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PUBLISHER
The Foundation for the Advancement of Economics (FREN)
Kamenička 6, Beograd
Tel/Fax: 011 3021 069
E-mail: office@fren.org.rs
http://*www.fren.org.rs*

AUTHORS
Milojko Arsić, Aleksandra Anić, Labour Market
Danko Brčerević, Economic Activity
Mirjana Gligorić, Balance of Payments and Foreign Trade
Milan Pejić, Prices and the Exchange Rate
Saša Ranđelović, Fiscal Trends and Policy
Svetozar Tanasković, Monetary Trends and Policy

TRANSLATION
Darko Popović
Marjeta Pevec
Vladica Đukić

DESIGN OF INNER PAGES
Stefan Ignjatović

PRINTING PREPARATION
Maja Tomić

COVER DESIGN
Nikola Drinčić

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Analytical and Notation Conventions

Values

The data is shown in the currency we believe best reflects relevant economic processes, regardless of the currency in which it is published or is in official use in the cited transactions. For example, the balance of payments is shown in euros as most flows in Serbia's international trade are valued in euros and because this comes closest to the measurement of real flows. Banks' credit activity is also shown in euros as it is thus indexed in the majority of cases, but is shown in dinars in analyses of monetary flows as the aim is to describe the generation of dinar aggregates.

Definitions of Aggregates and Indices

When local use and international conventions differ, we attempt to use international definitions wherever applicable to facilitate comparison.

Flows – In monetary accounts, the original data is stocks. Flows are taken as balance changes between two periods.

New Economy – Enterprises formed through private initiative

Traditional Economy - Enterprises that are/were state-owned or public companies

Y-O-Y Indices – We are more inclined to use this index (growth rate) than is the case in local practice. Comparison with the same period in the previous year informs about the process absorbing the effect of all seasonal variations which occurred over the previous year, especially in the observed seasons, and raises the change measure to the annual level.

Notations

CPI – Consumer Price Index

Cumulative – Refers to incremental changes of an aggregate in several periods within one year, from the beginning of that year.

H – Primary money (high-powered money)

IPPI – Industrial Producers Price Index

M1 – Cash in circulation and dinar sight deposits

M2 in dinars – In accordance with IMF definition: cash in circulation, sight and time deposits in both dinars and foreign currency. The same as M2 in the accepted methodology in Serbia

M2 – Cash in circulation, sight and time deposits in both dinars and foreign currency (in accordance with the IMF definition; the same as M3 in accepted methodology in Serbia)

NDA – Net Domestic Assets

NFA – Net Foreign Assets

RPI – Retail Price Index

y-o-y - Index or growth relative to the same period of the previous year

Abbreviations

CEFTA – Central European Free Trade Agreement

EU – European Union

FDI – Foreign Direct Investment

FFCD – Frozen Foreign Currency Deposit

FREN – Foundation for the Advancement of Economics

GDP – Gross Domestic Product

GVA – Gross Value Added

IMF – International Monetary Fund

LRS – Loan for the Rebirth of Serbia

MAT – *Macroeconomic Analyses and Trends*, publication of the Belgrade Institute of Economics

NES - National Employment Service

NIP – National Investment Plan

NBS – National Bank of Serbia

OECD – Organization for Economic Cooperation and Development

PRO – Public Revenue Office

Q1, Q2, Q4, Q4 – 1st, 2nd, 3rd, and 4th quarters of the year

QM – *Quarterly Monitor*

SORS – Statistical Office of the Republic of Serbia

SDF – Serbian Development Fund

SEE – South East Europe

SEPC – Serbian Electric Power Company

SITC – Standard International Trade Classification

SME – Small and Medium Enterprise

VAT – Value Added Tax

From the Editor

At the beginning of 2017 the results of Serbia's economy have deteriorated in several areas of the economy - economic activity slowed down while the external deficit and inflation increased. We estimate that the growth of the external deficit and inflation is mainly a result of cyclical factors related to the movement of prices on the world market, and therefore these deteriorations are temporary. However, the slowdown of economic growth is the result of general institutional weaknesses that have been manifested extremely in the electric power industry. At the beginning of this year Serbia also recorded good results in the field of public finances as well as certain improvements in the labour market. Significant progress in reforms was missing, among other things due to the presidential elections. Frequent elections in Serbia have significantly worse consequences than in other countries where there is a functioning market economy.

In the first quarter Serbia's economy grew by 1.2% year-on-year which is the lowest growth rate in the last twelve months and one of the lowest growth rates in Europe during that period. Although there is still possibility to accelerate growth in the remaining part of the year and reach planned 3% growth rate, the chance of higher growth than planned in this year was missed, as will be the case with many countries in Europe. Therefore, in this text, we will analyse in more details the causes of slowing economic growth at the beginning of this year.

The causes of economic growth slowdown can be trends in international environment, ineffective internal factors or weaknesses in economic policy and the economic environment. The impact of economic activity trends in large Western European economies on small open economies in Central and Eastern Europe is relatively strong. Growth in Western European economies is, almost as a rule, followed by an ever faster growth in Central and Eastern Europe, while recession in Western European economies leads to recession in Central and Eastern European countries. During the last major economic crisis which started in 2008 economic activity first declined in Western European countries by 4.4%, then the GDP fell by 5.1% in Central and Eastern Europe in 2009, and in Serbia by 3.6%. However, at the beginning of this year, European economies are expanding and the growth they have achieved is the highest since 2008. High growth is present in almost all European countries, so fifteen old and developed EU member countries recorded 2.3% growth rate in the first quarter, which is a solid result for this group of countries. The EU member states from Central and Eastern Europe recorded even stronger growth in the first quarter, which is 4.1% in average. Out of all European countries lower growth than Serbia in the first quarter was recorded by only Macedonia, Greece and Switzerland. That been said, economic trends in the international environment can in no way be the cause of the strong economic slowdown in Serbia in the first quarter of this year.

Slowdown of economic activity is also possible as a result of non-economic factors, such as natural disasters, political instability, etc. Large floods from 2014 directly affected the Serbian economy in that year, and the floods also affected negatively the economies of Bosnia and Herzegovina and Croatia. In some other years strong droughts caused a drop in agricultural production in Serbia by 10% and more, which resulted in the slowdown of economic activity in those years. However, during the first quarter of this year in Serbia, as in other countries of the region, there are no registered natural disasters of such magnitude to influence the movement of economic activity. Attempts to explain slowdown of the economy during the first quarter with cold weather during January are extremely unfounded as similar weather conditions were also in other countries in the region, and despite that they recorded a strong growth. For example, Croatia recorded a growth of 2.5%, Bulgaria 3.9%, Hungary 4.1% and Romania as much as 5.7%. The only country in the region which in the first quarter achieved poorer results than Serbia is Macedonia, but that can be explained by internal political problems, not weather.

Given that economic trends in the international environment are favourable and there were no major natural disasters and social conflicts, it remains to be examined whether the causes of economic slowdown can be found in economic policy and weaknesses of the economic environment. Looking at the causes of slowing economic growth in economic policy and the economic environment at first glance may seem surprising as Serbia has significantly reduced the fiscal deficit during the past two years, inflation is low and stable, interest rates are at a historical minimum, etc. In addition, certain reforms have been carried out, such as the labour market liberalization, more efficient approval of building permits, and some administrative procedures have been simplified, which is why Serbia made progress in the last two years of 19 places on the Doing Business list of the World Bank. Good results in establishing macroeconomic stability, particularly in fiscal consolidation, as well as some progress in reforms, received positive reviews from international financial organizations, investors and most domestic and foreign analysts. Although we could talk about some details in fiscal and monetary policy, hardly could the reasons for the slowdown of the economy be found in them. Therefore, any attempts to start growth by expanding fiscal and monetary policy would not yield lasting results.

For a long-term sustainable growth, in addition to macroeconomic stability a good economic environment is needed, i.e. a better quality of regulation of business operations, but more importantly, the consistency in their application is needed. It is important to adequately regulate the independence of the judiciary, the work of the cadastre, the public procurement procedure, the competition policy, the choice of management in public companies, the promotion policy in the administration, etc., but it is more important that these regulations are strictly applied in practice. The economic environment also includes the quality of the infrastructure, the availability of educational workforce, political stability, good relations with the world and other.

The slowdown in economic activity during the first quarter was most directly connected to the poor management of public companies, which resulted in a high fall in coal and electricity production. Poor EPS management had a direct impact on GDP growth in Serbia in the first quarter to be 1.2% rather than 2%. And a bad management is the consequence of institutional arrangements in which party activists are promoted at key positions in public enterprises and state administration, and public companies used to perform social functions, party financing and privileged personal gains. Thus, energy production problems are the manifestation of systemic weaknesses of Serbia's economy, and not of extraordinary circumstances such as the great colds during January. The systemic problems present in EPS exist also, to a greater or lesser extent, in other public companies, therefore it would not be surprising if similar problems arise in these companies also. According to the European Bank for Reconstruction and Development estimates Serbia and Albania are at the latest place according to the progress achieved in restructuring and quality of public companies management, compared to all Central and Eastern European countries. Serbia has not made progress in this area since 2005. However, even if there were no problem in EPS Serbia would achieved growth of 2%, which is twice lower than the average of Central and Eastern European countries, indicating that there are other obstacles that hinder the growth of the economy.

Apart from the poor management of public companies in Serbia, there are other fundamental problems that fetter private entrepreneurship and thus the growth of the economy, such as the weak property and contract protection, high burden on the private sector by complicated procedures, high level of corruption, poor competition policy, etc. In such environment entrepreneurs spend a great deal of time and money on establishing links with politicians and government officials instead of dedicating themselves to adopting new technologies, gaining new markets, finding cheaper sources of finance, etc. From the standpoint of the society lobbying and corruption activities are completely useless and represent pure waste of resources. The privileged status of some businessmen is severely distorting competition, which is the main driver of economic development. The extent to which the conditions for economic growth in Serbia are unequal is seen by the fact that the state grants high-yielding investment subsidies to some businessmen, while imposing restrictions and barriers to others that can be only solved by bribery of state officials and party activists. Disruption of competition is present when concluding affairs with the state and public companies, obtaining permits and approvals, resolving disputes and others.

The aforementioned weaknesses are closely related to the low efficiency of the state administration. According to the World Bank data, Serbia was at the 119th position in the world according to the efficiency of government management in 2015, and there has been no progress in this area over the past few years. Regarding the quality of governance Serbia stands badly on all indicators of the World Bank because according to each of them Serbia is not ranked better than 110th place in the world, and it is particularly badly placed according to the efficiency of government administration, quality of regulation and the rule of law. According to the indicator of country's quality of governance Serbia is placed one place above the last in comparison to the countries of Central and Eastern Europe, the only country below is Albania. Similar poor ratings Serbia also received from the World Economic Forum - where according to the level of competitiveness is at the 90th place in the world. The data of the World Economic Forum point to poor governance by the state, high corruption, etc., but also to the poor state of the road and rail infrastructure, inefficient competition protection, the underdeveloped financial sector, the inability to innovate etc. The inefficiency of the state administration and public companies is especially visible in the realization of public investments, which are for years below 3.5% of GDP. Delaying completion of the Corridor 10 from the end of 2015 to the end of 2016, and then to the end of 2017 and finally mid-2018, is an example of state inefficiency in the realization of public investments. And the efficiency of road construction has improved in recent years, and it is probably higher than the efficiency in other public investments.

The synthetic reflection of the weakness of the economic environment in Serbia is a low rate of total (private and state) investments which does not exceed 20% of GDP. Responsibility for this is primarily on the part of the state, which invests only little and inefficiently, and has created a business environment that is unfavourable to private entrepreneurship. And investments would be even lower without stimulation through high state subsidies. With such low investments Serbia cannot count on a rapid economic growth of 4-5%, and thus the gradual elimination of the historical lag in the level of development behind the countries of Central and Western Europe.

Achieving high growth of the economy while maintaining the fundamental weaknesses of the economic environment is only possible in a short period of time and in a relatively modest extent. Such temporary growth can be achieved by high growth in current consumption, subsidies, etc., but such growth raises fiscal and foreign trade deficits worsening macroeconomic stability and then again negatively influencing the future growth of the economy. Strong economic growth is only possible with high investments that increase the production potential of the economy, and such economic growth creates a realistic basis for a long-term sustainable increase of consumption and standard of living of citizens. However, in a market economy for high investments a good economic environment is necessary, and in its development Serbia is progressing very slowly. If in the coming year the economic environment does not improve significantly Serbia will choose between macroeconomic stability without significant growth on one side and alternating shifts in long-term unsustainable growth (generated by demand and subsidies) and crises on the other. Otherwise, Serbia, in its economic history as an independent country or as a part of Yugoslavia, repeatedly entered into periods of instability, several times after successful implementation of macroeconomic stabilization programs, because of the lack of economic environment reforms.

TRENDS

1. Review

Some of the most important macroeconomic trends deteriorated in Q1. Economic growth slowed down to 1.2% (year-on-year), i.e. halved compared to the last quarter of 2016 when it was 2.5%. Inflation rose sharply - in Q4 2016 annual inflation was 1.5%, and in Q1 2017 it was doubled, to 3.1%. Lastly, the current account deficit in Q1 increased to 8.5% of GDP from 4.5% of GDP from Q4 2016. Unlike these three indicators, major changes did not occur in monetary and fiscal developments, as well as in employment trends. Although the economic downturn, inflation and current account deficit in Q1 we estimate as temporary, it is actually a very good warning of how unstable macroeconomic trends are in Serbia, and the progress achieved in the previous two years weak. In order for Serbia to have long-term high and sustainable growth, low and stable inflation and balanced trade relations with foreign countries, it is necessary to carry out reforms that have been avoided for years - to improve the business environment (rule of law, reduce corruption, increase the efficiency of public administration), reform public companies, education and health, to boost public investments more intensively and other. Otherwise, the presence of macroeconomic risks, as well as the further increase of the lag behind the more developed countries of Central and Eastern Europe (which will almost certainly happen in 2017), will continue in the coming years.

Economic activity failed to meet expectations in the first quarter. Year-on-year GDP growth was only 1.2%, and seasonally adjusted growth compared to Q4 2016 was only 0.1% (see section 2 “Economic activity”). There are two reasons for unfavourable economic activity in Q1. The first relates to unfavourable one-off factors - a huge drop in production of EPS of about 15% due to the poor management of this company and a sharp drop in construction activity of about 5% due to a somewhat colder winter than last year. The second group of reasons for the low Serbian economic growth in Q1 refers to the structural, permanent, inability of the domestic economy to achieve high GDP growth rates. This impossibility is indicated by a very low share of investments in GDP of around 18%, and for high and sustainable economic growth the share of investments in GDP should be around 25%. Previous conclusions on the existence of two groups of reasons for low economic growth in Q1 can be illustrated by concrete numbers. One-off factors contributed to a decline in GDP growth in Q1 by about 1 pp, or economic growth in Q1 without falling production of EPS and falling construction, would be somewhat above 2%. However, this would still be very low growth. Namely, with the hypothetical GDP growth of 2-2.5% in Q1, Serbia would also be the country with the lowest economic growth in Central and Eastern Europe (except for Macedonia), since CIE countries in Q1 recorded an average y-o-y growth of more than 4%. For this lagging behind CIE countries, which actually lasts since the end of the world economic crisis, are responsible more permanent and not one-off factor. The reasons why Serbia’s economic growth is permanently lagging behind comparable CIE countries are discussed in more detail in the Foreword of this QM edition.

It is still possible to achieve a forecasted growth rate of 3% in 2017, but after a bad Q1 it will be significantly more difficult. In order to achieve the projected growth rate throughout the year in the next three quarters an average annual GDP growth of around 3.5% will have to be achieved, which would imply an acceleration of economic activity not only in relation to the unsuccessful Q1 but also in relation to a relatively successful 2016. Our analysis shows that this, although difficult, is still possible. The international environment in 2017 is exceptionally convenient. Euro interest rates are at a historical minimum, and oil prices are again extremely low and are not expected to grow. In addition to this (and probably because of this), the entire Central and Eastern Europe at the beginning of 2017 is recording the highest growth rates since the outbreak of the crisis, and also economic growth in Italy and Germany gradually accelerates which are the two biggest export markets of Serbia. These international factors should also pull the economy of Serbia in the remaining part of the year. There are also domestic indicators that give room for accelerated economic growth in the coming quarters. This possibility is suggested, above all, by the manufacturing industry, which in Q1 had a high and widespread growth of about 7%, which is a good and healthy basis for accelerating the growth of the entire economy. Of course, the precondition for a 3% economic growth is to eliminate the problems that EPS had when excavating coal in Kolubara in the coming months. At the end of the economic activity review, we note once again that with economic growth of 3% in 2017 the domestic economy will continue to increase the lag behind the Central and Eastern European countries, which will most likely achieve even greater growth.

Inflation accelerated in early 2017 and from the beginning of the year until April the price increase was over 3%, and during the whole 2016, from January to December, the price increase was 1.6% (see section 5 “Prices and the Exchange Rate”). However, the QM analysis shows that this acceleration was temporary, as evidenced by a drop in prices of 0.5% in May. Namely, the acceleration of inflation in 2017 was significantly affected by: 1) seasonal increase in prices of fruits and vegetables; 2) international factors (oil price rise) and 3) one-time increase in the prices of tobacco products and telephone services. All of these factors are now exhausted, and some of them, like the world oil price rise, reversed their direction. Also, since mid-May there is a mild, but still noticeable, nominal dinar appreciation. Because of all this we expect that the prices rise will stop in the coming months. In addition to the exogenous factors, the price increase episode at the beginning of 2017 suggests that there is also a part of the acceleration of inflation that was the result of the growth of domestic demand. That is very important to bear in mind when analysing the public announcements about the relatively large increase in public sector wages by the end of the year of about 10% (which is higher than nominal GDP growth) as well as about the significant increase in pensions. Our estimate is that such an increase would have a negligible impact on economic growth but would greatly increase inflation and foreign trade imbalance.

The external balance in Q1 was visibly deteriorated. The current account deficit rose to around 750 mln euros (8.5% of quarterly GDP), which is almost twice the increase compared to the same period last year and this is its highest quarterly value since 2012. It is also unfortunate that, unlike in 2016, the current account deficit in Q1 was no longer covered by the inflow of foreign direct investments (FDIs), although the FDIs movement in Q1 was generally not bad. FDIs amounted to 500 million euros in this quarter and were slightly larger in relation to the same period of the previous year, so it can be expected that in 2017 they will reach about 2 billion euros. The current account deficit in Q1 deteriorated due to the high growth in imports of goods and services by about 15%, while exports maintained stable growth from the previous quarters of about 10%. The growth in imports is largely the result of the deterioration of terms of trade, i.e. the rise in the price of energy products (see section 4 “Balance of Payments and Foreign Trade”) accompanied by extraordinary import of electricity due to the EPS production decline. Without these events the current account deficit in Q1 would be below 6% of GDP, which would be slightly higher than the last year, but not so dramatically. Since oil prices have fallen again in May and June, and in the summer months the need for electricity imports reduces (even if EPS does not solve its problems so fast), we expect the current account deficit to fall sharply to a level below 5% of GDP, and perhaps even significantly lower. Nonetheless, foreign trade trends from Q1 (as well as trends in economic activity and inflation) are a good warning how easily can come to a complete turnaround in relatively favourable macroeconomic developments in Serbia over the past two years. Bearing this in mind, to maintain the achieved results in balancing the foreign economic relations as well as to further improve them, it will be crucial that the government does not increase the expansion of fiscal policy as announced and that the NBS does not allow a real strengthening of the dinar that has already begun.

Employment continued with its moderately positive movements from 2016. The most reliable indicator of its movement in Serbia, registered employment (measured on the basis of the data from the Central Register of Compulsory Insurance - CROCI), shows a year-on-year growth of employment in Q1 of about 2% (see section 3 “Labour Market”). This indicator indirectly suggests that the slowdown of economic activity in Q1 was temporary, because if it was of a more permanent nature that would influence a slowdown in the growth in the number of employees, which did not happen. Data from the Labour Force Survey (LFS) which show a strong fall in unemployment and a somewhat higher employment growth than CROCI remain suspicious. We find it indisputable that employment increases and unemployment reduces, but the intensity of these changes is probably lower than the one that is estimated by the LFS.

Monetary developments did not change significantly in Q1 compared to the end of 2016 (see section 7 "Monetary Flows and Policies"). The level of non-performing loans is almost unchanged compared to the end of 2016 and credit activity is gradually recovering, but only for the household sector, while the economy is still returning debts. The NBS correctly estimated that the acceleration of inflation at the beginning of the year was triggered by temporary factors and decided to keep the unchanged reference rate at 4% (although y-o-y inflation in April was also 4%). Banks also did not reacted to accelerating inflation by raising interest rates, so the real interest rates in Q1, due to inflation acceleration, fell further. The low credit activity of the economy reinforces our view that there are deeper reasons for the relatively low Serbian economic growth which are related to bad business environment. Namely, if the business environment was stimulating for a strong and necessary increase in investments share in GDP this would certainly be reflected in greater credit activity of the economy.

Fiscal trends in Q1 and April and May were in principle positive (see section 6 "Fiscal Trends and Policy"). Public revenues were somewhat larger than planed and expenditures were lower so instead of the planned deficit in the first five months consolidated state surplus of over 25 billion dinars was achieved. Behind this improvement are the long-term and economically desirable trends of increasing tax collection, as well as some fiscal trends that are not economically good. These economically undesirable trends relate to the continued aggressive collection of non-tax revenues (mostly dividends of public companies which do not invest as much as needed) as well as the reduction of public investments, which were low even before this last reduction. By the end of the year we expect the fiscal deficit to be below 1% of GDP, i.e. that it will be significantly smaller than the planned 1.7% of GDP. Although public finances are largely stabilized there are still large fiscal risks that are primarily related to unreformed public and non-privatized state-owned enterprises. Although public sector reforms were part of the IMF arrangement, they practically have not even been started (except in Zeleznice Srbije), and privatization (or bankruptcy) of state-owned enterprises with the biggest losses (Petrohemija, Azotara, MSK, RTB Bor and others) are constantly being delayed.

Public debt continues to decline and at the end of April it fell to about 70% of GDP (according to the QM methodology). This represents a fairly large reduction in public debt compared to the end of 2016 when public debt was around 73% of GDP. However, around 600 million euros (1.8% of GDP) of public debt reduction is the result of a real appreciation of the dinar, rather than better fiscal flows. So, without dinar's appreciation the public debt would fall in the first four months from about 73% of GDP to about 72% of GDP. Therefore, there should be no illusions that Serbia's excessive public debt will continue to decline rapidly as in the first half of 2017 (we expect a stronger reduction of public debt in May and June due to the real appreciation of the dinar). On the other hand, in the forthcoming period there is a risk of public debt growth on the basis of the costs of restitution as well as compensation to depositors from the former Yugoslav republics who had old foreign currency savings in Serbian banks. Due to all of this, the reduction of public debt to the level acceptable for the country at the level of development as Serbia (below 50% of GDP) will last for years - and this is the time when an extremely responsible fiscal policy must be run.

As already said, due to the high public debt as well as the inefficient and unreformed public sector (including public enterprises) Serbia needs a restrictive and reformist fiscal policy in the coming years. However, good fiscal outcomes and approaching of the IMF arrangement expiry date have an impact on public pressure and government promises in terms of tax cuts and rising public spending (pensions, public sector salaries). This could, already in the coming year, make fiscal deficits much bigger than now, after three years of its painful reduction. Therefore, for a more permanent stabilization of public finances and the reduction of public debt it would be desirable to conclude a new arrangement with the IMF for the next three-year period, which would in addition to the general fiscal framework also have in focus the structural reforms of the public sector, which fell short completely during the previous arrangement.

Serbia: Selected Macroeconomic Indicators, 2006-2017

	Annual Data											2015				2016				2017
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Economic Growth								**y-o-y, real growth1)**												
GDP (in billions of dinars)	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3908.5	4043.5	4197.8	…	…	…	…	…	…	…	…	…
GDP	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	0.8	2.8	-1.7	1.2	2.3	1.1	3.8	2.1	2.8	2.5	1.2
Non-agricultural GVA	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.5	1.9	2.6	-1.9	2.7	3.7	2.2	4.1	2.0	2.3	2.1	1.3
Industrial production	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	8.2	4.7	-2.0	11.1	13.2	10.2	10.5	2.4	3.7	2.8	0.7
Manufacturing	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	5.3	5.3	4.2	7.3	6.4	3.2	6.5	5.9	4.4	5.3	7.3
Average net wage (per month, in dinars)2)	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	44,437	46,087	41,718	44,717	44,719	46,592	43,588	46,450	46,041	48,168	45,437
Registered Employment (in millions)	2.028	1.998	1.997	1.901	1.805	1,866	1,865	1,864	1,845	1,990	1989	1,983	1,985	1,998	1,989	1,978	2,008	2,023	2,030	2018
Fiscal data								**in % of GDP**												
Public Revenues	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	3.2	3.1	7.5	6.9	3.5	4.5	-1.4	7.4	7.8	9.2	5.6	5.2
Public Expenditures	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.2	-3.2	1.9	-5.4	-3.8	-1.3	-2.6	5.7	4.9	2.3	-3.7	-1.3
								in billions of dinars												
Overall fiscal balance (GFS definition)3)	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-258.1	-149.1	-57.1	-21.2	-14.2	-15.8	-98.0	-16.0	-2.1	13.8	-52.8	11.8
Balance of Payments								**in millions of euros, flows1)**												
Imports of goods4)	-10,093	-12,858	-15,917	-11,096	-11,575	-13,614	-14,011	-14,674	-14,752	-15,350	-16,209	-3,648	-3,869	-3,777	-4,057	-3,701	-4,230	-3,939	-4,339	-4,271
Exports of goods4)	5,111	6,444	7,416	5,978	6,856	8,118	8,376	10,515	10,641	11,357	12,732	2,601	2,997	2,882	2,877	2,956	3,294	3,131	3,351	3,245
Current account5)	-3,137	-4,994	-7,054	-2,084	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-1,370	-511	-279	-343	-445	-378	-309	-293	-390	-746
in % GDP 5)	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-6.8*	*-10.9*	*-11.6*	*-6.1*	*-5.9*	*-4.8*	*-4.0*	*-6.7*	*-3.2*	*-3.9*	*-5.2*	*-4.8*	*-3.6*	*-3.3*	*-4.5*	*-8.6*
Capital account5)	7,635	6,126	7,133	2,207	1,553	3,340	3,351	1,630	1,705	1,205	790	427	139	243	396	184	197	127	282	503
Foreign direct investments	4,348	1,942	1,824	1,372	1,133	3,320	753	1,298	1,236	1,804	1,861	339	441	510	514	480	404	492	485	501
NBS gross reserves (increase +)	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,797	166	-302	111	-32	300	-213	-836	-317	332	519	-455
Monetary data								**in millions of dinars, e.o.p. stock1)**												
NBS net own reserves6)	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	931,320	923,966	854,636	858,972	902,526	931,320	884,093	846,969	899,959	923,966	894,102
NBS net own reserves6), in mn of euros	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,486	7,649	7,486	7,094	7,125	7,509	7,649	7,180	6,864	7,303	7,486	7,217
Credit to the non-government sector	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	1,982,974	2,031,825	1,919,958	1,918,917	1929573	1,982,974	1,961,626	2,009,537	2,044,160	2,031,825	2,042,971
FX deposits of households	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	1,014,260	1,070,944	1,004,948	1,010,179	995123	1,014,260	1,027,439	1,048,123	1,053,841	1,070,944	1,087,084
M2 (y-o-y, real growth, in %)	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	6.7	5.5	8	6.4	5.8	2.6	5.5	7.2	7.3	9.4	8	6.4
Credit to the non-government sector (y-o-y, real growth, in %)	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	-8.3	1.2	1.4	0.9	3.7	2	0.7	1.4	1.6	4.2	5.2	0.9	0.5
Credit to the non-government sector, in % GDP	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	48.4	47.2	47.4	47.0	46.9	47.8	46.8	47.6	48.0	47.2	40.4
Prices and the Exchange Rate								**Y-o-y growth1)**												
Consumer Prices Index7)	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	1.6	1.5	1.8	1.9	1.4	1.6	0.6	0.3	0.6	1.5	3.5
Real exchange rate dinar/euro (average 2005=100)8)	92.1	83.9	78.5	83.9	88.0	80.43	85.3	80.2	81.8	83.1	84.21	83.8	83.0	82.6	83.2	83.48	84.31	84.08	84.21	83.1
Nominal exchange rate dinar/euro8)	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	120.8	123.26	121.6	120.4	120.2	120.8	122.85	123.01	123.3	123.26	123.88

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.

2. Economic Activity

Economic activity failed to meet expectations in the first quarter of 2017. The year on year GDP growth was 1.2%, and the seasonally adjusted growth compared to the previous quarter was only 0.1%. According to both indicators, Q1 is the quarter with the lowest GDP growth since 2015. Additional analysis shows that economic growth in Q1 in Serbia was considerably lower compared to other countries in the region, which in Q1 recorded an average y-o-y GDP growth of about 4.5%. There are two groups of reasons for unfavourable economic activity in Q1. The first relates to one-off factors - a huge drop in production of EPS, which was a result of poor management of this company and a sharp drop in construction activity due to a somewhat colder winter than last year. However, even if there were no such one-off factors Serbia would, with economic growth rate of somewhere over 2%, lag behind almost all Central and Eastern European countries. So, there is another, more permanent, reason why Serbia has been behind the region for years - and that is, above all, a bad business environment. Serbia is not attractive for investment, which is best seen by the very low share of investments in GDP of about 18% of GDP (and it should be close to 25% of GDP). Despite the poor results in Q1, it is still possible to accelerate economic activity by the end of the year, which would make possible planned GDP growth rate of 3%. In the coming quarters, we should expect better results of construction and electricity production (if EPS solves problems with production). Also, since all of Europe in 2017 has achieved record growth rates since the outbreak of the crisis, part of this growth should also be transferred to Serbia. However, even if this happens, which is not certain - the only sustainable and secure way for Serbia to permanently accelerate its economic growth and start to catch up with the more developed countries of the CIE is to implement structural reforms for improvement of the economic environment.

Gross domestic product

In Q1, a relatively low GDP growth of 1.2% was achieved

According to the latest SORS data, y-o-y GDP growth in Q1 was 1.2%, which we rate as a bad result. Namely, during 2016 the y-o-y GDP growth by quarters ranged from 2.1% up to 3.8%, so the results from Q1 2017 indicate a significant slowdown in economic activity in relation to the previous year. Also, the y-o-y growth rate of 1.2% in Q1 makes it difficult to achieve the forecasted GDP growth of 3% in 2017, because in order to achieve this goal in the coming quarters relatively high average y-o-y GDP growth of 3,5% must be achieved.

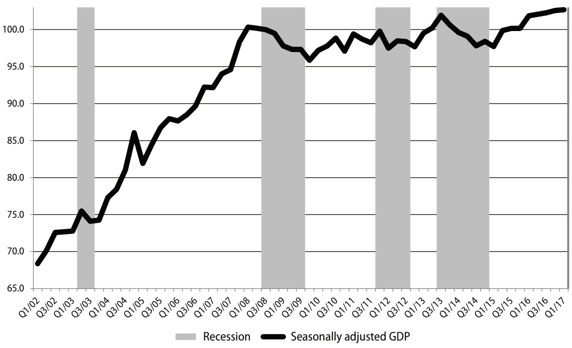
Seasonally adjusted GDP growth only 0.1%

Graph T2-1 shows series of seasonally adjusted GDP growth which somewhat more reliably shows the short-term trends of economic activity (shaded periods are recession-rated based on the Bry-Boschan procedures). The seasonally adjusted GDP growth in Q1 amounts to only 0.1% compared to the previous quarter, which is also the worst result since 2015. The analysis of seasonally adjusted GDP points to very similar conclusions as the analysis of its y-o-y growth - for example, a sharp acceleration of seasonally adjusted GDP is needed in the coming quarters in order to achieve a GDP growth rate of 3% in 2017. Converted to numbers, this means that for the growth of economic activity in 2017 of 3%, the seasonally adjusted quarterly GDP growth in the next three quarters should be 1.7% (average), which would represent a very high acceleration in comparison to the previous medium-term trends (in 33 quarters since 2009, the seasonally adjusted quarterly growth of more than 1.5% was recorded only four times in a span of several years, and now it should be expected in three consecutive quarters). In the second part of this text, we will explain in more detail why we believe that reaching a growth rate of 3% in 2017, although difficult, is still possible. In this part of the text, we will focus a little more on evaluating the results of the economic activity in Q1, considering them from the international context.

GDP growth in Q1 is well below the regional average

Table T2-2 shows GDP growth in Serbia and countries in the region. Although we have only shown the last three years in the table, since the beginning of the recovery from the crisis (since 2010) Serbia has achieved below average economic growth rates in relation to the countries in

Graph T2-1. Serbia: Seasonally adjusted GDP growth, 2002-2017 (2008 = 100)



Source: *QM* estimates based on SORS

the region. In Q1, this lag was further deepened as the average y-o-y growth in the region was 4.5%, and in Serbia 1.2%. Of all the observed countries whose data for Q1 is available (Table T2-2), only Macedonia had a lower growth than Serbia, but that was also expected taking into account a great political instability in the country at the beginning of the year. Additional analysis showed that not only the countries of the region, but practically all of Europe, recorded a solid acceleration of economic activity at the beginning of 2017. The remaining countries of Central and Eastern Europe had a similar acceleration of growth in Q1 as the countries of the Serbian environment and achieved an average y-o-y growth of around 4% (Slovenia 5%, Poland 4,2%, the Baltic countries slightly over 4%, Slovakia and the Czech Republic 3%). In Q1, Eurozone accelerated its year-on-year GDP growth to 1.9%, and the seasonally adjusted growth of Eurozone compared to the previous quarter was 0.6%, which would, when annualized, correspond to the annual growth rate of around 2.5%.

Table T2-2. Serbia and countries in the region: GDP growth and share of investments in GDP, 2014-2017

	2014	2015	2016	Q1 2017	Share of investments in GDP
Serbia	-1.8	0.8	2.8	1.2	17.7
Neighbouring countries (weighted average)	2.7	3.4	3.5	4.5	22.7
Albania	1.8	2.6	3.4	-	27.2
Bosnia and Herzegovina	1.1	3.1	2.5	-	17.3
Bulgaria	1.3	3.6	3.4	3.8	21.0
Croatia	-0.5	1.6	2.9	2.5	19.5
Hungary	4.0	3.1	2.0	4.2	21.7
Macedonia	3.6	3.8	2.4	0.0	23.0
Montenegro	1.8	3.4	2.4	-	20.3
Romania	3.1	3.9	4.8	5.7	24.7

Source: EU Commission, European Economic Forecast – Winter 2017

Low GDP growth in Q1 in Serbia has been influenced by temporary factors

One part of the explanation of the low GDP growth in Serbia in Q1 refers to the one-off factors. Namely, there was a sharp drop in coal mining and electricity production by about 10% and 15% respectively in Q1, and the worst situation was in March, with coal production decline of 20% and electricity of almost 25%. This drop in production is attributed to many years of poor management of EPS. For years, EPS has not invested enough in opening new coal pits and the old ones are technologically harder to exploit with increasing risks of damage. According to the information from the media the inappropriate mode of mining resulted in landslide in Kolubara reducing coal production and consequently electricity. Along with EPS, construction activity had a solid annual drop of about 5% in Q1, and this fall is most likely one-off in its nature –i.e. the result of slightly colder winter in 2017 than in 2016, which resulted in fewer construction works. When looking at other indicators of construction activity that are not so susceptible to meteorological changes, it can be seen that the fall in Q1 was most likely temporary. Cement production had a y-o-y growth of over 10%, interest rates were at a historical minimum, etc. If the fall in the production of electricity and construction did not occurred, the annual growth of GDP in Q1 would be between 2 and 2.5% rather than 1.2%.

However, Serbia would have relatively low economic growth even withouth temporary factors

Even if Serbia had growth in Q1 in the range of 2-2.5%, it would again be the lowest economic growth compared to all Central and Eastern European countries (except Macedonia) - and we also recall that Serbia's lagging behind the region has lasted since 2010. Therefore, we conclude that not only temporary factors were the reason for relatively low GDP growth in Q1, but that such result is only a continuation of long-term unfavourable economic trends. Indications of structural problems that prevent high GDP growth are presented in Table T2-2. Namely, in the last column of the Table, we show that the share of investments in GDP in Serbia is significantly lower than in the countries of the region - it is only about 18%[1] of GDP compared to about 23% of the GDP of the countries in the region. And with such a low level of investment, far lower than in economically comparable countries, Serbia cannot expect that it will catch up in the near future. We have written about the reason for low investments in detail on several occasions in the previous editions of QM, so we will not describe them here again. What is important to note is that these reasons are mainly of structural character (rule of law, inefficiency of the state administration, high level of corruption, poor state of the infrastructure, etc.) and can be eliminated only by midterm reforms of these areas that are persistently avoided in Serbia.

The structure of GDP growth in Q1 was not economically favourable

The structure of achieved GDP growth in Q1 by use is presented in Table T2-3. Unlike in 2016, when economic growth was triggered by investments (a growth of around 5%) and net exports (12% export growth was almost twice higher than the growth of imports), the growth structure in Q1 is significantly different. Personal consumption grew by almost 2% and this is its largest quarterly y-o-y growth since 2011. Although the goal of economic policy is certainly a faster growth of living standards and household spending, Serbia needs to increase personal spending for some time more slowly than GDP growth, as there is still an external imbalance (relatively high current deficit) - that is, Serbia still consumes significantly more than it produces, and investments are still low. In Q1, however, private consumption growth was significantly higher than GDP growth (Table T2-3). Another negative indicator that we see in the growth structure of GDP by use is a low investment growth of only 1.3%. In order for Serbia to hope for a high and sustainable growth of more than 4%, it is necessary that investments in the next few years grow at rates of over 5% in order to increase their share in GDP significantly. The third negative indicator is the faster growth of imports from exports, which leads to a relatively large decrease in net exports and further deterioration of the external imbalance.

Table T2-3. Serbia: GDP by expenditure method, 2009-2017

	Y-o-y indices													
	2009	2010	2011	2012	2013	2014	2015	2016	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	Share 2015
GDP	96.9	100.6	101.4	99.0	102.6	98.2	100.8	102.8	103.8	102.1	102.8	102.5	101.2	100.0
Private consumption	99.4	99.4	100.9	98.2	99.4	98.7	100.5	100.8	100.8	101.0	100.5	101.0	101.9	74.7
State consumption	100.6	100.8	101.1	102.4	98.9	99.4	98.5	102.3	102.3	103.7	100.8	102.3	100.5	16.2
Investment	77.5	93.5	104.6	113.2	88.0	96.4	105.6	104.9	106.8	104.4	106.2	102.6	101.3	17.7
Export	93.1	115.0	105.0	100.8	121.3	105.7	110.2	111.9	112.4	110.7	110.7	113.8	108.7	46.7
Import	80.4	104.4	107.9	101.4	105.0	105.6	109.3	106.8	104.3	111.1	105.7	105.9	110.9	56.4

Source: SORS

There is, however, a basis for faster GDP growth in the coming quarters

A somewhat more detailed analysis of GDP by use shown in Table T2-3 shows some positive indicators that should be the basis for acceleration of the GDP growth in the coming quarters. First of all, that is the fact that exports continued with a high growth trend of almost 10%. We estimate that the growth of imports will slow down in the coming quarters, which was increased in Q1 by the temporary growth of energy imports of about 60%. Namely, part of this increase in energy imports was the result of higher oil and gas prices in Q1 2017 compared to Q1 2016, which is now no longer the case, as prices have returned to low levels. Also, the import of electricity was extremely high, due to the problems in EPS operations, and this trend will certainly slowdown in the summer months when electricity consumption in Serbia is lower. With almost certain slowdown in imports in the coming quarters, with sustained growth rates of exports (economic activity in Europe accelerates its growth which should positively affect Serbian exports) - we expect that net exports will start to contribute again positively to GDP growth starting from Q2, instead lowering it, as was the case in Q1. Also, the low level of investment was mainly a result of the decline in construction activity, which we consider as temporary, while credit activity and production of investment products recorded solid growth. Therefore, in the

1 Precise data on the participation of investments in GDP in 2016 for Serbia and the countries of the region still do not exist, but based on a slightly faster growth of investments than other components of GDP in 2016, we conclude that this share in Serbia will increase from 17,7% of GDP to around 18% of GDP.

coming quarters, we expect a significant increase in investment growth. In the end, it is positive that state spending in Q1 had a very low growth, which we hope will be extended in the coming quarters, and that private consumption, although somewhat higher than it would be desirable, is not completely out of control. With expected growth in net exports and investments in the coming quarters, GDP growth could increase to around 3%. This would then mean that the structure of economic growth will again be sustainable if private and state spending is kept at similar levels as in Q1 –i.e. private and state spending grow again slower than the GDP growth.

In Q1 service growth was faster than material production growth

The GDP growth by production (Table T2-4) was consistent with GDP growth per consumption. Growth structure was dominated by services - financial activities with 4.5% y-o-y growth and trade, traffic and tourism with growth of 2.8%. On the other hand, the biggest decline of about 5% was in the construction activity. The total industrial production recorded a modest growth of 1.3%, which was the result of a solid growth of the manufacturing industry of about 7%, a strong decline in electricity production of about 15% and a decrease of total mining (because of coal production) of about 6%. Agriculture had a lower annual decline of around 2%, based on preliminary estimates, but this isn't still a good indication of the trends in agricultural production in 2017. For this we will have to wait the results of summer and autumn agricultural cultures that dominate the movement of this sector.

Table T2-4. Serbia: Gross Domestic Product by Activity, 2009-2017

	2009	2010	2011	2012	2013	2014	2015	2016	2016				2017	Share
									Q1	Q2	Q3	Q4	Q1	2015
Total	96.9	100.6	101.4	99.0	102.6	98.2	100.8	102.8	103.8	102.1	102.8	102.5	101.2	100.0
Taxes minus subsidies	98.6	99.5	101.1	97.8	98.9	99.2	100.9	101.1	101.0	101.7	100.2	101.4	102.0	16.0
Value Added at basic prices	96.6	100.8	101.5	99.2	103.3	98.0	100.7	103.1	104.4	102.2	103.3	102.7	101.0	84.0
Non agricultural Value Added	96.7	100.2	101.5	101.1	101.6	97.5	101.7	102.6	104.1	102.0	102.3	102.1	101.3	90,5[2)]
Agriculture	95.2	106.4	100.9	82.7	120.9	102.0	92.3	108.3	107.7	104.6	111.8	108.1	97.8	9,5[2)]
Industry	96.8	100.8	103.2	105.6	106.0	92.4	103.2	103.0	106.9	100.3	102.7	102.3	101.3	24,4[2)]
Construction	87.1	97.6	105.9	90.2	96.1	98.5	102.7	106.4	112.9	107.8	108.6	99.4	94.9	5,2[2)]
Trade, transport and tourism	92.9	100.0	99.5	99.3	102.3	101.1	102.2	103.9	105.1	103.1	103.4	104.2	102.8	18,4[2)]
Informations and communications	97.0	103.2	102.6	102.8	99.9	96.1	101.7	102.3	102.3	102.3	102.0	102.6	101.4	5,1[2)]
Financial sector and insurance	102.6	101.9	98.4	92.0	90.5	97.2	102.3	103.4	102.7	103.5	104.2	103.2	104.5	3,2[2)]
Other	99.7	99.8	100.9	101.8	100.2	99.9	99.8	101.1	101.4	101.4	100.6	101.2	100.6	34,3[2)]

Source: SORS

Despite poor results from Q1, we still keep the GDP growth rate estimate at 3% in 2017

Some of the main arguments because of which we expect acceleration of the economic growth in the coming quarters are already outlined in the previous section of the text. Namely, in the coming quarters we expect temporary factors that lowered economic growth in Q1 to be exhausted - above all in construction and electricity production. We also expect stronger positive influence of external factors on Serbia's economic activity. The accelerated economic growth of the EU countries with which the Serbian economy is cooperating will have positive impact on Serbia's exports. Also, if the acceleration of growth of the EU turns out to be more permanent, this will also affect the increase of foreign direct investments, which in Serbia come mainly from the EU countries. Another external factor, which in the past already had a significant impact on accelerating economic activity in Serbia, is a new strong drop in energy prices. This fall was particularly pronounced in June and completely annulled all effects of steady rise in energy prices over the previous year. More importantly, analysts expect low oil prices to remain for some time. The third factor is the low interest rates that continue to hedge their historical records and there is no indication that the situation will change in the near future. It is important, however, to point out that although we expect a solid acceleration of economic growth in the coming quarters and possible reach of the projected GDP growth at an annual level of 3%, Serbia will continue to be at the bottom when compared to the Central and Eastern European countries by economic growth. In order to change this the structural reforms are needed aimed at improving the economic environment and consequently a strong increase in the share of investment in GDP.

Industrial production

The weak growth of total industrial production in Q1 is due to two completely divergent trends

Industrial production in Q1 recorded a growth of 0.7% (Table T2-5), which is its lowest year-on -year growth over the previous two years. However, behind this result there are two completely divergent trends. On the one hand, the manufacturing industry had a high y-o-y growth of 7.3%, which was the largest since 2013, when Fiat Cars Serbia (FAS) was in full expansion of production. On the other hand, the drop in electricity production by about 15% and the decline of mining by about 6% are almost comparable with the results that these sectors recorded during the natural disasters (floods in 2014).

Table T2-5. Serbia: Industrial Production Indices, 2009-2017

	Y-o-y indices													Share
	2009	2010	2011	2012	2013	2014	2015	2016	2016				2017	2015
									Q1	Q2	Q3	Q4	Q1	
Total	87.4	102.5	102.2	97.1	105.5	93.5	108.2	104.7	110.5	102.4	103.7	102.8	100.7	100.0
Mining and quarrying	96.2	105.8	110.4	97.8	105.3	83.3	110.5	104	114.3	99.2	103.4	100.5	93.7	7.0
Manufacturing	83.9	103.9	99.6	98.2	104.8	98.6	105.3	105.3	106.5	105.9	104.4	105.3	107.3	80.1
Electricity, gas, and water supply	100.8	95.6	109.7	92.9	108.1	79.9	118.8	102.7	120.9	90.2	102.1	95.9	85.5	12.9

Source: SORS

The decline in electricity production and mining is the consequence of problems in EPS

Only one, and at the same time the largest company in Serbia - EPS is responsible for the bad results of electricity production and mining. This company has been poorly managed for years, resulting in huge cumulative losses and debt growth, as well as systematically very low investment levels. In the last ten years EPS has invested considerably less than the depreciation value in each year, which has led to the collapse of electricity generation capacity. One of the consequences of chronically low investments is a lack of investments in new coal mines, and the old ones are being slowly exhausted. In order to overcome this situation in the short term, EPS began with a risky undermining to reach the coal that has not been completely stripped. According to information from the media, the landslide in Kolubara led to its mix with the coal, which prevented efficient production in the winter months when coal and electricity production is seasonally the biggest. Since EPS did not provide sufficient coal reserves on time to overcome the period of reduced production in Kolubara, electricity production in Q1 fell by about 15% compared to the same period of the previous year, and the electricity shortage was imported (which also affected the deterioration of the trade balance of the country). We expect that during the period of reduced electricity production (from April to November) EPS will manage to solve this problem and to be ready for the next heating season with full capacity production.

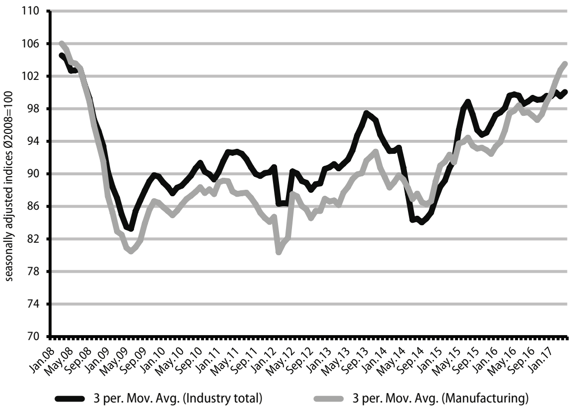
The high growth of the manufacturing industry is widespread

High y-o-y growth of the manufacturing industry by more than 7% in Q1 was fairly widespread by activities, which increases the likelihood that this will continue in the coming quarters. Out of a total of 24 manufacturing activities, 19 had a positive y-o-y growth rates, with by far the largest activity, the food industry had a very solid Q1 growth of 5.5%. With y-o-y growth of 30% in Q1 dominated the production of basic metals, which is the result of the privatization of ŽelezaraSmederevo, which occurred in 2016. Also, FAS entered 2017 with the production of the restored Fiat 500L model, so in 2017, for the first time in few years, the motor vehicle production has had a positive y-o-y growth. Among other manufacturing activities, the production of non-metallic minerals had a strong, two digit growth had (where cement production also belongs) as well as export-oriented and for many years already successful production of rubber and plastic products.

The manufacturing industry came to its pre-crisis level of production

Tendencies similar to the y-o-y indices in Q1 are also indicated by the seasonally adjusted indices of industrial production and manufacturing industry as shown in Chart T2-6. The graph shows that a total industrial production in Q1 approximately stagnated compared to Q4 2016, but that within this result the manufacturing industry (lighter line on the chart) strongly accelerated its growth, which means that seasonally adjusted production of electricity and mining were in huge drop compared to Q4. The graph also shows that manufacturing industry after the last strong growth in Q1 reached its pre-crisis level from 2008. Although this was undeniably a very

Graph T2-6. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2017



Source: SORS

long period and relatively slow recovery of the manufacturing industry, we have already said in previous QM issues that this recovery is actually much more positive than it looks at first glance. Namely, the current manufacturing industry is far more competitive than nine years ago, which is best seen by strong growth in exports compared to 2008 by over 60% (and the manufacturing industry produces the by far the most products which are exported). The competitive manufacturing industry from 2017, although identical by scale to that of 2008, now has much better prospects for future strong growth.

The production of investment goods has a high growth

Observed by use of industrial products (Table T2-7), the only group that recorded a strong year-on-year fall in Q1 was production of energy, while other groups had relatively high growth - from about 6% (consumer goods) to 13% (investment goods). Since most of these trends have already been practically described in the previous section of the text we will now hold a bit longer on the analysis of production of investment goods. This analysis is of special significance as the investments are the component of GDP which in Q1 had a very disappointing growth of only 1.3%, and investments must be the key driver of medium-term economic activity growth. The growth of production of investment goods of 13% indicates positive trends in investment activity in spite its slowdown in Q1 (which can be attributed entirely to construction activity). Namely, when we exclude the growth of the production of motor vehicles of about 7% from production of investment goods, as this production is dominantly exported (FAS), it is evident that the remaining part of this group of products has achieved a growth of almost 20%, which is exceptionally good result. On the basis of this it can be concluded that domestic demand for investment goods probably wasn't reduced in Q1, that is, the slowdown of investment activity in Q1, was, apparently, temporary.

Table T2-7. Serbia: Components of Industrial Production by Use, 2009-2017

	Y-o-y indices												
	2009	2010	2011	2012	2013	2014	2015	2016	2016				2017
									Q1	Q2	Q3	Q4	Q1
Total	87.4	102.5	102.1	97.1	105.5	93.5	108.2	104.7	110.5	102.4	103.7	102.8	100.7
Energy	98.8	97.7	106.2	93.6	113.2	82.6	116.9	101.9	118.3	94.3	96.5	97.1	88.0
Investment goods	79.3	93.6	103.2	103.8	127.6	95.9	103.0	101.6	97.7	100.3	104.7	102.6	113.0
Intermediate goods	78.4	109.2	102.2	91.2	99.0	96.8	105.3	109.5	111.2	110.6	108.0	106.5	110.3
Consumer goods	86.8	102.1	95.4	103.2	100.7	100.7	104.0	105.6	107.4	103.9	107.0	105.6	105.8

Source: SORS

Construction activity

Construction activity in Q1 recorded a drop of about 5%, which we estimate as temporary

As we showed in the previous sections of this chapter, the main reason for the slowdown of investments in Q1 was the unfavourable movement of construction activity. According to the data from national accounts statisticsin Q1 construction activity fell by about 5%, which is confirmed by y-o-y decrease in construction works performed in the country of 7%, measured in constant prices. However, the movement of construction activity in Q1, and also this undeniable fall from Q1 2017, should be taken with a certain reserve. This is because the construction activity in winter is always lower by about 50% compared to other seasons. This means that the Q1 result does not have to significantly affect the annual growth of this activity, as it can be easily annulled in the coming quarters. Also, the y-o-y comparison of construction activity in Q1 is under great influence of varying meteorological conditions in different years. Therefore, the y-o-y trend of construction activity in Q1 largely reflects the difference between the number of favourable construction days and not the essential trends of this activity. Since the winter of 2017 was somewhat colder than the winter of 2016, this is the most probable reason for the y-o-y decline in construction in Q1 of about 5%.

Cement production recorded a growth of over 10%

In order to assess the real trends of construction activity more reliably, we have analysed additional indicators that do not depend so much on the meteorological conditions. First of all, this is a cement production index, because cement is used in virtually all construction works and is relatively good indicator of movement of the entire sector (including small private companies that the official statistics cannot monitorreliably). Table T2-8 shows that the production of cement in Q1 had a y-o-y growth of more than 10%, indicating that the real trends of construction activity are likely to be positive in spite of the temporarily less performed construction works in the first three months of 2017. The last indicator we observed was the movement of the number of employees on the basis of data from the Central Register of Compulsory Insurance (CROCI), which are far more reliable than the Labour Force Survey (ARS) data. According to this data, the number of employees in construction increased in Q1 compared to the same period of the previous year by about 1%. If the permanent trend in construction activity is its reduction that would cause decrease rather than increase in the number of employees in this activity.

Table T2-8. Serbia: Cement Production, 2001-2017

	Y-o-y indices				
	Q1	Q2	Q3	Q4	Total
2001	89.5	103.5	126.9	148.1	114.2
2002	83.6	107.9	115.6	81.6	99.1
2003	51.1	94.4	92.7	94.4	86.6
2004	118.8	107.4	98.5	120.1	108.0
2005	66.1	105.0	105.8	107.4	101.6
2006	136.0	102.7	112.2	120.2	112.7
2007	193.8	108.9	93.1	85.0	104.4
2008	100.1	103.7	108.1	110.1	105.9
2009	34.1	81.4	86.0	75.3	74.4
2010	160.7	96.9	96.0	97.4	101.1
2011	97.7	101.3	96.2	97.7	98.3
2012	107.9	88.3	58.2	84.9	79.6
2013	83.5	78.7	127.6	93.5	94.9
2014	136.2	90.3	96.2	104.7	101.5
2015	77.9	112.4	104.5	108.7	103.1
2016	120.2	109.8	109.9	100.4	108.9
2017	110.4	-	-	-	-

Source: SORS

In 2017, construction will probably have a solid growth of between 5 and 10%

In 2017, we expect a growth in construction activity as in 2016 when it was 6.4%. We consider that there is no reason for a significant change in the trend of construction activity in 2017 compared to the previous year. It is true that public investment slowed down slightly at the beginning of the year, but this can still be compensated in the coming quarters. On the other hand, economic activity continues to recover (although at a slower pace than it would be desirable), interest rates are still at historically low levels, affecting the growth of credit activity in Serbia, the number of issued construction permits is growing, and the latest figures point to the gradual revival of the realestate market.

3. Labour Market

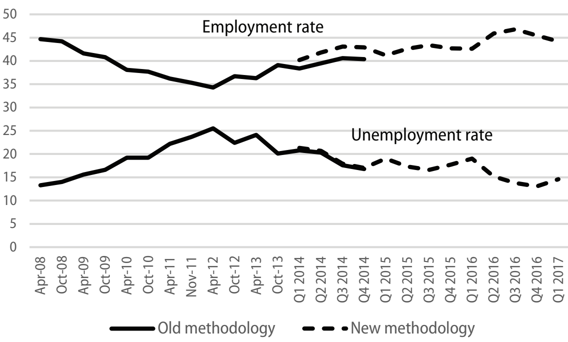
In the first quarter of 2017, earlier trends on the labour market continued. According to the LFS data, the activity rate was 51.8%, which is 0.8 pp lower than in the same quarter of the previous year, while the employment rates was 44.2%, up by 1.6 pp compared to Q1 2016. The unemployment rate dropped compared to the same quarter of the previous year, by as much as 4.4 pp and was 14.6% in Q1 2017. The decline in the rate of unemployment was the result of a reduction in the number of unemployed people by 149 thousand, but also of the decline in the number of active workers by 68 thousand. Negative demographic trends and high emigration had a negative impact on all labour market indicators. According to LFS data, the growth of formal employment was 4.9% year-on-year, while according to CRCSI data it was 2%. The rate of informal employment reached the lowest value in the last three years and is 19%. Nominal net wages increased by 4.2%, while real net wages increased by 1.1% year-on-year. Compared to the same period of the previous year, the real net wages increased the most in agriculture (5.7%), while a significant growth was also realised in information and communication sector and real estate. Public administration, education and healthcare recorded a lower year-on-year growth in real net wages. Cost of labour (in euros) increased by 3.4% year-on-year. Compared to Q1 2016, productivity has reduced and unit cost of labour has increased by -0.9% and 2.1%, respectively.

Employment and Unemployment

The unemployment rate recorded a significant decline compared to the same quarter of the previous year, while the employment rate recorded a moderate growth…

149,000 unemployed persons less than in Q1 2016.

Graph T3-1. Trends in Employment and Unemployment Rates (15+), 2008-Q1 2017.



Note: Due to a change in methodology, the date for the period before and after 2014 are not completely comparable.
Source: SORS, LFS

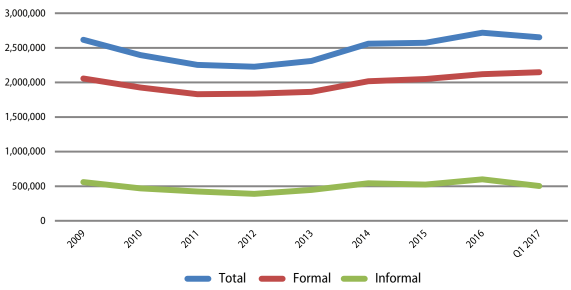
According to LFS, the trend of the basic labour market indicators continued in Q1 2017. The activity rate slightly decreased compared to Q1 2016 by 0.8 pp in the first quarter of 2017 and was 51.8%. Employment rate was 44.2%, which is a 1.6 pp increase compared to the same quarter of the previous year (Graph 3.1).

The unemployment rate was 14.6% and was lower compared to the same quarter of the previous year by 4.4 pp. There were 453,000 unemployed people in Q1 2017, which is by 149,000 less than in the same quarter of the previous year. In the same period, the number of active persons decreased by 68,000. The trend of strong inconsistancy between the LFS data on labour market trends and trends in other macroeconomic and fiscal aggregates continued. For example, total employment in Q1 according to LFS was by 3.2% higher than in the same quarter of the previous year, while GDP in the same period increased by 1%. Lack of inconsistancy in the trend of employment and economic activity, which has been present since 2012, has resulted in a significant drop in productivity and growth of unit labour cost. However, the growth of real wages on the liberalised private labour market is quite convincingly denying the data on productivity decline, while the strong growth of exports over the last few years contradict the growth of unit labour costs. In general, while other countries in the region in the post-crisis period had a growth of economy without a growth in employment, in Serbia, the statistical data indicates a different tendency – strong growth of employment with a modest growth of GDP.

Formal employment is increasing significantly, while informal employment is declining…

According to LFS, total number of employees in Q1 2017 was 2,652 million, which is a year-on -year growth of 3.2%. Formal employment is growing, while informal employment is declining, 4.9% and -3.4% y-o-y, respectively. The rate of informal employment dropped to 19%. The decline of informal employment is primarily the result of seasonal decline in the volume of work

Graph T3-2. Trends in Total Formal and Informal Employment According to LFS, 2009-Q1 2017.



Note: Due to a change in methodology, the data for the period before and after 2014 are not fully comparable.
Source: SORS, LFS

in agriculture, where the share of informally employed is the highest. The trend of total formal and informal employment is shown on Graph 3.2.

The data on the trends in formal employment for Q1 differ significantly between CRCSI (Central Registry of Compulsory Social Insurance) and LFS. According to LFS, formal employment increased by as much as 4.9%, while according to CRCSI that growth of 2%, year-on-year. It is expected that the difference between the data collected according to two methodologies be accidental, which means that sometimes one methodology would show a bigger growth and sometimes the other one would. However, based on data shown in Table 3.1., it would seem that difference is systematic – in all quarters of the previous year and in the first quarter of this year, the growth of employment according to LFS has consistently been quite higher than the growth according to CRCSI.

Table T3-3. Year-on-Year Change in the Number of Employees and Real GVA by Sectors, 2016 and Q1 2017 in %

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Total employment CRCSI	-0.3	1.2	1.3	2.1	2.0
Formal employment LFS	1.9	2.7	3.8	5.2	4.9
Total employment LFS	2.7	6.7	7.2	5.8	3.2
Total GVA	4.4	2.2	3.3	2.7	1.0
Employment- agriculture	-3.7	6.0	6.1	-3.4	-8.0
GVA-agriculture	7.7	4.6	11.8	8.1	-2.2
Employment-industry	4.2	7.8	7.9	7.6	9.3
GVA-industry	6.9	0.3	2.7	2.3	1.3
Employment-construction	-2.9	4.0	-2.1	-1.8	-12.6
GVA-construction	12.9	7.8	8.6	-0.6	-5.1
Employment-services	4.7	6.8	8.2	9.1	5.7
GVA-services	2.6	2.1	1.7	2.4	1.6

Note: Source for employment was LFS, except for total employment, which is stated according to both LFS and CRCSI.
Source: SORS, LFS, CRCSI and SNA.

According to LFS, the growth rate of the total number of employees and the number of employees in the industry and services sectors are higher than the real growth rate of GVA…

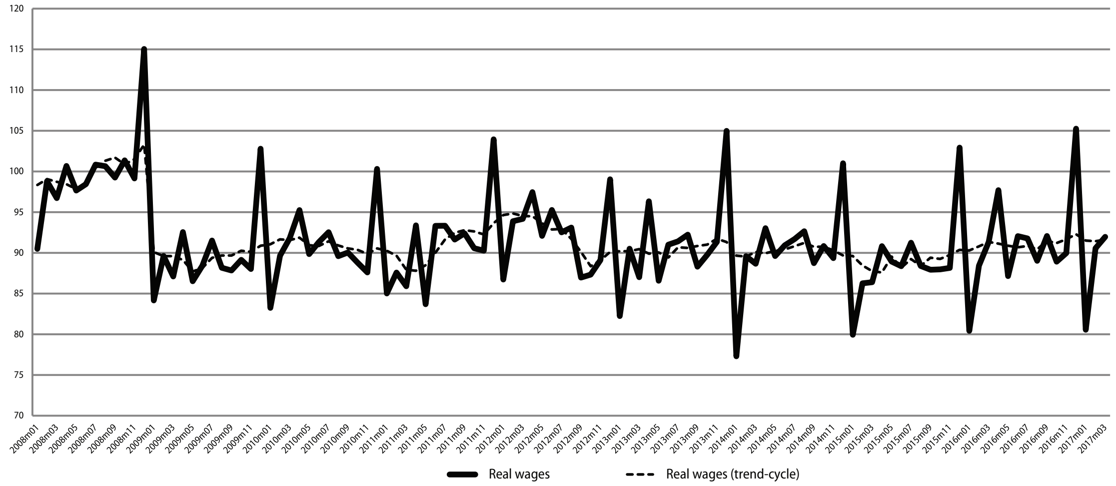
Table T3-3. Year-on-Year Change in the Number of Employees and Real GVA by Sectors, 2016 and Q1 2017 in %shows a relative change in the number of employees in real GVA in 2016 and Q1 2017 compared to the same quarter of the previous year. If we exclude the first quarter of 2016, the growth rates of total employees in the observed period are higher than the growth of real GVA, which implies a decline in productivity. Similar trends were recorded in the sector of industry and services. In Q1 2016, the industry sector had 510,000 employees, while in the same quarter of 2017, that number was 557,000, i.e. 47,000 higher, which is a 9.3% growth. At the same time, the industry GVA increased by 1.3%, which is by as much as 8 pp less compared to the growth rate of the number of employees in the same period. On the other hand, the CRCSI data show a significantly lower growth in the industry of 4.5%, but also higher compared to the real growth rate of GVA in the industry.

Wages

Average net wages were nominally higher by 4.2% and by 1.1% in real terms compared to Q1 2016.

In Q1 2017, average nominal net wages were 45,437 RSD or 367 EUR. Compared to the first quarter of 2016, average net wages increased both nominally and in real terms by 4.2% and 1.1%, respectively. Graph 3.3 shows trends in the base index of real average net wages since 2008. General trends in real wages over the last few years indicate stagnation with relatively strong seasonal fluctuation, which is approximately in line with the trends of economic activity.

Graph T3-4. Indices of Real Average Net Wages (2008=100)

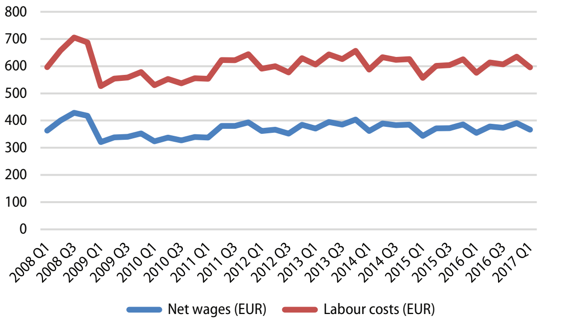


Source: Author's calculation with SORS data

Average net wages and cost of labour in euros increased by 3.4% year-on-year.

Trends of wages and cost of labour in euro are important when establishing the international competitiveness of Serbia's economy. Net wages in EUR and cost of labour increased by 3.4% year-on-year, which is somewhat faster than the growth of economic activity. Faster growth of wages in euro than the growth of production and productivity[1] is moderate for now and is not jeopardising Serbia's competitive position. However, if this trend were to continue in the coming period, it would deteriorate the price competitiveness of Serbia's economy, which would further cause a deterioration in the foreign trade balance.

Graph T3-5. Trends of Average Net Wages and Cost of Labour in EUR, 2008-Q1 2017.



Source: Author's calculation with NBS data.

Agriculture, information and communication, and real estate sector realised a significant year-on-year growth of seasonally adjusted real net wages…

The highest year-on-year growth of seasonally adjusted real net wages was recorded in the sector of agriculture – as much as 5.7%. Information and communication recorded a growth of 3.5%, while the real estate sector had a 3.1% growth. Graph 3.5 shows year-on-year growth rates of seasonally adjusted real net wages for certain sectors.

Public administration, education and healthcare recorded a small growth of wages.

Graph T3-6. Year-on-Year Trend of Seasonally Adjusted Real Net Wages, 2016-Q1 2017.

Source: Author's calculation with SORS data

Notes: A – Agriculture, forestry and fishery; C – Processing industry; F – Construction; G – Wholesale and retail; motor vehicle and motorcycle maintenance; O – Public administration and defence; compulsory social insurance; P – Education; Q – Healthcare and social protection

We can see that the processing industry recorded a significantly lower growth in Q1 2017 compared to the growth rates during 2016. We can also see that construction, after three consecutive quarters of declining wages, recorded a growth in Q4 2016 and Q1 2017. Activities that are predominantly in the state sector, recorded a modest growth of wages: administration had 0.3%, while education and healthcare had a year-on-year growth of 1.3%. Even though administration and auxiliary services had a growth of seasonally adjusted real net wages in Q1 2017 compared to the 2016 average of as

1 Based on data on registered employment, the productivity in Q1 compared to the same period of the previous year dropped by 0.9%. However, it is our estimate that this decline is temporary and a result of decelerated GDP in the first quarter. Based on LFS data on total employment, according to which we have a reserve, the productivity in the first quarter dropped by as much as 2%.

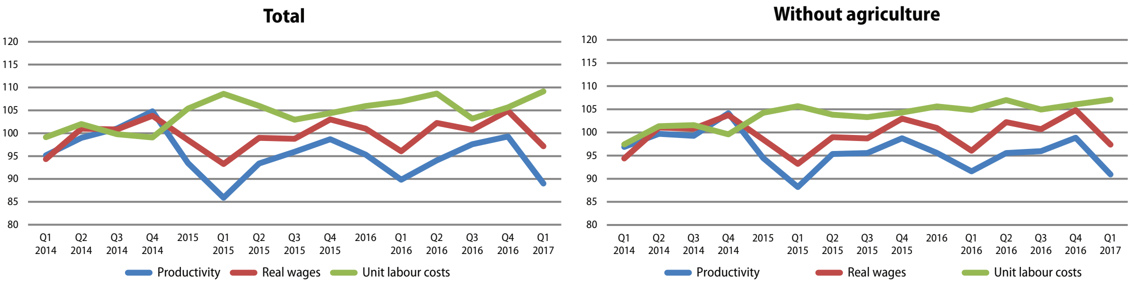
much as 4.3%, the year-on-year growth was 0%. The 2016 average was considerably affected by the growth in the first quarter of 2016 compared to the same period of the previous year by almost 14%, even though the rest of the quarters of 2016 recorded a decline or a modest year-on-year growth.

Labour Productivity

Trends in registered employment, real GVA and real net wages indicate a decline in labour productivity and an increase in the unit labour cost

In the first quarter of 2017, the trend in labour productivity and unit labour cost was the same as in the previous period (Graph 3.6). According to CRCSI data, the number of employees in Q1 2017 increased by 2% compared to the same quarter of the previous year. In the same period, real GVA increased by 1.1%, which caused a drop in labour productivity of 0.9%. The decline of productivity is somewhat lower when we exclude agriculture, -0.7%. Real net wages increased by 1.4%, so the increase in unit labour cost was 2.1% in non-agriculture sectors. According to LFS, the data on total employment indicated an even bigger decline of productivity and growth of unit labour costs, -2% and 5.7%, respectively, in Q1 2017 compared to the same quarter of the previous year. It is our estimated that the implied productivity drop and growth of unit labour costs according to LFS data is fictitious and rather a result of a mistake in labour statistics.

Graph T3-7. Labour Productivity and Unit Labour Costs, indices (2014=100), 2014-Q1 2017.



Source: Author's calculation using SORS data.
Note: CRCSI data was used for the number of the employed.

Annex 1 Main Labour Market Indicators according to LFS and CRCSI, 2014-Q1 2017.

	2014				2015					2016					2017
	Q1	Q2	Q3	Q4	prosek	Q1	Q2	Q3	Q4	prosek	Q1	Q2	Q3	Q4	Q1
Activity rate (%)	51.0	52.6	52.5	51.6	51.6	50.8	51.5	52.0	51.9	53.3	52.6	54.1	54.3	52.3	51.8
Employment rate (%)	40.2	41.8	43.1	42.9	42.5	41.2	42.6	43.4	42.7	45.2	42.6	45.9	46.8	45.5	44.2
Unemployment rate (%)	21.3	20.7	17.9	17.0	17.7	19.0	17.3	16.6	17.7	15.3	19.0	15.2	13.8	13.0	14.6
Informal employment rate (%)	19.7	20.4	22.8	21.8	20.4	19.7	19.7	21.5	20.4	22.5	20.3	22.7	24.1	20.9	19.0
Employment in 000, (LFS)	2,454	2,548	2,627	2,609	2,574	2,504	2,588	2,624	2,581	2,719	2,571	2,762	2,814	2,731	2,652
Employment, index, (2014=100), (LFS)	95.9	99.6	102.6	101.9	100.6	97.8	101.1	102.5	100.8	106.3	100.4	107.9	109.9	106.7	103.6
Formal employment in 000, (LFS)	1,969	2,030	2,028	2,041	2,050	2,011	2,078	2,059	2,054	2,137	2,049	2,135	2,137	2,161	2,148
Formal employment, index, (2014=100), (LFS)	97.6	100.6	100.5	101.2	101.7	99.7	103.0	102.1	101.8	105.9	101.6	105.9	105.9	107.1	106.5
Total employment in 000, (CRCSI)	1,836	1,845	1,850	1,851	1,989	1,983	1,985	1,998	1,989	2,008	1,978	2,008	2,023	2,032	2,018
Total employment, index, (2014=100), (CRCSI)	99.5	100.0	100.3	100.3	107.8	107.5	107.5	108.2	107.7	108.8	107.2	108.8	109.6	110.1	109.3

Note: Registered employment in 2017 does not include March data, as it is unavailable.
Source: SORS

Annex 2 Real net Wages and Labour Productivity, 2014-Q1 2017.

	2014				2015					2016					2017
	Q1	Q2	Q3	Q4	prosek	Q1	Q2	Q3	Q4	prosek	Q1	Q2	Q3	Q4	Q1
Average real net wages, index, (2014=100)	94.3	101.0	100.8	103.8	98.5	93.3	99.0	98.8	103.0	101.0	96.1	102.2	100.7	104.9	97.2
Average net wages, total, (€)	361	389	383	386	368	343	371	372	386	374	355	378	373	391	367
Average net wages, industry, (€)	359	382	378	378	374	351	376	379	389	385	369	391	382	399	376
Average gorss wages, total, (€)	498	537	529	531	506	473	510	512	531	515	489	520	515	538	505
Average gorss wages, industry, (€)	494	528	523	521	515	483	518	523	536	532	508	539	528	551	519
Productivity, without agriculture, index, (2014=100)	96.9	99.7	99.3	104.2	94.5	88.2	95.3	95.6	98.7	95.6	91.6	95.5	96.0	98.7	90.9
Productivity, total, index, (2014=100)	95.2	99.0	101.0	104.8	93.5	85.9	93.4	95.9	98.7	95.3	89.8	94.1	97.6	99.2	89.0

Note: Industry includes B,C and D activities, weighted average of wages. The dinar exchange rate against the euro, period average (NBS). Labour productivity was calculated based on the registered employment data.
Source: SORS and NBS

4. Balance of Payments and Foreign Trade

Current account deficit in Q1 2017 was 746 million euros, i.e. 8.6% of GDP, which is above last year's level. This is primarily because of the increase in trade deficit brought about by the accelerated growth of imports and decelerated growth of exports. In Q1 2017, exports were by 9.8% and imports by 15.4% above the level of Q1 2016, while according to the seasonally adjusted values, exports and imports increased by 2.4% and 8.0%, respectively. April data show a decelerated growth of foreign trade trends, and about the same growth of exports as imports. Such results in foreign trade at the beginning of 2017 are mostly due to deteriorating trade ratio, i.e. rise in energy prices, while decelerated growth of exports is explained by temporary factors. If there were no rise in global energy prices, the growth of imports would have been by around one third lower, and the share of trade and current account deficits in GDP would have been by 2.3 pp below the realised level in Q1. We talked about this scenario in previous issues of *QM*, the one where trade ratio is deteriorating, which is disturbing the favourable trends in current Balance of Payments. The level of foreign trade and current account deficits in 2017 will primarily be determined by trade ratios, i.e. further trends in global prices – primarily of energy, by the dynamic of the recovery of the local demand, as well as by the growth of economic activity in the Eurozone countries. Therefore, in 2017 we expect the trend of decreasing current account deficit to be halted in 2017 and be around 4-4.5% of GDP. During Q1, a net inflow of 49 million euros in capital was recorded, so the forex reserves in this period decreased by 455 million euros. Low net inflow of capital in Q1 was due to the outflow of Portfolio and Other Investments, while FDI were slightly higher than the average quarterly values of 2015 and 2016. In 2017, we expect that FDI will be at the last year's level or slightly above it, i.e. sufficient for covering the current account deficit. Therefore, we estimate a solid inflow of foreign capital for 2017, bearing in mind that foreign investors will see the positive results of fiscal consolidation and macroeconomic stability, as well as decreased risk premium and increased country credit rating.

Current account deficit in Q1 2017 was 746 million euros, i.e. 8.6% of GDP and was above the level of Q1 2016

Data point to a moderate deterioration in the Balance of Payments in the first four months of 2017. Certain circumstances and expectations in the country and the international surroundings suggest that the trend of decreasing current account deficit will stop in 2017, and that it will amount to 4% and 4.5% of GDP this year. As trade balance deteriorated at the begging of 2017, it would be good if the national economic policy (primarily fiscal and forex policies) were designed so they do not contribute additionally to the worsening of foreign trade trends – decrease of exports and increase of imports.

Current account deficit in Q1 2017 was 746 million euros (Table T4-1), and was higher than the realised value of Q1 of the previous year. Share of current account deficit in GDP in the first three months of 2017 was 8.6% of GDP, which is by 3.8 pp of GDP above the level of the same period in 2016. This rise of current account deficit is mostly the result of the growth of trade deficit. The share of Primary Income deficit in GDP has increased (by 1.4 pp), while the lower share of net inflow on the Secondary Income Account in GDP (by 0.2 pp of GDP) was completely offset by the growth of net exports on the Services Account.

Trade deficit recorded a significant increase compared to the same period last year

In Q1 2017, exported goods amounted to 3,245 million euros, while the value of imports in this period was 4,271 million euros[1], so the trade deficit in Q1 was 1,026 million euros. Trade deficit, observed in relative terms, made 11.8% of GDP and was by 2.5 percentage points of GDP higher than the realised share in Q1 2016. This growth of trade deficit compared to GDP was exclusively the result of growth of imports, which increased by 2.4 pp of GDP, i.e. 49.0%, while the share of exports in GDP almost remained unchanged (increased by 0.1 pp) and was 37.3%.

1 NBS data for import and export of goods, as well as trade balance, differ from the SORS data (which we use in the sections on Exports and Imports), because they do not include finished goods (see Box 1 on the change of methodology in calculating the Balance of Payments in QM37). That is why there is a certain difference in levels of exports and imports, as well as growth rates, depending on the source of data.

Table T4-1 Serbia: Balance of Payments

	2014	2015	2016	2015				2016				2017
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
				mil. euros								
CURRENT ACCOUNT	-1,985	-1,577	-1,370	-511	-279	-343	-445	-378	-309	-293	-390	-746
Goods	-4,111	-3,993	-3,476	-1,046	-872	-895	-1,180	-745	-935	-808	-988	-1,026
Credit	10,641	11,357	12,732	2,601	2,997	2,882	2,877	2,956	3,294	3,131	3,351	3,245
Debit	14,752	15,350	16,209	3,648	3,869	3,777	4,057	3,701	4,230	3,939	4,339	4,271
Services	465	725	895	136	114	215	260	182	188	273	253	219
Credit	3,810	4,273	4,581	927	1,004	1,167	1,175	992	1,068	1,267	1,254	1,106
Debit	3,344	3,548	3,686	791	890	952	915	810	880	994	1,001	887
Primary income	-1,343	-1,658	-1,950	-296	-468	-491	-402	-486	-456	-550	-458	-652
Credit	642	682	630	144	203	165	170	142	185	140	164	101
Debit	1,985	2,340	2,581	441	671	656	572	628	641	690	623	753
Secondary income	3,003	3,349	3,161	695	948	828	877	670	895	793	804	713
Credit	3,400	3,795	3,637	789	1,060	946	1,000	772	1,010	922	933	849
Debit	397	446	476	93	112	117	123	102	115	130	129	135
Personal transfers, net [1]	2,442	2,671	2,510	568	758	665	680	521	735	624	630	564
Of which: Workers' remittances	1,863	2,077	1,874	437	605	523	512	379	577	458	460	414
CAPITAL ACCOUNT - NET	7	-18	-10	4	-1	1	-22	5	-4	-1	-9	1
FINANCIAL ACCOUNT	-1,705	-1,205	-790	-427	-139	-243	-396	-184	-197	-127	-282	-503
Direct investment - net	-1,236	-1,804	-1,861	-339	-441	-510	-514	-480	-404	-492	-485	-501
Portfolio investment	-369	289	916	-474	341	105	317	363	331	-10	232	219
Financial derivatives	-6	2	9	2	4	-7	3	0	1	5	3	-5
Other investment	1,703	141	448	273	-11	-131	10	770	190	38	-550	238
Other equity	0	0	0	0	0	0	0	0	0	0	0	0
Currency and deposits	830	-218	220	69	79	-133	-233	318	20	-19	-99	-79
Loans	757	230	326	221	-39	-48	97	320	273	-4	-263	332
Central banks	574	153	23	57	55	26	15	12	7	4	0	4
Deposit-taking corporations,	795	434	279	100	103	10	222	100	197	80	-97	271
General government	-728	-464	-299	63	-220	-86	-221	30	11	5	-345	38
Other sectors	115	107	322	0	23	2	82	179	57	-93	179	19
Insurance, pension, and standardized	0	0	0	0	0	0	0	0	0	0	0	0
Trade credit and advances	116	129	-98	-17	-51	50	146	131	-102	61	-188	-16
Other accounts receivable/payable	0	0	0	0	0	0	0	0	0	0	0	0
SDR (Net incurrence of liabilities)	0	0	0	0	0	0	0	0	0	0	0	0
Reserve assets	-1,797	166	-302	111	-32	300	-213	-836	-317	332	519	-455
ERRORS AND OMISSIONS, net	273	390	590	80	141	99	70	189	116	167	118	242
PRO MEMORIA				in % of GDP								
Current account	-5.9	-4.7	-4.0	-6.7	-3.2	-3.9	-5.2	-4.8	-3.6	-3.3	-4.5	-8.6
Balance of goods	-12.3	-11.9	-10.2	-13.7	-10.1	-10.3	-13.7	-9.4	-10.8	-9.2	-11.3	-11.8
Exports of goods	31.8	33.8	37.3	34.2	34.7	33.2	33.3	37.2	38.1	35.6	38.3	37.3
Imports of goods	44.1	45.7	47.5	47.9	44.8	43.5	47.0	46.6	48.9	44.8	49.6	49.0
Balance of goods and services	-10.9	-9.7	-7.6	-11.9	-8.8	-7.8	-10.7	-7.1	-8.6	-6.1	-8.4	-9.3
Personal transfers, net	7.3	8.0	7.4	7.5	8.8	7.7	7.9	6.5	8.5	7.1	7.2	6.5
GDP in euros [2]	33,420	33,564	34,131	7,617	8,632	8,689	8,627	7,948	8,644	8,795	8,744	8,708

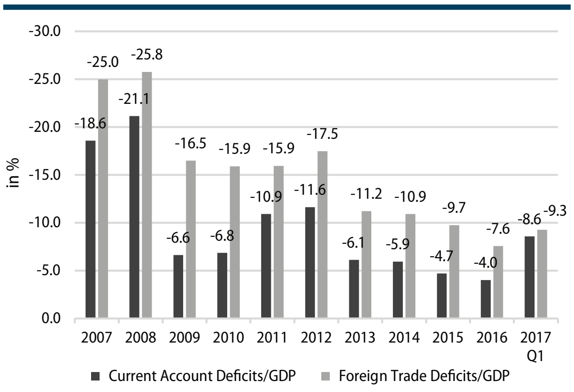
Note: Balance of Payments of the Republic of Serbia is aligned with the international guidelines of the IMF's Balance of Payments Manual no. 6 (BPM6).
Source: NBS
1) Personal transfers are current transfers between resident and non-resident households.
2) Quarterly values. Conversion of the annual GDP to euro was done according to the average annual exchange rate (average of official daily middle exchange rates of NBS).

Foreign trade deficit also recorded a year-on-year growth and was 807.0 million euros in Q1 2017. This deficit makes 9.3% of GDP and was by 2.2 pp higher compared to the recorded level of Q1 2016 (Graph T4-2 and Table T4-1).

A positive impact on the growth of exports in 2017 will be made due to the forecasted recovery of the Eurozone countries...

… imports will grow faster due to the expected recovery of local demand, as well as deteriorating trade ratio

Graph T4-2 Serbia: Current Account and Foreign Trade Deficits, 2007-2017



Source: NBS, *QM*

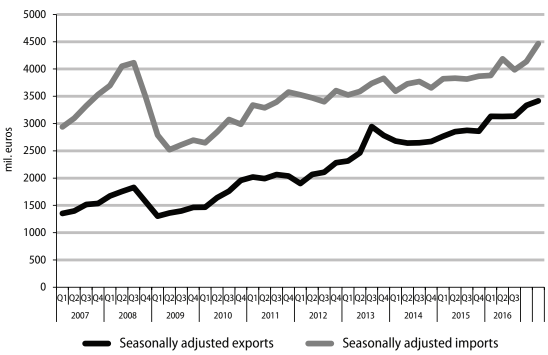
At the beginning of 2017, imports recorded a fast year-on-year growth of 15.4%, while the year-on-year growth of exports of 9.8% is quite solid, causing the trade deficit to increase in the observed period. Seasonally adjusted trade data confirm the faster growth of imports than exports. According to the seasonally adjusted values, exports were by 2.4% and imports by 8.0% higher in Q1 2107 than in Q4 2016 (Graph T4-3). Still, April SORS data indicate that both imports and exports are decelerating their growth, and that the growth rate of exports is slightly below the growth rate of imports of goods (5.1% and 5.3%, respectively). The slowdown of foreign trade flow in April is most likely a result of a lesser number of working days due to the Easter holidays.

Coverage of imports by exports was 76% and was below the last year's values of 79%. This is mostly due to a considerable decline in trade ratio, which we pointed out several times in the previous issues of QM[2], primarily because of the trends in the price of oil on the global market. Still, it should be emphasised that this kind of trend in trade ratio is highly variable and that oil prices have fallen considerably already in the second quarter. The trade ratio index (the quotient of export and import prices) reached high values from the second half of 2015 to the first half of 2016, i.e. in the period of low global price of oil. After that, this index started to gradually decline, primarily due to a certain rise in the price of oil derivatives. In Q1 2017, this index was 93.4, which indicates that the quotient of export and import prices was significantly below the level of the beginning of 2016 (see Graph T4-4). As the global prices of energy in euros increased by 61% in this period, if we exclude the effects of growth of these prices, the import of goods would be by 10% above the level of Q1 2016, i.e. the growth of imports would be lower by one third. That means that the trade deficit would be 9.5% of GDP instead of the current 11.8% of GDP. Therefore, deteriorating trade ratio because of the rising global price of energy affected the trade deficit and made it by 2.3 pp higher than if this decline had not happened, i.e. current account deficit in Q1 would have been 6.3% of GDP instead of the current 8.6% of GDP[3].

We can expect a somewhat higher level of current account deficit in 2017 than in the previous year

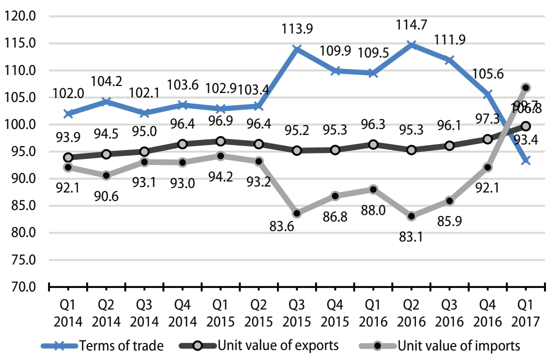
Current internal and external circumstances will probably result in lack of further decrease of current deficit. The higher energy price on the global market than last year's, unfavourable weather conditions, and their potential implications on export results, as well as the expected growth of local demand, are key factors that would lead to an increase in deficit on the Foreign Trade and Current Accounts in 2017. On the other hand, falling energy products prices in the second quarter and persistently high prices of metal, as well as demand growth in the countries of Eurozone will impact deficit reduction. After weak results in the first quarter, it is important not to create additional inputs that would worsen the negative trends in the current account by using the policy of excessive dinar strengthening or extreme strengthening of domestic demand.

Graph T4-3 Serbia: Seasonally Adjusted Exports and Imports, Quarterly, 2007-2017



Source: NBS, SORS, *QM*

Graph T4-4 Year-on-Year Trade Ratio Indices, 2014-2017



Source: SORS, *QM*

Inflow on the Secondary Income account was 8.2% of GDP

Net inflow on the Secondary Income account was 713 million euros in Q1 2017, or 8.2% of GDP. Out of that amount, 564 million euro or 6.5% of GDP was from Personal Transfers. Even though the inflow on the Secondary Income account and Personal Transfers has somewhat increased in absolute terms, when expressed in GDP, it is by 0.2 and 0.1 lower compared to Q1 2016, respectively.

In Q1, there was a low capital inflow…

Q1 recorded a lower net inflow of capital of 49 million euros4, which caused forex reserves at the end of Q1 to be lower by 455 million euros compared to the level recorded three months earlier (Table T4-1). On the one hand, there was some deleveraging of Portfolio and Other Investments – 219 and 238 million euros, respectively. In other investments, a net deleveraging of 332 million euros was recorded in loans, where the highest deleveraging was recorded in banks (271

2 See QM44-QM47, *Balance of Payments and Foreign Trade*
3 Also, if we take into account the out of the ordinary increase of imports due to growth of electricity imports by 42 million euros, we get that the growth of imports would be 9% year-on-year. See the chapter on Imports further down.
4 Inflow of 291 million euros, including the *Errors and Omissions* account.

…it is due to Portfolio and Other Investments, from one side, as well as inflow of FDI, from another side

million euro) and in the state (38 million euros), while in other sectors it was lower (19 million euros net, see Table T4-1). On the other hand, there was an increase on the Cash and Deposit account of 79 million euros, and 16 million euros on Commercial Loans and Advances. Inflow of FDI was 501 million euros (5.8% of GDP), which is slightly above the usual quarterly inflows of 2015 and 2016 (on average around 5.4% of GDP). Therefore, we expect inflow of FDI in 2017 to be solid and sufficient for covering current account deficit. We expect a solid inflow of capital, having in mind that investors will see the positive results realised in fiscal consolidation and macroeconomic stability, as well as the reduction in the risk premium and increased credit rating of Serbia by certain rating agencies. The precondition is that the Government perseveres in its fiscal consolidation policy and launches structural reforms which have been delayed for a long time.

A reduction in NBS forex reserves has been recorded

Net reduction in the level of forex reserves in Q1 2017 was 455 million euros. The biggest reduction in forex reserves was recorded in January (315 million euros), followed by a smaller decline (160 million euros) in February. A modest growth in the level of forex reserves of 21 million euro was recorded in March. The majority of the forex outflow since the beginning of the year has been the result of seasonal factors, i.e. outflow in January was linked with an increase of forex reserves in December. In April, there was a more considerable reduction of forex reserves by 263 million euros, as a consequence of a significant deleveraging of the state in the amount of 333 million euros of loans, i.e. regular servicing of commitments to foreign creditors[5]. Therefore, NBS forex reserves at the end of April were 9.41 billion euros, covering 200% of the M1 money supply and a six-month value of import of goods and services. During Q1, NBS intervened on the Interbank Foreign Exchange Market with the aim of mitigating excessive short-term fluctuations of the exchange rate by selling 345 million euros, and in April by buying 40 million euros[6].

Exports

A considerable growth of exports was recorded during Q1 2017…

In the first three months, the exports were 3,504 million euros, which is by 13.4% higher than the value of exports in Q1 of the previous year (Table T4-5). Thus, exports decelerated their growth slightly compared to the previous quarter (year-on-year growth rate of exports in Q1 2017 was 15.7%), but it is still estimated as positive. The primary reason behind this deceleration are unfavourable weather conditions[7].

During Q1, most of the export components realised a solid growth…

… with the exception of Energy, growth of which has considerably declined.

Although the energy prices in Q1 were above last year's, the export value of energy products declined by 15.2%. The decline of these products continued in April and was 36.2% compared to the value of export in the same month of 2016. Still, as energy exports make only 2.4% of total exports, trends in the value of exports of energy products do not significantly affect the dynamic of total exports.

Export results in April were somewhat weaker

Table T4-5 Serbia: Export, Year-on-Year Growth Rates, 2014-2017

	Exports share in 2016	2014	2015	2016	2017		2016		2017	
					Q1	April	Q3	Q4	Q1	April
	in %	in mil. euros					in %			
Total	100.0	11,159	12,041	13,430	3,504	1,242	9.8	15.7	13.4	6.7
Total excluding road vehicles	89.8	9,621	10,630	12,055	3,143	1,112	10.7	18.7	16.7	8.9
Energy	2.4	414	342	328	67	20	-17.5	15.9	-15.2	-36.2
Intermediate products	34.8	3,687	4,084	4,668	1,297	484	11.9	19.5	23.3	19.0
Capital products	25.0	2,877	3,064	3,352	872	307	11.6	7.3	4.3	-0.6
Capital products excluding road vehicles	14.7	1,340	1,653	1,977	511	178	18.7	19.2	16.5	6.5
Durable consumer goods	5.5	586	664	739	186	66	6.6	11.6	19.1	7.1
Non-durable consumer goods	23.8	2,614	2,848	3,198	774	256	9.6	12.1	7.4	-3.5
Other	8.5	981	1,040	1,144	307	109	9.8	41.5	24.4	20.6

Source: SORS

5 https://www.nbs.rs/internet/cirilica/scripts/showContent.html?id=11388&konverzija=no
6 NBS.
7 Due to the frozen Danube in January and beginning of February, there was a reduced export of steel and agricultural products (especially corn and wheat), see *Inflation Report*, May 2017.

The value of exports of road vehicles during Q1 was 9% below last year's

The value of exports of road vehicles was 9% below the last year's level (361 million euros in Q1 2017, compared to 397 million euros in Q1 2016). Year-on-year growth of total exports after excluding road vehicles was 16.7%. Still, even though the company "Fiat Automobiles Serbia" has not significantly contributed to the growth of exports since 2014, total automobile industry (a lot of small companies) is a branch that records the highest value of exports and is significantly contributing to the total export results of the national economy[8]. The declining trend of automobile exports could possibly decelerate in the coming period because of the start in production of a redesigned model of FIAT.

In addition to Energy exports, the export of all other goods recorded a growth in Q1 2017 (Table T4-5). What is especially important is the accelerated growth, as well as the high growth rate of export of Intermediate Goods (23.3% y-o-y), because the export value of these goods make more than a third of the value of total exports. In addition, the exported value of Durable Consumer Goods accelerated and is by almost one fifth higher than last year's. Export of other export components decelerated, although it still recorded quite high export growth rates of Capital Goods after Excluding Road Vehicles (16.5% y-o-y), Non-Durable Consumer Goods (7.4% y-o-y) and so-called Other Exports (24.4% y-o-y).

In addition to a more pronounced decline of Energy exports, a year-on-year decrease of exports was recorded in April in *Capital Goods* and *Non-Durable Consumer Goods,* as well as decelerated growth in other export components. Weaker export results in April are probably the result of a smaller number of working days, as the non-working days around Easter Holiday were all in April.

Important for the exports of 2017 will be the economic activity of the Eurozone countries

In the coming period, we can expect further growth of exports because of the growth of economic activity and imports of the Eurozone countries. The dynamic of the export growth in the coming period will also be determined by trends in the prices of primary goods on the global market, primarily cereals and basic metals, important export products of Serbia. The importance of the production of the new FIAT model on export, and especially net export results is still uncertain.

Import

Fast growth of imports recorded in Q1 …

…while their growth decelerated in April

Total imports in Q1 2017 were 4,587 million euros. This value of imports was considerably higher than last year's – a 15.4% increase, and it significantly accelerated the growth compared to the previous quarters (year-on-year growth rates in 2016: in Q1 2.6%, in Q2 8.7%, in Q3 5.0%, and in Q4 7.2%, see Table T4-6). This growth of import value is the result of a year-on-year growth of the value of all import components, except Capital Goods. The significant recovery of imports since the beginning of the year happened mostly because of the significantly higher level of energy prices compared to the level from the beginning of 2016. So, the value of energy imports was by 55.2% above the last year's. We expect the abovementioned trends – growth of energy prices, growth of local demand – will determine the dynamic of import recovery in the coming period, acting in the direction of accelerating its growth.

Still, imports decelerated their growth in April. The value of imports in this month increased by 5.9% year-on-year. This was primarily due to the significant deceleration of imports of *Durable and Non-Durable Consumer Goods.* In addition, the growth of Intermediate Goods and Energy decelerated. After a year-on-year growth of 22.7% in Q1 2017, the so-called Other Imports in April 2017 were by 1.3% below the value of April 2016. Similar to exports, the decelerated growth of imports in April was the result of a smaller number of working days in that month.

...due to a much higher price of energy

Growth of imports in Q1 was recorded in all components except in the import of *Capital Goods.* Import of energy products in Q1 was higher by 55.2% (in April by 38.8%) compared to the same period of the previous year, which was exclusively due to the increase of global energy prices. According to IMF data, the price of energy expressed in dollars in Q1 2017 was by as much as 56%

8 NBS, *Inflation Report,* May 2017.

above the price of Q1 2016, while expressed in euros, the rise in price was 61%. When we exclude the impact of price on the year-on-year growth of energy values, we get that the import of energy during the first three months of the current year was by 4% below the last year's imports.

According to SORS data, the import value of energy products in Q1 2017 was 526 million euros, which represents a year-on-year growth in energy imports of 55.2%. However, had there not been the out of the ordinary import of electricity in the amount of 42 million euros in Q1 2017, the growth of energy imports would have been 484 million euros, i.e. by 42.8% above the last year's level, while the total imports would have recorded a year-on-year growth at a rate of 14.4% instead of the current 15.4%. As the global energy prices in euro increased by 61% in this period, after we exclude the effects of the growth of these prices, the imports would have been by 10% above the level of Q1 2016. If we add to that the mentioned effects of out of the ordinary increase of electricity imports, we get that the year-on-year growth of imports in Q1 2017 would have been 9.0%. This means that the year-on-year growth of energy prices contributed to the recorded growth rate of total imports (15.4%) by around one third, i.e. by around 5.4 pp, while the unusual import of electricity contributed by 1 pp.

High year-on-year growth was also realised by the import of goods classified under Other[9] - which recorded a year-on-year growth of 22.7%, although it recorded a decelerated growth compared to the previous quarters, and even a year-on-year decline in value in April. On the other hand, a fast growth and a considerable acceleration of imports during Q1 was recorded in all other import groups, except Capital Goods: Non-Durable Consumer Goods (17.7%), Intermediate Goods (16.8%), and Durable Consumer Goods (after having negative growth rates in all quarters of 2016, in Q1 2017 they recorded a year-on-year growth of 14.9%, see Table T4-6). The exception was the import of Capital Goods, which was by 9.3% below the last year's level. Decline in the import of capital goods is one of a few unfavourable tendencies, which put into question the possibility of a fast growth of Serbian economy in the future. In April, the import of Durable and Non-Durable Consumer Goods decelerated considerably, as well as the growth of Intermediate Goods and Energy.

In the coming period, the level of import will be determined by the global price of energy and local demand

The factor that could also affect the acceleration of import growth in the coming period is the expected growth of local demand. Additionally, a faster growth of imports are expected because of the rise in global energy prices. As the growth of current spending reflects on the growth of imports quite quickly, if the local demand in 2017 would grow faster than the growth of GDP, with the anticipated effects of exogenous factors on the growth of imports this year, it would be good if the national economic policy (fiscal policy and foreign exchange policy) would be designed in a way that would not additionally contribute to the growth of local demand and deterioration of the foreign trade trends.

Table T4-6 Serbia: Imports, Year-on-Year Growth Rates, 2014-2017

	Imports share in 2016	2014	2015	2016	2017		2016		2017	
					Q1	April	Q3	Q4	Q1	April
	in %	in mil. euros					in %			
Total	100.0	15,490	16,388	17,390	4,587	1,526	5.0	7.2	15.4	5.9
Energy	8.8	2,180	1,873	1,533	526	139	-20.2	-3.6	55.2	38.8
Intermediate products	32.8	5,156	5,526	5,712	1,513	532	2.4	3.0	16.8	10.7
Capital products	22.2	3,757	4,024	3,864	821	330	-5.2	-4.9	-9.3	-0.8
Durable consumer goods	2.2	328	416	377	93	31	-6.7	-8.4	14.9	0.6
Non-durable consumer goods	14.4	2,360	2,512	2,511	648	214	0.5	-1.1	17.7	1.0
Other	19.5	1,709	2,037	3,393	987	281	65.4	61.4	22.7	-1.3
Imports excluding energy	91.2	13,311	14,514	15,857	4,061	1,387	8.2	8.5	11.7	3.5

Source: SORS

9 Classified in this group are mainly storaged goods.

Foreign Debt

Foreign debt at the end of 2016 was 26.6 billion euros

At the end of 2016, Serbia's foreign debt was 26,592 million euros, i.e. 78.2% of GDP (Table T4-7). During Q4 2016, the foreign debt increased by 918 million euros, and during the entire 2016 it increased by 358 million euros. The level of foreign debt expressed in euros for the most part increased because of the foreign exchange fluctuations – primarily the depreciation of euro against the dollar (around one quarter of the foreign debt is in dollars).

During Q4 2016, the foreign debt increased by 918 million euros or by 2.5 pp of GDP (from 75.7% of GDP to 78.2% of GDP), mostly due to currency fluctuations. Increase of net borrowing during Q4 2016 was predominantly the result of increased foreign debt of the public sector – by 757 million euros (i.e. by 2.1 pp of GDP). To a lesser extent, the growth of total foreign debt was also affected by the increase in the foreign debt of the private sector – by 161 million euros (0.4 pp of GDP). The growth of public debt in the private sector is exclusively due to the higher level of short-term debt compared to the level recorded during Q3. Banks increased their short-term debt by 181 million euros, and the business sector by 47 million euros. At the same time, deleveraging of long-term foreign debt was recorded in the private sector by 66 million euros – the banks deleveraged 111 million euros, while the business sector deleveraged by 45 million euros (see Table T4-7).

Foreign debt of the public sector increased in 2016

At the end of 2016, compared to the end of 2015, total foreign debt was by 358 million euros higher. In that period, the public sector increased its borrowing abroad by 384 million euros, while the total deleveraging of the private sector was 27 million euros.

During 2016, banks deleveraged long-term loans by 654 million euros, while the business sector borrowed additional 239 million euros. Short-term loans of banks in the observed period were higher by 400 million euros, while short-term debts of the business sector recorded a decrease by 14 million euros (Table T4-7).

Table T4-7 Serbia: Foreign Debt Trend Dynamic, 2013–2016

	2013	2014	2015	2016			
				Mar.	Jun	Sep.	Dec.
	stocks, in EUR millions, end of the period						
Total foreign debt	25,644	25,679	26,234	25,731	25,695	25,674	26,592
(in % of GDP) 4)	*74.8*	*76.8*	*78.2*	*76.7*	*75.8*	*75.7*	*78.2*
Public debt1)	13,120	14,145	15,295	14,934	15,031	14,923	15,680
(in % of GDP)4)	*38.3*	*42.3*	*45.6*	*44.5*	*44.3*	*44.0*	*46.1*
Long term	13,120	14,140	15,295	14,934	15,031	14,923	15,680
o/w: to IMF	697	152	15	7	0	0	0
o/w: Government obligation under IMF SDR allocation	434	463	493	483	488	484	494
Short term	0	5	0	0	0	0	0
Private debt2)	12,525	11,534	10,939	10,798	10,664	10,751	10,912
(in % of GDP) 4)	*36.5*	*34.5*	*32.6*	*32.2*	*31.5*	*31.7*	*32.1*
Long term	12,328	11,441	10,636	10,476	10,378	10,289	10,223
o/w: Banks debt	3,219	2,503	2,057	1,912	1,730	1,514	1,403
o/w: Enterprises debt	9,108	8,935	8,575	8,560	8,644	8,769	8,814
o/w: Others	1	3	4	4	4	6	6
Short term	196	94	303	322	286	462	690
o/w: Banks debt	171	57	186	237	222	406	587
o/w: Enterprises debt	25	37	117	85	64	56	103
Foreign debt, net 3), (in% of GDP)4)	42.2	47.2	47.2	48.4	48.4	47.5	48.2

Note: Foreign debt of the Republic of Serbia is calculated according to the "matured debt" principle, which includes amounts of debt from capital and amounts of calculated interest not paid in the moment of agreed maturity.

Source: NBS, QM

1) Foreign debt of the Republic of Serbia's public sector includes the debt of the state (not including the debt of Kosovo and Metohija, for loans concluded before the arrival of KFOR, unregulated debt toward Libya and the clearing debt toward former Czechoslovakia), National Bank of Serbia, local self-governments, funds and agencies formed by the state, and the debt for which state guarantee was issued.

2) Foreign debt of Republic of Serbia's private sector includes the debt of banks, companies and other sectors for which no state guarantee has been issued. Foreign debt of the private sector does not include loans concluded before December 20, 2000 for which no payments are done (1,030 million euros, out of which 449 million euro is from domestic banks, and 581 million euro is from domestic companies).

3) Total foreign debt reduced by NBS forex reserves.

4) Sum value of GDP of the observed quarter and previous three quarterly values of GDP.

5. Prices and the Exchange Rate

Inflation accelerated in Q1, but was still within the limits of the target corridor of the National Bank of Serbia and at the end of the quarter amounted to 3.5%. It was also within limits of the target corridor in April and May and amounted to 4.0% and 3.4% respectively. The acceleration in inflation during Q1 is partly a consequence of the growth in the prices of energy and other products in the world market while partly a consequence of the growth in domestic demand and regulated prices. Underlying inflation (measured by the consumer price index excluding prices of food, energy, alcohol and tobacco) is also within the limits of the new NBS target band and it amounted to 2.2 % at the end of the quarter, while it remained almost unchanged in April and May (2.1% and 2.2% respectively). National bank hasn't changed the key policy rate since the beginning of the year and it amounts 4.0%. In 2017, inflation is expected to decline gradually, due to a decline in the prices of energy products, as well as due to favorable influence of seasonal factors. In Q1, the dinar nominally depreciated by around 0.4%, which was followed by the period of appreciation, so in April and May dinar strengthened by about 0.7% against the euro. Significantly higher inflation in Serbia when compared to Eurozone countries contributed to a further strengthening in the real dinar exchange rate – appreciation of 1.6% in Q1 and additional 0.7% in April and May. Such a high real appreciation affects the deterioration of the price competitiveness in Serbian economy.

Prices

Inflation increased in Q1, but it moved within the limits of the NBS target band, where it remained both in April and May

At the end of the first quarter of 2017, year-on-year inflation amounted to 3.5%, which is well above the value of late 2016 (Table T5-1). Inflation entered the limits of the National Bank of Serbia target band for the first time since Q3 2013 (i.e. since February 2014 if monthly data are observed). At a monthly level, inflation was 1.5% in January, while in February and March it amounted to 0.7% and 0.2% respectively. Year-on-year inflation in January increased to 2.4% and entered within the limits of the new NBS target band , where it remained until the end of May 2017. Monthly price growth in January amounted to 1.5% and contributed to its significant growth at year-on-year level (mostly due a growth in the prices of food and tobacco products). This trend continued in the following months, when in February and May, relatively high monthly inflation affected the year-on-year growth, while deflation was recorded only in May.

World prices that increased inflation at the end of previous and beginning of this year, affected its fall during second quarter

The November oil price growth and stabilization in the period December-February was followed by the trend of its fall in March 2017, which continued in the coming months. It is expected that the fall in world oil prices will spill over to other prices, although the effect will be modest given that it is close to a historical minimum, its further significant decline cannot be expected. The prices of basic metals, after a considerable growth, began to decline in the first months of the second quarter. National Bank did not decrease the key policy rate during Q1 and April and May of 2017, thus it amounted to 4.0% (Graph T5-3).

Underlying inflation in Q1, as well as April and May, stood as well within the limits of the target band

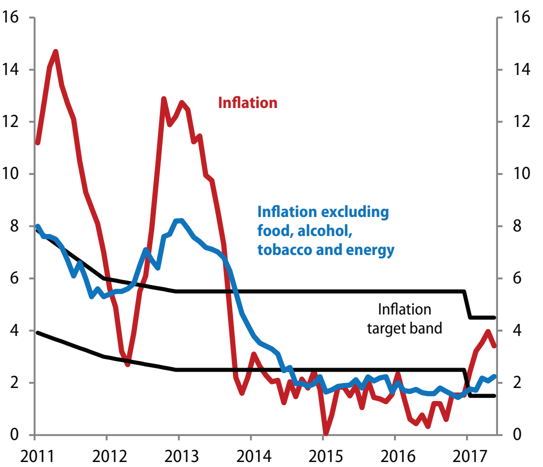
Underlying Inflation (measured by the consumer price index, excluding the prices of food, alcoholic, tobacco and energy) was below the mid-point of the NBS target interval in Q1 and amounted to 2.2% at the end of the quarter (Graph T5-2). In April, the underlying inflation remained at a stable level of 2.1%, or 2.2% respectively, and together with overall inflation, it moved within the limits of the target band. Stable and generally fixed dinar exchange rate (the NBS allows a movement in a narrow exchange rate range) as well as a modest growth of domestic demand are the main factors that keep underlying inflation stable over a long period of time (ranging in a narrow interval from 1.4% to 2.2% for nearly last three years). A fall in the price of crude oil and seasonal fall in the prices of agricultural products will affect the decline in inflation over the coming months, while the impact of domestic demand will crucially depend on fiscal policy. We expect that during this year, fiscal policy will be moderately restrictive, and it will also act towards reducing inflationary pressures. The character of fiscal policy in the next year, after the expiration of the arrangement with the IMF, is currently difficult to estimate, as it is not certain how serious the announcement of a large increase in wages and pensions is. However, it is quite certain that eventual fiscal expansion would have more impact on the growth of imports and inflation than it would trigger economic activity.

Table T5-1. Serbia: Consumer Price Index, 2011-2017

	Consumer price index				
	Base index (avg. 2006 =100)	Y-o-y growth	Cumulative index	Monthly growth	3m moving average, annualized
2011					
dec	154.3	7.0	7.0	-0.7	2.5
2012					
dec	173.1	12.2	12.2	-0.4	9.9
2013					
dec	176.9	2.2	2.2	0.2	-0.9
2014					
mar	179.1	2.3	1.2	-0.3	5.1
jun	180.4	1.2	2.0	0.1	2.9
sep	181.2	2.1	2.4	0.7	1.6
dec	180.0	1.8	1.8	-0.4	-2.4
2015					
dec	182.8	1.6	1.6	-0.2	-1.9
2016					
mar	183.5	0.6	0.4	-0.1	1.5
apr	184.2	0.4	0.8	0.4	0.9
may	184.3	0.8	0.8	0.1	1.3
jun	184.4	0.3	0.9	0.1	2.0
jul	184.3	1.2	0.8	-0.1	0.2
aug	185.9	1.2	1.7	0.9	3.5
sep	184.8	0.6	1.1	-0.6	0.9
oct	186.1	1.5	1.8	0.7	4.0
nov	185.9	1.5	1.7	-0.1	0.0
dec	185.6	1.5	1.5	-0.2	1.8
2017					
jan	188.3	2.4	1.5	1.5	4.8
feb	189.6	3.2	2.2	0.7	8.2
mar	190.0	3.5	2.4	0.2	9.8
apr	191.5	4.0	3.2	0.8	7.0
may	190.6	3.4	2.7	-0.5	2.1

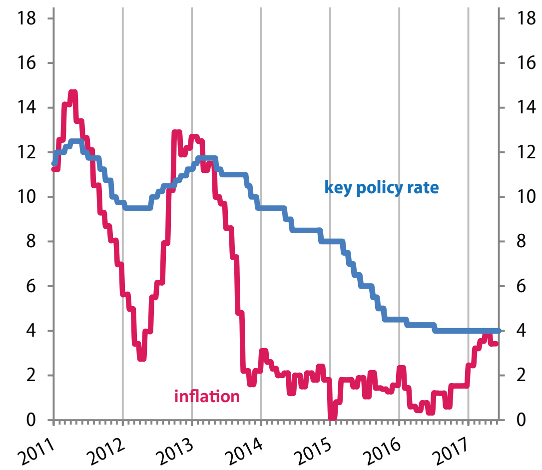
Source: SORS.

Graph T5-2. Serbia: Y-o-y Inflation Rate and Underlying Inflation and the NBS Target Band 2011-2017



Source: NBS and *QM* estimates

Graph T5-3. Serbia: NBS Reference Interest Rate and y-o-y Inflation Rate, in %, 2011-2017



Source: NBS

The acceleration of inflation in the first quarter is significant, but this is a temporary tendency

In the first quarter of 2017, there was a relatively high price increase of 2.4% (Table T5-4). January achieved a high price increase of 1.5%, while February and March recorded a lower inflation of 0.7% and 0.2% respectively. Inflation in Q1 was mostly contributed by: food price increase of 4.9%, which represents a contribution to inflation of 1.4 percentage points (pp), mainly due to vegetable price growth (21.0%, contribution of 1.0 pp) and fruits (14.7%, contribution of 0.3 pp), followed by petroleum products (5.8%, contribution of 0.3 pp), telephone services (5.1%, contribution of 0.2 pp), tobacco products (4.5%, contribution of 0.2 pp) and solid fuels (6.5%, contribution of 0.2 pp). The largest disinflation effect was caused by the seasonal fall in clothing and footwear prices (a decline of 3.9%, contribution of -0.2 pp) and prices from the group of recreation and culture (1.2%, contribution of -0.1 pp).

Moderate monthly inflation in April and deflation in May

In April 2017, the price increase was 0.8%, which was mainly due to food price increases (growth of 2.5%, contribution to inflation of 0.7 pp), clothing and footwear (growth of 1.4%, contribution of 0.06 pp) and oil derivatives (1.0% increase, contribution of 0.06 pp) while the fall of solid fuel prices had disinflationary effect (fall of 0.9%, contribution of -0.09 pp). The prices of other groups of products and services did not significantly affect the April inflation. The rise in food prices occurred due to the continuation of the seasonal increase in vegetable prices (growth of 7%, contribution of 0.3 pp) and fruits (8.5%, contribution of 0.2 pp). However, as weightings for products whose prices change significantly at the monthly level also change significantly (due to the effect of substitution with other, cheaper products - for example, other types of fruits and vegetables instead of those that at that time have a high price), this would in particular mean that in January and April inflation measured using monthly weightings was to a certain extent lower than inflation whose calculation includes price indices weighted by fixed weighting on an annual level. The opposite effect shall occur when the prices of vegetables and fruits have a seasonally expected decline (at the end of Q2 and early Q3 for vegetables, or during Q4 and Q1 for fruits). Given that the seasonal effect of growth and decline in the prices of certain products (fruits, vegetables, meat, clothing and footwear, tourist arrangements) usually occur in the same months of the year, when calculating the year-on-year rate they annul each other to a large extent, while large deviations occur in monthly rates. Consumer price index declined by 0.5% in May, mostly due to a beginning of a seasonal fall in the prices of vegetables (14.6%, contribution of -0.8 pp), further decline in the prices of solid fuels and the fall in the prices of petroleum products. The continuation of fruit prices growth (10.3%, contribution of 0.2 pp) and meat (2.0%, contribution of 0.15 pp) had an inflationary effect.

Table T5-4. Serbia: Consumer Price Index: Contribution to Growth by Selected Components

	Share in CPI (in %)	price increase in Q1 2017	Contribution to overall CPI increase (in p.p.)	Price increase in April 2017	Contribution to overall CPI increase (in p.p.)	Price increase in May 2017	Contribution to overall CPI increase (in p.p.)
Total	100.0	2.4	2.4	0.8	0.8	-0.5	-0.5
Food and non-alcoholic beverages	32.0	4.8	1.5	2.1	0.7	-1.4	-0.5
Food	28.4	4.9	1.4	2.5	0.7	-1.6	-0.5
Alcoholic beverages and tobacco	7.3	3.6	0.3	-0.1	0.0	0.0	0.0
Tobacco	4.6	4.5	0.2	0.0	0.0	0.0	0.0
Clothing and footwear	4.5	-3.9	-0.2	1.4	0.1	0.2	0.0
Housing, water, electricity and other fuels	13.7	1.2	0.2	-0.7	-0.1	-0.2	0.0
Electricity	5.0	0.0	0.0	0.0	0.0	0.0	0.0
Furniture, household equipment, routine maintenance	4.6	0.4	0.0	0.4	0.0	-0.1	0.0
Health	5.0	0.6	0.0	0.0	0.0	0.4	0.0
Transport	12.8	2.9	0.4	0.5	0.1	-0.3	0.0
Oil products	5.9	5.8	0.3	1.0	0.1	-0.5	0.0
Communications	5.0	4.5	0.2	0.0	0.0	0.1	0.0
Other items	15.1		-0.1		0.1		0.0

Source: SORS and *QM* estimates

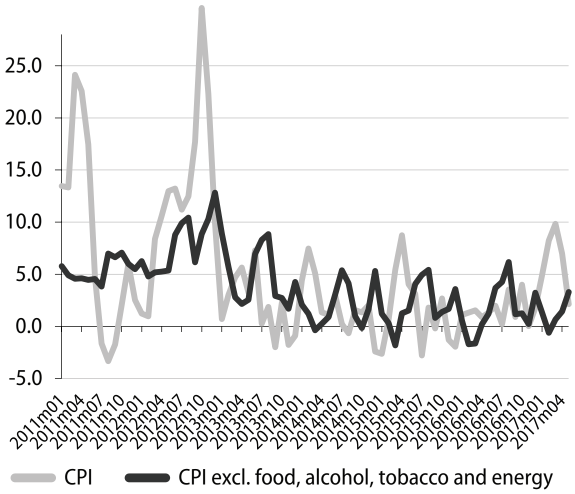
Overall inflation is relatively high in Q1 and April, while underlying inflation is at a stable low level

Overall inflation (3m annually) at the end of Q1 was 9.8% (Graph T5-5), while in April it fell to 4.8% (largely due to the output of January inflation rate from the average calculation), and in May it stood at relatively low 2.1% (due to May deflation and February inflation output from the calculation). Underlying inflation (3m annual average inflation without food, alcohol, tobacco and energy) was 0.7% at the end of Q1, while in April it increased to 1.4% and in May to 3.3%. The high volatility of an annualized 3m average of the overall inflation is a result of, in addition to the way it is calculated, the absence of a stable trend in the movement of monthly values of prices that determine them and can be explained by the changes in the prices of one-off and seasonal character (e.g. a significant rise in total inflation is largely a result of January increase in vegetable prices and the use of constant weightings in the calculation of this product group throughout the year, regardless a significant substitution with cheaper products and consequent weighting changes). When there are one-off or seasonal changes that greatly affect inflation, 3m average does not represent a reliable indicator of its movement, and a better indicator would be an annual average over a longer period (e.g. 6m), in which the impact of one-off price change or year-on-year inflation is

The acceleration in inflation during Q1 is a result of the impact of external and internal factors

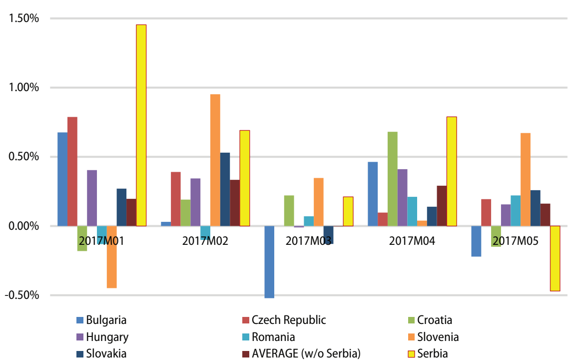
During the first quarter, inflation accelerated in other countries of the region and throughout the EU. The growth of inflation in Europe is a consequence of the growth of energy prices in that period, and probably the expansionary monetary policy of the ECB and of some national banks had some impact. However, inflation growth in Serbia was higher than in other countries of the region. The average inflation rate in selected countries of Central and Eastern Europe was 0.5% in Q1, 0.3% in April and 0.16% in May, while in Serbia inflation in Q1 was 2.4%, in April 0.8% and May recorded deflation of 0.5%. In Q1, the growth in oil derivative prices had a similar impact on inflation in Serbia and other countries in the region (this growth had somewhat lower contribution to inflation in Bulgaria and Czech Republic and significantly higher in Hungary). Higher inflation in Serbia points to the existence of specific domestic factors that have influenced its growth. Specific factors for Serbia are related to the

Graph T5-5. Serbia: CPI and Underlying Inflation Trend, Annualized Rates, in %, 2011-2017



Source: SORS and *QM* estimates

Graph T5-6. Inflation in Serbia and in selected CEE countries



Source: Eurostat, RZS and *QM* estimates

The Exchange rate

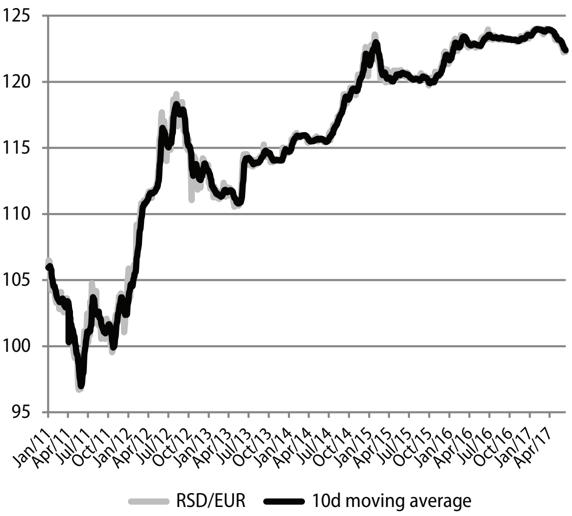
At the end of Q1 the dinar slightly depreciated, while it strengthened to about 122 dinars per euro from April to June

In Q1, the dinar weakened against the euro by 0.4% in relation to the end of 2016 (i.e. by 0.5%, observed at the quarterly average), in April it increased by 0.6% (0.2% on monthly average), while in February it increased by 0.4% (0.5% on a monthly average) (Graph T5-7), when the exchange rate was slightly below 123 RSD per euro. The appreciation continued in June and the current exchange rate is just over 122 dinars per euro. From January to the end of May, the appreciation was significantly higher in relation to the US dollar and the Swiss franc. In relation to the dollar, during Q1, the dinar increased by 0.9% (i.e. it fell by 1.7% at the level of the quarter average), while in April and May it increased by 2.4%, i.e. by 3.2%, respectively

(0.5% and 3.5% at the monthly average). The dollar depreciated by 1.0% in Q1 against the Swiss franc (by 1.4% at the quarter average), appreciating by 1.7% in April, and in February appreciated by an additional 1.3% (0.4% and 2.1% on a monthly average).

The movement of the exchange rate in Serbia is different than the movement of the exchange rates in most of the countries in the region, while in April and May was at the level of the average

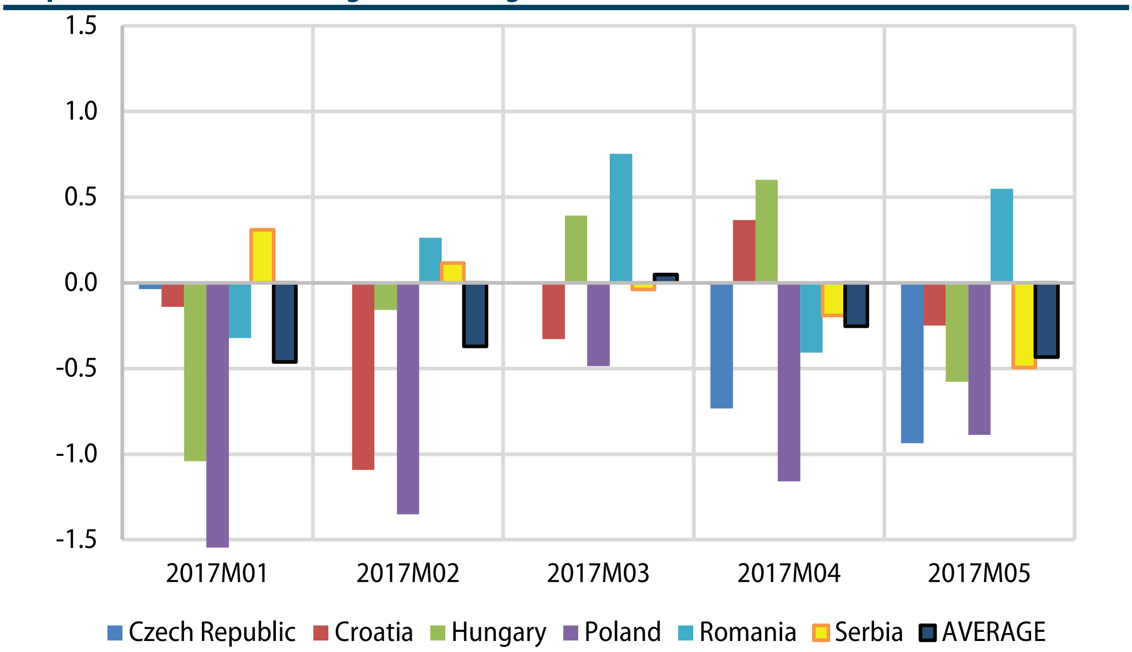
Graph T5-7. Serbia: Daily RSD/EUR Exchange Rate, 2011-2017



Source: NBS

During Q1, compared to the currencies in countries in the region with a similar exchange rate regime, the dinar had relatively small changes in value against the euro (Graph T5-8) and the change in the exchange rate was occurring in the opposite direction from the movement of other currencies. This is largely a consequence of the influence of the National Bank of Serbia on the movement of the exchange rate - selling foreign exchange on the interbank foreign exchange market (IFEM) to prevent significant depreciation. Central banks in countries with a lower degree of euroisation than in Serbia can implement measures aimed at achieving price and financial stability relatively independent to the changes in the foreign exchange rate, which in a highly-evolved economy, such as Serbia, is possible only in the relatively narrow corridor of the exchange rate. During April and May, in the period when moderate appreciation was recorded, the dynamics of the dinar exchange rate was at the level of the average of all selected currencies.

Graph T5-8. Nominal Exchange Rate Change (in %) in Selected Countries

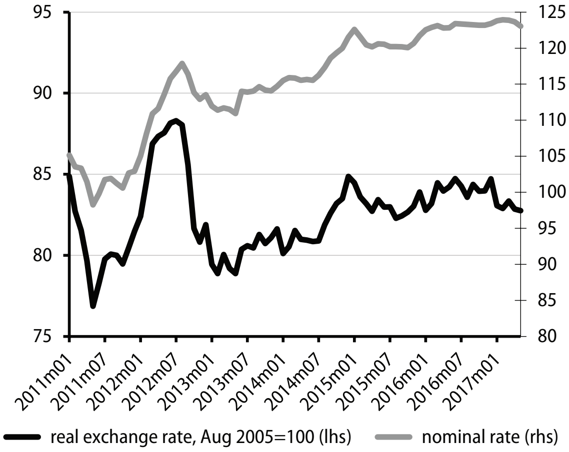


Source: Eurostat, NBS, *QM* estimates
Note: an increase represents depreciation

Relatively high real appreciationin Q1 and continuation of this trend in April and May

In Q1, the Dinar real appreciated by 1.6%, in April by 0.6% and in May by an additional 0.1% against the euro. In the observed period, the dinar has nominally strengthened to a lesser extent, but the large real appreciation is the result of significantly higher inflation in Serbia compared to the eurozone countries. The relatively modest growth of competitiveness of the Serbian economy realized with real depreciation in Q4 2016 of about 0.4% was annulled by significantly higher appreciation in Q1, so the overall outcome by competitiveness is negative (from January to May,

Graph T5-9. Serbia: Nominal and Real RSD/EUR Exchange Rate, Monthly Averages, 2011-2017



Source: NBS, SORS, Eurostat and *QM* estimates
Note: an increase represents depreciation

the dinar really appreciated by 2.3%). Historically, the real exchange rate of the dinar in January was approximately the same as in the same period of 2015 (Graph T5-9). Real appreciation of the dinar in the last part of the year is in contrast with the relative decline in the productivity of the Serbian economy in relation to productivity in EU countries, the main trading partners of Serbia. Strengthening of the dinar together with a relative decline in productivity aggravates the competitiveness of the Serbian economy.

6. Fiscal Trends and Policy

In the period January-April 2017, a noticeable growth of public revenue was realised, while public spending recorded a mild decline. Consequently, a consolidated fiscal surplus of 21.5 billion dinars was realised in this period (around 1.5% of four-month GDP). The growth of public revenue in the first four months was widespread and was the result of the growth of turnover and imports, growth of profitability of the economy in the previous year, increase in the excise rates, and combating grey economy. The decline of spending was also widespread, and the highest decrease was recorded in capital spending and subsidies. Positive fiscal trends continued in May as well, since the budget revenue of the Republic continued its real year-on-year growth, and a moderate surplus in the budget was realised in that month. The fiscal result achieved in the first four months of 2017 was better by around 40 billion dinars compared to the plan, out of which, around one half was thanks to a higher tax collection rate, while the rest was the result of an aggressive collection of non-tax revenue and slower realisation of capital spending. If the trends from the previous part of the year, especially in terms of tax collection, continue, and non-tax revenue and public spending are realised according to plan, the consolidated fiscal deficit in 2017 could be less than 1% of GDP. However, good fiscal results and the upcoming expiration of the IMF agreement affect the rising pressure of the public and Government's promise concerning the cutting of taxes and considerable increase of spending, which could already next year make the fiscal deficit significantly higher. Therefore, in order to have a long-lasting stabilisation of public finances and to reduce the public debt, it would be good to conclude a new agreement with the IMF for the next three years, which would focus not only on the general fiscal framework, but also on the structural reforms of the public sector. Public debt at the end of April 2017 was 70.1% of GDP, by over 4% of GDP lower than at the end of 2016, primarily because of the real appreciation of the dinar against the dollar and the euro, as well as because of the favourable current fiscal trends.

Fiscal Tendencies and Macroeconomic Implications

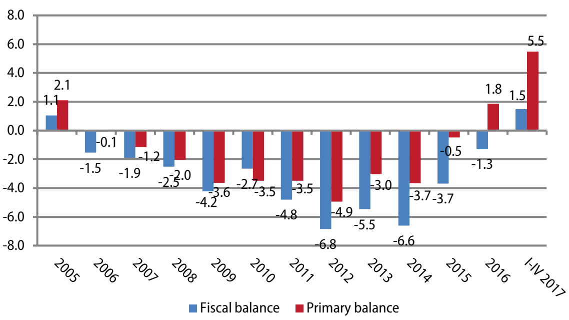
In the first four months of 2017, a consolidated surplus of 21.5 billion dinars was realised (1.5% of GDP) …

In the period January-April 2017, a significant real growth of public revenue was realised compared to the same period last year and compared to the previous four months, while public spending continued its moderate real decline. Therefore, a consolidated fiscal surplus of 21.5 billion dinars was realised in this period (around 1.5% of the four-month GDP).

Positive fiscal trends continued in May as well

Positive fiscal trends continued in May as well, since budget revenue of the Republic continued its year-on-year growth in a a similar dynamic as in the previous months, while spending recorded a mild decline, so a budget surplus was realised that month of around 1.8 billion dinars.

Graph T6-1 Serbia: Consolidated Fiscal Balance and Primary Balance (% GDP)



Source: *QM* calculation

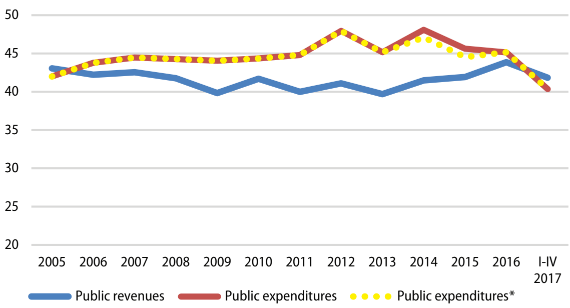
In the period January-April 2017, tax revenue recorded a high, widely spread growth

In the period January-April 2017, consolidated tax revenue realised a high year-on-year real growth (by 4.7%), as well as a seasonally adjusted real growth (by 2.5%) compared to the previous four months. The growth of revenue was widespread, since all forms of tax revenue recorded an increase. The biggest relative growth compared to the first four months of 2016 was recorded in corporate income tax (by 27.4%), which is the result of a pronounced pro-cyclicality of this tax, which in the period of crisis had the biggest decline, and in the period of economic recovery the highest growth. Beside the pro-cyclicality of the corporate income tax, the high growth of revenue is partly the result of delayed effect of cancelling tax investment loan. Still, in absolute amounts, the highest contributions to the growth of tax revenue came from the increase in VAT revenue (2.1%), social contributions (6.2%), and excise (6.3%). Revenue from consumption tax had a solid growth in the first four months of 2017, thanks to increased spending, which is partly owed to the increase in wages of the public sector and pensions over the year, as well as to the considerable growth of imports and increase of excise tax at the beginning of the year, and probably to the combating of the grey economy as well. Revenue from tax on production factors also achieved a considerable growth in the first four months. High real year-on-year growth of revenue from personal income tax (4.2%) and social contributions was the result of moderate growth of formal employment, thanks to the mild growth of economic activity, combating grey economy, and increase of wages.

Aggressive collection of non-tax revenue continues

Even though non-tax revenue in the first four months of 2017 was lower by around 1.9% compared to the same period last year, that decline was smaller than planned, since it was expected that non-tax revenue in 2017 would be lower by around 15% than in 2016. This indicates a continuation in the policy of aggressive collection of dividends from public and state-owned enterprises. Since this policy has been implemented for several years, it could reflect negatively on their business performance, on the availability and quality of their products and services, as was the case with Elektroprivreda Srbije (Serbia's power company) at the beginning of this year. Instead of the aggressive collection of dividends, the state should enable and stimulate these enterprises to invest these profits, which would have a positive effect on the overall investment level in the country, which is low, as well as on the performance of these companies in the future.

Graph T6-2 Serbia: Consolidated Public Revenue and Public Spending (% GDP)[1]



Source: *QM* calculation based on MoF data

Almost all categories of public spending continued their decline, the highest being in capital spending and subsidies

Public spending in the period January-April 2017 recorded a moderate real decline compared to the same period last year (by 4.4%), and a real seasonally adjusted decline was realised compared to the previous four months as well (by 4.2%). The decrease of spending in the first four months was widely spread, since a real decrease was recorded in almost all types of spending. The relative decline was the highest in capital spending (by one third), as well as in spending on subsidies (by 10%).

The fall of capital spending was higher than could be explained by weather conditions

The fall of capital spending by over one third compared to the same period last year (i.e. by almost 30% compared to the previous four months), so that it was only 1.5% of GDP in the first four months of 2017, can partly be explained by extremely unfavourable weather conditions in January, indicated by the fact that the decline was bigger in January than in February. However, since capital spending in April was by almost 30% lower than in the same month of the previous year, there is a risk that the decline of capital spending in the first four months of 2017 was affected by other factors as well. In 2017, growth of capital spending by around 6% is planned, or by around 0.2% of GDP. If the trends from the previous part of the year continue in the coming months as well, there is a risk that the planed target will not be achieved. This would not be good for the improvement of quality of infrastructure and economic growth, because the planned amount of capital spending for this year is also considerably smaller than in other countries of the Central and Eastern Europe.

The significant reduction of spending on subsidies in the first four months of 2017 are estimated as right and necessary, but in order to achieve the planned reduction at the level of the entire year by around 20%, it is necessary for the spending on subsidies in the rest of the year to be additionally reduced. Besides this spending, a moderate real decline of spending on interests

1 Public spending* is adjusted for one-off spending on subsidies and pensions in December 2014 and 2015.

was realised in the first four months of 2017, which was the result of a mild decline in the level of public debt, reduction in the country risk (thanks to the stabilisation of public finances), real appreciation of dinar, and general favourable conditions on the international capital market.

The most significant categories of spending – on pensions and wages of public sector employees, recorded a mild real decline in the first four months (by 2.6% and 1.6%, respectively) due to low indexation, continued policy of hiring freeze in the public sector, and effects of parametric pension system reform from 2014. The reform referred mostly to raising the retirement age limit and introducing penalties for early retirement, which is estimated as justified and in line with practices in almost all European countries. Revision of parametric pension reform from 2014 via announced abolishing of penalties for early retirement, which was a precondition for concluding the agreement with IMF, had a negative impact on sustainability of the pension system and public finances, as well as on the credibility of the Government and the state in international financial institutions.

The general hiring freeze should be replaced by a targeted reduction in the number of employees in certain segments of the public sector

Even though the hiring freeze in the public sector in the last three years resulted in a considerable reduction in the number of employees, the structure of that reduction is assessed as negative, since it was mostly linear, instead of targeting those segments of the public sector where the surplus of employees is the highest (public enterprises, local self-governments, etc.). Therefore, in order to avoid jeopardising the functioning of certain segments of the public sector, in the coming period, the general hiring freeze should be replaced by a targeted reduction in the number of employees in those segments where the surplus of employees is the highest.

The fiscal result in the first four months was by around 40 billion dinars better compared to the plan…

Considering intra-annual dynamics of public revenues and spending over the past few years, it is estimated that the fiscal result realised in the first four months of 2017 was better compared to the planned one by around 40 billion dinars. One half of that is owed to the higher tax collection, while the other half is thanks to the agreessive collection of non-tax revenue and weak realisation of capital spending.

...where one-half is owed to the higher tax collection, while the other half is thanks to the aggressive collection of non-tax revenue and weak realisation of capital spending

Based on the usual intra-annual dynamic, it is estimated that tax revenue in the period January -April 2017 was higher by over 20 billion dinars compared to the plan, and the plan was exceeded in all forms of tax. Better collection of tax revenue compared to the plan could be a result of accelerated inflation, considerable growth of imports, higher profitability of the economy, and combating grey economy. At the same time, non-tax revenue recorded a decline, which is significantly lower than planned, while capital spending had a strong y-o-y fall, even though it was planned that in 2017 it would be higher than in the previous year. Thus, the non-tax revenue collection in the period January-April was higher by around 12 billion dinnars than planned, while capital spending was lower than planned by around 8 billion dinars. Flows in public spending, aside capital spending, in the first four months of 2017 were mostly in line with the plan, even though certain types of spending had some deviations.

Fiscal deficit in 2017 could be lower than 1% of GDP

If the trends related to the dynamic of tax collection realised in the first four months continue for the rest of the year as well, if non-tax revenue and public spending are realised in line with the plan, and if the state assumes no further non-guaranteed obligations of public and state enterprises, the consolidated fiscal deficit in 2017 could be less than the planned 1% of GDP. This would be considered a good result, since it was planned to be around 1.7% of GDP, and it would contribute to the decrease of public debt. However, positive fiscal trends lead to stronger pressures and promises in terms of reducing the taxes and increasing the revenues (e.g. high increase of wages and pensions, abolishing penalties for early retirement, etc.).

…but there are still risks of its considerable growth in the coming years, after the expiration of the IMF agreement

Pressures, promises and expectations of this kind will only increase as the three-year agreement with IMF approaches its end. The realisation of these promises would have a very negative effect on the sustainability of public finances in the coming period, since these measures would neutralise a significant part of the fiscal adjustment achieved so far. Therefore, in order to strengthen to results achieved so far and secure a considerable reduction of public debt in the coming period, we recommend that the arrangement with IMF be renewed, which would in this new cycle focus more on structural reforms of the public sector.

Public Debt Trend Analysis

Serbia's public debt at the end of April 2017 was 24.2 billion euros (69.1% of GDP)…

At the end of April 2017, Serbia's public debt was 24.2 billion euros (69.1% of GDP), and when non-guaranteed debt of the local communities is included, it was around 70.1% of GDP, which is by around 660 million euros less compared to the end of 2016.

…and when the debt of local communities is included – 70.1% of GDP

In relative amounts, the debt at the end of April 2017 was by around 4% of GDP lower compared to the end of 2016, because of the nominal reduction of the public debt and mild growth of GDP. Observed by debt structure, there was a reduction in the direct debt in the period January-April (by around 540 million euros), as well as the indirect debt (by around 120 million euros).

The reduction of debt in the period January-April was the result of the appreciation of dinar and favourable fiscal trends

The significant reduction of the public debt in the period January-April was the result of the appreciation of dinar primarily against the dollar, as well as the favourable fiscal trends, so there was no need for additional net borrowing in order to finance the fiscal deficit in the current period. The dinar exchange rate against the dollar in the period January-April significantly appreciated by 6%, while against the euro, the real appreciation of dinar was significantly lower and was around 1.6%. Considering the currency structure of Serbia's public debt, the appreciation of dinar against the dollar and the euro affected the nominal reduction of the public debt by over 600 million euros, which neutralised the majority of the negative effects of the change in the exchange rate on the amount of the public debt at the end of 2016. Part of the public debt reduction in the period January-April could be considered temporary, since the dinar exchange rate against the dollar is extremely volatile.

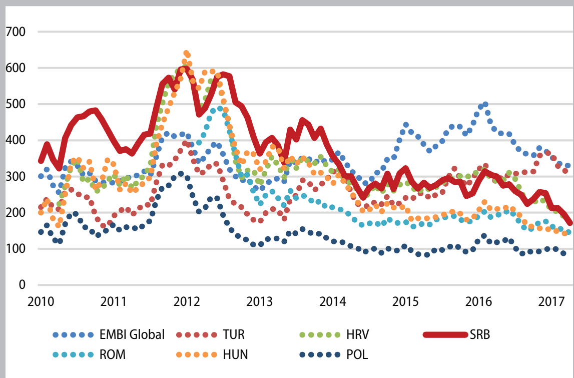
Table T6-3 Serbia: Public Debt[1] 2000-2017.

	Amount at the end of period, in billions EUR														
	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Q1 2017	Apr 2017
I. Total direct debt	14.2	9.6	8.6	8.0	7.9	8.5	10.5	12.4	15.1	17.3	20.2	22.4	22.7	22.5	22.1
Domestic debt	4.1	4.3	3.8	3.4	3.2	4.1	4.6	5.1	6.5	7.0	8.2	9.1	8.8	8.7	8.7
Foreign debt	10.1	5.4	4.7	4.6	4.7	4.4	5.9	7.2	8.6	10.2	12.0	13.4	13.9	13.8	13.4
II. Indirect debt	-	0.7	0.8	0.8	0.9	1.4	1.7	2.1	2.6	2.81	2.5	2.4	2.1	2.0	2.0
III. Total debt (I+II)	**14.2**	**10.3**	**9.4**	**8.9**	**8.8**	**9.8**	**12.2**	**14.5**	**17.7**	**20.1**	**22.8**	**24.8**	**24.8**	**24.5**	**24.2**
Public debt / GDP (MF)[2]	**201.2%**	**50.2%**	**35.9%**	**29.9%**	**28.3%**	**32.8%**	**41.8%**	**45.4%**	**56.2%**	**59.6%**	**70.4%**	**75.5%**	**72.9%**	**69.2%**	**67.7%**
Public debt / GDP (QM)[3]	**169.3%**	**52.1%**	**36.1%**	**29.9%**	**28.3%**	**32.8%**	**41.9%**	**44.4%**	**56.1%**	**59.4%**	**70.4%**	**74.6%**	**73.2%**	**70.7%**	**69.1%**

1) According to the Public Debt Law, public debt includes debt of the Republic related to the contracts concluded by the Republic, debt from issuance of the t-bills and bonds, debt arising from the agreement on reprogramming of liabilities undertaken by the Republic under previously concluded contracts, as well as the debt arising from securities issued under separate laws, debt arising from warranties issued by the Republic or counterwarranties as well as the debt of the local governments, guaranteed by the Republic.
2) Estimate of the Ministry of Finance of the Republic of Serbia
3) *QM* estimate (Estimated GDP equals the sum of nominal GDP in the current quarter and three previous quarters)
Source: *QM* calculations based on the MoF data111110117.1315113.365

Box 1 Risk Premium Movements of Investing in State Bonds of the Central and Eastern European Countries

Graph T6-4 EMBI for the Countries of the Central and Eastern Europe

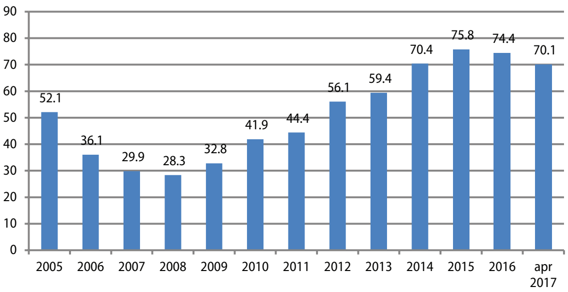


Source: Author's calculations based on numerous publicly available sources

Strong fiscal adjustment, improved sustainability of public finances, as well as the favourable trends on global financial markets, led to a considerable reduction in the risk premium on state bonds of the Republic of Serbia. The Emerging Market Bond Index (EMBI) for Serbia at the end of April was around 170 base points, which is close to the average of the observed countries of the Central and Southeast Europe. Out of the observed countries, Hungary, Romania and Poland have a lower value of EMBI, while Croatia and Turkey have a higher value than Serbia (Graph T6-4). The decline of EMBI is positively reflecting on the conditions for new borrowing, but it still does not reflect on the overall cost of interest, since the new loans, taken out primarily for the payments of matured debts, are still a small part of the overall debt. In order to have a more considerable reduction of the cost of interest, it is necessary to further reduce and stabilise at a low level the risk premiums for investing in Serbia's state bonds in the longer term, so that the share of new, cheaper loans would significantly increase. Comparison with countries of similar development level (e.g. Romania) indicates that there is room for further reduction of the risk premium on Serbia's state bonds, and that it requires permanent stabilisation of public finances. Any new fiscal expansion, which is at risk of occurring, especially after the expiration of the IMF agreement at the beginning of 2018, would affect the considerable growth of EMBI for Serbia, and a new increase of interests on new borrowing. Considering that a growth of interest rates on the global market is expected in the coming period due to the reduced expansiveness of the monetary policies of ECB and FED, in order to keep the interest rates of Serbia's borrowing at a low level, it is necessary to further reduce the country risk, i.e. EMBI, which can be achieved only under the assumption of further macroeconomic stabilisation.

After many years of significant increase, the strong fiscal adjustment and economic growth in 2016 led to a moderate decrease of public debt in relation to GDP. Positive trends in the dynamic of the public debt continued at the beginning of 2017 as well, which is the result of not only favourable fiscal results (achieved surplus in the consolidated state budget), but also the appreciation of the dinar against the euro. In order to continue the trend of reducing the level of the public debt, it is necessary for the fiscal deficit to be permanently stabilised at a level of up to 1% of GDP, to permanently remove the fiscal risks stemming from public and state enterprises by conducting their essential restructuring and privatisation (where it is justified), as well as for the state to cease with the practice of assuming non-guaranteed debts of the state and public enterprises.

Graph T 6-5 Trends of Serbia's Public Debt (% GDP)



Source: *QM* calculations

Annexes

Annex 1. Serbia: Consolidated General Government Fiscal Operations, 2010-20176 (bn RSD)

	2010	2011	2012	2013	2014	2015	2016					2017	
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	jan-apr
I PUBLIC REVENUES	**1,278.4**	**1,362.6**	**1,472.1**	**1,538.1**	**1,620.8**	**1,694.8**	**414.7**	**460.8**	**476.9**	**490.3**	**1,842.7**	**449.9**	**606.8**
1. Current revenues	1,215.7	1,297.9	1,393.8	1,461.3	1,540.8	1687.6	413.3	458.8	472.5	488.7	1833.3	448.0	604.7
Tax revenue	1,056.5	1,131.0	1,225.9	1,296.4	1,369.9	1463.6	353.2	405.0	405.3	422.2	1585.8	386.4	527.3
Personal income taxes	139.1	150.8	35.3	156.1	146.5	146.8	34.5	37.7	40.5	42.4	155.1	37.5	51.2
Corporate income taxes	32.6	37.8	54.8	60.7	72.7	62.7	13.3	31.1	18.1	17.8	80.4	18.9	25.1
VAT and retail sales tax	319.4	342.4	367.5	380.6	409.6	416.1	103.8	114.9	112.7	122.0	453.5	109.6	155.3
Excises	152.4	170.9	181.1	204.8	212.5	235.8	57.4	65.5	75.2	67.5	265.6	64.9	84.9
Custom duties	44.3	38.8	35.8	32.5	31.2	33.3	8.6	8.7	9.2	9.9	36.4	9.3	12.4
Social contributions	323.0	346.6	378.9	418.3	440.3	505.7	120.5	130.8	132.6	143.6	527.5	129.6	20.4
Other taxes	46.0	43.5	42.6	43.5	57.3	63.3	15.1	16.3	16.9	19.0	67.3	16.6	178.0
Non-tax revenue	159.2	36.9	37.9	34.9	170.9	224.0	60.1	53.8	67.1	66.5	247.5	61.6	77.5
II TOTAL EXPENDITURE	**-1,419.5**	**-1,526.1**	**-1,717.3**	**-1,750.2**	**-1,878.9**	**-1,844.0**	**-430.7**	**-462.9**	**-463.1**	**-543.0**	**-1,899.7**	**-438.1**	**585.3**
1. Current expenditures	-1,224.8	-1,324.8	-1,479.9	-1,549.8	-1,628.0	-1696.6	-403.9	-419.5	-416.4	-478.2	-1,717.9	-415.7	553.3
Wages and salaries	-308.1	-342.5	-374.7	-392.7	-388.6	-419.2	-99.8	-104.6	-103.7	-109.5	-417.7	-102.5	137.3
Expenditure on goods and services	-202.5	-23.3	-235.7	-236.9	-256.8	-257.6	-57.5	-67.2	-68.4	-90.6	-283.6	-60.4	82.1
Interest payment	-34.2	-44.8	-68.2	-94.5	-115.2	-129.9	-45.9	-32.0	-31.6	-22.0	-131.6	-47.4	58.1
Subsidies	-77.9	-80.5	-111.5	-101.2	-117.0	-134.7	-18.0	-24.1	-20.4	-50.2	-112.7	-18.9	26.4
Social transfers	-579.2	-609.0	-652.5	-687.6	-696.8	-710.0	-171.9	-176.3	-178.3	-190.3	-716.8	-174.5	233.7
o/w: pensions5)	*-394.0*	*-422.8*	-473.7	-498.0	-508.1	-490.2	-122.1	-123.8	-123.2	-125.2	-494.2	-123.1	164.5
Other current expenditures	-22.9	-31.7	-37.4	-36.9	-53.7	-45.3	-10.7	-15.3	-13.9	-15.7	-55.6	-11.9	15.7
2. Capital expenditures	-105.1	-111.1	-126.3	-84.0	-96.7	-114.5	-17.4	-31.2	-37.5	-53.1	-139.3	-12.0	21.2
3. Called guarantees	-2.7	-3.3	-3.7	-7.9	-29.7	-30.1	-8.7	-11.2	-8.2	-11.0	-39.1	-8.3	8.3
4. Buget lendng	-30.0	-25.0	-38.2	-35.6	-55.4	-2.7	-0.6	-1.0	-1.0	-0.7	-3.3	-2.2	2.5
CONSOLIDATED BALANCE	**-141.0**	**-163.5**	**-245.2**	**-212.1**	**-258.1**	**-149.1**	**-16.0**	**-2.1**	**13.8**	**-52.8**	**-57.1**	**11.8**	**21.5**

Source: *QM* calculations based on the MF data

Annex 2. Serbia: Consolidated General Government Fiscal Operations, 2010-2017 (real growth rates, %)

	2010	2011	2012	2013	2014	2015	2016					2017	
							Q1	Q2	Q3	Q4	Q1-Q4	Q1	jan-apr
I PUBLIC REVENUES	**-1.5**	**-4.6**	**0.6**	**-2.2**	**3.2**	**3.1**	**7.4**	**7.8**	**9.2**	**5.6**	**7.5**	**5.2**	**3.8**
1. Current revenues	-1.5	-4.4	0.1	-2.6	3.3	3.3	7.3	7.9	8.6	5.8	7.4	5.1	3.8
Tax revenue	-2.5	-4.1	1.0	-1.7	3.5	0.3	7.1	9.2	7.5	4.8	7.2	6.1	4.7
Personal income taxes	-3.9	-2.9	2.1	-12.2	-8.1	-1.2	4.5	5.2	6.8	1.6	4.5	5.6	4.2
Corporate income taxes	-3.6	3.9	35.1	2.9	17.4	-15.0	1.2	19.3	55.8	43.4	26.9	37.6	27.4
VAT and retail sales tax	-0.7	-4.0	0.0	-3.8	5.4	0.2	6.4	14.1	3.2	7.7	7.8	2.4	2.1
Excises	4.2	0.6	-1.2	5.1	1.6	9.4	22.2	13.8	16.6	-2.9	11.4	9.5	6.3
Custom duties	-14.9	-21.5	-14.0	-15.6	-6.5	5.9	7.4	9.6	10.2	5.4	8.1	5.1	4.8
Social contributions	-6.5	-3.9	1.9	2.6	3.1	-2.1	2.7	3.2	3.7	2.9	3.2	4.3	6.2
Other taxes	14.5	-15.2	-8.8	-5.2	29.2	8.9	10.9	0.7	-2.8	12.7	5.1	7.0	3.6
Non-tax revenue	5.8	-6.1	-6.2	-8.7	1.5	27.9	8.5	-1.1	15.9	12.8	9.3	-0.5	-1.9
II TOTAL EXPENDITURE	**-1.7**	**3.3**	**4.3**	**-0.3**	**5.2**	**-3.2**	**5.7**	**4.9**	**2.3**	**-3.7**	**1.9**	**-1.3**	**-4.4**
1. Current expenditures	-2.2	3.1	4.1	-2.7	2.9	-1.4	3.7	2.7	0.4	-5.1	0.2	-0.2	-2.6
Wages and salaries	-5.9	0.4	2.0	-2.6	-3.1	-9.7	-0.4	-0.4	-0.4	-4.5	-1.4	-0.4	-1.6
Expenditure on goods and services	-0.3	4.3	1.5	-6.6	6.2	-1.1	11.3	13.5	4.2	7.7	8.9	2.1	-0.3
Interest payment	-0.3	17.4	41.9	28.8	19.3	11.2	11.6	-2.6	-3.4	-10.4	0.2	0.2	-4.5
Subsidies	40.6	7.4	29.1	-15.6	13.2	13.6	-5.3	0.5	-20.0	-26.2	-17.3	1.7	-10.0
Social transfers	13.9	5.8	-0.1	-2.1	-0.7	0.5	1.6	0.8	1.0	-3.7	-0.1	-1.6	-2.0
o/w: pensions5)	-3.9	3.9	4.4	-2.3	-0.1	-4.8	-0.5	0.2	-0.2	-0.8	-0.3	-2.3	-2.6
Other current expenditures	-6.1	23.9	9.9	-8.4	42.6	-16.7	30.0	21.8	39.9	4.0	21.4	7.8	-11.6
2. Capital expenditures	-11.8	5.3	6.0	-38.2	12.7	16.8	64.1	30.7	25.3	3.6	20.3	-33.5	-33.6
3. Called guarantees	-2.7	-3.3	-3.7	248.7	267.8	0.1	25.3	36.0	8.2	43.4	28.5	-7.9	-24.9
4. Buget lending	-30.0	-25.0	-38.2	44.2	52.2	-95.1	27.7	19.9	43.7	-3.3	20.8	243.9	166.7

Source: *QM* calculations based on the MF data

7. Monetary Trends and Policy

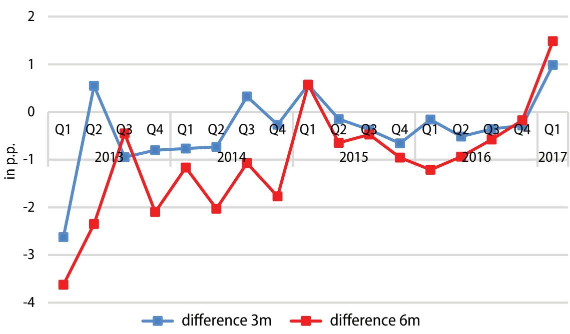
The y-o-y Inflation rate speeded up its growth through first four months only to drop to 3.5% in May. Inflation at the start of the year was within the target band which stood at 3±1,5% at the start of 2017. Since the rise in inflation was caused mainly by once-off elements, the National Bank of Serbia (NBS) kept its key policy rate unchanged to the end of the quarter. NBS interventions in Q1 were oriented at the Inter-banking foreign exchange (FX) market which was dominated up to April by depreciation pressure only for appreciation pressure to appear after that. In order to prevent excessive daily depreciation of the Dinar, the NBS sold 345 million Euro in Q1 and then in April and May it was net buyer with 160 million Euro. The sale of foreign exchange in Q1 had a negative effect on the level of NBS net own reserves which dropped by 270 million Euro. This also had a negative effect on the drop in primary money in Q1 to 441 million which was caused in part by increased bank investments in REPO bonds of 207 million Euro. The net lending of banks in Q1 were based on REPO operations and loans to the households while the trend of debt repayment of the enterprises continued. A part of the debt repayment by the enterprises is owed to the writing off and sale of debts to non-banking entities but when this is excluded, the net lending to the enterprises in Q1 were negative once again by about 50 million Euro. The lack of a greater debt repayment by the enterprises on the basis of cross-border loans and the rise in net lending to the households by 180 million caused at the end of Q1 the overall amount of the net lending to the private sector from both domestic and foreign sources in the first three months to stand at a positive 58 million Euro. Following an evident drop in the participation of NPLs in the previous quarter, minimal changes in this segment were noted from the start of the year. The overall participation of NPLs is practically unchanged compared to the end of the previous year with a slight rise in NPLs to corporate segment, but that was compensated by a drop in the other two segments. The somewhat higher inflation rate in Q1 caused a speedier reduction of real interest rates on Dinar loans for current assets and investments. At the same time, interest rates on indexed loans remained at the same level as at the end of last year except in the case of loans for current assets which were additionally reduced.

Central Bank: Balance and Monetary Policy

Price rise at year's end bring inflation into target band

Following a slight rise in the y-o-y rise in prices at the end of 2016, a speeding up of inflation which stood at 4% in April was recorded in Q1 and in May it went back down to 3.5% and closer to the target level. Since the rise in inflation was caused mainly by once-off factors, the NBS kept its key policy rate unchanged to the end of the quarter. We see that NBS policy as correct because base inflation which reflects the systematic component of inflation in the entire period was below the middle of the target corridor. Bearing in mind the somewhat higher level of inflation since the start of the year and unchanged key policy rate, the profitability of the placement in REPO bonds dropped significantly but the drop in REPO stock came in April after an increase in March (Table T7-2). The speeding up of inflation was not completely expected by the NBS and that is shown by the deviation of the planned from the real inflation NBS at the level of 1-1.5 percentage points three to six months in advance (Graph T7-1). Bearing in mind, the fact that the level of inflation is the consequence of once-off changes we expect a reduction in the deviation in coming quarters.

Graph T7-1. Deviation from predicted inflation 3 to 6 months in advance of the real 2013-2017



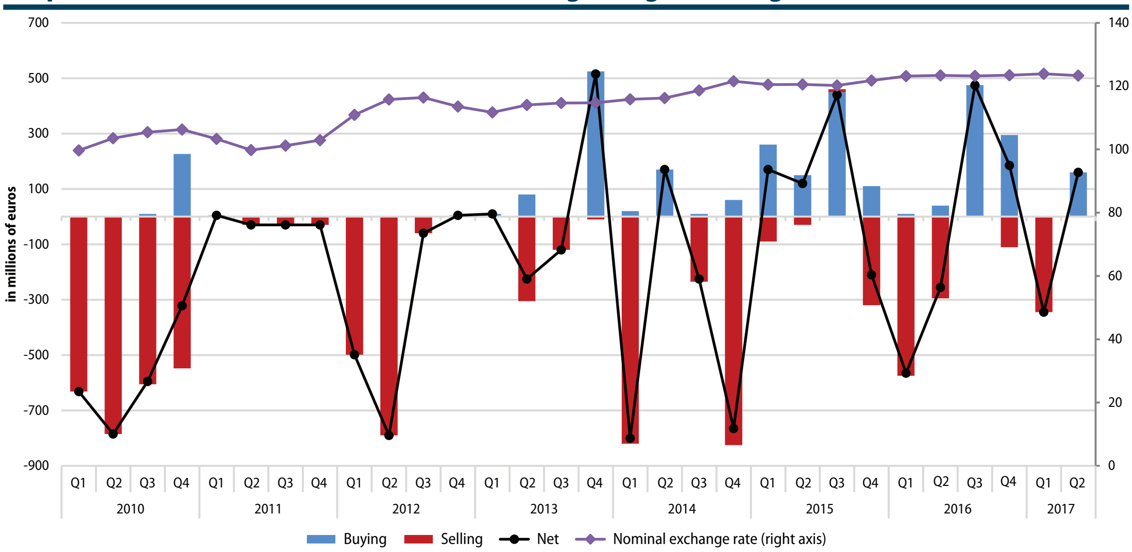
Source: NBS

Table T7-2. NBS interventions and foreign exchange reserves 2015-2017

	2015				2016				2017
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
Repo stock (in milions of euros)	2.85	168.72	508.19	253.24	246.50	239.12	325.82	279.23	480.53
NBS interest rate	7.50	6.00	5.00	4.50	4.25	4.25	4.00	4.00	4.00
NBS interest rate	-1.13	3.08	5.00	6.66	2.60	1.78	3.17	1.94	-5.11
NBS interest rate	11.33	5.70	6.29	-0.76	-0.34	3.35	4.57	3.37	4.48
NBS interventions on FX market (in millions of euros)	170.00	290.00	730.00	520.00	-555.00	-820.00	-345.00	-160.00	-345.00
INCREASE	**in millions of euros, cumulative from the beginning of the year**								
NBS own resreves[2)]	607.7	638.6	1022.9	1163.0	-469.43	-785.86	-346.46	-163.03	-269.73
NDA	-515.6	-460.4	-956.2	-783.4	45.62	395.60	-99.67	94.92	-171.42
Government, dinar deposits[3)]	-151.9	-13.7	-308.7	-217.4	41.52	275.36	35.00	195.73	-41.59
Repo transactions[4)]	68.0	-97.4	-413.3	-166.4	5.09	19.53	-279.20	-25.66	-207.38
Other items , net[5)]	0.0	0.0	0.0	0.0	0.00	0.00	0.00	0.00	0.00
H	92.1	178.3	66.7	379.6	-423.81	-390.27	-446.13	-68.11	-441.15
o/w: currency in circulation	-133.7	-95.5	-39.9	76.8	-68.06	-20.21	40.74	157.26	-104.02
o/w: excess liquidity	210.3	229.5	104.1	408.0	-284.91	-319.01	-465.39	-241.74	-351.17
	in millions of euros, cumulative from the beginning of the year								
NBS, net	676.36	561.44	762.45	667.97	-865.84	-1061.63	-784.51	-137.62	-464.59
Gross foreign reserves	638.67	440.86	613.29	508.46	-880.04	-1080.32	-807.49	-153.76	-469.25
Foreign liabilities	37.69	120.58	149.16	159.52	14.21	18.69	22.97	16.14	4.66
IMF	39.37	106.55	129.87	141.97	8.10	15.09	16.00	14.12	-0.04
Other liabilities	-1.67	14.04	19.29	17.54	6.10	3.59	6.98	2.02	4.69
NBS, NET RESERVES-STRUCTURE									
1. NBS, net	676.36	561.44	762.45	667.97	-865.84	-1061.63	-784.51	-137.62	-464.59
1.1 Commercial banks deposits	-20.68	-29.93	65.59	100.98	331.11	302.75	339.40	90.80	144.67
1.2 Government deposits	-47.99	107.13	194.81	393.89	65.30	-26.98	98.65	-116.22	50.18
1.3 **NBS own reserves** (1.3 = 1 - 1.1 - 1.2)	607.70	638.64	1022.85	1162.84	-469.43	-785.86	-346.46	-163.03	-269.73

Source: NBS.
1) "Initial M2" designates the state of the primary money at the start of the current or end of previous year.
2) Definition of net own reserves NBS is given in section 8 „Monetary trends and policy", Frame 4, QM no. 5.
3) State includes all levels of government: republic and local government level.
4) This category includes NBS treasury bonds and repo operations.
5) Other domestic assets net include: domestic loans (net bank debts, including treasury bonds and repo transactions; net enterprises debts) together with other assets (capital and reserves; and items in the balance: other assets) and corrected by exchange rate differentials.

Graph T7-3. NBS interventions on Inter-banking foreign exchange (FX) market 2010-2017



Source: NBS

In order to ease depreciation pressure in Q1 the NBS sold foreign exchange …

Depreciation pressure at the end of the year continued in Q1 which caused the NBS to intervene on the Inter-banking foreign exchange (FX) market. In order to prevent a greater depreciation of the Dinar the NBS sold 345 million Euro in Q1 (Graph T7-3). In April and May, pressure appeared on the FX market to strengthen the Dinar after which the NBS intervened buying 160 million Euro which partly eased the appreciation pressure. The sale of foreign exchange led to a reduction of NBS net own reserves in Q1 by 270 million Euro (in Q4 2016 the value of net own reserves increased by 183 million Euro, Table T7-2) which had an indirect effect on the level of primary money. The reduction of the NBS net own reserves led to a drop of 441 million Euro

… appreciation pressure grew stronger as of April and the NBS bought foreign exchange

in primary money in Q1 from the start of the year. The drop in primary money was also caused by the negative effect of a reduction of net domestic assets by 171 million Euro. In Q1, the net own reserves were reduced because of increased investments by business banks in REPO for 207 million Euro and an increase in state Dinar deposits by 42 million Euro while on the positive side an increase in other net assets of 86 million Euro was recorded.

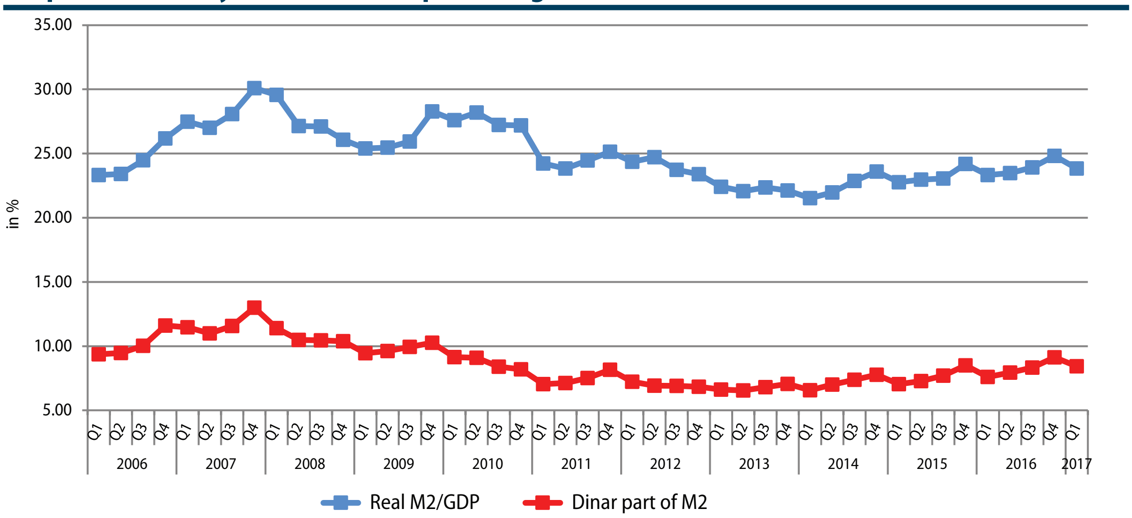
Monetary System: Structure and Trends of Money Mass

A slowing down of the y-o-y real growth of M2 was registered in Q1 …

… while loans to the non-government sector recorded a somewhat higher rate of growth in real terms

In the first three months, the money mass M2[1] continued its trend of growth carried over from previous quarters and recorded an increase of 10.3% y-o-y (in Q4 2016 the money mass grew by 9.9% y-o-y, Table T7-5). Compared to the values at the end of December 2016, the money mass was reduced by 0.6% which is the consequence of the combined effect of the increased Dinar part of the M2 and the drop recorded on the net foreign assets. The net domestic assets contributed to the quarterly rise of the M2 with 1 percentage point (p.p.) but the reduction on the foreign currency side of the net foreign assets of -1.6 p.p. caused the M2 to record a drop at the end of Q1 compared to the start of the year. Compared to the same period of the previous year and following corrections by the inflation rate, the growth of the money mass in real terms in Q1 stood at 6.4% y-o-y, which continues the slowing down of growth since the middle of last year. In Q1, the real growth of loans to the non-government sector continued at 2.1% y-o-y within which various trends were recorded linked to loans to the households and the enterprises. The households segment with a real rate of 8.8% y-o-y was speeding up the growth of credit activity (in Q4 2016, the y-o-y real growth of loans to the households stood at 7.5%). On the other hand, the enterprises segment recorded a real drop in Q1 of -2.3% y-o-y which is the consequence of the continued debt repayments to domestic and foreign banks.

Graph T7-4. Money mass trends as percentage of GDP, 2005-2017



Source: *QM* calculation

1 Monetary aggregate M2 in section Monetary Trends and Policy includes the narrow aggregate M1, savings and timed deposits as well as foreign currency deposits in business banks. Because of that the aggregate M2 which we are observing is equal to the monetary aggregate M3 in NBS reports

Trends

Table T7-5. Growth of money and contributing aggregates, 2015–2017

	2015				2016				2017
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar
					y-o-y, in %				
M2[1)]	8.5	7.8	4.1	7.2	7.9	7.8	10.2	9.9	10.3
Credit to the non-government sector[2)]	5.8	4.2	2.2	2.8	2.2	4.7	5.9	2.6	4.1
Credit to the non-government sector[2)], adjusted[3)]	2.8	1.2	1.7	2.5	0.6	3.1	3.9	1.5	3.5
Households	5.5	4.9	3.8	4.3	3.8	5.8	8.4	9.4	11.0
Enterprises	1.2	-1.0	0.3	1.3	-1.4	1.4	1.0	-3.3	-1.3
					real y-o-y, in %				
M2[1)]	6.4	5.8	2.6	5.5	7.2	7.3	9.4	8.0	6.4
Credit to the non-government sector[2)], adjusted[3)]	1.6	0.3	1.1	1.8	0.2	2.3	2.8	0.9	2.1
Households	3.9	3.4	2.9	3.4	2.9	4.6	6.6	7.5	8.8
Enterprises	0.3	-1.5	0.0	0.8	-1.5	0.9	0.4	-3.2	-2.3
					in bilions of dinars, end of period				
M2[1)]	1835.4	1876.1	1893.8	1999.7	1979.6	2023.2	2087.0	2196.8	2182.7
M2[1)] dinars	567.8	595.3	632.4	702.6	645.5	685.0	727.1	808.0	772.7
Fx deposits (enterprise and housholds)	1267.7	1280.8	1261.4	1297.0	1334.1	1338.2	1359.9	1388.7	1410.0
					quarterly growth M2[4)] and shares				
M2[1)]	-1.6	2.2	0.9	5.6	-1.0	2.2	3.2	5.3	-0.6
NFA, dinar increase	-2.5	1.5	2.0	3.7	-2.9	2.0	2.1	3.9	-1.6
NDA	0.9	0.7	-1.0	1.9	1.9	0.2	1.1	1.4	1.0

Source: NBS
1) Money mass: components – see Analytical and Notation Conventions *QM*.
2) Loans to non-government sector – loans to enterprises (including local government) and households.
3) Trends corrected by exchange rate differentials. Corrections were done under assumption that 70% of loans to the non-government sector (both households and enterprises) indexed against the Euro.
4) Trends are corrected by exchange rate differentials and inflation. Corrections are done under the assumption that 70% of loans to the non-government sector (both households and enterprises) indexed against the Euro.

Greatest contribution to growth of M2 achieved thanks to growth of M1…

… with increase in participation of time and savings deposits compared to previous quarters

The biggest individual contribution in the structure of the nominal growth of the M2 money mass which stood at 10.26% y-o-y in Q1, as in previous quarters, was from the growth of the narrowest monetary aggregates M1. In Q1 the growth of M1 accounted for 4.49 p.p. of the nominal growth of M2 (in Q4 2016 M1 accounted for 5.17 p.p. of the nominal growth of M2 which stood at 9.86% y-o-y). The remaining element of the M2 money mass also had a positive effect in Q1 with foreign currency deposits contributing 3.84 p.p. while the savings and timed deposits saw their greatest contribution to the growth of M2 over the past five years with 1.93 p.p.

Banking Sector: Lending and Sources of Financing

Overall lending by business banks rose in Q1 …

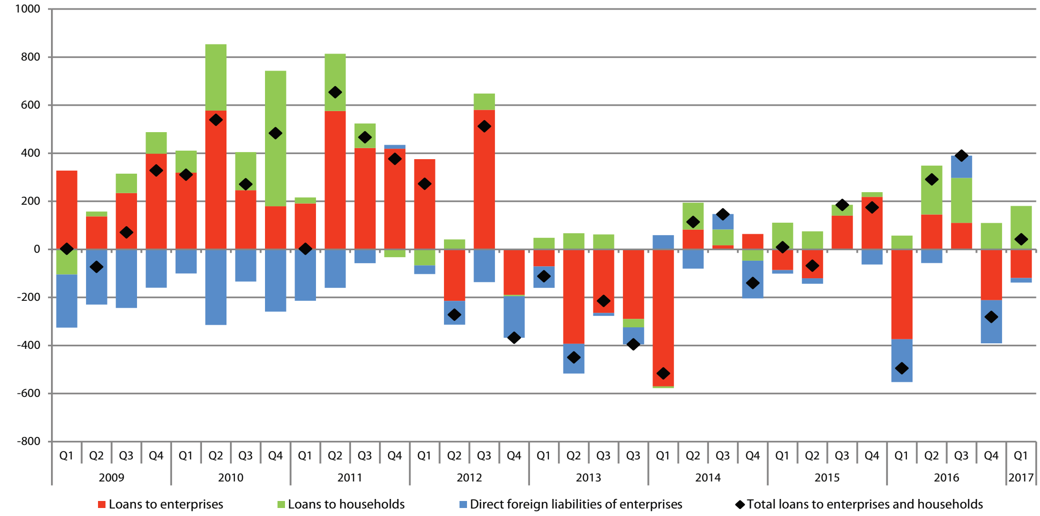
… thanks to a growth of REPO placements and net loans to the households

The value of new bank lending, decreased by the amounts repaid to banks on earlier lending, increased in Q1 by 255 million Euro (Table T7-7). The greatest part of that growth was achieved on the basis of lending in REPO whose stock rose in Q1 by 202 million Euro. The remainder of the growth of the net lending is owed to the continuing trend of growth of net lending to the households which increased its debts by another 180 million Euro. On the other hand, the enterprises continued net repayments to domestic banks to the level of 119 million Euro in Q1 (the enterprises net paid off 330 million Euro in debts to domestic banks in 2016) and that continued in April with another 91 million Euro. On the side of decreased net lending there were some positive trends in public finances which caused a drop in the net loans to the government by 8 million Euro (in 2016 the net crediting of the government stood at 784 million Euro).

Growth of net lending to households managed to compensate for debt repayment by enterprises in Q1

The negative trend of repayments by the enterprises to foreign creditors was reduced in Q1 when 19 million Euro were repaid in cross-border loans (Graph T7-6). The enterprises paid of 138 million Euro of debts to domestic and foreign banks in Q1, including some 70 million Euro which were written off or sold as NPLs while the rest is the drop of credit activity to the enterprises in real terms. The biggest share in the structure of newly approved loans to the enterprises went to loans for current assets (about 52%) while the participation of investment loans (some 24%) remained at a level similar to previous quarters. The continuing growth of repayments by the households caused the overall lending from domestic and foreign sources to be positive in Q1. Data for April suggest that a drop in overall lending to the enterprises and households was recorded once again primarily because the enterprises repaid its debts which the 76 million Euro rise in loans to the households in April could not compensate. The biggest share of the newly approved loans to the households in Q1 (almost 60%) were cash loans while housing loans accounted for 18% when their growth continued because of favorable trends in interest rates.

Graph T7-6. Yield of new loans to enterprises and households, 2009-2017



Source: *QM* calculation
See footnote 1 in Table T7-5

Table T7-7. Bank operations – sources and structure of lending, corrected1) trends, 2015-2017

	2015				2016				2017
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	
	in millions of euros, cumulative from the beginning of the year								
Funding(-, increase in liabilities)	241	33	-368	-513	377	168	-363	-1,130	354
Domestic deposits	47	-118	-324	-918	223	-235	-708	-1,425	107
Households deposits	-11	-104	-114	-282	-16	-235	-362	-625	-69
dinar deposits	96	19	-57	-196	3	-75	-154	-290	27
fx deposits	-107	-123	-57	-86	-19	-161	-208	-334	-96
Enterprise deposits	58	-14	-211	-635	239	0	-346	-800	175
dinar deposits	168	112	-75	-455	385	222	5	-352	207
fx deposits	-110	-126	-136	-181	-146	-222	-351	-448	-31
Foreign liabilities	36	150	58	225	181	397	427	335	218
Capital and reserves	158	1	-101	179	-27	6	-82	-40	29
Gross foreign reserves(-,decline in assets)	-150	-115	-262	-497	214	337	284	244	-35
Credits and Investment[1]	-20	149	928	1,252	128	426	1,129	997	255
Credit to the non-government sector, total	24	-21	165	407	-316	32	329	186	61
Enterprises	-86	-207	-67	158	-374	-228	-118	-372	-119
Households	111	186	231	248	57	260	447	559	180
Placements with NBS (Repo transactions and treasury bills)	-66	100	439	192	-7	-14	276	27	202
Government, net[2]	22	69	324	653	452	408	525	784	-8
MEMORANDUM ITEMS									
Required reserves and deposits	444	605	288	311	-598	-864	-859	-565	-161
Other net claims on NBS[3]	-182	-309	-209	-100	-107	160	6	201	-324
o/w: Excess reserves	-204	-317	-225	-134	-102	160	3	187	-326
Other items[4]	-352	-379	-404	-343	0	-204	-175	253	-79
Effective required reserves (in %)[5]	22	23	20	20	17	16	15	16	16

Source: NBS
1) Calculations of the yield is done with the assumption that 70% of overall lending are indexed in Euro. Yields for original Dinar deposits were calculated using the average exchange rate for the period. For foreign currency deposits as the difference calculated on the basis of the exchange rate at the ends of the period. Capital and reserves calculated using the Euro exchange rate at the ends of the period and do not include the effects of changes to the exchange rate when calculating the remainder of the balance.
2) NBS bonds include government and treasury bonds NBS which are sold at repo rates and at rates set on the market for permanent auction sales with a due date longer than 14 days.
3) Net loans to the government: loans approved to the government are decreased by the government deposits in business banks, the negative prefix designates a rise in deposits over loans. Government includes all levels of government: republic and local level.
4) Other NBS debts (net): the difference between NBS debts to banks on the basis of cash and free reserves and debts to the NBS.
5) Items in bank balances: other assets, deposits by companies in receivership, inter-banking relationships (net) and other assets not including capital and reserves.
6) Effective mandatory reserve is the participation of the mandatory reserve and deposits totaling sum of overall deposits (households and enterprises) and bank debts abroad. The basis for calculation of the mandatory reserves does not include subordinate debt because that is not available.

Sources for new bank investment decreased in Q1…

… due to net repayment of domestic banks to their centrals abroad and drop in domestic deposits

Following record increases in the previous quarter, a drop of 354 million Euro in the sources for new bank investment was recorded in Q1 (Table T7-7). The largest part of the reduction (around 60%) is due to the repayments of loans by domestic banks on funds drawn from their head offices abroad. That repayment trend by domestic banks has been present since 2011 and on that basis along bank sources for new placements have been reduced by 778 million Euro in the past two years alone (2015-2016) along with the repayments in Q1. In the period after the outbreak of the financial crisis, banks in Serbia repaid funds to their head offices abroad due to their need to secure liquidity but the repayment of loans over the past few years suggests that business banks in Serbia are unable to efficiently place funds with domestic companies. There was also a reduction in domestic deposits in Q1 which had an negative effect on the drop in credit potential by the domestic banking sector. Domestic deposits were reduced in Q1 by 107 million Eur which is solely the result of a drop in deposits by the enterprises. In the first three months, the deposits of the enterprises recorded withdrawals of 175 million Euro and another 100 million Euro in April. The reduction of the deposits was achieved in Dinars (207 million Euro) while the FX deposits of the enterprises increased by 31 million Euro. Unlike the enterprises, the total net deposits by the households in Q1 rose by 69 million Euro but that growth was achieved solely on the FX side while the households Dinar deposits dropped by 27 million Euro. In April, the rise in the deposits of the households continued both in Dinars and FX for another 58 million Euro. In Q1, commercial banks reduced their capital and reserves by 29 million Euro which lowered the sources for new lending further along with the drop in deposits and repayments by banks out of the country.

Participation of NPLs slightly drops in Q1 …

… with the companies' segment recording a somewhat higher participation than in the previous quarters

According to Credit Bureau data, there was no great change in the participation of NPLs in overall lending at the end of Q1 but at the end of April a slight drop of 0.08 p.p. was recorded (Graph T7-10). For the first time in a year of constant reductions, the participation of NPLs placed to corporate sector recorded a rise of 0.44 p.p. (at the end of Q4 those loans accounted for 19.48% of the total, Table T7-8). Viewed in absolute terms, the value of NPLs among corporate sector did not record a rise in Q1 but because of the loan repayments by the enterprises to domestic banks in Q1, the amount of loans to corporate sector was reduced and the relative participation of NPLs was increased. The participation of NPLs in the other segments also saw improvement which was sufficient to neutralize the effect of the growth of that participation among corporate sector, and there were no changes compared to the previous quarter at the level of the entire banking system. An improvement of 0.45 p.p. was recorded in NPLs placed to individuals and they now stand at 9.21%. According to data from April the reductions are continuing. This improvement is mainly the consequence of the growth of credit stock of the households due to the increase in new net lending in Q1 while the lesser effect is achieved on the basis of solving NPLs in this segment. The greatest reduction of 0.93 p.p. was achieved in the segment of NPLs placed to entrepreneurs whose participation now stands at 26.49%. Since NPLs to entrepreneurs account for just 3.5% of all NPLs, this change did not have any great effect on the drop in overall participation.

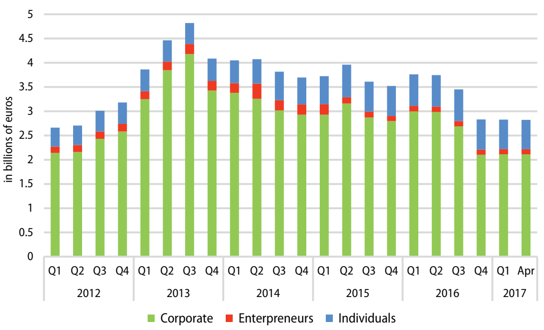
Table T7-8. Participation of NPLs according to type of debtor, 2008-2017

	2009	2010	2011	2012	2013	2014	2015				2016				2017	
	Dec	Dec	Dec	Dec	Dec	Dec	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Apr
							balance at the end of period									
Corporate	12.14	14.02	17.07	19.06	27.76	25.5	25.85	28.63	25.52	24.40	26.89	26.26	23.56	19.48	19.92	19.96
Entrepreneurs	11.21	15.8	17.07	15.92	20.82	43.29	45.19	34.91	32.03	29.92	33.03	30.12	28.44	27.42	26.49	26.23
Individuals	6.69	6.71	7.24	8.32	8.59	9.97	10.16	11.60	10.68	10.53	10.95	10.63	10.36	9.66	9.21	9.03
Ammount of dept by NPL (in bilions of euros)	1.58	1.94	2.63	3.19	4.09	3.70	3.72	3.96	3.61	3.52	3.76	3.75	3.45	2.83	2.83	2.82

Source: *QM* calculation

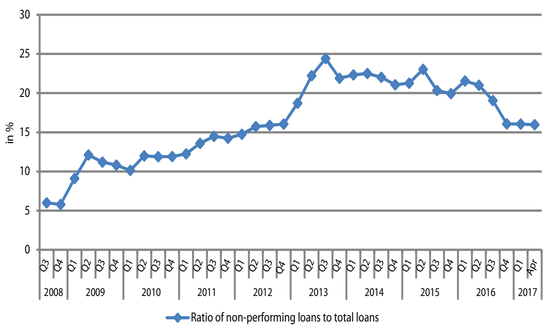
Following a significant drop in the absolute amount of NPLs late in 2016 because they were written off or sold to non-banking entities, the situation with the absolute amount of NPLs did not change at the end of Q1 (Graph T7-9). According to data from April, the overall value of loans whose repayments are late by more than 90 days stands at 2.83 billion Euro which is the same level as in December 2016. This figure suggests that the reduction in Q4 last year is more the consequence of a single writing off of debts rather than the start of a trend of continuous reductions of NPLs. Considering the fact that NPLs have stagnated for several months at the high level of around 16%, it is necessary to consider the introduction of regulatory stimulation to solve this problem.

Graph T7-9. Amount of remaining debt from late repayments, 2012-2017



Source: *QM* calculation

Graph T7-10. Participation of NPLs in overall lending, 2008-2017



Source: *QM* calculation

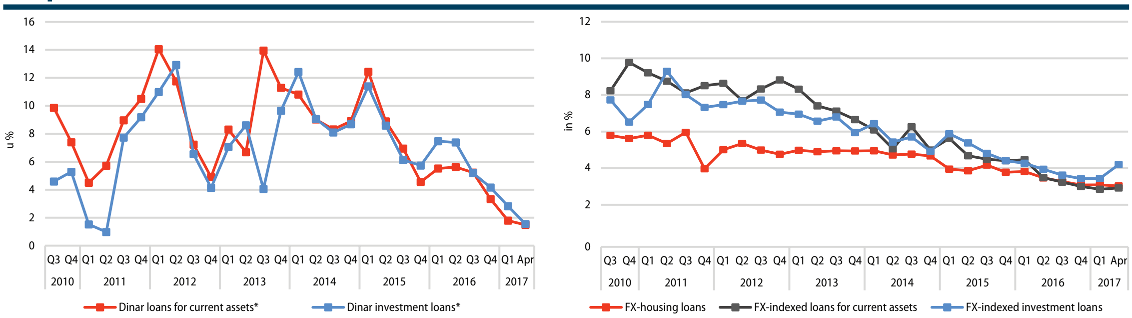
Interest Rates: State and Trends

Interest rates in real terms on Dinar loans continued their drop in Q1…

… because of speedier inflation at the start of the year

The unexpected increase of y-o-y inflation had a significant effect on the dynamics of interest rates on Dinar loans while minimal changes were registered in indexed loans. The only greater change in indexed loans is noted in loans for current assets where the interest rate was reduced by 0.15 p.p. to 2.85% in Q1 while the rates on housing and investment loans in this category remained virtually unchanged compared to the end of 2016 (Graph T7-11a). The rise in inflation in the first three months of 2017 caused commercial banks to correct the nominal interest rates on Dinar loans but the interest rates in real terms continue to drop (Graph T7-11b). That is especially pronounced in real rates on Dinar loans for current assets which stood at 1.79% following corrections for inflation which is a reduction of 1.54 p.p. compared to the previous quarter. A somewhat smaller reduction of 1.34 p.p. was recorded in the real interest rate on investment loans which stood at 2.82% at the end of Q1. The trend in reducing real interest rates on Dinar loans continued in April with an added 0.25-0.3 p.p. but on the other hand there was a significant increase of 0.76 p.p. in interest rates on indexed investment loans. The rise in the interest rates on indexed loans for investments could signalize the end of a period of extremely cheap conditions of financing which could potentially have a negative effect on the already low level of net credit lending to the economy. The effects of the expected rise in interest rates in Europe on interest rates in Serbia could be eased if Serbia would additionally lower the premium on risks. The key steps to do that are the stabilization of the fiscal deficit at a level below 1% of the GDP, further progress in solving the problem of NPLs and a speeding up of the growth of the economy.

Graph T7-11. Interest rates on Dinar and indexed loans, 2010–2017



Source: *QM* calculation
* real interest rates