TRENDS

1. Review

Serbia faced mostly adverse macroeconomic trends in 2014. However, these trends were quite heterogeneous – the year began with a slight downturn in macroeconomic trends in Q1, which accelerated sharply in Q2 and Q3 (due to the May floods), while Q4 saw some signs of recovery. Economic activity decreased (by 1.8%), inflation was below the lower limit of the target corridor set by the NBS, and the positive trends in the current account deficit detected in 2013 were reversed. Furthermore, unsustainable fiscal policy, involving huge fiscal deficit and increase in public debt from about 60% of GDP at the beginning of the year to the worrying more than 70% of GDP at its end, was another serious problem Serbian economy faced in 2014. Some important breakthroughs were made in economic policy in 2014 through amendments to a number of systemic laws (Law on Pension and Disability Insurance, Labor Law, Law on Privatization, Law on Bankruptcy Proceedings, Law on Planning and Construction), along with the necessary reduction in public sector wages and pensions. However, huge and probably professionally more demanding part of the work is to be done in 2015 and the succeeding years. During that period (in accordance with the arrangement with the IMF) the government is expected to resolve the growing problems in public enterprises, to privatize money loosing state-owned enterprises and the enterprises undergoing restructuring (or to declare bankruptcy), to reduce the number of public sector employees through reforms in the major budget users – such as education system or health care system.

Serbian economy was in recession throughout 2014 and real GDP shrank by 1.8%. May's floods, which caused a sharp drop in mining industry (coal production) and electricity production in the last seven months of the year, are among the reasons for Serbia's poor economic performance in 2014. However, it should be emphasized that even if the floods had not occurred, economic activity in 2014 would have been in recession, meaning that the real causes of the drop in economic activity are much deeper and therefore difficult to eliminate. About 2/3 of the decrease in GDP can be attributed to the floods (and slow post-flood reconstruction), meaning that even if the devastating May floods had not occurred, GDP would have shrunk by 0.6% (see Chapter 2 "Economic Activity").

Seasonally adjusted GDP grew by 0.4% in Q4 2014 relative to Q3, and preliminary data for January (industrial production, retail trade, average wage etc.) indicate further rise in economic activity at the beginning of 2015. However, it is too soon, and probably wrong, to claim that Serbian economy has started climbing out of recession. It is hard to believe that a sustainable economic recovery came after years of falling investment, and exactly when public sector pensions and wages were cut. The fact that some macroeconomic trends showing recovery are inconsistent with each other, and in some cases even impossible from the aspect of balance of payments (for example, rather improbable strong seasonally adjusted growth in food industry in November and December 2014 (Graph T2-8), real y-o-y increase in average wage in manufacturing industry of more than 15% in January, rise in employment in time of recession etc.) arouses doubts as to whether the suggested recovery in GDP is sustainable and true.

This issue of *QM* gives a more detailed analysis of the upward economic trends detected in Q4 2014 and in January 2015, because the prospects of economic growth in 2015 and in the succeeding years depend on how sustainable these trends are. The *first* possibility is that there has been a true and sustainable recovery in economic activity in the preceding few months. If so, Serbian economy would grow notably in 2015 and in the succeeding years. However, we believe that this is the least likely possibility. The *second* possibility, which cannot be ruled out by any means, is that some of the indicators showing improvement in economic activity were wrongly calculated by the Statistical Office of the Republic of Serbia. This would mean that the detected improvements were temporary and that economic activity would soon decrease to the level at which it would have been if there had not been any positive developments in Q4. The *third* possibility, which we find especially interesting, is that the improvement in economic activity was caused by formalization of economic flows that had been hidden from the SORS (reduction in shadow economy). In that case, GDP would keep growing until this influence is exhausted. Expected economic trends would then take place – though with somewhat higher level of GDP. For now, we believe that our forecast predicting 0.5-1% decrease in economic activity in 2015 given in the previous issues of *QM* is correct. On one hand, 2015 started with somewhat better results than expected, which might boost economic activity (or slow down its drop). On the other hand, in our previous analysis, we counted on increase in coal and electricity production, which has not been restored to its pre-flood level yet, and on a successful privatization of Železara Smederevo, which failed.

Inflation was down to only 1.7% at the end of 2014, and y-o-y rise in prices was even smaller and stood at only 0.8% (in January 2015 y-o-y inflation was down to its lowest level since 1960, of only 0.1%). The major causes of such low inflation are the following - economic recession accompanied by drop in domestic demand, small rise in food and energy prices and administratively controlled prices, low imported inflation, and unduly restrictive monetary policy (see Chapter 5 "Prices and the exchange rate"). Interestingly, the above mentioned disinflationary factors were strong enough to offset the impact of dinar depreciation on prices. During the last year (to February 2015 inclusive), nominal exchange rate for dinar against euro depreciated by about 5%, and by more than 25% against dollar, while the prices went up by only 0.8%.

The NBS has been failing to fulfil its legal obligation to keep the inflation within the target corridor of 4±1.5% for a long time. Since October 2013, when inflation fell below the target corridor, rise in prices was within the target corridor for only two months, and it was below the bottom limit of the corridor for as much as 14 months. Although the NBS announced that the inflation would be pushed up to the target corridor by the middle of 2015 and that it would be raised to 4.2% by the end of the year, we believe that this cannot be achieved without a more determined monetary easing. Our analyses show that the announced 15% increase in electricity price (direct impact on inflation of about 0.7 p.p.), expected modest rise in oil prices, and gradual easing of disinflationary pressures based on the prices of primary agricultural products, will not be sufficient to push up the inflation to the target corridor, meaning that the NBS will have to take some additional measures to achieve it. The arrangement with the IMF, which additionally ensures macroeconomic stability in the following period, makes room for a more determined monetary easing.

Controlled depreciation of dinar exchange rate could be an effective measure against deflation – of course, as long as it does not jeopardize balances of a large number of foreign currency borrowers. Controlled depreciation of dinar would boost economic growth, because better price competitiveness of national economy would encourage rise in net exports. However, real depreciation of dinar against euro of 2.5% in Q4 2014 was followed by its real appreciation in the first two months of 2015. In response to these disinflationary pressures, the NBS purchased euros on the interbank market and thus prevented further appreciation of dinar. However, the NBS has some other mechanisms at its disposal (reference interest rate, currency structure of the mandatory reserves etc.) through which dinar can be weakened (which we find necessary). We believe that the optimum level of dinar depreciation would be the one which would push up the inflation to the target corridor set by the NBS.

Current account deficit accounted for 6% of GDP in 2014 and remained almost unchanged compared with 2013 (see Chapter 4 "Balance of payments and foreign trade"). This happened because, among other reasons, world prices of energy fell sharply in the second half of 2014. Energy accounts for about 15% of the imported goods, and almost 5% of the exported goods, meaning that large fluctuations in energy prices affect the current account deficit. If oil prices had not dropped (50% decrease from June to December in USD), along with the prices of other energy products, current account deficit in 2014 would have widened compared with 2013, which leads to conclusion that Serbian foreign trade actually suffered a downturn in 2014 (in fact, there was a real drop in net exports in 2014). Sharp rise in exports which started in 2013 suddenly stopped in 2014, and the second half of the year even saw a drop in exports. This occurred because the major driver of exports in 2013, the FAS company, reached its full production capacity, and no other product emerged to take its place. Investments suffered the sharpest drop of all GDP components during the previous years, which is the fundamental cause of the halt in exports - because strong rise in exports cannot be achieved without rise in investments.

However, we believe that the current account deficit will narrow in 2015 compared with 2014. This reduction will be caused by drop in imports rather than increase in exports. Trends in the world oil prices from the beginning of the year to the middle of March indicate that the average energy prices in 2015 will be much lower than in 2014 – consequently, Serbia's current account deficit will shrink. Additionally, expected recovery in electricity production and coal extraction after reconstruction of the coal mines that had been flooded, will have positive impact on the balance of energy imports and exports. Furthermore, implementation of fiscal consolidation measures will cause a drop in domestic consumption and consequently, a fall in imports in 2015. Finally, the government could boost the foreign trade and reduce the current account deficit in 2015 by preventing real appreciation of dinar (or allowing/inducing its depreciation).

Capital inflows in 2014 were low and insufficient to make up the current account deficit. This was one of the causes of the considerable reduction in foreign currency reserves of the NBS in 2014 (more than EUR 1 billion). Furthermore, the structure of the capital inflows was quite unfavourable. Public foreign debt grew because the government borrowed more to finance the fiscal deficit. On the other hand, private foreign debt shrank. Foreign direct investments (FDI), the component of capital inflows of largest importance to Serbian economy, were at a very low level three years in a row. FDI totalled about EUR 1.4 billion in 2014 (including reinvested profits), and accounted for only 60% of the FDI received in 2011 (the same assessment methodology was used). Reliable forecasts about the trends in capital inflows in 2015 have not been made yet. Hopefully the arrangement with the IMF will boost FDI. However, one should bear in mind that the investment spending in EU countries, which are the major source of FDI in Serbian economy, is still falling (see Chapter 8 "International Environment"). Public foreign debt is expected to shrink in 2015 as a consequence of fiscal consolidation and reduction in fiscal deficit. It is quite unlikely that the current downward trend in the private foreign debt will rebound already in 2015, although greater microeconomic stability and elimination of some other problems (for example, large share of bad debt) could have positive impact on these trends.

Trends in labour market published by the SORS, and assessed through the Labour Force Survey, remained inconsistent with other macroeconomic trends in 2014. Namely, employment rose and unemployment fell although Serbian economy was in recession. According to the latest Labour Force Survey, employment rate in Q4 2014 rose to 50.4% and unemployment fell to 17.6%. Since economics is unable to explain this phenomenon of rising employment and decreasing unemployment during the previous years (since 2012), the only possible explanation is that the data published by the SORS is unreliable.

Fiscal deficit widened to very high 6.6% of GDP in 2014 (see Chapter 6 "Fiscal Flows and Policy). Although it was unsustainably high, the fiscal deficit was somewhat smaller than planned in 2014 budget (7.1% of GDP), and in the budget revision adopted in October (8% of GDP). Public revenues were by RSD 30 billion below the projections made at the beginning of the year, primarily because macroeconomic indicators fell short of the plan – average inflation was much below the targeted level (2.1% instead of 5.5%), and so did GDP (although it was expected to grow by 1.5%, GDP shrank by 1.8%). Discrepancy between the actual and projected level of public expenditures was even larger, more than RSD 60 billion. Capital expenditures suffered the largest cut (by more than a half). However, this reduction was not planned and justified but was caused by the government's inefficiency in its carrying out infrastructure projects.

Judging from the latest fiscal trends, there are some grounds for optimism. Public revenues went up in Q4, and similar trend continued at the beginning of 2015. We believe that this increase was to a large extent caused by reduction in the shadow economy. Additionally, the process of fiscal consolidation began at the end of 2014 through reduction in public sector pensions and wages. Although some analysts, politicians, and representatives of other interest groups argued against this measure claiming that it would not be effective because it would cause a drop in demand, in economic activity and in public revenues – the early results show that such claims were unfounded. Fiscal results achieved in December 2014 and in the first two months of 2015 are within the expected and planned level, which proves the efficiency of this measure. The arrangement with the IMF signed at the end of February, is another guarantee that the government will be fiscally responsible in the following period. We therefore believe that the government currently keeps the direct fiscal flows – budget revenues and expenditures – under control, and that it would be no surprise if fiscal deficit fell below the targeted 5.9% of GDP in 2015.

There are, however, some concerns as to whether the reforms envisaged in fiscal strategy (and in the arrangement with the IMF) will be carried out successfully. The announced privatization of Železara Smederevo failed, and the enterprise has not been declared bankrupt. Although the government announced that the status of the petrochemical complex (Azotara, Petrohemija, MSK) would be resolved in the first half of 2015, it has not come out with any specific information about the actions that have been taken so far. Furthermore, the government is obliged by the Fiscal Strategy and the arrangement with the IMF to reduce the number of public sector employees in the following three years. It is, however, appalling that the government still does not know the exact number of people employed by the public sector, because a comprehensive registry of public sector employees – which is a precondition for successful rightsizing of the public sector – has not been set up yet. The process of public sector downsizing needs to be based on a suitable plan, methodology and criteria; otherwise it could do more harm than good, because majority of surplus employees work in vital systems, such as education and health care system.

Public debt grew to more than 70% of GDP at the end of 2014, and the rapid growth continued at the beginning of 2015 although there was no significant rise in government borrowing. Public debt exceeded 75% of GDP as early as at the end of February. Debt-to-GDP ratio increased in the preceding months primarily due to a strong depreciation of dinar against US dollar (by about 25% in the preceding 6 months) and consequential increase in the share of dollar denominated debt in GDP. Since the majority of relevant studies show that the appreciation of dollar against euro (and dinar) is going to last, it is quite clear that the government's optimistic forecasts presented in the Fiscal Strategy (adopted less than two months ago) which predict that public debt will reach 79% of GDP at the end of 2016 and then start shrinking, will not come true.

Serbia: Selected Macroeconomic Indicators, 2005-2014

	Annual Data										Quarterly Data							
											2013				2014			
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Economic Growth									y-o-y, real growth[1]									
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3884	…	…	…	…	…	…	…	…
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	2.4	1.1	3.4	3.3	-0.2	-1.3	-3.6	-1.8
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.4	2.2	-0.3	2.4	2.3	-0.2	-1.8	-4.7	-2.4
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	5.2	3.0	10.8	3.3	2.1	-4.8	-13.9	-9.5
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	5.4	3.2	8.8	2.2	3.6	-2.0	-5.6	-2.8
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	41,419	44,248	43,939	46,185	41,825	44,971	44,934	46,371
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	…	…	1.724	1,724	1,720	1,705	1,863	1,896	1,895	1,864
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	3.1	-5.7	-3.5	-2.6	0.1	-0.8	4.3	3.5	5.4
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.0	-9.1	-9.8	2.3	-4.2	4.4	3.7	-3.0	14.8
									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	-257.5	-46.2	-44.7	-66.1	-55.0	-68.1	-45.0	-39.8	-105.2
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	-14,028	-14,693	-13,393	3,341	3,623	3,712	4,017	3,384	3,759	3,731	-2,476
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	9,732	2,151	2,578	2,979	2,832	2,510	2,769	2,656	1,794
Current account5[5]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-668	-387	-381	-671	-503	-495	-502	-312
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-12.3*	*-6.5*	*-6.1*	*-8.3*	*-4.4*	*-4.3*	*-7.8*	*-6.3*	*-5.8*	*-5.9*	*-6*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	612	356	277	671	496	372	337	272
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	1,210	171	264	446	347	316	397	334	152
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,332	859	-886	-164	887	-800	-370	509	-671
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	788,293	673,147	674,731	701,822	757,689	696,802	756,996	787,778	788,293
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	6,486	6,025	5,917	6,122	6,605	6,015	6,513	6,641	6,486
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	1,927,668	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004	1,842,407	1,888,471	1,927,668
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	907,288	924,684	933,170	933,839	937,875	949,418	976,865	998,277
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	6.7	-2.6	-4.7	1.2	2.3	1.9	3.5	4.3	6.7
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	1.2	-8.2	-9.2	-8.9	-6.5	-8.3	-5.7	-3.3	1.2
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	52.9	51.7	50.3	48.3	48.5	46.8	48.6	49.5
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	1.8	11.2	9.7	4.8	2.2	2.3	1.2	2.1	1.8
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	81.8	79.5	79.5	80.8	81.2	80.7	80.9	81.8	83.9
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	111.69	112.15	114.2	114.3	115.8	115.6	117.4	120.29

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