TRENDS

1. Review

At the end of the year, as a rule, we summarize the most important macroeconomic trends that marked the previous twelve months. Among them, by their significance, two particularly stand out. Economic activity finally "broke away" from years of stagnation – with growth of around 2.7% in 2016, GDP exceeded its level from 2008 and it is certain that it will continue to grow in the coming years. That GDP growth is significantly lower than the historical benchmark for Serbia (average GDP growth was 6% in 2002-2008 period), and it is lower also than the average of the neighbouring countries (3.5%) - however, it was achieved during the fiscal consolidation and in economically healthy and sustainable way, which constitutes a good basis for its further increase. Second important result refers to favourable fiscal trends and strong reduction of the government deficit to below 2% of GDP. That led to a slight decrease of the public debt to GDP ratio for the first time since 2008. Stopping the growth of public debt to GDP ratio is one of the crucial indicators of macroeconomic stabilization, as this eliminates the direct threat of crisis. However, the public debt is still too high, about 75% of GDP, so fiscal policy in the coming years will have to be very responsible and cautious. Beside these two particularly important results from 2016, the remaining macroeconomic developments could be assessed as mainly favourable. Inflation is extremely low and stable, the average price growth in 2016 was only slightly higher than 1%, which is perhaps too low for Serbia, as deflation was recorded in five months of 2016. Current account deficit continues to decline and is now at the level of about 4% of GDP, and employment is also slowly recovering, although probably much more modest than the latest data from the LFS show.

The achieved favourable macroeconomic trends are not only the result of domestic economic policies, but also favourable regional trends. This is indicated by the fact that along with Serbia three neighbouring countries (Bulgaria, Romania and Croatia) in 2016 positively surprised with significantly faster economic growth than expected, on average, by 0.9 p.p, which is the same as Serbia. External incentives to growth of economies in the region were provided by the global decline in oil prices, low interest rates for borrowing in euros and solid import growth of the Eurozone (3.5% in real terms). However, in order for favourable international trends to "raise" particular economy, domestic economic policies had to create the appropriate conditions. This is well-illustrated by the fact that countries with the internal problems, such as Bosnia and Herzegovina and Macedonia, this year did not benefit from the favourable international circumstances. Their economic growth even fell short of expectations. Probably the Serbian economy would not feel this favourable economic moment if the Government did not begin a program of macroeconomic stabilization at the end of 2014, which included politically very unpopular measures such as the reductions in pensions and salaries in the public sector. In addition, we should not forget important reforms to improve the Labour Law, the Law on Pension and Disability Insurance and the Law on Planning and Construction, and also an important guarantee of macroeconomic stability certainly is the concluded precautionary arrangement with the IMF.

It is, however, very dangerous to presume that job is completed with these measures and that it is now completely certain that Serbia's economic growth will automatically continue to accelerate in the coming years with the improvement of other macroeconomic parameters. On the contrary, favourable international circumstances will not last forever and the Government has to recognize and take advantage of this good moment for addressing major structural problems of the domestic economy. Only in this way will it be possible for Serbia's economic growth to continue to accelerate and to remain high even when the international situation is reversed - and this is, sooner or later, bound to happen. Unfortunately, the reforms almost stopped in 2016. Inefficient public sector, and within it, especially non-privatized state-owned enterprises continue to make debt and thereby create fiscal risks. Also, there is no progress in reforming the health care and education, the judiciary is still very inefficient, the informal economy is widespread, but there are many other problems, which are in a little more detail explained in the section *From the Editor* of this QM issue. For all these reasons, 2017 could be a very important year for the long-term prospects of the domestic economy. In it we will see whether the Government will continue to implement a responsible fiscal policy and, most importantly, finally start implementing the most difficult reforms that were postponed for years - or will passively wait for the completion of the Arrangement with the IMF,satisfying with the achieved so far. The latter would have negative implications for long-term development of Serbia.

The growth of economic activity in Serbia in 2016 will be around 2.7%. We assess this as a good result, as economic activity continues to accelerate based on the economically sound and sustainable way - with a relatively strong investment growth of about 6% (see Section 2. "Economic Activity"). GDP growth in 2016, however, is still slightly lower than the average of the countries in the region, which is about 3.5%, but the Serbian economy is gradually catching up with this average. Additional approaching to regional trends is expected in 2017, which is predicted to have continued acceleration of economic growth in Serbia of 3%, and this prediction is also confirmed by the analysis of QM. Although at first glance GDP growth of 3% in 2017 seems only as slight acceleration compared to 2.7% in 2016, it should be borne in mind that during 2016 agriculture had a high growth (around 8%) due to the comparison with the dry 2015, which will not be repeated in 2017 – and so the planned acceleration of GDP growth is quite satisfactory. Another reason for satisfaction, if the forecasted growth is achieved, is that it is estimated that in 2017 rebalance of domestic economy will continue in the direction of further increase of investments and net exports, with a decrease in the share of personal and government consumption in GDP. For long-term sustainable high economic growth of over 4%, however, there is a need of a few more years of relatively strong increase in investment in order for their share in GDP to increase from the current 18.5% to about 25%. The Government could significantly contribute to this trend by improving investment environment and by continuing with policies that ensure macroeconomic stability.

Balance of payments trends continue to solidly improve in 2016. (seeSection 4 "Balance of Payments and Foreign Trade"). Current account deficit will be reduced to only 4% of GDP, which is the lowest value in the last fifteen years. A high current account deficit in the period 2005-2008, which at one point exceeded 20% of GDP, was one of the largest and most dangerous macroeconomic imbalances in Serbia, which is why it is very important that this problem is now under control. It's also good that the current deficit reduction in 2016 is mainly based on high export growth of about 10% (with a slightly slower import growth of about 5%). These developments led to the increase of the coverage of imports by exports to almost 80%, and when we add the trade of services to the trade of goods (where Serbia has a positive balance in trade with the world), the coverage of imports by exports grows at over 85%. Also, it is very positive that this, reduced, current account deficit is completely covered by the healthiest capital inflow from abroad and foreign direct investments. In 2017, we expect the current account deficit to fall below 4% of GDP, while in the medium-term the objective of the economic policy should be the further gradual reduction, and then a surplus. Slower growth of domestic demand from the GDP growth, as well as maintaining the dinar exchange rate at a competitive level could play a key role in that. In the future the level of the current account deficit is likely to be positively affected by the assessed economic growth of the Eurozone and negatively by the initiated and expected rise in energy prices on the world market.

Inflation in 2016 was very low (see Section 5 "Prices and the Exchange Rate"). Average price increase will amount to 1.1-1.2%, which is the lowest average annual inflation since we have monitored it. Although the low and stable inflation is economically desirable, mild acceleration in inflation compared to its current level would be economically desirable, because it would avoid the risk of deflation - during 2016 there was a fall in prices in even five months. Also, it is not good for the credibility of NBS that inflation is below the target corridor for too long, and inflation was last time in the corridor of the NBS in February 2014. For all these reasons it is acceptable to expect (and plan) mild acceleration of price growth in 2017. This will, along with (reasonable) lowering of the NBS target band at 3 ± 1.5%, introduce inflation in early 2017 in the boundaries of the new corridor, in which it should be retained over a longer period.

Developments in the labour market in 2016 are gradually improving, but the true measure of these improvements is the growth of the registered employment of about 1%, which is monitored on the basis of the data from the Central Registry of Compulsory Social Security, and not, hardly possible, increase in the total employment of 6% shown by the Labour force Survey (LFS). Namely, the trends of the overall employment and unemployment measured by this survey in 2016, as in previous years, significantly differ from other macroeconomic and fiscal trends, which is why we express our doubt about their credibility (see Section 3 “Labour Market”). According to this survey, for several years there has been a strong growth in employment, well above the growth of production. Although at first glance, strong employment growth and reduced unemployment, as shown by the LFS, sounds like a positive economic trend, when put into the context of a much smaller increase of GDP implies a huge reduction in the average productivity since 2012 - which totally relativizes the previous assessment. This, apparently, did not happen, because exports in the reporting period had a very strong growth. In 2017 we expect a continuation of mild positive labour market developments and the (actual) employment growth of 1 to 1.5%. Real wages in 2016 recorded a growth of 2.5-3%, which is in line with movements in economic activity and it is likely that their growth in 2017 will continue at a similar pace as in 2016. Increase of wages in 2017 will be affected by the increase of the minimum wage as of January 1, but, on the other hand, a slight acceleration in inflation will affect their real decrease, so we expect that the real wage growth in 2017 will be around 3%.

From the fiscal standpoint in 2016 good and important results had been achieved (see Section 6 “Fiscal Flows and Policy”). The general government deficit will be below 2% of GDP, which is only half of the planned deficit for this year. Also, achieved level of deficit leads do halting of the growth of public debt to GDP ratio for the first time since 2008. This reduces the chances for a public debt crisis, which was a real danger two years ago. However, we should bear in mind that the public debt is still very high (74-75% of GDP) and that it is therefore necessary to significantly reduce it in order for Serbia to be closer to a sustainable level of public debt (below 40% of GDP) – and for this to happen a period longer than a decade will be required. Also, behind such large deficit reduction there are no savings on expenditures, but largely unplanned growth of income. The growth of tax revenues was mainly a result of the suppression of the grey economy and the consequent improvement of the collection rate, which we single out as one of the most positive fiscal flows in 2016 and a part of the increase in revenues is owed to better macroeconomic conditions. However, it is not certain whether a similar pace of increase of public revenues could be maintained and continued in the future - certain one-off payments from 2016 will certainly not be repeated in the coming years, and the increase in tax collection was achieved without the necessary reform of the Tax Administration, thus it is not certain whether this will continue. The bad thing in 2016 is that different public sector reforms are late and are being delayed for the next period.

Budget plans for 2017 envisage further stabilization of public finances and we expect that this will happen despite of the slow reforms. The stabilization is reflected primarily in planned relatively low general government deficit of 1.7% of GDP (75 billion), which will lead to further reduction of the public debt to GDP ratio. However, it is reasonable to observe such plans from another angle. Namely, for 2017 new significant savings are not planned - the only new measures of fiscal consolidation is the amendment of the Law on Local Government Financing, which will lead to a deficit reduction of only 5 billion. It can be therefore said that the fiscal plans for 2017 are essentially confirmation of the results achieved in 2016, as the budget deficit will be roughly equivalent to that which would be achieved in 2016. That is why such budget plan for the next year we consider as insufficiently decisive, especially bearing in mind that there is a risk of the re-increase of the public debt to cover losses due to the unreformed public and un-privatized state-owned enterprises, the introduction of discretionary measures aimed at reducing taxes or increasing expenditures, etc. Also, there are additional problems, such as the unsustainable finances of some local governments, debts of health care institutions, lack of public investments, and there is a risk that after the ban on employing in the public sector is lifted vacancies created during the validity of this measure will be filled (just as, after the reduction of the employment in the general state it rose again in 2006, immediately after the departure of the IMF). All these factors indicate that the process of healing public finances in Serbia is not nearly finished and that fiscal consolidation should not end prematurely.

Serbia: Selected Macroeconomic Indicators, 2006 - 2016

	Annual Data										2015				2016		
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Q1	Q2	Q3	Q4	Q1	Q2	Q3
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	…	…	…	…	…		
GDP	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	0.8	-1.7	1.2	2.3	1.1	3.8	1.9	2.6
Non-agricultural GVA	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.5	1.9	-1.9	2.7	3.7	2.2	4.1	1.7	2.1
Industrial production	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	8.2	-2.0	11.1	13.2	10.2	10.5	2.4	3.7
Manufacturing	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	5.3	4.2	7.3	6.4	3.2	6.5	5.9	4.4
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	41,718	44,717	44,719	46,592	43,588	46,450	46041
Registered Employment (in millions)	2.028	1.998	1.997	1.901	1.805	1,866	1,865	1,864	1,845	1,990	1,977				1,978		
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	6.9	3.5	4.5	-1.4	7.4	7.8	9.2
Public Expenditures	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.2	-3.2	-5.4	-3.8	-1.3	-2.6	5.7	4.9	2.3
									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	-21.2	-14.2	-15.8	-98.0	-16.0	-2.2	13.8
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	-3,648	-3,869	-3,777	-4,057	-3,705	-4,230	-3,937
Exports of goods4)	5,111	6,444	7,416	5,978	6,856	8,118	8,376	10,515	10,641	11,357	2,601	2,997	2,882	2,877	2,953	3,307	3,122
Current account5)	-3,137	-4,994	-7,054	-2,084	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-511	-279	-343	-445	-369	-271	-240
in % GDP 5)	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-6.8*	*-10.9*	*-11.6*	*-6.1*	*-5.9*	*-4.8*	*-6.7*	*-3.2*	*-3.9*	*-5.2*	*-4.6*	-3	-3
Capital account5)	7,635	6,126	7,133	2,207	1,553	3,340	3,351	1,630	1,705	1,205	427	139	243	396	173	158	71
Foreign direct investments	4,348	1,942	1,824	1,372	1,133	3,320	753	1,298	1,236	1,804	339	441	510	514	459	374	438
NBS gross reserves (increase +)	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,797	166	111	-32	300	-213	-836	-317	332
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	854,636	858,972	902,526	931,320	884,093	846,969	899,959
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	7,094	7,125	7,509	7,649	7,180	6,864	7,303
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	1,919,958	1,918,917	1929573	1,982,974	1,961,626	2,009,537	2,044,160
FX deposits of households	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	1,014,260	1,004,948	1,010,179	995123	1,014,260	1,027,439	1,048,123	1,053,841
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	6.4	5.8	2.6	5.5	7.2	7.3	9.3
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	3.7	2	0.7	1.4	1.6	4.2	5.2
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	47.9	47.6	47.6	48.4	47.4	49.4	49.2
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	1.8	1.9	1.4	1.6	0.6	0.3	0.6
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	83.8	83.0	82.6	83.2	83.48	84.31	84.08
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	121.6	120.4	120.2	120.8	122.85	123.01	123.3

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.