TRENDS

1. Review

Macroeconomic indicators in Q2 clearly reflect the two main characteristics of the domestic economy. The first, favourable, is macroeconomic stability. Inflation is relatively low and stable, at about 3% annually, with a tendency for gradual slowdown. The current account deficit in Q2 was also relatively low for Serbia, and amounted to 3.2% of GDP, while public finances were marked by the budget surplus with a strong decline of public debt. Another, unfavourable feature of the Serbian economy is the inability to accelerate the economic activity. Achieved economic growth of only 1.3% was the lowest in Central and Eastern Europe (except Macedonia). For such a slow economic growth in Serbia, excuse cannot be a drought or even bad EPS management, which led to major problems in the power sector. Low economic growth and systematic lagging behind comparable countries are the result of more permanent weaknesses of the domestic economy.

The two main characteristics of the domestic economy in 2017, mentioned above, (macroeconomic stability, but also low economic growth) are the result of economic policies carried out in the past years. We have written about these policies in detail in QM several times - clearly pointing out their possible outcomes. In short, over the past few years relatively strong fiscal measures have been implemented - public sector pensions and wages have been reduced, certain taxes and excises have been increased, and along with that exceptionally strong increases in public revenue collection was recorded as a result of more decisive work by the Tax Administration. Monetary policy was at the same time very cautious. The NBS gradually lowered the interest rate, with a certain delay related to market signals, and relatively strong interventions on the interbank market maintained a very stable dinarexchange rate. Desirable macroeconomic stability has been achieved with these measures. However, unlike the achievement of macroeconomic stability, economic policy completely failed in the reform which was supposed to support economic growth. Necessary reforms of public companies were not implemented (except for Zeleznica), a large number of state owned enterprises continue to make huge losses and their status is still not resolved (eg.Azotara), public investments are not being implemented efficiently, as well as healthcare and education reforms. In addition to all of this, little has been done to improve the economic environment, which would stimulate the growth of private investments (the rule of law, reduction of corruption, increased efficiency of public administration, and so on).

International circumstances were rarely ever so favourable for the high economic growth of Serbia (and other CEE countries) as in 2017. Expansive monetary policy ofthe ECB transmitted to low interest rates on euro-denominated borrowings, which also spilled over to CEE countries, including Serbia. In addition, the increase in demand on the Eurozone market has stimulated strong growth of CEE exports to the countries of Eurozone. In the first six months of 2017 the exports of Central and Eastern European countries to the countries of the Eurozone increased to more than 10% y-o-y (in 2016 this growth was only 4%). Monetary expansion of the ECB also stimulates growth of FDI in the CEE countries, as most of their foreign investments come from the Eurozone, which also positively impacts the economic growth of the region. In addition to all of this, CEE countries also benefited from low energy prices, since most of these countries are net importers of energy. After a temporary rise at the beginning of the year, energy prices returned quickly to their historically low levels. Due to all this, the CEE region in 2017 has seen the largest growth in economic activity since the outbreak of the crisis in 2008, and this growth is over 4%.

Serbia, unlike other comparable countries, has not taken advantage of this favourable international momentum to significantly accelerate GDP growth in 2017. GDP growth in Serbia in Q2 was only 1.3%, and in the first half of the year it was 1.2% (see section 2 “Economic activity”). It is true that Serbia’s poor economic performance in 2017 has been affected by droughts and problems in the electric power sector, but even excluding these factors, Serbia’s economic growth in the first half of 2017 would amount to only about 2.5% and would again be the lowest compared to all other CEE countries (excluding Macedonia, which had political instability). The reason for this, systemic lagging of Serbia's economic growth in comparison to other comparable countries, can be seen in low share of investments in the GDP of only 18% (in other CEE countries it is over 22%). Without significant acceleration of investments, primarily by domestic private sector, Serbia will hardly be able to achieve high growth rates. Because of all of this, we once again point out to the importance of urgent implementation of structural reforms that are crucial for increasing investments and accelerating Serbia's economic growth - because such favourable international circumstances will not last long, and Serbia, because of the unformed public sector and poor investment environment, fails to make the best of them.

The gradual growth of employment continued in Q2. According to the data from the Central Registry of Compulsory Social Insurance (CROCSI), the y-o-y growth of registered employment in Q2 amounted to 2.5%, which was in line with non-agriculture GDP growth. In addition, average wages also increased in real terms by 0.9%, so the real growth in the wage mass in Q2 was almost 3.5%. The trend of faster growth of the wage mass compared to the GDP growth rate (increase of unit labour costs) is unsustainable in the long-term, but we do not expect that in the coming quarters a significant slowdown of the current trends of employment growth and average wage growth will happen. Namely, important reasons for low economic growth are drought and poor EPS management, and they do not have much impact on employment trends. For this reason, it is better to compare the growth of the wage mass with the growth of the "trend" GDP - which is actually very close to the real growth of the wage mass, for the assessment of the sustainability of the current growth of employment and wages.

Unlike CROCSI data, data from the Labour Force Survey (LFS, which show a strong fall in unemployment and significantly higher growth in employment, are very suspicious. According to the LFS data, the y-o-y growth rate of formal employment in Q2 amounted to over 5%, which is not in line with employment growth trends based on the CROCSI data, but also not in line with other macroeconomic developments, such as the economic growth or collected contributions for social security (see section 3 "Labour market"). Thus, we find it indisputable that there is an increase in employment and the reduction of unemployment in 2017, but the intensity of these changes is most likely closer to the indications of the CROCSI data, or, in any case, less than what LFS estimates indicate.

As we already announced in the previous issue of QM, the acceleration of the inflation in the first quarter has proven to be temporary. After 2.3% inflation in Q1, in Q2 it slowed down to 0.5%, and we saw deflation of 0.2% in July and August (see section 5 "Prices and the Exchange rate"). Factors influencing price growth at the beginning of the year (seasonal increases in fruit and vegetable prices, oil prices, tobacco products, and telephone services) were rapidly depleted, and some even changed direction (prices of oil and prices of fruits and vegetables). Additionally, the relatively low inflation in the middle of the year was also influenced by the relatively strong dinar appreciation. The dinar in Q2 nominally appreciated when compared to the Euro by 2.5%, and this trend continued and deepened until mid-September, when the dinar reached its highest nominal value in relation to Euro since autumn 2014 - despite the fact that NBS during the period purchased about one billion euros on the interbank foreign exchange market. This appreciation of the dinar is economically damaging, especially in the current circumstances of low economic growth, as it reduces international competitiveness of the domestic economy and should be stopped by the monetary policy measures. By the end of the year, we do not expect large changes in inflation. The rise in the prices of agricultural products is unlikely to occur, despite droughts. The reason for that is that sufficient production has been achieved to satisfy domestic demand (exports will be reduced), and the drought was of local character (Balkans), so the world prices have not risen. Taking all this into account, in 2017 we expect inflation of about 3% annually.

As a reaction to the slowdown in inflation and strong appreciation pressures, the NBS, at the beginning of September, decided to reduce the key interest rate from 4% to 3.75%. Other monetary developments did not show any major changes in Q2 compared to the previous quarters. Credit activities of banks continues to grow solidly, primarily driven by the growth of lending to households, while lending from the business sector continues to lag behind (although there are some indications of gradual revival of activity in this segment also). After a relatively strong decline at the end of 2016, the share of non-performing loans in total loans has stabilized in 2017 at about 15%.

Movements in the Q2 balance of payments also stabilized (as well as the inflation) in accordance with the expectations made in the previous issue of QM. Q1 achieved a very high current account deficit of about 750 mln euros (9% of GDP), which was in Q2 reduced to below 300 mln euros (3.2% of GDP). A slightly more favourable foreign trade movements were significantly influenced by the improvement of the terms of trade, i.e. the reduction of energy prices, where Serbia is a net importer, and the rise in the price of basic metals, where Serbia is a net exporter (see section 4 "Balance of Payments and Foreign Trade"). It is also favourable that in Q2 the current account deficit was again fully covered by the inflow of foreign direct investments (FDIs), which in Q2 reached a level of almost 500 million euros - which was not the case in Q1.

At the level of the whole year, we expect the current account deficit to be about 1.6 billion euros (4.5% of GDP) and fully covered by foreign direct investments, which we expect to reach about 2 billion euros. Although these are not bad balance of payments results for Serbia, especially when compared to current account deficits of over 10% of GDP just a few years ago or the ones over 20% of GDP in years before the world economic crisis - there are certain reasons for caution. First of all, after four years of continuous reduction of the current account deficit, it rose again in 2017 compared to the previous year (when it was below 1.4 billion euros). Additionally, one part of the improvement of foreign trade trends is based on the improvement of the terms of trade (the reduction in world prices of imported products compared to Serbia's exports products), which can easily change. Because of all this, to maintain the achieved results in balancing the foreign trade relations, but also for further necessary improvements, it will be crucial for NBS, with available measures, to prevent the real strengthening of the dinar, but also that the government does not increase pensions and wages in the public sector above GDP growth rate.

Public finances, in Q2 and July,were marked by the continuation of the surplus of the consolidated budget, which reached about RSD 75bn from the beginning of the year to the end of July (see section 6 "Fiscal Flows and Policies"). The surplus over the first seven months hides a strong public revenue growth by about 5% in real terms compared to the previous year, while the public expendituresw ere reduced by about 2% in real terms. On the public revenues side, the largest growth in the previous year (and in relation to the 2017 budget plan) had corporate income tax, which is in real terms even more than 45% higher than in the previous year. This was due to the fact that in 2016 the profitability of the economy grew strongly, influenced by the improving terms of trade (primarily the fall in energy prices) and the fall in capital costs on the international market. Compared to the plan, a huge increase is recorded also in non-tax revenues, mostly due to the unusually large payments of state institutions to the budget (NBS has mad unplanned payment of RSD 9.6bn, the Deposit Insurance Agency of 1.5bn., etc.). On the public expenditures side, there was a sharp decrease in interest expenditures compared to the plan, primarily due to the appreciation of the dinar against the dollar and euro (less because ofthe reduction of interest rates), and, in addition, pension expenditures are reduced due to lower inflow of new retirees (increasein the age limit for retirement of women). However, behind a significant part of the reduction of public expenditures, there is an economically undesirable reduction of public investments which were even 20% lower in real terms in the first seven months of 2017 than in the same period last year. By the end of the year, we expect a certain acceleration of public investments, higher payment of subsidies and usual strong increase in expenditures for the purchase of goods and services in December. That is why we believe that the current, large, fiscal surplus will be reduced, but that in addition the state will achieve budget surplus in 2017, which we currently estimate at 20 to 30 billion dinars.

Public debt fell to below 68% of GDP at the end of July, down by almost 7 pp. compared to the end of 2016. Although the public debt reduction was significantly influenced by the achieved fiscal, the greatest credit for this reduction has the exceptionally strong appreciation of the dinar against the dollar and, to a lesser extent, the euro. Since the beginning of the year the dinar has strengthen in real terms against the dollar by about 15%, and since almost one third of Serbia's public debt is in the dollar - this affected the reduction of the public debt by about 5 pp. of the GDP.

Since in 2017, in all probability, a surplus (with relatively strong public debt reduction) will be achieved, this means that in 2018 no additional measures are needed to reduce spending and / or increase revenue - for the first time since the outbreak of the crisis in 2008. This, however, does not mean that it is justified to spend budget funds irrationally, nor to ignore major fiscal risks coming from the unreformed public sector. Good fiscal policy in the coming years should also support faster economic growth, instead of being an obstacle as it is now. For this reason, efforts to reform large public companies must be intensified, above all EPS, whose bad performance has considerably lowered the GDP growth rate in 2017, as well as to solve the fate of the remaining state-owned enterprises, which represent a high fiscal risk and hinder economic growth of the country, but also to significantly increase public investment. A major mistake in economic policy in 2018 (and in the following years) would be to allow faster growth of public sector pensions and wages than the nominal GDP growth. Such an increase in expenditures for pension and wages would not significantly stimulate economic growth and would almost certainly lead to the growth of external and internal imbalances of the Serbian economy (current account deficit and inflation).

Serbia: Selected Macroeconomic Indicators, 2006-2017

	Annual Data																				
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2015				2016				2017	
												Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Economic Growth										y-o-y, real growth[1]											
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	1.0	1.3
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	1.6	2.3
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	3.1
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	5.1
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	46041	48168	45437	48670
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	2058.5
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	5.5
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	-1.7
										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	11.7	32.3
Balance of Payments										in millions of euros, flows[1]											
Imports of goods[4]	-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 0	-4,271	-4,662
Exports of goods[4]	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	3,685
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	-287
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*	*-3.2*
Capital account[5]	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 0	503	236
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 0	501	487
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	222
Monetary data										in millions of dinars, e.o.p. stock[1]											
NBS net own reserves[6]	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	881,125
NBS net own reserves[6], 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	7,221
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	2,050,579
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	1,067,142
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	4.8
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	2.7
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	47.7
Prices and the Exchange Rate										Y-o-y growth[1]											
Consumer Prices Index[7]	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	3.6
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	82.5
Nominal exchange rate dinar/euro[8]	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	122.91

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.