TRENDS

1. Review

Movements of the most important macroeconomic aggregates in Q2 (economic growth, inflation, current deficit, employment and public debt), were almost entirely consistent with, not too much favourable, expectations we stated in the previous issue of QM. This is a consequence of the fact that, in Q2, measures are missing, primarily in the area of fiscal policy, which would reverse the unfavourable course Serbia's economy is on. However, rating agencies and financial markets reacted faster than the Government to the unsustainable trends. In the mid 2012 credit rating for Serbia was downgraded, but even before that, market raised the costs of new borrowings for Serbia. Therefore, our most general assessment is that in Q2 – because of the political cycle and the slow formation of the new Government - the opportunity to stop the unfavourable macro-economic trends, cumulating since the beginning of 2012, was missed. Because of this, all future measures that must be adopted, will cost more, but also, what is of particular danger, the crisis of public debt is becoming slightly more probable.

Preliminary assessments are that GDP achieved real annual decrease of around 0.6% in Q2. This is actually a somewhat better result of economic activity compared to Q1, when the annual decrease of GDP was 1.3%. A slight recovery in Q2, compared to Q1, is confirmed by seasonally adjusted indices of GDP (Table T2-1). More detailed analysis, however, reveals that real (sustainable) recovery in economic activity has not started yet, because the slightly better result in Q2 compared to Q1 was a consequence of the unsustainable growth of public spending. The only two possible lasting engines of economic recovery, investments and net exports, were still in the zone of negative y-o-y growth in Q2. We believe that, by the end of the year, a significant recovery in economic activity is not possible, so the total decrease of GDP in 2012 could be around 1%. There is unfortunately a risk that a fall of GDP in 2012 will be a little higher, in the event that the final assessment of the effects of drought on agricultural production turns out to be less favourable than expected.

Inflation accelerates in Q2, primarily due to the increase in the prices of foodstuff, and this trend continues in July and August (see Section 5. Prices and the Exchange rate). Food prices are not the only reason for the acceleration of inflation. QM analysis shows that market inflation, i.e. inflation calculated by excluding the prices of food, energy, alcoholic beverages and cigarettes from the overall inflation, significantly accelerates, especially from June. Because of this, our opinion is that, beside increase in the prices of food, acceleration of inflation was influenced by some other factors, such as the Dinar depreciation and very expansive fiscal policy in the first half of the year. We estimate that the inflation will be two-digit by the end of the year (probably in the 10% - 11% corridor), which is significantly above the upper limit of NBS target band (Inflation target for December 2012 is 4% with a tolerance band of ±1.5).

The current account deficit is still at unsustainably high level, although we have noticed some improvements in comparison to Q1 (see Section 4. Balance of Payments and Foreign Trade). Deficit amounted to 718 million in Q2, which is approximately 130 million euros higher than the same period last year. Compared to Q1, when the current account deficit stood at almost 1.2 billion euros, this is a significant improvement – although this improvement is somewhat relativized by the fact that the current account deficit is seasonally higher in Q1 compared to other quarters, and in February, as a result of extremely cold weather, the current account deficit was further increased due to a decrease in exports of around 20%. Our analysis indicates that, by the end of the year, further decrease of the deficit, due to the strong depreciation of the Dinar in 2012 and expected decrease of domestic demand and also possible gradual increase in exports, is probable. We expect that the current account deficit will amount to 10% of GDP in 2012.

Movements in exports deserve special attention, because the growth of exports (with investments) is the only possible engine of economic activity growth over the medium term. Our estimate of trends in exports by the end of the year is difficult, because exports are affected by different factors with opposite directions. On the one side, we expect export growth of Fiat Automobili Srbija Company, and on the other, the reduction in exports of agricultural products as a result of drought. Also uncertain is the future production of Železara Smederevo which, when operates, has a high percentage share of Serbian exports (significance of this company in the foreign trade balance, however, should not be overestimated, because the company is also a big importer). As an important indicator of future trends in exports, we point out unit labor costs measured in Euros (Euro ULC), because they indicate international price competitiveness of the economy. Euro ULC decreased significantly in Q2, due to the depreciation of the Dinar – which means that the price competitiveness of the economy increased (Graph T2-5). That should be an important stimulus to further growth in exports, so our final estimate is that the exports in the coming period will gradually increase. An additional necessary condition for this to happen is that when we probably reached the level of the course that is appropriate for the model of economic growth based on exports, not to allow now another strong real Dinar appreciation.

On the capital inflow side, in Q2, we recorded a net outflow of capital from Serbia in the amount of nearly 450 million euros. Outflows on the capital balance are the consequence of banks repayments towards foreign countries, with low levels of foreign direct investment and relatively low borrowing of the economy abroad. Because of the current account deficit and capital outflows, in Q2, there were strong depreciation pressures on the dinar exchange rate and reduction of foreign reserves. The Dinar exchange rate, compared to Euro, depreciated by about 1.5% in real terms in Q2 and since the beginning of the year by about 8% (see Section 5 Prices and Exchange Rate). Foreign exchange reserves fell by about 1.1 billion euros in Q2, and since the beginning of the year by the end of August by over 2.1 billion euros, which cannot last indefinitely. We believe that these trends could be permanently changed with credible fiscal policy measures i.e. by implementation of decisive fiscal consolidation, which would reduce the government deficit and bring order to the public finances. Namely, fiscal consolidation would: 1) have direct impact on reducing domestic demand and imports, which would reduce the current deficit, 2) increase the safety of investments in Serbia, which would have a positive impact on the growth of FDI and 3) would reduce the risk of the country, which would lower the price of the borrowing for the economy. It is interesting to note that these, very important, effects of the fiscal consolidation on needed establishment of external balance, are in the public overshadowed by the direct danger of a public debt crisis.

Country risk is increasing. Country risk for Serbia, measured using EMBI (Emerging Markets Bond Index) has not only increased compared to the level it held in May but, what is especially worrying, increased compared to the relevant countries in the region (Croatia, Hungary). Thus now, EMBI for Croatia is by approximately 150 basis points lower than in Serbia, and EMBI for Hungary is lower than the one for Serbia by about 100 basis points, which means that the borrowing for Serbia is about so much more expensive in relation to these countries. We note that only six months ago EMBI for Serbia was lower than the one for Croatia and Hungary. In August credit rating agencies Standard & Poor's and Fitch downgraded Serbia's rating (Fitch only changed its forecast to negative, because their assessment of Serbia's credit rating was already lower, and S&P reduced the credit rating from BB to BB-). The explanation states that there has been a deterioration in fiscal and external financial position of the country, but also that the negative assessment was influenced by the changes to the National Bank of Serbia Law and the absence of a credible plan for fiscal consolidation. In addition, agencies have stated that the credit rating of Serbia in the future is more likely to fall than it is to be improved. The negative outlook indicates that the credit rating of Serbia will fall if the situation remains unchanged until the next revision.

High unemployment remains a big structural problem of the domestic economy. Negative trends on the labor market continue (see Section 3. Employment and Wages). According to the April 2012 Labour Force Survey (LFS) the unemployment rate of the active labor force population (aged 15-64) increased to 26.1%, while the employment rate fell to 44.2%. The fall in employment is still taking place only in the private sector, while in the public sector we have noticed slight increase - totally in contrast with the overall trends in the labor market over the necessary reduction in public expenditure. Even after a year, from the moment Serbian Government adopted the Employment Incentive Decision, we do not see any positive signs in the labor market trends.

Fiscal policy in Q2 was excessively expansive. The consolidated deficit in Q2 amounted to 56 billion dinars and in the first half of the year reached even 110 billion dinars (sees Section 6. Fiscal Flows and Policy). We note that in December 2011 it was agreed with the IMF that the fiscal deficit in the first half of the year reaches only 61 billion dinars, which means that already in the first half of the year deviation from the plan is more than 50 billion dinars. The reasons for this deviation are: 1) the deteriorated macroeconomic environment compared to the plan from December 2011. (lower economic growth, lower value of the Dinar, higher inflation and higher domestic demand) and 2) very expansive fiscal policy in the first half of the year which is reflected in a sharp increase in public expenditure. This large deviation from the plan cannot be compensated in the remaining part of the year, which is practically recognized in the revised state budget for 2012 - which (implicitly) increased consolidated deficit to around 222 billion dinars. The problem we have identified in relation to the revised budget (and in accordance with the report of the Fiscal Council and IMF assessments) is that with these new measures it increases rather than decreases the deficit. Namely, the revised budget new government measures such as thirteenth pension, subsidies to mitigate the effects of drought, increased subsidies in the economy (FIAT, liquidity loans, loans for construction, etc.), as well as increased allocations for employees in certain ministries (MoIA). Such a generous expenditure measures could not be compensated, by the end the year, by increasing taxes and reduced increase of pensions and earnings, because of which, the deficit in 2012 – instead to reduce - actually increased.

The Budget rebalance and proposed changes of legal regulations, practically defined some of the measures from overall fiscal consolidation package. These measures are primarily related to set up of rules for the control of the growth of pensions and salaries in the public sector and tax increase. Also, system for control of budget expenditures of users with their own revenues, was improved, all of which are steps in the right direction. What is left to be done, and without which we do not believe that the successful fiscal consolidation can be implemented, refers to fiscal decentralization. Last year's amendment of the Law on financing local self-government units created vertical imbalance between revenues and expenditures of the central and local levels of government that almost collapsed the system of public finance, about which we wrote in several previous issues of QM. With a lack of this measure, the remaining necessary reforms of expenditures, related to the decrease in employment in the public sector, pension reform, reduction and reform of subsidies system and limit of the issuance of government guarantees for borrowing by public enterprises, are conspicuously absent from the present plans of the Government.

Growth of the public debt in 2012 is very worrying. Level and trend of the strong growth of the public debt indicate that the probability of the debt crisis is highly possible. Public debt rose about 8 percentage points of GDP (from 48% to 56% of GDP) from the beginning of the year. The reason for the increase of the public debt ratio in GDP in 2012 is the high deficit, but also the depreciation of the Dinar, given that the greater part of the public debt is denominated in euros, and the GDP is realized in dinars. The growth of the public debt was also influenced by the state intervention in order to stabilize the banking sector (Agrobanka, Razvojna banka Vojvodine, Privredna banka Beograd). It is very likely that the public debt will reach a level of 60% of GDP by the end of the year, which is for countries like Serbia, the level of public debt at which the possibility of the outbreak of the crisis is highly possible.

Additional problem regarding high public deficit and debt is that it is necessary to acquire about 1.7 billion euros, only until end of 2012, in order to finance the deficit and principal repayment of public debt, and an additional four billion euros in 2013. Announced signing of bilateral agreements will not be able to provide sufficient funds, so the Government will have to try to acquire the remaining needed funds on the financial market. Under current circumstances – without arrangement with the IMF – that will not be possible. Because of this the Government is now forced to quickly adopt the credible mid-term savings plan which will be positively assessed by the relevant institutions. Otherwise, the debt crisis is inevitable.

Monetary policy was faced with not at all easy choice. An obviously expansive fiscal policy and consequent depreciation pressures and accelerating inflation (which at the time was relatively low), indicated that the increase in monetary restrictiveness is needed. On the other hand, slow recovery of the economic activity and growth of unemployment suggested expansionary monetary policy. Between „two harms" the National Bank of Serbia decided to increase the restrictiveness of monetary policy, which we consider justified and in accordance with the legal commitments of NBS relating to the preservation of price stability. Restrictive monetary policy in Q2 was primarily reflected in the sale of foreign currency, which was used to withdraw Dinars, and ease the depreciation pressures (see Section 7. Monetary Flows and Policy).

Another significant change in monetary policy should be emphasized - at its session on July 12, the NBS decided that instead implementing the key policy rate on two week repo transactions of bonds (reverse repo), the rate is to be implemented on one week repo transactions of bonds (standard repo).

The transfer from the reverse to the standard repo is the reaction of the NBS to the change in the direction of operations in the foreign currency market. In simple terms, in conditions of the large inflow of foreign capital, selling of foreign currency created money, and the NBS was forced to restrain inflation by issuing reverse repurchase securities, thus withdrawing excess liquidity. Now, when the direction of transactions in the foreign currency market has been changed, foreign currency offer is significantly lower than the demand, so on the basis of foreign currency transactions Dinar money is withdrawn. In those circumstances, Dinar liquidity drops and a need appears for the NBS to implement standard repo transactions for raising liquidity. We believe that this decision is justified, but that the NBS should carefully monitor the movements in the foreign exchange market in the future, as well as the government borrowing and spending, in order to timely respond in the direction of creating or withdrawing the liquidity.

In the banking sector, Q2 was a marked by the reduction in lending of about 170 million euros compared to the end of March. At the same time, however, the economy increased its foreign debt on the basis of cross-border loans. Because of this, decrease in total lending of economy and the population in Q2 was partially mitigated, and stood at around 40 million euros. From July, however, we noticed a new increase in the economy loans from the domestic banking sector and from abroad, which we will carefully analyse in the next edition of QM. Unfortunately, a share of non-performing loans in total loans continued to grow. At the end of June, the share of non-performing loans in total loans amounted to 15.7%, which is an increase by almost one percentage point compared to Q1. The greatest impact on the overall growth of the share of non-performing loans had the legal entities, who recorded an increase of share from 17.7% at the end of March, to 19.3% at the end of June. Compared to the beginning of the first wave of the crisis (end of 2008), share of non-performing loans has nearly tripled, and the reasons for this, apart from the economic crisis, is foreign currency indexation of most loans, but also the lack of caution by banks, which, in the period before the crisis, fought for the increase market share at the cost of less selective granting of loans.

Serbia: Selected Macroeconomic Indicators, 2004–2012

	Annual Data						Quarterly Data									
	2005	2006	2007	2008	2009	2010	2010				2011				2012	
							Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Prices and the Exchange Rate								y-o-y[1]								
Consumer Price Index[2]	16.5	12.7	6.5	11.7	8.4	6.5	4.4	4.0	6.5	9.6	12.7	13.6	10.6	7.9	4.7	…
Real fx dinar/euro (avg. 2005=100)[3]	100.0	92.1	83.9	79.7	84.1	86.5	85.3	86.1	87.2	86.7	83.0	78.3	79.9	80.5	84.6	…
Nominal fx dinar/euro (period average)[3]	82.92	84.19	79.97	81.46	93.90	102.90	98.60	101.30	105.15	106.56	104.00	99.80	101.51	102.09	108.01	…
Economic Growth								y-o-y, real growth[1]								
GDP (in billions of dinars)	1,683.5	1,962.1	2,276.9	2,661.4	2,720.1	2,881.9	..	..	..	..	..	..	..	..	..	..
GDP	5.4	3.6	5.4	3.8	-3.5	1.0	-0.2	1.0	1.7	1.2	3.0	2.5	0.6	0.6	-1.3	-0.6
Non-agricultural GVA	5.8	4.9	6.1	4.1	-4.2	1.6	-0.4	1.7	3.3	1.9	3.5	2.4	0.0	0.1	-0.7	…
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	1.1	7.3	4.3	-1.8	6.4	3.6	-1.9	1.3	-5.5	-2.8
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	2.5	8.1	5.8	-0.4	5.8	0.7	-3.1	-3.3	-6.7	0.2
Average net wage (per month, in dinars)[4]	17,478	21,745	27,785	29,174	31,758	34,159	31,924	34,192	34,372	36,149	35,108	37,994	38,760	40,139	39,068	41,664.0
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	1.838	1.815	1.796	1.773	1.769	1.755	1.755	1.738	1.734	1.7
Fiscal data			in % of GDP								y-o-y, real growth					
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4,0	2.5	-3.6	-1.3	-2.8	-6.6	-3.8	-4.7	1.7	4.8
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	-1,4	-3.1	-3.2	0.3	-3.0	-4.9	1.1	-5.4	10.0	9.0
								in billions of dinars								
Overall fiscal balance (GFS definition)[5]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-24,1	-31.2	-28.8	-52.3	-26.3	-42.4	-44.4	-45.1	-54.1	-56.1
Platni bilans								in millions of euros, flows[1]								
Imports of goods[6]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-2,659	-3,032	-3,182	-3,302	-3,269	-3,392	-3,440	-3,850	-3,403	-3,556
Exports of goods[6]	4,006	5,111	6,444	7,416	5,978	7,402	1,473	1,861	1,938	2,129	1,955	2,163	2,169	2,151	1,852	2,283
Current account[7]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-760	-615	-519	-188	-760	-621	-683	-903	-1,177	-718
in % GDP[7]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-11.7*	*-8.7*	*-7.2*	*-2.6*	*-10.7*	*-7.5*	*-8.3*	*-11.3*	*-17.0*	*-9.7*
Capital account[7]	3,863	7,635	6,126	7,133	2,207	1,986	698	596	488	204	644	566	642	899	1,017	663
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	284	136	176	265	307	259	661	600	-372	234
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	-367	-321	-313	73	168	33	1,078	523	-916	-1,100
Monetary data								in millions of dinars, e.o.p. stock[1]								
NBS net own reserves[8]	175,288	302,783	400,195	475,110	578,791	489,847	563,529	547,249	493,899	489,847	460,348	484,971	514,453	606,834	615,234	583,121
NBS net own reserves[8], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,652	5,287	4,684	4,609	4,455	4,860	5,083	5,895	5,376	5,037
Credit to the non-government sector	518,298	609,171	842,512	1,126,111	1,306,224	1,660,870	1,389,783	1,523,040	1,583,687	1,656,905	1,658,603	1,700,248	1,714,617	1,784,237	1,897,034	1,938,662
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	604,783	651,132	681,704	732,066	730,892	742,597	744,100	775,600	834,253	888,372
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	14.5	17.1	11.4	2.4	-5.4	-8.0	-1.2	2.7	10.7	12.0
Credit to the non-government sector (y-o-y, real growth, in %)	28.6	10.3	24.9	25.2	5,2	13.9	9.1	19.9	17.9	15.0	4.5	-1.0	-1.1	0.5	10.5	8.1
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	50.3	54.4	55.7	57.5	55.9	55.6	54.6	55.2	57.3	59.4

Source: FREN

1) Unless indicated otherwise.

2) Data for 2004, 2005 and 2006 are based on the Retail Price Index. SORS switched to using the Consumer Price Index to calculate inflation in 2007.

3) The calculations are based on 12-month averages for annual data, and three-month averages for quarterly data.

4) 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.

5) 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).

6) 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".

7) 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".

8) 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.