TRENDS

1. Review

Unfavourable macroeconomic trends are continuing. Key problems of domestic economy are related to the low economic growth and unsustainable fiscal position of the country, and these problems have additionally grown in the first half of 2014. The economy is stagnating and it's possible it will again go into a recession – which would be the third time already since 2008. The reasons for unfavourable trends and lack of lasting recovery of economic activity are not the latest floods, but deeper and more lasting economic trends. The fiscal deficit is increasing and by the end of the year, it will probably be more than 8% of GDP and the public debt will be 70% of GDP, so the risk of public debt crisis is growing by the day. For now, there are no measures of economic policy that could mitigate these negative trends – reform measures that will improve the business environment are in the announcement, but not implementation stage, and the Government still refuses to accept as inevitable the reduction of by far the biggest public expenditure – pensions, and NBS is not loosening enough the restrictiveness of the monetary policy.

Economic activity in Q1 entered into stagnation, which we announced in the previous issues of *QM*. The realised year-on-year growth rate of 0.4% in Q1 actually means that the seasonally adjusted GDP remained unchanged compared to Q4 2013 (see Section 2 "Economic Activity"). If a similar trend were to continue until the end of 2014, the entire year would have a growth of economic activity of around 0%. The stagnation of the economic growth is not unexpected, although it was preceded by a solid GDP growth of 2.5% in 2013. However, during 2013, the economy had a large growth of over 20% (as it was compared to an extremely dry 2012), and Fiat Automobiles Serbia (FAS) increased its production in manifold. Without these two factors, the rest of the economy would have been in a decline of around 0.5%. Since the high growth of agriculture ended in 2014, and FAS reached its full production capacity, the stagnating growth of GDP, which began in Q1, revealed the real negative trends of economic activity, which were present but hidden throughout 2013.

The latest floods left behind catastrophic consequences in affected areas. Still, the negative impact of floods on total GDP in 2014 is limited and we estimate (taking also into account the effects of renovation) that it would be 0.5 p.p. of GDP at most (see Highlight 2). It is necessary to separate the effects that the floods have on property (which is currently being estimated at around a billion euros or around 3% of GDP) from the effects that the floods have on GNP and GDP. A flooded house, for example, has a huge property damage, but a very little impact on GNP and GDP. A slightly different example is the flooding of agricultural land. It has a relatively low impact on property, because these lands will be, for the most part, equally usable in the next agricultural season (and some could be used even in the current season), but a relatively high impact on production, because the crops in 2014 were destroyed on them.

The following example probably illustrates best why recent floods will not have a significant impact on GDP. An economic sector that has probably been affected the most by flooding is agriculture. According to currently available data, around 80,000 hectares of agricultural land has been flooded. This, however, represents only 3% of seeded agricultural land in Serbia (Vojvodina was mostly spared). If we take into account that aside from farming, agriculture includes livestock breeding as well (which was affected in a slightly lower percentage), but also that new crops will be planted on certain flooded lands as soon as this year, we can conclude that the decline of agricultural production due to floods should not exceed 2%, and the decline of GDP on this bases should not exceed 0.2 p.p. It is interesting to note that the 2012 drought decreased agricultural production by over 17% and GDP by over 1.5 p.p., which somewhat relativises the claim of extremely large losses of total agriculture in the latest floods. Observed microeconomically, large individual damages on certain farms are undeniable and certain state support is needed in those cases, but with a parallel development of the insurance market for agricultural land.

We have dedicated a bit more space in this Overview to floods in order to additionally stress the real reasons why the economic activity in 2014 will probably stagnate or fall into a mild recession. Those being the dominant negative macroeconomic trends – unsustainable fiscal position (high and growing public debt and high deficit), reduction of foreign and domestic investments, low borrowing activity, deceleration of exports, etc. - and not the floods. *QM* analysis indicates that the floods will have a very limited negative impact on the economy, which, taking into account the effects of renovation, should not exceed 0.5 p.p. of GDP, so the economic growth rate in 2014 will probably be between -0.5% and 0%.

Inflation is quite low and in March and April it was below the lower limit of the NBS target corridor (see Section 5 "Prices and Foreign Exchange Rate"). The year-on-year inflation in April was only 2%, and the prices increased 1.8% from the beginning of the year till end of April. There is no indication that the inflation would accelerate in the coming months. We expect the continuation of stagnating economic activity with a decline of domestic demand, stable dinar exchange rate and seasonal decline in food prices – which will all have a disinflationary effect. The recent floods will not have a significant impact on food prices and inflation either, because they affected a relatively small part of agricultural land, and there is always a possibility of importing deficient agricultural products.

NBS reaction to an inflation lower than the target corridor was quite restrained. The reference interest rate since the beginning of May was kept at the December level of 9.5% and then lowered to 9% (see Section 7 "Monetary Trends and Policy"). There is no doubt that Serbia needs to keep implementing a slightly more restrictive monetary policy than the one that would be appropriate in the circumstances of an extremely low inflation (below the target corridor), because there are issues of large structural imbalances, primarily the fiscal deficit. However, we feel this is not a good enough excuse to have the reference interest rate by as many as seven percentage points higher than the current inflation. Comparisons to reference interest rates in other eurozone countries of Eastern Europe that are implementing the same monetary policy as Serbia (targeting inflation and flexible exchange rate), but also the rate based on which REPO auctions are published and which is by 1-2 p.p. lower than the reference interest rate, clearly indicate a need for reduction of the reference interest rate.

Another argument in favour or reexamining the current restrictiveness of monetary policy is related to the dinar exchange rate. Higher reference interest rate (with NBS interventions) contributes to a pretty stable dinar exchange rate in 2014, which fluctuated in a narrow interval between 115 and 116 dinar to a euro (see Section 5 "Prices and Foreign Exchange Rate"). In case the reference interest rate significantly drops, strengthening of depreciation pressures could be expected and a certain weakening of the dinar. Limited dinar depreciation would have some positive and negative effects. On the positive side, it would have a favourable impact on the price competitiveness of the domestic economy and the growth of exports (see Graph T2-5) – which, in the conditions when domestic demand still surpasses the GDP, would have to be (along with the growth of investments) the main driver of economic growth. On the negative side, depreciation of dinar would additionally worsen the position of foreign currency debtors – and the high level of non-performing loans (over 22%) is growing in 2014, even with the stable dinar exchange rate. It is the stand of *QM* that a moderate real depreciation of dinar (by around 5%) would still have more positive than negative effects on the economy, which is one more valid argument in favour of reducing the NBS reference interest rate.

High unemployment remains one of the biggest structural issues of domestic economy. After the inexplicable and most likely wrongly measured decline of unemployment and increase of employment during 2013, the negative trends on the labour market are visible again in the official statistics in 2014. The number of the unemployed is rising, while the number of the employed is falling, measured both by the Labour Force Survey (LFS) and the RAD survey. The unfavourable trends in economy have reflected in Q1, more than before, on the trend in wages and not only unemployment. The wages have nominally grew in a year only 0.5%, which due to the decelerated inflation did not lead to a large real reduction of wages (2.2% reduction in real terms), but it represents the lowest nominal year-on-year growth of wages since 2000.

The current deficit continues to drop, but at the same time, the trends in capital and financial balance sheet are deteriorating (see Section 4 "Balance of Payments and Foreign Trade"). In Q1, a current deficit of 4.2% of GDP was realised, which is a reduction compared to 5% of GDP from the same period last year. Behind the improvement of the current account balance is a still high growth of exports and a stagnation of imports, but it is questionable how long this growing trend of exports will keep up in the future. What is even more worrying than a possible deceleration of exports is the net capital outflow from Serbia, which was almost half a billion euros in Q1. Business sector and banks are deleveraging abroad, as they are settling their obligations, and there are almost no new projects and the accompanying new borrowing. Foreign direct investments, which are the healthiest part of capital inflow, were extremely low in Q1 and slightly lower than 150 million euros. For now it seems highly unlikely that the officials' announcements about a billion euros of FDI coming into Serbia in 2014 will be realised. It's not because a billion euros is an unattainably ambitious goal for FDI in Serbia (in 2011 it was 1.8 billion euros), but because Serbia in 2014, with bad and unreformed business environment and exposed fiscal risks, is not an attractive investment destination for foreign capital.

Fiscal position of the country at the beginning of 2014 significantly worsened (see Section 6 "Fiscal Trends and Policy"). By April, the fiscal deficit was a staggering 81 billion dinar, which indicates that by the end of the year, the deficit will have exceeded 8% of GDP instead of the planned 7.1% of GDP. The reason for the additional increase of the fiscal deficit in 2014 is lower public revenue compared to the planned, while the public expenditure is under control for now. Public revenue is lower than planned, because the effects of reducing the grey economy are lacking, but also because of the extremely low inflation, which was not expected when budget projections were being made. A fiscal deficit of over 8% of GDP is by far the biggest in Europe and Serbia will not be able to finance it for long.

For now, the huge fiscal deficit is financed mainly on the domestic securities market. From the beginning of the year till end of May, the state borrowed additional 75 billion dinars at the domestic securities market (while renewing all the existing obligations). The conditions of state borrowing, especially for dinar securities, are extremely unfavourable. The weighted average interest rate for dinar bonds, in the first five months of 2014, was as high as 9.6% and its weighted average maturity was slightly less than 2.5 years. These investments are very profitable for investors, as it has become apparent that NBS is prepared, even at the cost of significantly depleting the reserves, to defend the dinar exchange rate against the euro (in Q1, NBS spent over 800 million euros on interventions on the forex market). If such an exchange rate policy is maintained in the future, investors in state securities, who mostly come from abroad, will have huge yields, and the state will have expenses for interests, which will be much higher than those for borrowing in euros. Therefore, the temporarily satisfying liquidity of the state should be observed in the context of how it was secured.

As the result of a high fiscal deficit and increased state borrowing in order to finance it, the public debt continues to grow. At the end of April, the public debt was over 65% of GDP, and by the end of the year, it will exceed even 70% of GDP. In order for the share of public debt in GDP to stop growing, the fiscal deficit has to be reduced to around 2.5% of GDP, which will take Serbia several years, judging by the current level of deficit of over 8% of GDP. We feel that the signing of a new arrangement with IMF is a necessary guarantee for investors in order for them to continue financing the state deficit, until the state get its public finances in order.

Announced fiscal consolidation has not progressed very far. In order to have sustainable public finances in Serbia, it is necessary to make decisive steps on three fronts: 1) improve the business operations of public and state companies, which are currently a huge fiscal expenditure, 2) implement comprehensive reforms (pension reform, reform of the system of wages and employment, etc.), and 3) reduce excessive public spending in the short term. Additional difficulties in reducing the deficit will be the recovery of damages due to recent floods, which will undoubtedly incur a certain fiscal expense (see Highlight 2). Even though the necessity of implementing fiscal consolidation has undoubtedly been recognised as a priority economic policy necessary for avoiding a public debt crisis, its implementation is not going smoothly. The announced 10% cut in public sector wages (and abolishing the solidarity tax) is necessary, but the problems Serbia is facing require far bigger and more decisive measures. The only public expenses that have the necessary volume for a stronger fiscal adjustment are pensions, and their reduction is still, in our opinion, being unnecessarily delayed.

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
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	0.4
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	…
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
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
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
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
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
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
							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	…
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	-3,411
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	2,623
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,176	-1,586	-625	-290	-160	-510	-314
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*	-4.2
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	300
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	771	158	139	224	250	146
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800
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
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
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
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
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
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
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
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
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
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

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