# TRENDS

## 1. Review

Macroeconomic trends significantly worsen in Q1 2012. The economy is in recession, the current deficit is growing and so is unemployment, and with all this, the inflation accelerates. More detailed analysis indicates that the poor results in the first quarter were strongly influenced by a number of temporary factors – such as a state of emergency in February, a pre-election fiscal expansion, the problems in the production of the certain large enterprises, and even the purchase of shares of Telecom from the Greek company OTE. However, even when we exclude all temporary and one-off factors, macroeconomic trends call for caution and require a thoughtful and coordinated response from the economic policy. Such a response was mostly absent in early 2012 - a fiscal policy in Q1, as in April, was pre-electoral in nature (immoderately expansive), while the NBS was trying to mitigate the consequent excessive drop in the dinar exchange rate with increased interventions in the interbank market.

The economy is in recession. The year-on-year decline in the real GDP in Q1 is estimated at 1.3%, and this is the third consecutive quarter in which the value of a seasonally adjusted GDP has gradually reduced (see Section 2 „Economic Activity"). The unemployment, as an additional indication of a recession - is in growth - which also confirms our assessment of the situation in which the domestic economy is. The current recession is not as strong as the one after the first wave of crisis (2008 and 2009), so our estimate of GDP growth in 2012 remains slightly optimistic and unchanged compared to the previous editions of QM, that is 0% (for the entire year). This actually means that after the fall of production in Q1 we still expect the start of a recovery in the second half of the year, led by the growth in net exports. However, compared to our previous forecasts, a risk grows that such a recovery will not occur, primarily because of the possible unpleasant surprises from the euro area, which would lead to a negative growth of GDP in 2012, but also because of the growing domestic imbalances that can result in the economic crisis and a greater decline in GDP.

A reversal of the economic activity trend in the remaining part of the year would require a change in the basic drivers of the economic growth. The model according to which the economic growth would be driven by domestic consumption is unsustainable, not only in the middle-term but also in the short-term. Developments in Q1 are the best confirmation of this assertion. In fact, private and especially public spending had a relatively high growth in Q1 2012 (real year-on-year growth in government spending was 7.5%). The consequences were the growth of current deficit, the depreciation of the dinar and the unsustainable growth of the public debt, not the increase in the economic activity and employment - as advocates of fiscal stimulus expect. The two mentioned macroeconomic aggregates - the balance of payments and fiscal deficit - deserve a special attention in this review, because, whether we can avoid a possible crisis and macroeconomic instability depends upon their trends in the future.

The current account deficit amounted to 1160 million in Q1, an increase of over 50% over the same period last year, when it stood at 760 million euros. The largest part of the explanation for this growth lies in the part of the current trends in the trade balance - exports and imports.

Exports of goods and services in euros marked an annual decrease of 2.2% in Q1, while imports increased by 4.1%, which led to a significant increase in trade deficit (see section 4 "Balance of payments and foreign trade"). The reasons for this increase are temporary, but also essential in nature. Under temporary factor we primarily consider unusually large drop in the exports in February, during the state of emergency caused by extreme weather conditions. Therefore, in February, a drop in exports of over 20% occurred (seasonally adjusted in relation to January), which has been compensated in March. Another factor that influenced the decline in exports in Q1, for which we are not entirely sure whether it is temporary or permanent in nature, is the delay in the production of compounds of the Železare Smederevo steel plant influencing the exports of iron and steel to decline by 63%, compared to Q1 2011. The growth of imports on the other hand was influenced by unusually high imports of energy, which was, again, the consequence of a cold winter, but also a growth in the prices of these products. In addition to temporary, we have found also the essential reasons for the increase in the current account deficit, and those are (previously mentioned) the growth of domestic consumption, which exerted a pressure on the import increase, as well as the accumulated appreciation of 2011, which favours the growth of imports and reduction of exports.

High imbalance in the current account would be much less dangerous if, at the same time, is not accompanied by a strong contraction of capital inflows. Net capital inflow in Q1 amounted to only 90 million euros, which represents a very strong decrease in comparison to the same period last year when over 800 million euros entered the country. Even when we exclude one-time capital outflow caused by repurchase of Telekom Srbija shares from the Greek telecommunication company OTE in the amount of 380 million euros, and the withdrawal of capital from Telenor (about 120 million euros), our estimate remains the same – that the capital inflows are significantly reduced and that this trend is likely to remain unchanged throughout the 2012. With high current account deficit and insufficient capital inflows from abroad, pressures on the reduction of the foreign exchange reserves and the depreciation of the dinar exchange rate are getting stronger.

It is not difficult to imagine the possible trends in the balance of payments by the end of the year. Current account deficit will decrease, as directly indicated by the trends of seasonally adjusted exports and imports in March and April, and economic analysis that explains what lies behind these observed trends. This analysis indicates the following reasons for reducing the current deficit by the end of the year: 1) the effects of a number of temporary factors that have influenced strong growth of the current deficit are over – here we primarily refer to the fiscal expansion, which will undoubtedly be reduced after the elections, even without a probable fiscal consolidation, 2) relatively strong depreciation of the dinar in the first half of 2012 will rise import prices and, with a slightly larger delay, stimulate the growth of exports and 3) the announced start of a serial production of car company Fiat Automobili Srbija could significantly affect the growth of exports, of course, provided that there is no delay in the realization of these plans. The other side of the coin - the capital inflows - will probably remain insufficient to finance even this expected, decreased, current deficit in the remaining part of the year. The main reasons for the low capital inflows are relatively permanent and will not change so quickly. These are primarily 1) an adverse economic cycle in the Eurozone where, by far the largest part of investments in Serbia comes from, 2) tightened regulation of the banking sector in the EU, which triggers the outflow of the capital from "daughter" banks to their European plants and 3) increased risk of the region and the country and related rise in prices and lower availability of loans.

Described fundamental imbalance between the high current account deficit (the deficit will remain relatively high, no matter how much reduced in the remaining part of the year) and a lack of capital inflows that would finance this deficit, became obvious from the beginning of 2012, particularly in April and May. NBS sold over 1.2 billion euros from the beginning of the year in order to prevent excessive weakening of the dinar, but in the same period the dinar nominally declined by approximately 15%, compared to the euro (see Section 5 "Prices and exchange rate"). NBS is now turning to additional measures which could affect the stabilization of exchange rates - increase of the reference interest rate and change in the structure of reserve requirements - but without removing the essential reason for the balance of payments imbalance, ranges of these measures are likely to remain limited.

Probably more important measures to preserve macroeconomic stability in the time of perceived balance of payments imbalances are still on the side of fiscal policy. Fiscal policy should be strongly consolidated in accordance with the recommendations of the Fiscal Council in May. The recommended consolidation would affect the balance of payments twice - on the one hand considerably lower government spending would affect the reduction of imports and thus help reducing the current account deficit, and on the other hand clear signal would be given to the financial markets, which would result in a significant reduction of a country risk and increase of the capital inflow from abroad on the basis of the credit growth and FDI growth. The lower country risk is reflected in lower interest rates on borrowing, not only the state but also the economy and population, but it would also greatly contribute to the growth of a foreign direct investment. Note that the country risk measured by EMBI (Emerging Markets Bond Index) from the beginning of the year rose by about 100 BP. What is particularly worrying is that it seems that for some time the risk grows faster in comparison with the one in the similar countries from the region (Croatia, Hungary).

A sharp fiscal consolidation is necessary not only because of its positive impact on the broader macroeconomic aggregates such as balance of payments, but primarily because the public finances in Serbia are itself on the unsustainable trajectory (see Section 6 "Fiscal Flows and Policy"). Public debt has exceeded 50% of GDP at the end of May, which, for the countries of similar development level as Serbia, is the level at which debt crisis is highly probable. What is more worrying is the trend of public debt, i.e. its rapid growth since 2008. Public debt rose by over 20 percentage points in the period of just over for years – form 29.2% of GDP to over 50% of GDP. Continuation of similar trends will very quickly result in debt crisis thus the trend must be reversed as soon as possible.

The key driving force behind the public debt growth is the fiscal deficit, which almost lost control in the first four months of the year. The consolidated general government deficit from January to April amounted to 80 billion dinars which means that more than half of the planned deficit for the entire year (152 billion dinars) is spent in the first for months. Although we expect the growth of the fiscal deficit to slow down by the end of the year, and the total deficit in 2012 to stand at around 200 billion dinars, it will again lead to an increase of the public debt at the end of the year to over 55% of GDP and to potential problems which so large debt carries. It is therefore essential that the new government immediately takes decisive measures which will reduce the fiscal deficit and thus reverse the trend of public debt. Due to a size of the problem we believe that comprehensive measures must be taken on both the revenue and the expenditure side of the budget. Without these measures, we estimate that the debt crisis is highly likely.

Inflation was somewhat pushed aside due to the escalation of some other problems (balance of payments and fiscal deficit), but this does not mean that it should not be observed with extreme caution. The growth of prices in the first four months of 2012 slightly accelerates, primarily due to the increase in the prices of food, gasoline and cigarettes, while the underlying inflation (Consumer Price Index excluding the prices of food, energy, alcoholic beverages and tobacco) remains stable and relatively low. Underlying inflation suggests that the actual trend of the growth in the prices in the first four months of 2012 is about 5% at the level of the whole year - what would be the overall inflation in 2012 if there are similar trends continued until the end of the year. However, we expect this trend to somewhat accelerate in the following period, because we expect an increase in inflation due to the sharp depreciation of the dinar and the fiscal expansion. This acceleration should not be excessive, because low aggregate demand and stabilization of energy prices and the stock of goods on world markets (primarily agricultural and food products) are pushing inflation down. All that remains is to wait the data for May and June, which will probably give us more reliable framework within which we expect inflation in 2012. Our current estimate is that the inflation will most likely stay single-digt even with the eventual rising of the VAT rate for two or more percentage points.

High unemployment remains a major structural problem of the domestic economy. According to the available, yet incomplete data, negative trends in the labour market continue (see Section 3 "Employment and wages"). Unemployment rate rises, and has probably already reached 25% of the working age population, and the employment rate continues to fall and will probably drop below 45%. The decrease of employment is taking place only in the private sector, while in the public sector we even recorded minor growth of employment – completely opposite from the overall trends in the labour market and highly necessary decrease in public expenditure. In this number of QM under the Section 3 “Employment and wages” we have specially analysed low activity of the working population as one of the characteristics and special problems of the labour market in Serbia.

## Serbia: Selected Macroeconomic Indicators, 2004–2012

| | Annual Data | | | | | | | Quarterly Data | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | 2010 | | | | 2011 | | | | 2012 |
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 |
| **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 | 3,175.0 | .. | .. | .. | .. | .. | .. | .. | | |
| GDP | 5.4 | 3.6 | 5.4 | 3.8 | -3.5 | 1.0 | 1.6 | -0.2 | 1.0 | 1.7 | 1.2 | 3.0 | 2.5 | 0.6 | 0.6 | -1.3 |
| Non-agricultural GVA | 5.8 | 4.9 | 6.1 | 4.1 | -4.2 | 1.6 | 1.4 | -0.4 | 1.7 | 3.3 | 1.9 | 3.5 | 2.4 | 0.0 | 0.1 | .. |
| Industrial production | 0.6 | 4.2 | 4.1 | 1.4 | -12.6 | 2.5 | 2.2 | 1.1 | 7.3 | 4.3 | -1.8 | 6.4 | 3.6 | -1.8 | 0.4 | -5.9 |
| Manufacturing | -1.0 | 4.5 | 4.7 | 1.1 | -16.1 | 3.9 | -0.4 | 2.5 | 8.1 | 5.8 | -0.4 | 5.8 | 0.6 | -2.1 | -4.4 | -7.1 |
| 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 |
| 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 |
| **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 |
| 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 |
| | | | | | | | | 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 |
| **Platni bilans** | | | | | | | | in millions of euros, flows[1] | | | | | | | | |
| Imports of goods[6] | -8,286 | -10,093 | -12,858 | -15,917 | -11,096 | -12,176 | -13,952 | -2,659 | -3,032 | -3,182 | -3,302 | -3,269 | -3,392 | -3,440 | -3,850 | -3,395 |
| Exports of goods[6] | 4,006 | 5,111 | 6,444 | 7,416 | 5,978 | 7,402 | 8,438 | 1,473 | 1,861 | 1,938 | 2,129 | 1,955 | 2,163 | 2,169 | 2,151 | 1,852 |
| Current account[7] | -1,805 | -3,137 | -4,994 | -7,054 | -2,084 | -2,082 | -2,968 | -760 | -615 | -519 | -188 | -760 | -621 | -683 | -903 | -1,159 |
| *in % GDP*[7] | *-8.6* | *-12.9* | *-17.2* | *-21.6* | *-7.2* | *-7.4* | *-9.3* | *-11.7* | *-8.7* | *-7.2* | *-2.6* | *-10.7* | *-7.5* | *-8.3* | *-11.1* | *-16.5* |
| Capital account[7] | 3,863 | 7,635 | 6,126 | 7,133 | 2,207 | 1,986 | 2,752 | 698 | 596 | 488 | 204 | 644 | 566 | 642 | 899 | 1,008 |
| Foreign direct investments | 1,248 | 4,348 | 1,942 | 1,824 | 1,372 | 860 | 1,827 | 284 | 136 | 176 | 265 | 307 | 259 | 661 | 600 | -372 |
| NBS gross reserves (increase +) | 1,675 | 4,240 | 941 | -1,687 | 2,363 | -929 | 1,801 | -367 | -321 | -313 | 73 | 168 | 33 | 1,078 | 523 | -916 |
| **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 | 606,834 | 563,529 | 547,249 | 493,899 | 489,847 | 460,348 | 484,971 | 514,453 | 606,834 | 615,234 |
| NBS net own reserves[8], in mn of euros | 2,050 | 3,833 | 5,051 | 5,362 | 6,030 | 4,609 | 5,895 | 5,652 | 5,287 | 4,684 | 4,609 | 4,455 | 4,860 | 5,083 | 5,895 | 5,376 |
| Credit to the non-government sector | 518,298 | 609,171 | 842,512 | 1,126,111 | 1,306,224 | 1,660,870 | 1,897,034 | 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 |
| FX deposits of households | 190,136 | 260,661 | 381,687 | 413,766 | 565,294 | 730,846 | 775,600 | 604,783 | 651,132 | 681,704 | 732,066 | 730,892 | 742,597 | 744,100 | 775,600 | 834,253 |
| 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 |
| 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 |
| 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 |

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.