

## 2. Economic Activity

Economic activity trends are deteriorating. Real y-o-y GDP fall in Q1 2012 amounted to about 1.3%, and seasonally adjusted index shows a decrease in production compared to Q4 2011. The Serbian economy is in recession because seasonally adjusted GDP is declining for three consecutive quarters – and so is employment. The recession, which the Serbian economy is currently in, is not as deep as the one in the first wave of the crisis (fall of 2008 and 2009). By the end of the year we expect a start of the recovery driven by the growth in the net exports, which will contribute to the overall economic growth in 2012 of about 0% - despite poor results in the first quarter. However, there is a growing risk that the economic growth in 2012 will be negative, and this will primarily depend on the outcome of the crisis in the EU with which the domestic economy is closely linked. Depreciation of the dinar in the first half of the year has had undoubtedly a positive effect on the growth of the domestic economy, although this still does not reflect on the movement of the Euro-ULC (which we use to measure the price competitiveness of the domestic economy). Industrial production declined in Q1, but the latest data for April may be the first hint of the recovery. Construction in Q1 continues a solid growth from the previous year, which will probably slow down as the year progresses.

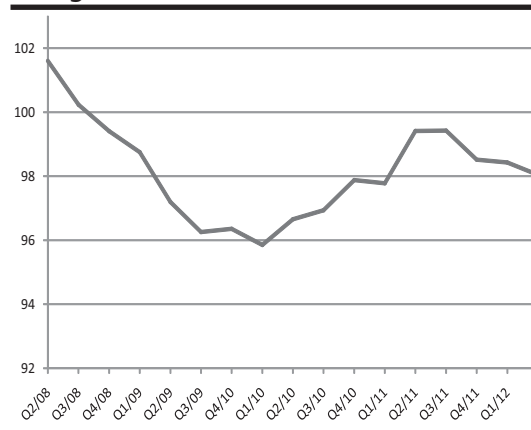
### Gross Domestic Product

**Y-o-y decline of GDP in real terms at around 1.3% in Q1**

According to preliminary SORS estimates based on the available economic activity performance data, real y-o-y GDP growth in Q1 stood at 1.3%. This estimate is in accordance with our expectations from the previous QM. Y-o-y GDP growth rates continue to gradually declined from Q1 2011 when the y-o-y growth was 3%. These data clearly indicate the gradual deterioration of trends in economic activity in the previous year.

**Seasonally-adjusted indices suggest the reducing in the production**

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



Source: QM estimates based on SORS data

Trends in economic activity can best be shown using seasonally-adjusted data. Graph T2-1 shows seasonally-adjusted GDP growth indices in comparison with the 2008 average. Seasonally adjusted indices confirm that the trend of the production recovery from the crisis in 2008 and 2009 stopped after Q1 2011, and that from then on the economic activity has gradually decreased. Q1 2012 also saw a decline in the production compared to the previous quarter (by about 0.4%). The trend of seasonally adjusted GDP indicates that the level of production from Q1 2011 will be achieved, at best, in Q3 or Q4 2012. In the next quarter (Q2), smaller annual decline in production, which we estimated to be about 1%, will probably be achieved.

**Economic activity is still significantly below its pre-crisis level**

Nearly four years after the outbreak of the first wave of crisis, economic activity is still 3% lower than the level it held in Q1 2008 (Figure T2-1). Some expectations that the economic crisis from the autumn of 2008 will have “double-dip” and leave lasting effects on the economic activity, seem to be confirmed. An illustration of this statement is that the level of production in early 2008 (under the optimistic assumption of recovery from the second half of 2012) will be reached in 2013 or 2014 year, in other words, five to six years after the outbreak of the crisis. In terms of the future developments in the economic activity in Serbia, decisive influence will probably have the outcome of the crisis in the eurozone, with which the Serbian economy is closely linked. Although we are still unable to totally exclude the possibility of a further deterioration of the economic conditions in the coming quarters, we still estimate that the stabilization is more probable.

## 2. Economic Activity

**GDP likely to stagnate in 2012**

If the situation in the international environment is stabilized as we predict and the Serbian economy gets back on the path of recovery in the ensuing quarters (similar to that taken after the first wave of the crisis), GDP growth in 2012 relative to 2011 will be about 0%. Therefore, we hold on to the estimate from the previous two editions of *QM*, for now, (*QM*25-26 and *QM*27) when we expressed the expectation that the economic activity in 2012 will be stagnant. However, compared with the previous forecasts, risks that the economic growth in 2012 will be negative are now much higher.

**Construction and telecommunications lead**

Growth in GDP considered by production is shown in Graph T2-2. This Graph shows growth by individual sectors of the economy up to and including the latest official data regarding Q4 2011.<sup>1</sup> The sectors of construction and information and communication saw relatively high real growth, while trade recorded the greatest drop. Similar trends, viewed by production sectors, are also expected in Q1 for which there are still no official data available. In Q1 we expect significantly smaller decline and a gradual recovery of the trend of trade - as indicated by available data on volume of retail trade. On the other hand, this recovery will be compensated (and surpassed) by the negative impact of the further decrease in the manufacturing industry on GDP. Manufacturing mostly contributed to the decline of the economic activity in the last twelve months, because it crossed the path from the high y-o-y increase of 6.2% in Q1 2011 (Table T2-2) to a fall in Q1 of 2012 of over 5%.

**Table T2-2. Serbia: Gross Domestic Product by Activity, 2008-2012<sup>1)</sup>**

	2008	2009	2010	2011	2011				share
					Q1	Q2	Q3	Q4	2011
Total	103.8	96.5	101.0	101.6	103.0	102.5	100.6	100.6	100.0
Taxes minus subsidies	101.4	98.3	100.9	101.9	103.4	103.2	100.9	100.7	17.7
Value Added at basic prices	104.5	96.4	101.3	101.5	103.1	102.3	100.5	100.5	85.0
Non agricultural Value Added	104.1	95.8	101.6	101.4	103.5	102.4	100.0	100.1	89.5 <sup>2)</sup>
Agriculture	108.7	100.8	99.6	100.9	98.4	100.8	102.2	101.3	10.5 <sup>2)</sup>
Manufacturing	100.8	84.2	100.9	100.6	106.2	101.8	98.1	97.7	14.0 <sup>2)</sup>
Construction	104.7	80.3	92.9	107.7	99.1	111.0	109.2	108.6	4.1 <sup>2)</sup>
Wholesale and retail trade	106.7	92.5	101.7	94.5	100.2	94.7	91.6	92.6	13.0 <sup>2)</sup>
Transport and storage	97.4	90.0	108.2	103.1	108.8	103.0	102.3	98.9	5.4 <sup>2)</sup>
Informations and communications	110.8	110.0	105.4	108.4	105.2	109.7	109.8	108.7	8.4 <sup>2)</sup>
Financial sector and insurance	113.4	105.5	107.2	101.0	105.7	100.9	99.5	98.0	3.9 <sup>2)</sup>
Other	103.7	101.6	100.8	102.0	102.9	103.1	100.6	101.6	40.6 <sup>2)</sup>

Source: SORS

1) In the previous year's prices

2) Share in GVA

For a more detailed analysis of the Serbian economy, it is necessary to analyze GDP *by use*. Because SORS does not publish GDP data *by use* at the quarterly level, *QM* analysis is based on circumstantial indicators. It is our belief that, if quality analysis of economic activity and quality economic policy is desired, it would be exceptionally useful for state institutions to monitor GDP *by use* at the quarterly level. Let us reiterate that such a practice is common in almost all statistical offices in Europe. We pointed out the necessity of regular monitoring of quarterly GDP data *by use* in several papers published in previous issues of *QM*.<sup>2</sup>

**The high growth of consumption prevented a drop in y-o-y economic activity in Q1 of over 1.3% ...**

When GDP is observed by use (private consumption, public consumption, investment and net exports), the y-o-y decline of 1.3% of GDP in Q1 is actually the sum of two divergent trends: 1) high-growth of public, and slightly lower, but positive, growth of a private consumption, and 2) a strong decline in investments and net exports. Public spending in real terms recorded a high y-o-y growth of 7.5% in Q1, thus contributing to a positive y-o-y growth of GDP by 1.2 percentage points (pp). Private consumption had significantly lower y-o-y growth in comparison with the public spending, but because of the larger share in GDP, private consumption contributed

1 For some industry sectors: construction, manufacturing, mining, electricity, and, to some extent, agriculture, trade and financial services, there are movement indicators for Q3 2011. That is why our analysis of these sectors partly includes Q3 as well.

2 See the Highlights: "How Much Has Economic Activity Really Declined in 2009?" *QM* 17, and Highlights: "The Reliability of Official Gross Domestic Product Data in Serbia", *QM* 24.

more to GDP growth- by 1.4 percentage points. Investments negatively contributed to the economic growth in Q1 by 1 percentage point, while net exports contributed to the GDP decline by about 3 percentage points. All components combined together indicate an annual decline in production of about 1.4% in Q1, which is consistent with the preliminary assessment by SORS, standing at 1.3%.

***But these trends are unsustainable - even in the short term.***

These trends - the growth of the consumption and a reduction in net exports and investment - result in a dangerous increase of macroeconomic imbalances, and as such they are - unsustainable. Current account deficit has increased sharply in Q1, and the fiscal deficit reached nearly 55 billion dinars from the beginning of the year until the end of March. The consequence of all this (and other factors) was also a strong depreciation of the dinar in the first five months of 2012. All these trends point to the unsustainable structure of economic growth in Q1.

***Private and public consumption will no longer be able to drive growth***

The annual growth of the public and private consumption in Q1 was temporary, not only because it causes macroeconomic imbalances, but also because of the difficulty of its further funding. Public consumption will have to considerably reduce its growth in the rest of the year, because further increase of the deficit and the public debt which public consumption would have to be funded from, is economically unsustainable. Available data indicate a solid annual growth of private consumption real terms in Q1 (between 2.5% and 3%), but in this case we also expect slower growth by the end of the year. Wage mass, financing most of the private consumption, will slow its growth, as a consequence of employment reduction (wage mass depends on wages and employment), and we have noticed quite a slowdown in the credit activity of the population, which will probably continue in the future.

***Investments are in the decline***

Investments recorded y-o-y decline in Q1 and we don't expect significant changes in the remaining part of the year. Fall of exports and domestic production of capital goods indicate the decline of the investment activity. Some other indicators slightly mitigate the observed adverse trends - these are the slight increase in lending activity of the economy and growth in cement production, as the basic building material and a high growth in the public investments. Somewhat lower level of investments in 2012, in comparison to 2011, is expected, since the major projects from 2011 (FIAT, NIS) are completed. Without new projects of a similar size, it is hard to expect that a high level of investment activity from 2011 can be reached. Therefore by the end of the year, we do not expect any significant changes compared to Q1. Although we do not expect this to happen, we must not ignore the risks of further deepening of the investment activity fall in the remaining part of the year. It is likely that the public investments will slow its growth recorded in Q1, but their share in total investments is not large, and will not significantly change the overall trends. A sudden drop in lending activity, which may occur under the influence of several channels on the financial sector (an increase in country risk, non-performing loans, capital withdrawals of banks whose parent companies are from the EU, etc.), could be much more dangerous for a decrease in the investments.

***Recovery in the second half of the year depends on the growth of net exports***

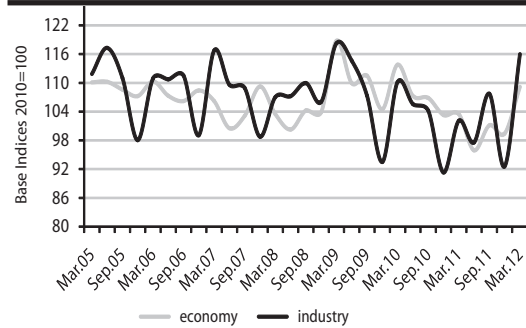
The fall in net exports in Q1 is most likely temporary - until the end of the year we expect the change of the trend, acceleration in the growth of export and a slowdown of import. In the first quarter, exports of goods and services recorded an annual decrease of 2.2%, while imports of goods and services recorded an annual increase of 4.1%. A more detailed analysis reveals that the overall export was affected significantly by the decrease in exports of base metals, presumably because of the problems that Železara Smederevo steel plant faced, but also the extraordinary circumstances in February (a state of emergency due to the unusually cold winter), when the exports marked an annual decrease of 20%. The growth of imports in Q1 was significantly affected by the high growth of imports of energy products (18.5%), which was also partly conditioned by one-time circumstances (an unusually cold winter). In the remaining part of the year, we expect the growth in the net exports due to: 1) a completion of the adverse impact of temporary factors from Q1, 2) start in serial production of the FIAT automobili Srbija company 3) depreciation of the dinar in late 2011 and in the first half of 2012, which affects the increase of the price competitiveness of the domestic economy. Despite all the aforementioned reasons, it still remains somewhat uncertain whether the growth in net exports in the remaining part of the year will be

**Unit labor costs temporary incline**

sufficient to reverse the trend of GDP. This means that the growth of net exports first needs to make up for the inevitable slowdown in the private consumption and the government spending in the remaining part of the year, but also that the growth of net exports needs to be sufficient enough to reach over and reverse the trend of GDP. It is our opinion that this is possible, along with significant risks. In that case economic growth in 2012 will be 0%.

Unit Labour Costs<sup>3</sup> (ULC), measured in dinars, continued to increase in Q1, which means that the share of labour costs in the realized added value has been in incline, making it an unfavourable trend (Graph T2-3). More detailed analysis reveals that in Q1 multiple factors influenced ULC to increase significantly. First of all, ULCs are always seasonally slightly higher in Q1 than in all other quarters, because many sectors of the economy significantly reduce their activity during the winter, which is usually not fully accompanied by the reduction in the wages and employment.

**Graph T2-3. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2012**



Source: QM based on SORS and NBS data

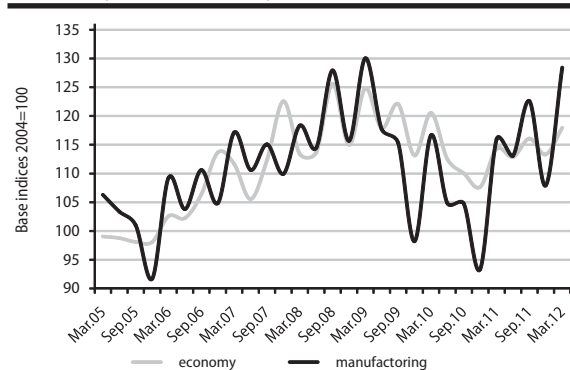
Besides the usual seasonal increase in ULC, a temporary additional growth in Q1 was influenced by the relatively high growth of wages which, in the observed quarter, significantly increased their real growth (partly due to the disinflation).<sup>4</sup> Finally, it should be noted that during the state of emergency in February there was an irregular, sharp decline of some economy sectors (manufacturing), while employment in this period remained somewhat unchanged. Aforementioned factors are considered temporary and that is why ULC will drop considerably from next quarter on.

**Somewhat surprisingly moving of euro-ULC ...**

Unit labor costs measured in euros (euro-ULC) are an indicator of the price competitiveness of the Serbian economy because they define the greatest national cost component (labor costs) in relation to added value. We calculate euro-ULC for the manufacturing sector (that produces by far the greatest share of tradable goods), and for the economy as a whole,<sup>5</sup> as shown in Graph T2-4. We use 2005 as the benchmark year for observing changes in euro-ULC, because that is the year when significant decline in the price competitiveness of the Serbian economy began due to the strong appreciation of the national currency that only ended when the economic crisis escalated in Serbia.

**... which have increased substantially in Q1**

**Graph T2-4. Serbia: Real Unit Labor Costs in the Economy and Industry, 2005-2011**



Source: QM based on SORS and NBS data

Note: the growth of euro-ULC on the graph represents the decline in price competitiveness

The graph shows that the euro-ULCs have significantly increased in Q1, especially in the manufacturing industry. This information hides mainly temporary factors that have been described in previous paragraphs. It should be noted that the growth of euro-ULC in manufacturing is largely a direct consequence of the fall in production in February due to the state of emergency. Under such circumstances, production freezes for the short period of time, but there is no need to reduce employment (and the data showed – earnings too) as the reason for the fall in production is not fundamental, but of a temporary nature.

<sup>3</sup> Unit Labor Costs in dinars are calculated for the economy (excluding the Agriculture and Public Administration sectors) and industry.

<sup>4</sup> For more details see Section Employment and Wages in this issue of QM

<sup>5</sup> Excluding the Public Administration and Agriculture sectors.

**The dinar depreciation will certainly increase the price competitiveness starting from the next quarter**

The decline in the dinar value has positive influence on the increase of price competitiveness of domestic economy. Due to the described temporary factors this effect was not seen Q1, but we expect that the data for the next quarter will show a rapid increase of price competitiveness of the economy (probably for more than 10%). The growth of the price competitiveness (reducing Euro-ULC) will be strong support to the further increase in net exports which we expect to grow significantly in the second half of the year and be a crucial factor of the economic growth in the future. Therefore, we consider a controlled depreciation of the dinar actually desirable from the viewpoint of the recovery and future sustainable growth in the economic activity. We therefore believe that a recent weakening of the dinar exchange rate in May and early June, if under control, may be useful for the Serbian economy in the medium term.

**Industrial production**

**Industrial production falling in Q1**

Industrial production recorded high y-o-y fall of 5.9% in Q1 2012. This decline is in line with our expectations set forth in the previous QM. Within the scope of the industrial production manufacturing industry had the worst performance and recorded an annual decline of 7.1%. The fall in electricity supply amounted to 3.4%, while mining production was at the same level as in the year before (Table T2-5). The y-o-y indices of growth in Q1 however, are not the best indicators of the actual situation in the industrial production because they were under very strong influence of meteorological conditions in early February.

**Table T2-5. Serbia: Industrial Production Indices, 2007-2012**

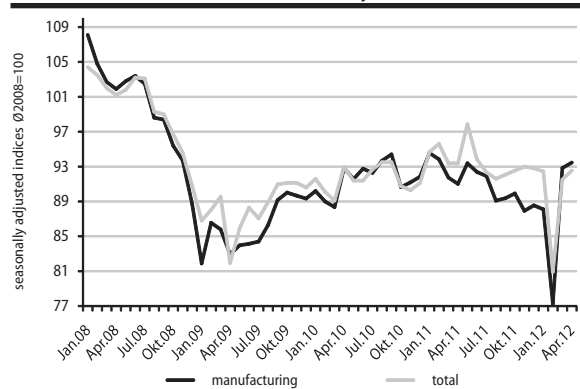
	Y-o-y indices										share
	2007	2008	2009	2010	2011	2011				2012	2011
						Q1	Q2	Q3	Q4	Q1	
Total	104.1	101.4	87.4	102.5	102.2	106.4	103.6	98.2	100.4	94.1	100.0
Mining and quarrying	100.2	105.3	96.2	105.8	110.4	107.5	118.8	103.6	115.0	100.1	9.9
Manufacturing	104.6	101.1	83.9	103.9	99.6	105.8	100.6	97.9	95.6	92.9	73.1
Electricity, gas, and water supply	103.2	102	100.8	95.6	109.7	107.5	113.2	101.7	117.1	96.6	17.0

Source: SORS

**It is possible that the seasonally adjusted indices indicate a necessary change in the trend**

Graph T2-6 shows seasonally-adjusted production indices of industry as a whole and manufacturing in particular. Seasonally-adjusted data indicate that, with smaller fluctuations, from Q1 2011 there was a significant drop in industrial production, particularly in the manufacturing industry and that the trend lasted until the end of 2011. However, Q1 2012 saw unusual movements which primarily reflect the impact of state of emergency on industrial production (Figure T2-6). After February, in which there has been an extraordinary decline in industrial production by over 10 percentage points, March saw not only expected to recover, but the seasonally adjusted index of the manufacturing industry significantly outperformed their value it had before the fall in February. Although at that point we could not be sure whether there is a shift in the trend of industrial production on the horizon, or it is temporarily increased to compensate for the backlog from the February, the latest data from April shows that a shift in the trend is indeed possible (Figure T2-6). This shift is actually necessary in

**Table T2-6. Serbia: Seasonally Adjusted Industrial Production Indices, 2008-2012.**



Source: SORS

order to avoid a decline in production in 2012 and in order for the economic activity to remain at the same level as in 2011 (GDP growth of 0%). In the previous part of this paper we have shown

**Forecasts for the next quarter are optimistic, but still unreliable**

that for that the growth of net exports in the second half of the year is necessary, which does not mean anything else but the recovery of manufacturing industry - which produces by far the largest number of export products.

In the next quarter (Q2) we therefore expect significant decline of the annual industrial production compared to that of Q1. Although our forecast is still highly unreliable, because of large fluctuations in the past few months - we expect that industrial production will have annual decline of about 2%, and it will move in a positive annual growth index that can happen in Q3 2012, of course provided that there isn't a further escalation of the crisis in the eurozone. In Graph T2-6 we note that the industrial productions, nearly 3 years since the recovery has started, is still more than 10% below its pre-crisis level. Latest trends indicate that the pre-crisis level of the industrial production cannot be reached before the middle of 2013.

**All groups of industrial products declining**

A breakdown by use (Table T2-7) shows that all groups of goods entered negative y-o-y production growth in Q1. Energy production and consumer goods, as expected, had a slightly milder decline, because of the lower elasticity of demand for these products (most of the production of consumer goods is food industry).<sup>6</sup> On the other hand, a high decrease in the production of intermediate goods we associate with problems in the production of compounds of the Železara Smederevo steel plant. Decline in production of investment goods by over 10% likely announces lower investment activity in 2012.

**Table T2-7. Serbia: Components of Industrial Production , 2005-2012**

	Y-o-y indices								
	2008	2009	2010	2011	2011				2012
					Q1	Q2	Q3	Q4	
Total	101.4	87.4	102.5	102.1	106.4	103.6	98.2	100.4	94.1
Energy <sup>1)</sup>	101.7	98.8	97.7	106.2	103.7	111.3	96.5	114.5	95.9
Investment goods <sup>2)</sup>	105.9	79.3	93.6	103.2	132.2	103.7	100.3	99.1	89.1
Intermediate goods <sup>3)</sup>	100.3	78.4	109.2	102.2	113.8	98.4	93.6	92.9	90.8
Consumer goods <sup>4)</sup>	101.6	86.8	102.1	95.4	96.5	98.1	95.8	90.5	97.4

Source: SORS

## Construction

**Relatively high growth of construction in Q1 ...**

Latest construction statistics made available by SORS indicate extremely high y-o-y growth of this sector of the economy. The value of construction work performed rose by about 20% in real terms in Q1. We view these data with a degree of caution, since construction statistics are, according to some indicators, biased toward state-owned and other large companies.

Taking into consideration the fact that the construction sector comprises a large number of small and medium-sized enterprises, whose statistical monitoring is very unreliable, we use the cement production index as an additional indicator for monitoring this sector of the economy<sup>7</sup> (Table T2-8). Although not sufficiently precise, we believe that data obtained in this way are a good additional indication of possible trends in construction.

<sup>6</sup> The movement of energy production is further influenced by the business policy of a small number of large companies (NIS, EPS) - thus large fluctuations in production are often (Table T2-7)

<sup>7</sup> Cement consumption would be the most appropriate indicator, but data on cement consumption are not available at the quarterly level. Studies have shown that cement production approximates consumption with relative reliability.

**Table T2-8. Serbia: Cement Production, 2001-2011**

	Y-o-y indices				Total
	Q1	Q2	Q3	Q4	
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	-	-	-	-

Source: SORS

*But the figures for Q1 are not the best indicator of actual trends in construction activity*

tion activity in Q1 was seasonally very low. Even relatively small changes in activity can lead to very high changes in the y-o-y indices. Therefore, we will wait for data from the next quarter for the final evaluation of the trends in construction activity. Our estimate from the previous QM was that the construction activity is likely to stagnate in 2012, at the same level of 2011. If, however, positive indications from Q1 continue in Q2, preliminary estimates will be revised upward.

Table T2-8 shows that cement production had y-o-y growth of 7.9%. Taking both figures into consideration we believe that the real annual growth in construction activity was between 10% and 15%. The reason for this forecast lies in our belief that official construction statistics probably overestimate the growth of this sector but that cement production is also not a reliable enough indicator to consider its value as absolutely representative.

However, data for Q1 we take with some reserve since the construc-