

TRENDS

1. Review

Following depreciation in May, the value of the dinar in relation to the euro now probably stands close to a sustainable level. The recovery in economic activity slowed in Q1 relative to the second half of 2009, but the good news is that recovery is now based on growing exports rather than on rising domestic demand. At 4.8% of GDP, the 2010 fiscal deficit will be higher than planned, but its rise is being driven exclusively by lower-than-planned public revenue rather than growing public expenditure. In short, these are the most important issues covered in this *QM's Trends*.

The Serbian dinar depreciated in May, together with currencies of nearly all Eastern European countries with flexible exchange rate regimes (Poland, Romania, Hungary and the Czech Republic). The synchronized nature of these drops leads to the conclusion that the sudden depreciation occurred because of a change in the mood of investors in financial markets: reacting to the likelihood of a new outbreak of the crisis in Europe, investors temporarily abandoned European currencies and thus caused a drop in their value (including that of the euro itself).

Factors somewhat deeper than a mere financial market risk assessment, however, underlie the depreciation of the dinar. The Serbian currency was overvalued before the crisis struck; its apparent strength was underpinned by substantial foreign capital inflows. When these inflows were halted by the crisis, the dinar began to return to its real value, the level it maintained before the start of strong capital inflows and attendant appreciation. As capital inflows increased abruptly after 2005, we now expect the exchange rate to return to levels seen prior to this; we thus take 2005 as a basis for comparison with the current value of the dinar.

After riding out the latest wave of depreciation (at the time of writing, the euro has exceeded the 102 dinar mark), the dinar came close to its 2005 real value but is yet to reach it. The dinar's real exchange rate (adjusted for inflation) against the euro now stands at Q4 2006 levels, meaning that it still exceeds its 2005 value by some 10% in real terms (see Graph T5-8).

The value of the dinar, however, should be viewed in the context of the Serbian economy's international competitiveness. The depreciation of the dinar is now restoring some of Serbia's competitiveness lost through major real appreciation since 2005. Euro-wages are the first indicator of this shift in competitiveness. By late May the depreciation of the dinar slashed euro-wages to real levels similar to those seen in Q4 2007.

The change in euro-wages is, however, also a consequence of a shift in productivity, rather than just of real appreciation. Thus Unit Labor Costs expressed in euros (euro-ULCs) are the true measure of competitiveness: these incorporate changes to productivity in addition to changes in euro-wages. Preliminary May data indicate that euro-ULCs stand at levels similar to those seen in Q1 2006 (Graph T2-6), up by just a few percent on their 2005 values.

The drop in euro-ULCs following the May depreciation leads to the conclusion that the coming period is not likely to hold strong new depreciatory pressures. Of course, the financial market can always be the source of new shocks that could lead to temporary fluctuations, but movements of wages and inflation will be key for lasting changes in the exchange rate. As wage growth and inflation remain under control for now, we expect the dinar to stabilize at close to levels reached after the latest depreciation and thereafter to move in line with changes to these aggregates.

The recovery of economic activity in evidence since the second half of 2009 slowed in Q1. The slow pace of recovery is evidenced by the fact that economic activity now stands at a level some 3% lower than that seen in 2008, despite y-o-y growth of an estimated 0.9% in Q1. Given such a pace, real 2008 GDP levels will be reached only in 2011. Nevertheless, some encouragement can be derived from the fact that exports picked up in Q1, becoming an ever more important driver

of economic growth. Latest April data confirm strong export growth: exports were up by 27% at the y-o-y level, while their seasonally-adjusted growth rate in relation to March was 4.1%. This is yet another indicator of the fact that the exchange rate is conducive to economic recovery, and that it is also macroeconomically sustainable. We expect export growth to slightly accelerate economic recovery for the rest of the year.

The mild recovery in economic activity seen in Q1 was still insufficient to lead to significant changes in the labor market. The fall in employment has failed to slow down, while the unemployment rate has grown to alarmingly high levels. At 1.85 million, the Q1 number of registered employed people is the lowest it has been in thirty years. The unemployment rate will probably exceed 19% after the April workforce survey is published.

The current account deficit and inflation rose in Q1 relative to the preceding quarter, but remained under control. The current account deficit, standing at just under 10% of GDP in Q1, at first glance seems rather large, but several factors combined to make it seem much greater than it actually is. Firstly, current account deficit is seasonally higher in Q1. In addition, due to changes in import calculation methodology, Q1 saw a formal increase in the deficit of over 2% of GDP in relation to the preceding quarter; this is covered in more detail in Section 4, Balance of Payments and Foreign Trade, of this issue of *QM*.

Inflation stood at 1.9% in Q1, or some 8% at the annual level assuming the trend remains the same over the remaining quarters of 2010. Still, over two thirds of overall price growth in Q1 can be attributed to increases in the prices of electricity, tobacco and oil products. If we were to exclude movements in these prices from total inflation (as well as those of food produce, prices of which fell in Q1), the inflation trend would appear close to the center of the NBS target band of $6 \pm 2\%$, as indicated by the rise in underlying inflation shown in Graph T5-3.

Relaxation of monetary policy continued in Q1. The reference interest rate was brought down to 8%, and now, after a year of gradual reductions, stands at a level in line with our recommendations. Lending was on the increase in Q1, but growth remained immeasurably lower than before the crisis struck. At 11%, the share of bad loans (i.e. those late in repayment) in total loans remained rather large in Q1.

The hallmark of Q1 fiscal policy was a continuing unplanned fall in real tax revenue, due to both the insufficient speed and the structure of economic recovery, dominated as it is by exports. Exports are free of value added tax (VAT), and so the apparent slight recovery in economic activity is not paralleled in the same degree by a rise in tax revenue. On the other hand, the slump in domestic demand reflected directly on a fall in tax revenue, as it mainly resulted in a fall in imports and, consequently, in VAT and customs revenue. As tax revenue was lower than planned, agreement was reached with the IMF for the consolidated budget deficit to stand at 4.8% of GDP in 2010. This increase in the deficit is nothing more than an admission of reality – of the fact that government revenue would be lower than planned – and does not imply an increase in consolidated expenses.

All of the above leads to the conclusion that the 2010 consolidated budget deficit will be the highest since the start of transition, even if increases in pensions and public-sector wages are not taken into account, and that it will need to be cut substantially in the medium term. Even the announced bonuses will need to be provided for through redirection of existing assets or extraordinary appropriations (using earnings of Telekom Srbija, which are slightly greater than forecast), as the deficit would otherwise exceed the level agreed on with the IMF.

The high consolidated budget deficit and the need to rein in public finances will call for highly responsible fiscal policies in the medium term. For this to succeed, a Fiscal Responsibility Law – of a kind already extant in most European countries – will have to be enacted as quickly as possible. In addition, it will also probably be necessary to carry out comprehensive taxation reform, which would, among other things, support a new model of post-crisis economic growth based more on growing exports and less on rising domestic consumption.

Serbia: Selected Macroeconomic Indicators, 2004-2010¹⁾

	Annual Data						Quarterly Data					
	2004	2005	2006	2007	2008	2009	2009				2010	
							Q1	Q2	Q3	Q4	Q1	
Prices and the Exchange Rate												
						y-o-y²⁾						
Consumer Price Index	..	..	..	6.5	11.7	8.4	10.1	8.7	7.9	5.9	4.4	
Retail Price Index	10.1	16.5	12.7	6.8	10.9	10.1	9.8	9.9	9.4	9.2	7.2	
Real fx dinar/euro (avg. 2005=100) ³⁾	100.5	100.0	92.1	83.9	79.7	84.1	86.0	84.3	82.6	83.5	85.3	
Nominal fx dinar/euro (period average) ³⁾	72.62	82.92	84.19	79.97	81.46	93.90	93.71	94.17	93.24	94.47	98.60	
Economic Growth						y-o-y, real growth²⁾						
GDP (in billions of dinars)	1,381	1,684	1,962	2,302	2,723	2,954	..	..	..	..	..
GDP	8.3	5.6	5.2	6.9	5.5	-3.0	-4.1	-4.2	-2.3	-1.6	0.9	
Non-agricultural GVA	6.4	6.8	7.5	8.7	5.7	-2.8	-3.6	-3.7	-2.1	-1.8	1.4	
Industrial production	7.1	0.8	4.7	3.7	1.1	-12.1	-17.0	-17.8	-10.6	-3.8	2.8	
Manufacturing	9.7	-0.7	5.3	4.2	0.7	-15.8	-22.6	-21.6	-14.6	-5.4	4.6	
Average net wage (per month, in dinars) ⁴⁾	14,108	17,478	21,745	27,785	29,174	31,758	30,120	31,808	31,737	33,366	31,924	
Registered Employment (in millions)	2.047	2.056	2.028	1.998	1.997	1.882	1.981	1.850	1.835	1.861	1.845	
Fiscal data						in % of GDP					y-o-y, real growth	
Public Revenues	41.2	42.1	42.4	42.1	41.5	38.6	-12.6	-13.4	-4.2	-5.0	-4.0	
Public Expenditures	40.0	39.7	42.7	42.8	43.7	42.7	-3.4	-6.0	-0.3	-9.2	-1.4	
						in billions of dinars						
Overall fiscal balance (GFS definition) ⁵⁾	17.5	14.8	-33.5	-58.2	-68.9	-121.8	-11.7	-44.3	-21.4	-40.0	-23.9	
Balance of Payments						in millions of euros, flows²⁾						
Imports of goods ⁶⁾	-8,302	-8,286	-10,093	-12,858	-14,964	-10,919	-2,755	-2,609	-2,642	-2,913	-2,622	
Exports of goods ⁶⁾	2,991	4,006	5,111	6,444	7,416	5,978	1,291	1,536	1,550	1,602	1,471	
Current account ⁷⁾	-2,197	-1,805	-3,137	-4,994	-6,089	-1,904	-979	-175	-278	-472	-725	
in % GDP ⁷⁾	-11.6	-8.6	-12.9	-17.2	-17.8	-6.0	-13.6	-2.2	-3.4	-5.6	-9.8	
Capital account ⁷⁾	2,377	3,863	7,635	6,126	6,180	1,999	956	204	302	537	674	
Foreign direct investments	773	1,248	4,348	1,942	1,824	1,372	643	251	113	366	284	
NBS gross reserves (increase +)	349	1,675	4,240	941	-1,687	2,363	-240	880	716	1,007	-367	
Monetary data						in millions of dinars, e.o.p. stock²⁾						
NBS net own reserves ⁸⁾	103,158	175,288	302,783	400,195	475,110	578,791	502,606	489,062	528,439	578,791	563,529	
NBS net own reserves ⁸⁾ , in mn of euros	1,291	2,050	3,833	5,051	5,362	6,030	5,303	5,234	5,681	6,030	5,652	
Credit to the non-government sector	342,666	518,298	609,171	842,512	1,126,111	1,306,224	1,215,843	1,218,702	1,245,735	1,306,224	1,389,783	
FX deposits of households	110,713	190,136	260,661	381,687	413,766	565,294	450,852	461,401	482,827	565,294	604,783	
M2 (y-o-y, real growth, in %)	10.4	20.8	30.6	27.8	2.9	9.8	-3.2	2.1	0.9	9.8	11.5	
Credit to the non-government sector (y-o-y, real growth, in %)	27.3	28.6	10.3	24.9	25.2	5.2	21.7	16.4	11.8	5.2	6.3	
Credit to the non-government sector, in % GDP	23.9	29.6	28.6	35.0	42.0	45.8	45.9	45.8	44.5	45.8	47.5	
Financial Markets												
BELEXline (in index points) ⁹⁾	1,161	1,954	2,658	3,831	1,198	1,312	844	1,173	1,548	1,312	1,307	
Turnover on BSE (in mil. euros) ¹⁰⁾	423.7	498.8	1,166.4	2,004.4	884.0	443.7	61.2	72.6	55.8	254.0	49.4	

Source: FREN.

1) For more details (monthly series) see www.fren.org.rs.

2) Unless noted otherwise.

3) Calculation based on twelve-month averages for annual data and three-month averages for quarterly data.

4) Data for 2008 have been corrected on the basis of the widened reach of the sample used in calculating the average wage. Thus nominal wage values for 2008 are comparable with nominal values for 2009, but not with those for previous years.

5) Overall fiscal balance (GFS 2001 methodology) - Consolidated fiscal surplus/deficit adjusted for "budgetary loans" (lending minus repayment according to old GFS methodology).

6) The Statistical Office of the Republic of Serbia has changed its foreign trade methodology. Starting on 1 January 2010, in line with UN recommendations, Serbia began applying the general trade system, a wider concept than the one used previously, for better comparability with criteria set out in the Balance of Payments and the System of National Accounts. For a detailed explanation, see QM 20, Section 4, Balance of Payments and Foreign Trade.

7) In Q1 2008, NBS changed the Balance of Payments methodology. Due to this change, there is a drop in current account deficit, and a decrease in the capital account balance. For a more detailed explanation, see QM 12, Section 6, Balance of Payments and Foreign Trade.

8) NBS net own reserves = NBS fx reserves, net - (foreign deposits of commercial banks + government foreign deposits). For details see Monetary Flows and Policy.

9) Index value at the last day of the given period.

10) Total turnover on Belgrade Stock Exchange, includes turnover of stocks and FFCD bonds. Dinar amounts for stocks turnover are converted into euros using the average exchange rate for the given period.