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 sug-

gests 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 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	1.2
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, 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	-4,271
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
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 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	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. 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
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
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 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
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/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

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.