TRENDS

1. Review

Serbian economy is not in a good shape and its recovery will take a long time. Economic activity is stagnating, which is one of the causes of a low inflation and large reduction of the current deficit. Extremely low investments, domestic and foreign, are probably the best indicator of currently very poor prospects of the local economy. Without new investments, it will be impossible to initiate economic activity, increase employment, and increasingly hard to maintain the dinar exchange rate. The first major challenge of the new Government after the elections will be to implement fiscal consolidation and make an arrangement with IMF. This would be a guarantee of macroeconomic stability and, along with other measures, the first necessary precondition for starting a new investment cycle. However, even if a decisive fiscal consolidation would start immediately after the new Government is formed, as well as the implementation of reforms and changes of most important laws for improving the business environment, the first positive results of such a policy would be seen in mid-2015 at the earliest.

In 2013, the economic activity had a solid growth of 2.4%. However, the truth behind this growth is that agriculture had a growth rate of over 20%, mostly due to the comparison with a dry season of 2012, and the fact that Fiat Automobiles Serbia (FAS) increased its production by two and a half times compared to 2012. But if we were to remove these two factors from GDP realised in 2013, the rest of the economy would have had a decline of around 0.5%. What is even worse, the GDP component that had the biggest decline in real terms of around 10% in 2013 were investments. And investments hold double importance for GDP, because when they are realised they directly increase GDP, but they also create preconditions for future production increase.

In 2014, we expect the economic activity to stagnate, i.e. for the GDP growth rate to be close to 0%. The effects of the increased production of FAS will wear off in 2014, and agriculture will not be able to achieve high growth rates as in 2013. Therefore, the real trend of economic activity will be revealed, which is close to stagnation. The stagnation in 2014 is also confirmed by GDP component analysis. Private and state spending will undoubtedly decline, and investments and net exports will be able to somewhat compensate for this decline, but they won't be able to ensure positive growth rates (see Section 2 "Economic Activity").

The inflation was almost completely stopped and in 2013, from January to end of December, it was only 2.2%. The main reasons for stopping the inflation were low domestic demand, stable dinar exchange rate and drop of prices of agricultural products (see Section 5 "Prices and the Exchange Rate"). Similar trends are continuing in 2014 as well. In the fist two months of 2014, the inflation was 1.5% mainly due to a single increase of administrative prices in January and the increase of lower VAT rate from 8% to 10%. Therefore, market prices are still calm and we expect this trend to continue during 2014. Only in the case of considerable depreciation of dinar in the following months could there be a certain inflation acceleration.

Dinar exchange rate is currently under strong depreciation pressures, and we estimate the NBS policy, that is maintaining at any cost an unchanged value of dinar during 2014, to be expensive and not very useful. From the beginning of the year until mid-March, NBS spent as much as 820 million euros on interbank market interventions. We do not consider the sale of such a large amount of euros for the purposes of defending the dinar value a good economic policy for many reasons: 1) country's forex reserves are being significantly depleted; 2) the flip side of selling large amounts of euros from foreign reserves is the purchase and sterilisation of the relevant amount of dinar, which is a bad policy in conditions of increased insolvency of businesses and low inflation; 3) sale of euros from foreign reserves treats only the consequence, but not the essential cause of weakening of the dinar, and it cannot be justified if the depreciation pressures on dinar are not temporary. The *QM* analysis indicates that aside from temporary there are essential reasons for the weakening of dinar. And 4) a moderate depreciation of dinar would be beneficial and not detrimental to the economic activity, because it would increase its price competitiveness (Graph T2-5). For all these reasons, we believe that NBS should decrease its interventions on the foreign exchange market and allow a certain depreciation of dinar.

Pressure on the dinar exchange rate and (perhaps economically hasty) sale of over 800 million euros of foreign reserves in less than three months, could also be a good indication of how unstable the macroeconomic balance of Serbia was during 2013 and even now. That is, the stable dinar exchange rate during 2013 was realised in an environment of low economic growth, low FDI, huge unemployment, public debt and fiscal deficit. Unless these imbalances and weaknesses of the domestic economy are systematically removed, the negative results could very quickly take over and the current fragile macroeconomic stability could very easily be ruined.

The current deficit in 2013 was around 5% of GDP, which is half of what it was in 2012, when it was 10.1% of GDP. The reasons for such a large reduction of current deficit are: 1) high growth of exports, which is partly due to increased exports of automobiles, and 2) low growth of imports, which was influenced by the reduction of domestic demand (see Section 4 "Balance of Payments and Foreign Trade"). Despite the large reduction compared to the previous year, the current deficit of 5% of GDP is unsustainable in conditions of low foreign direct investments and weak economic growth. Capital account in 2013 managed to stay positive mostly due to state borrowing, and on the other side, the FDI was low and the banks and businesses were deleveraging their foreign debt. Since the state cannot keep borrowing indefinitely, such a capital account structure cannot be a permanent counterweight, not even to this reduced current deficit of around 5% of GDP.

In 2014, we expect a similar structure of balance of payments as it was in 2013. The current deficit will probably continue to drop, but not as much as it did in 2013, because the potentials of the automobile industry have been depleted and there are no new large exporters in sight. The imports will either stagnate or decrease due to the further decline of domestic demand. FDI will remain low, because Serbia with its economic problems is not an attractive destination for investments, and it is also highly unlikely that by the end of the year there will be some large foreign investment that would come out of direct negotiations between the state and investors.

Low employment remains one of the biggest economic issues of Serbia, even though the latest data from the Labour Force Survey (LFS) indicate a strong growth of employment and a reduction of unemployment. However, our analyses indicate that in the macroeconomic environment of Serbia there could not have been a significant increase in employment during 2013 (see Section 3 "Employment and Wages" and Highlight 3). In our view, the latest data from the Labour Force Survey on the one hand sends a wrong signal to the decision makers, while on the other hand they raise doubts about the reliability of statistical data on Serbia's economy with many investors and analysts following the trends in Serbia's economy.

The monetary policy during 2013 and the beginning of 2014 was led too carefully, perhaps even to the detriment of businesses. Keeping the reference rate at a level of 9.5%, with the y-o-y inflation rate of around 3%, could reflect an intention by NBS to use the repo rate to mitigate strong depreciation pressures on the foreign exchange market, that have been present since the beginning of 2014. At the same time, problems in the banking sector continue to grow. Since the last issue of *QM,* two banks had their licenses revoked – Belgrade Commercial Bank (Privredna banka Beograd) and Universal Bank (Univerzal banka). The high drop of around 10% y-o-y in the real value of loans approved to the business sector continues, and even the registered decline of share of bad credits in the past few months cannot be interpreted positively, as it is a temporary result of license revoking from problematic banks. Therefore, it is our opinion that NBS should strengthen its preventive and controlling role on the market, so the list of banks being shut down wouldn't expand any further, but that it should also loosen its monetary policy and together with the Government seek mechanisms for resolving the insolvency issues of the business sector, which are the main threat to the banking sector.

Even though the challenges facing the monetary policy are big, we believe there are even bigger issues with the fiscal policy. The realised deficit of 5.7% of GDP in 2013 was slightly lower than was expected at the end of the year, but it is still the highest deficit in Central and Eastern Europe (see Section 6 "Fiscal Trends and Policy"). A more detailed analysis of the realised fiscal deficit of 2013 additionally raises concerns. Public revenue continues to underperform, while the deficit stayed at the planned level through large savings in discretionary spending (primarily reduction of capital investments, but also purchase of goods and services, and subsidies). The problem is that the reduction of revenues is a systematic problem and it cannot always be offset by *ad hoc* savings, especially since part of those savings at the end of 2013 was realised by state's delay in settling its obligations – which means that last year's fiscal deficit was somewhat artificially reduced, and the unsettled obligations of 2013 become obligations of 2014.

That is why we expect the deficit in 2014 to be even higher than the planned 7.1% of GDP, i.e. at least 8% of GDP, unless severe measures of fiscal consolidation are passed immediately after the formation of the new Government. It is almost certain that the public revenues in 2014 will underperform compared to the plan, and there are numerous obligations and risks on expenditure side that were not foreseen by the budget, such as the debt towards the banks for subsidised loans of 7.5 billion dinars. In addition to all that, the budget foresees funds allocated to the Smederevo steel factory (Železara Smederevo) just for the first half of the year, and it is already clear that the fate of this company will not be resolved in such a short time. Additional risk could be incurred by Srbijagas operations during 2014, because we do not know how far the restructuring of the company has come along and the planned enabling of the company to operate without the (implicit) state subsidies.

Even the foreseen fiscal deficit of 7.1% of GDP is unsustainable and it would require additional austerity measures during 2014. Further deterioration of fiscal trends that we observed requires those savings to be even bigger and more comprehensive. In the short-term, the economic policy does not have many options for curbing the growing deficit. The biggest budgetary expenses are public sector wages and pensions, but let us also stress that these are at the same time the biggest economic imbalances of our public finances, because a state such as Serbia should be spending around 10% instead of the current 13% of GDP on pensions, and around 8% instead of the current 10.5% of GDP on wages.

Public debt at the end of 2013 reached a level of at least 63.5% of GDP (including total debt of local self-government), and it will continue to grow during 2014 as well. In order to overturn the growing trend of public debt and thus avoid a crisis, it is necessary to reduce the fiscal deficit from current 8% of GDP to around 2.5% of GDP, which will be possible in 2017 at the earliest. Such a large reduction of deficit will require a sharp short-term reduction of deficit in 2014 and the first half of 2015, but also a start of the reforms that are being announced for several years now, and which will yield savings in the mid-term – pension reform, public sector wages and employment reforms, reforms of the public enterprises, financing of local self-governments, system of subsidies, etc.

In order for investors to keep financing the fiscal deficit and other state obligations in the coming years as well, it is necessary for the deficit reduction plan by 2017 to be credible. That is why the new Government needs to adopt all necessary reform laws in the first year of its mandate, as well as make an arrangement with IMF. Without that, it will be difficult to secure investors' trust and their financing of large state obligations at moderate interest rates – and this will be crucial in the multi-year transition period of transferring from a record-high and unsustainable fiscal deficit to a sustainable deficit, which reduces the share of public debt in GDP.

Fiscal consolidation is a precondition to any economic growth, because otherwise, a crisis and macroeconomic instability could ensue very quickly. However, fiscal consolidation alone will not be able to initiate economic growth (which is not its goal anyway). Let us stress again that from the standpoint of economic growth, the year 2014 is probably a lost year, because its foundation was poorly set during 2013. For the economic growth as of 2015, the work of another ministry, the Ministry of Economy, will be crucial, which will have to write a set of laws towards improvement of the business environment, as well as to improve Serbia's position on all relevant competitiveness lists (WEF, World Bank). In the short-term, until the business environment has improved, the state should probably consider the possibility of direct negotiations with some of the large foreign investors.

Serbia: Selected Macroeconomic Indicators, 2005-2013

	Annual Data								Quarterly Data							
	2005	2006	2007	2008	2009	2010	2011	2012	2012				2013			
									Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Economic Growth							y-o-y, real growth1)									
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	3208.6	3347.1	…	…	…	…	…	…	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	-2.6	0.0	-1.8	-1.7	3.0	0.6	3.7	2.6
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	0.6	-0.5	2.0	0.5	0.4	1.3	-1.2	1.0	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	-5.5	-2.8	-3.6	-0.6	5.2	3.0	10.8	3.3
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	-6.7	0.2	-3.8	1.5	5.4	3.2	8.8	2.2
Average net wage (per month, in dinars)2)	17,478	21,745	27,785	29,174	31,758	34,159	…	…	39,068	41,664	41,187	43,625	41,419	44,248	43,939	46,185
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	1.734	1.7300	1.7260	1.7240	1.724	1,724	1,720	1,705
Fiscal data				in % of GDP								y-o-y, real growth				
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5			1.7	4.8	-0.8	-3.2	-5.8	-3.2	-2.7	0.1
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7			9.8	7.7	-3.5	1.5	-10.8	-7.0	1.8	-6.2
							in billions of dinars									
Overall fiscal balance (GFS definition)3)	14.8	-33.5	-58.2	-68.9	-121.8	-136.4			-54.9	-57.0	-36.5	-69.0	-37.4	-44.1	-57.1	-40.2
Balance of Payments							in millions of euros, flows1)									
Imports of goods4)	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,272	-3,392	-3,559	-3,412	-3,849	-3,386	-3,690	-3,774	-2,700
Exports of goods4)	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,822	1,838	2,247	2,221	2,426	2,235	2,685	3,089	2,049
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,155	-1,180	-757	-551	-697	-625	-290	-160	-172
in % GDP 5)	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.6*	*-17.3*	*-10.2*	*-7.5*	*-8.7*	*-8.2*	*-3.5*	*-1.9*	*-3.1*
Capital account5)	3,863	7,635	6,126	7,133	2,207	1,986	2,694	2,988	1,124	702	479	693	602	235	62	187
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	-362	234	117	253	155	139	224	125
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	-916	-1,100	-340	1,218	859	-886	-164	-24
Monetary data							in millions of dinars, e.o.p. stock1)									
NBS net own reserves6)	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	615,234	583,121	608,235	656,347	673,147	674,731	701,822	757,689
NBS net own reserves6), in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	5,376	5,037	5,225	5,781	6,025	5,917	6,122	6,605
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,784,237	1,958,084	1,897,034	1,938,662	1,999,697	1,958,084	1,933,868	1,929,205	1,911,059	1,870,642
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	834,253	888,372	890,782	909,912	907,288	924,684	933,170	933,839
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	10.1	12.0	3.4	-2.2	-2.6	-4.7	1	2.5
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	0.5	-2.1	10.5	8.1	5.9	-2.1	-8.2	-9.2	-9	-6.5
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	59.3	60.2	61.6	59.9	57.3	60.3	53	50.7
Prices and the Exchange Rate							Y-o-y growth1)									
Consumer Prices Index7)	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	3.4	5.4	10.3	12.2	11.2	9.7	4.8	2.2
Real exchange rate dinar/euro (average 2005=100)8)	100.0	92.1	83.9	78.5	83.9	88.0	80.43	85.3	84.6	87.7	87.3	81.5	79.5	79.5	80.8	81.2
Nominal exchange rate dinar/euro8)	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	108.01	113.67	117.02	113.44	111.69	112.15	114.2	114.3

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