TRENDS

1. Review

Most of the important macroeconomics trends did not significantly change in Q2 when compared to Q1. Economic activity continues with its low growth which will amount to between 1.5 and 2% on an annual level, inflation is slowing down and until the end of the year will most probably be between 4 and 5%, while current account deficit is also in decline and in 2013 will amount to about 6% of GDP. Macroeconomic picture of Serbia, however, is somewhat less favourable than that indicated by aforementioned numbers. The growth of the economy in Q2, and throughout the entire 2013, comes from the recovery of agriculture after a drought in 2012 and a strong increase in the production of a small number of successful companies (Fiat, NIS). The largest part of the Serbian economy is actually in recession, and that recession is one of the factors that influence a somewhat faster reduction in inflation and the current account deficit. We therefore believe that this growth of the economy is not sustainable (because it is made of only few sectors of the economy, and the total investment is very low, which threatens the growth in the coming year), but also that two basic imbalances of the domestic economy (external – current account deficit and internal - inflation), although considerably reduced, are not yet fully mastered.

Therefore, one of the questions we ask in this issue of QM is: will the growth of GDP continue in 2014 when its current growth sources dry out? Namely, high growth of agriculture in 2013 is specific and one-off, and Fiat and NIS are approaching their full capacity employment, which means that they will no more be able to contribute to the overall growth of the economy – now, for example, production of motor vehicles is growing by about 3.5 times compared to the previous year. Answer to this question is worrying, because our analysis shows that all macroeconomic indicators which refer to the drivers of the further economic growth are very bad. Private investments, as well as loans to the private sector, are in Q2, in a large decline, similar to Q. In addition, foreign direct investments (FDI) are almost two years on, for Serbia, a extremely low level, and state investments in first seven months of 2013 are for one third lower than in the same period of the previous year. In addition to all this, it should be mentioned that the economic recovery of the Eurozone, to which the economy of Serbia is closely linked, is still weak and uncertain. As it is still not too late for these observed negative trends of the domestic economy to be turned around or at least to be mitigated, it is now necessary to turn attention to them and implement appropriate economic policies on time.

Individual analyses from Trends section therefore indicate that in addition to some irrefutably good results of the economy – such as a high growth of exports – economic policy is facing great challenges. The situation is further complicated by the fact that it is necessary to achieve large number of different goals at the same time: 1) mitigate negative tendencies in the greater part of the economy, 2) lay healthy foundations for a future economic growth and growth of employment with structure reforms, improvement of business environment and attraction of FDI, and 3) reduce high fiscal deficit and avoid possible public debt crisis. Fiscal policy undoubtedly has the greatest part of responsibility in those processes, but the monetary policy could also contribute to the revival of the credit activity with gradual relaxation. This is somewhat related to the issue of appropriate dinar exchange rate, where the moderate depreciation of the dinar would be useful to the increase in the price competitiveness of the domestic economy, at the cost of moderate increase of inflation. Implementation of all necessary reforms would not be painless, but neither fast nor un-risky process, so we think that it is in need for international institutional support, which could be provided by new arrangement with the IMF.

GDP in Q2 recorded year-on-year growth of only 0.7% but it should be noted that the quarter to which the economic activity is compared, Q2 2012, was somewhat better than other quarters in that year (see section 2 „Economic activity"). Because of that we conclude that the economic activity trends in Q2 were quite similar to those from Q1 and despite somewhat lower y-o-y growth in Q2, the estimated growth rate in 2013 of between 1.5 and 2% will most probably be achieved. The structure of the achieved growth in Q2, but also in the entire first half of the year, shows us that three out of four basic components of GDP (investments, personal and state consumption) are in decline, but that the decline is compensated by the high growth of net exports. Of all mentioned trends, the most worrying is the fall in investments which decreases a potential for the future growth of the economy.

High unemployment remains perhaps the biggest structural problem of the domestic economy. The employment rate in April stood at about 45.8% of the working age population, and the unemployment rate about 25%. Youth unemployment is particularly high and stands for about 50%. There has already been some discussion in the general public about the April data which indicate some increase in employment and fall of unemployment. We interpret this data very cautiously. First of all, noted increase in employment is small, and statistics measuring it is insufficiently reliable so that such small changes could be considered as relevant. Further, if the increase in employment is actually achieved, this information is somewhat neutralized by the fact that the sectors in which the increase was achieved are mainly "non-production" and / or under the direct control of the state. These are: administrative and supporting services, public administration and obligatory social security, water supply and water waste management. On the other hand, the production and market-oriented parts of the economy (construction, manufacturing, financial services) also according to the official April data, record a drop in employment (see section 3 "Employment and Wages"). We also note that high unemployment is a problem of the domestic economy which in the future cannot be eliminated without significant increase of the economic growth. Since the acceleration of economic growth is unlikely in the coming year, ambitiously set goals of the new government to reduce the unemployment rate below 20% in the next year - are not realistic.

Current account deficit in Q2 was, for Serbia, extremely low and amounted to only 3.3% of quarterly GDP (see Section 4: "Balance of Payments and Foreign Trade"). Such a low current account deficit is a result of permanent and temporary trends. By permanent trends we mean improvements in the foreign trade, i.e. fall of the foreign trade deficit. This is the result of high growth of exports (mostly contributed by Fiat) accompanied by the stagnation of imports – mostly contributed by the fall in domestic demand. High growth of exports and stagnation of imports led to the fact that over 70% of imports in Q2 were covered by exports, which is the most favourable relationship between exports and imports since 2001. Temporary factor that led to a record-low current account deficit in Q2 was slightly higher than the usual current transfers – more precisely remittances. These inflows often have fluctuations during the year, but on an annual basis, they are rather stable, so that their growth in Q2 is evaluated as a temporary. Taking all aforementioned into account, we expect that by the end of the year the current account deficit could amount to 6-7% of GDP, which means that it could almost reduce for about 40% compared to the 2012, when it amounted to 10.5% of GDP.

And while the situation in the current part of the balance of payments is considerably improving, its capital part is very unfavorable. Net FDI in Q2 amounted to only 140 million euros, which is a continuation of a bad trend that lasts for already a year and a half. In this period, total net FDI inflow was only 520 million euros (230 million euros in 2012 and 290 million euros in the first half of 2013). We note that FDI in the period between 2007 and 2011 were, on average, over 1.5 billion a year, and that in 2011 they were 1.83 billion euros. Alongside the FDI reduction, we notice a continuation of the trend of debt repayment of the domestic economy towards foreign countries. But this repayment is not the effect of strengthening in the domestic economy, but rather the opposite – of a recession in the majority of the economy stands and doubts of the creditors about the solvency of the debtors. Simply speaking, previously taken loans from abroad are now being returned and new projects are not being started.

Shortage of capital inflows is reflected in the weakening of the dinar exchange rate. By intervening in the interbank market, NBS influenced this weakening not to be large, but this was achieved at the cost of significant reduction of foreign exchange reserves. In Q2, currency reserves were reduced by as much as 866 million euros, out of which, over 300 million euros was spent on the defence of the exchange rate (in Q2 from the foreign exchange reserves part of the IMF loan in the amount of 140 million euros was also repaid). QM supports the view that it is necessary to prevent any potential source of macroeconomic instability and the related NBS interventions may be useful mechanism to prevent the risk of uncontrolled fall of the dinar exchange rate. On the other hand, we believe that moderate and controlled depreciation of the dinar would be beneficial for the economy of Serbia, which is justified by the relatively unfavourable trend of its price competitiveness, which we measure by unit labor costs in Euros (Graph T2-5). We remind that a low current account deficit in 2013 is largely the consequence of the recession in which the greater part of the Serbian economy stands and that there is still large structural imbalance between exports and imports. Therefore, the NBS interventions aimed at defending the dinar exchange rate would have to be very balanced and primarily implemented when the shocks which affect the decrease in the value of the dinar are undoubtedly temporary.

The increase in the prices in Q2 was relatively low 1.7%. July even recoded a significant deflation of 0.9%, so that the total increase in the price amounted to only 2% since the beginning of the year until the end of July (see section 5 "Prices and the Exchange Rate"). A near halt in inflation in 2013 is a consequence of many different factors. First of all, the recessions, in which the majority of the Serbian economy stands, and the decline in real household consumption prevent large price growth. In addition, the dinar exchange rate is relatively stable, global food prices are falling, while oil prices remained stable until July - but already in August strongly increased due to the escalation of the crisis in Egypt and the Middle East. By the end of the year increase in the price of energy is likely, but we do not expect any other major changes, and so the annual inflation could amount to around 4%, i.e. be within the target corridor of the NBS.

Despite inflation which currently stands at about 4%, NBS reference rate is high 11%. The formal reason for this level of reference rate is a still high year on year inflation which, at the end of July, stood at 8.6%. We believe, however, that the y-o-y inflation is not the best indicator on the basis of which decisions on monetary policy should be made in conditions of high and variable inflation characterized by sudden breaks, as it is the case today in Serbia. Annualized inflation in the past few months would be a better parameter for the management of monetary policy, and a response based on it could lead to faster responses of NBS than in the case of using the y-o-y rate. In essence, the QM analysis provides support for the conduct of somewhat more cautious monetary policy, because the government deficit is very high and there are serious risks of macroeconomic instability. This however does not mean that the NBS should go to the extreme, which is perhaps the case now, and to completely ignore other targets for preserving the price stability (the primary objective of NBS). Because, it is already more than obvious that the actual inflation rate since the end of 2012 is within the NBS target band, and this is not seen just due to the observing of the y-o-y inflation which itself includes the high inflation in September and October of 2012 (when, among other things consumption taxes were increased).

Unfavourable trends in the major part of the economy are confirmed by the movements in credit activities (see Section 7 "Monetary Flows and Policy"). The annual real decline in credit lending to the private sector stood at 9.2%, which is the biggest drop since QM follows this series of data. We presume that the part of the decline in credit activities is a consequence of a halt in subsidized loans program, since the funds planed for its financing were exhausted already in March, and according to the new revised budget new funds are not planned. In addition, growth of non-performing loans rapidly increases. Participation of non-performing loans in total (calculated with QM methodology) from the beginning of the year increased from about 16% to over 22% in late July. These data indicate that the NBS in collaboration with the Government had to think about a gradual reduction in the restrictiveness of monetary policy in the future.

Fiscal policy could also mitigate the negative trends in the economy. Although the possibility of a serious fiscal stimulus in conditions of a high deficit, rising public debt and low fiscal multiplier is almost excluded, the priorities of economic policy could certainly be re-examined. Namely, in 2013 almost common practice repeats in which most cuts in the necessary reduction of public expenditures are the cuts in public investments rather than in the current expenditures. Public investments in the first seven months of 2013 are actually lower by 33% compared to the same period of the last year. In Q2 they were particularly low, only 1.8% of GDP and for the level of development of Serbia we believe that these should be at about 5% of GDP. Poor choices in priorities the Government also made by abolishment of subsidized loans, which of all stimulus to the economy we considered the most efficient.

Fiscal deficit in Q2 amounted to 4.6% of GDP and slightly decreased compared to Q1, but this is not the consequence of systematic efforts of the Government, but forced savings on a discretionary expenditures - public investments, procurement of goods and services and subsidies - after public revenues significantly underperformed (see Section 6 "Fiscal Flows and Policy"). Despite some reduction of the fiscal deficit in Q2, current fiscal policy is actually completely unsustainable. Deficit will amount to about 6% of GDP in 2013, while public debt will reach the level of about 63-64% of GDP. It is obvious that the partial fiscal consolidation from October 2012 (in which, in addition to tax increase and control of the growth of pensions and public sector wages, the most important structural reforms were left out) did not produce the desired results

Therefore, a second round of fiscal consolidation must start now, in order to reduce the fiscal deficit and thus avoid a public debt crisis. Since the pensions and wages of public sector employees are by far the largest part of government spending, without their correction, a powerful deficit reduction will hardly be feasible.

It is particularly important that the mistakes from October 2012 are not repeated this time and that along with the expected short-term measure, serious reforms are finally implemented. Good indication for this are the announcements coming from the Government about pension reform, reform of labour legislation, creation of a central registry of employees in public administration, reform of public enterprises, as well as the first steps that have been made in resolving the fate of companies still under the umbrella of the Agency for privatization. There are, however, more important areas of public sector which need reforms. Above all, creating and implementing serious reform plans for the two largest state systems - health and education. We note that the failure in the previous implementations of the reforms, however, has never been the consequence of a lack of plans and skills, but the lack of political will for their implementation. So, once again the key question is whether the initial enthusiasm and commitment to reforms will survive when painful and politically unpopular measures begin to be implemented?

Serbia: Selected Macroeconomic Indicators, 2004 - 2013

	Annual Data								Quarterly Data					
									2012				2013	
	2005	2006	2007	2008	2009	2010	2011	2012	Q1	Q2	Q3	Q4	Q1	Q2
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	…	…	99.99	102.4203236	100.724764	100.88941	…	…
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.7	-2.6	-0.1	-2.1	-2.1	2.1	0.7
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	1.5	1	0	2.6	0.7	0.7	1.2	…
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
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
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
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
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
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7			10.3	9.2	-2.9	1.5	-10.8	-6.6
							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	-37.0	-44.1
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	-3,403	-3,577	-3,430	-3,862	-3,413	-3,701
Exports of goods4)	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,822	1,854	2,282	2,244	2,442	2,260	2,711
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,155	-1,176	-740	-546	-694	-627	-276
in % GDP 5)	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-10.6*	*-17.0*	*-9.8*	*-7.3*	*-8.7*	*-8.2*	*-3.3*
Capital account5)	3,863	7,635	6,126	7,133	2,207	1,986	2,694	2,988	1,120	685	490	692	612	220
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	242	-362	234	117	253	155	139
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
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
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
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
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
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
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
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

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.