreign capital and pushes down domestic demand. We think that it would probably be beneficial to use current depreciation pressures to allow limited and controlled depreciation of dinar - especially because inflation stands below the NBS's targeted corridor.

Labour market statistics continues to show some quite contradictory trends that we find hardly possible. Y-o-y formal employment fell by about 2% in Q2, which is in line with other macroeconomic indicators (primarily recession), and we think that this data is most probably accurate. What, however, does not cease to surprise us is that according to the Labour Force Survey (now carried out quarterly, as well), rise in employment and decline in unemployment continued in Q2. This time, it can be attributed to seasonal and temporary factors (temporary informal hiring for the purpose of flood protection, for example), but we emphasise once again that under the recession Serbian economy is currently facing, the rise in employment that Labour Force Surveys have been showing since 2013 is not possible.

Corporate borrowing is still low and below the last year's level, but it shows some signs of recovery in Q2, thanks to the new cycle of subsidized loans for liquidity and working capital (see Section 7 "Monetary flows and policy"). We think that this programme is currently justifiable because corporate borrowing is declining sharply and, by providing subsidies on interest, the government makes great and favourable impact on overall credit activity using relatively small funds. On the other hand, amount of nonperforming loans continues to grow gradually in Q2, so the following three institutions should jointly address this problem to find the optimum solution: banks, the NBS and the Ministry of finance. The government should however ensure that solution to this problem does not become fiscal expenditure.

Unsustainability of fiscal policy is the major problem national economy is facing currently. Perhaps our estimate that they far exceed recession, price stagnation, high unemployment, unsustainable current account deficit and large and growing share of nonperforming loans best illustrates how enormous the problems confronting fiscal policy are. Fiscal deficit (inclusive of below-the-line expenditures) will exceed 8% of GDP in 2014. Fast growing public debt will amount to more than 70% of GDP at the end of the year and will continue to grow in the years ahead. Although the government has provided sufficient funds to cover its liabilities in the following six months (until the loan for budget support granted by the United Arab Emirates is spent), they need to start implementation of a determined fiscal consolidation programme during that period. Otherwise they run the risk of public debt crisis in the following years – steep drop in GDP, dinar depreciation and macroeconomic instability.

Fiscal deficit will exceed 8% of GDP in 2014 instead of the projected 7.1% of GDP (see Section 6 “Fiscal flows and policy”). This large fiscal deficit is not driven by rise in expenditures, which will probably be somewhat below the projections. It is above the expected level because public expenditures fell short of the projections. Public revenues went down because macroeconomic circumstances worsened – recession instead of economic growth projected at 1%, inflation rate at only 2% instead of the projected 5% and trends in labour market somewhat below the expected. In addition, extra revenues from reduction in shadow economy that have been projected in the budget will fall short of projections. Large savings will be made on expenditure side through reduction in public investments (which is not a good way to reduce public expenditures), while expenditures on subsidies will exceed the targeted level.

Public debt (including the debt of local self-governments) amounted to EUR 22 billion at the end of August (when the loan from the UAE was received). With exchange rate at 119 dinars for one euro, public debt already exceeds 70% of GDP. We estimate that public debt will reach about 72% of GDP by the end of the year, but some events would push it even higher. One such event would be issuance of a large amount of government guarantees on loans to EPS, needed to finance import of electricity and its current operations. This would hit severely not only public debt but overall public finance in Serbia, so we think that it would be much better to raise the price of electricity instead.

Finally, we arrive to the central issue of economic policy during the preceding months – fiscal consolidation. Under current fiscal flows, the only way to achieve fiscal consolidation is strong reduction in the largest public expenditures – pensions and public sector wages. However, this will not be sufficient unless the government put in order operations of public companies because otherwise all savings will be used to make up for their poor performance. This time fiscal consolidation needs to be carried out in a way that would really reverse negative trends in public finance, instead of adopting insufficient measures that only put off crisis and make things even worse in the following year (calling for more radical measures afterwards). Without sufficient cuts, government will maybe escape public debt crisis in 2015, but the health of public finance will deteriorate further.

Under poor economic indicators, Serbia will almost certainly remain in recession in 2015, even if no measures for fiscal consolidation are taken. Fiscal consolidation will deepen recession. The Government and NBS should therefore start coordinated implementation of fiscal consolidation and relevant anti-recession measures. The Government’s task would be to increase efficiency of public investments, improve business environment, and negotiate with and bring in large foreign investors (with minimum fiscal spending). The NBS’s task would be to ease monetary policy and to prevent deflation and rise in illiquidity of companies (recession and deflation are the largest obstacles to fiscal consolidation). The NBS should also, in coordination with the Government, try to find out how to increase corporate borrowing and solve the problem of nonperforming debt.

Serbia: Selected Macroeconomic Indicators, 2005 - 2014

	Annual Data									Quarterly Data					
										2013				2014	
	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1	Q2	Q3	Q4	Q1	Q2
Economic Growth							y-o-y, real growth[1]								
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	3208.6	3348.7	3618.2	…	…	…	…	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	3.0	0.6	3.7	2.7	0.1	-1.1
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	0.6	0.4	1.3	-1.2	1.0	0.4	0.1	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	5.2	3.0	10.8	3.3	2.1	-4.8
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	5.4	3.2	8.8	2.2	3.6	-2.0
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	…	…	…	41,419	44,248	43,939	46,185	41.825	44.971
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	…	1.724	1,724	1,720	1,705	1,697	1,697
Fiscal data					in % of GDP							y-o-y, real growth			
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	-5.8	-3.2	-2.7	0.1	-0.6	4.5
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	-10.8	-7.0	1.8	-6.2	6.7	2.2
							in billions of dinars								
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-37.4	-44.1	-57.1	-40.2	-64.7	-39.1
Balance of Payments							in millions of euros, flows[1]								
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,205	-14,934	-3,386	-3,690	-3,774	-4,084	3,384	3,747
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,726	10,956	2,235	2,685	3,089	2,946	2,512	2,768
Current account5[)]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,176	-1,586	-625	-290	-160	-510	-483	-383
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.8*	*-5.0*	*-8.4*	*-3.5*	*-1.9*	*-6.3*	*-6.5*	*-4.8*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,019	1,395	605	235	62	493	533	361
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	771	158	139	224	250	289	251
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800	-370
Monetary data							in millions of dinars, e.o.p. stock[1]								
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	673,147	674,731	701,822	757,689	696,802	756,996
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,025	5,917	6,122	6,605	6,015	6,513
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,870,916	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004	1,842,407
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	907,288	924,684	933,170	933,839	937,875	949,418
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	-2.6	-4.7	1	2.5	1.9	3.5
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	-8.3	-8.2	-9.2	-9	-6.5	-8.3	-5.7
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	50.7	57.3	60.3	53	50.7	48.5	48.7
Prices and the Exchange Rate							Y-o-y growth[1]								
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	11.2	9.7	4.8	2.2	2.3	1.2
Real exchange rate dinar/euro (average 2005=100)[8]	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	80.2	79.5	79.5	80.8	81.2	80.7	80.9
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	111.69	112.15	114.2	114.3	115.8	115.6

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.