TRENDS

1. Review

The unfavorable movements seen in Eurozone economies, with which Serbia is closely connected, could very easily lead Serbia's economy into a new recession. This is why we have devoted a large part of Trends in this issue of QM to diagnosing the current state of the Serbian economy and recognizing potential weaknesses that could leave it vulnerable should the downturn worsen. The two Highlights, largely relying on these data and analyses, provide a brief look into the future from the point of view of economic activity and appropriate fiscal policy.

Economic activity entered a period of stagnation in the middle of 2011 – the GDP figure achieved in Q1 remained more or less unchanged over the following two quarters. If the same trend continues until the end of the year, real GDP growth in 2011 will amount to about 2%. The newest indicators for October – a drop in industrial production, deceleration of exports and low retail figures – could mean that a somewhat less favorable outcome could still ensue. When GDP is considered by use, investment is seen to have grown in 2011 (with real growth of about 10%), private and public spending have declined in real terms by between 2% and 3%, while net exports have made a slight positive contribution to economic growth (see Section 2, Economic Activity).

Economic growth is set to be lower in 2012 than in 2011. The Quarterly Monitor estimates that even achieving the low GDP growth rate presently forecasted at some 1.5% will constitute a serious challenge (see Highlight 1). Although we have identified several internal weaknesses of the Serbian economy that could have an adverse impact on economic growth, the decisive factor in determining movements in economic activity in Serbia in 2012 will most probably be the slowdown/recession in the Eurozone.

Exports, which had driven the recovery of production after the 2008 crisis, began to stall as early as the middle of 2011 (see Section 4, Balance of Payments and Foreign Trade). The recession, which is forecasted to hit some European countries, in particular Italy, one of Serbia's major trade partners, will have an adverse effect on export growth in 2012. Export growth in 2012 in particular will not be positively affected by strong real appreciation of the dinar in 2011, which reduced the price competitiveness of the Serbian economy by about 10% (see Graph T2-5). Not only could negative trends across the Eurozone drive export demand down: they could affect domestic demand as well, as they will in all likelihood lead to decreased capital inflows into Serbia in 2012. One must recall that the Eurozone is by far the largest Serbia's source of investments and foreign loans.

The current account deficit will amount to some €2.5bn in 2011, about 7.5% of GDP, approximately the same amount as in the previous year. Due to large capital inflows from abroad – investments made by FIAT and Delhaize, but also because of the substantial borrowing by the state – there were no problems in financing this deficit. Foreign currency outflows were higher than inflows; this drove foreign currency reserves up by over a billion euros and made the dinar appreciate strongly in real terms, rising by about 9% between January and September (see Section 5, Prices and the Exchange Rate).

However, next year could be different. Liabilities of the private and the public sector arising from past borrowing have been growing at a considerable rate for years. Thus, according to a rough estimation, nearly €7bn will be necessary to service the existing foreign debt principal and interest payments in 2012. During the first wave of the crisis, in 2009, annual liabilities for servicing these debts were nearly twice as low – standing at some four billion euros. This is why the Serbian economy needs increasingly larger inflows of foreign currency to ensure that the balance of payments is indeed balanced, although the current account deficit has remained relatively stable since 2009. It is questionable whether 2012 will see sufficient capital inflows, as in 2011, to cover both the foreign trade deficit and the outstanding foreign liabilities. Several studies carried out by international agencies could also be a signal for caution, indicating as they do a possible outflow of bank capital from Eastern European countries and back into the parent banks to provide the greater capitalization they require in their home markets. According to these analyses, Serbia could be moderately affected by any flight of capital from the banking sector.

In our view, Serbia's economy is still relatively well-protected from any balance of payments risks as foreign currency reserves held by the NBS are at present rather high (in excess of €11bn), but also due to the €1bn precautionary arrangement in place with the IMF. Nevertheless, we believe that economic policy must not neglect potential balance of payments issues should the eurozone crisis escalate. Given the circumstances we expect to prevail in 2012, any increase in banking sector liquidity caused by a decrease of the reserve requirement would probably lead to greater capital outflows from Serbia.

Unemployment remains the greatest structural problem faced by the Serbian economy. Although our analyses show that Serbia is probably still not among the first line of nations that are to be affected by any potential crisis (unlike other countries that are already putting harsh austerity measures in place), it should always be borne in mind that Serbia, as opposed to other economies, bears the burden of extremely high unemployment. The low growth rate in 2011 caused unemployment trends to worsen further over the course of that year (see Section 3, Employment and Wages). According to the latest data from the April Labor Force Survey, the employment rate was down to just 45.5%, while unemployment reached some 23%. October data, yet to be published, are expected to bear out the fact that the labor market has continued trending downward.

The latest data again show that job cuts were made exclusively in the private sector – as over the previous three years – while the number of employees in the public sector is stagnating. With this in mind, we are especially concerned by the fact that salaries at public enterprises, whose employees are already shielded from the crisis, rose by as much as 19.8% at the year-on-year level in Q3 (or 8.3% in real terms). Low economic growth means that we do not expect any significant improvements in the labor market in the coming year.

The stagnation in economic activity, coupled with a drop in global food prices, pushed inflation out of the spotlight. Having recorded high growth in Q1, inflation began to decelerate strongly in Q2 (see Section 5, Prices and the Exchange Rate). Inflation reached 6.8% since the beginning of the year, of which as much as 5.5% in Q1. The slowdown in inflation was caused by lower growth of the prices of food products, but also by weak domestic demand, further borne out by the relatively low and stable underlying inflation rate (excluding food, energy, alcoholic beverages and tobacco). Underlying inflation stood at between 0.3% and 0.4% per month (below 5% when annualized); this is currently the most accurate measure of price movements in Serbia.

Considering the strong deceleration of inflation and the stagnation of economic activity, the NBS has been gradually reducing the prime lending rate to its current level of 10% (see Section 7, Monetary Flows and Policy). We believe that cuts to the prime lending rate represent desirable policy at the present, and that it should perhaps be pursued even more vigorously, as the risk of prices rising in the near future is low – which would result in a gradual easing of restrictions on monetary policy. We believe that the ideas that appear in public more and more frequently of reducing the reserve requirement are very dangerous: the reserve requirement is one of the guarantees of the stability of the financial system. The latest data on non-performing loans (NPLs) show that their numbers are increasing, with the share of NPLs in the total sum of lending standing at 14.5% at the end of Q3 (measured according to QM methodology). Although these data are to some extent compromised by the fact that NPLs include borrowing by state-owned bankrupt banks (Beobanka, Investbanka, etc.), their constant growth is nonetheless a cause for concern. Thus, in early 2009, the share of NPLs in total lending amounted to some 9%, rising to about 12% in mid-2010, and in September 2011 reaching the 14.5% referred to above.

Fiscal policy is facing serious challenges. As economic growth in 2011 was lower than planned, but also because of the structure of this growth, which was based on rising investment and exports rather than consumption that could generate any substantial tax revenues – public revenues saw a real drop in relation to the previous year (see Section 6, Fiscal Flows and Policy). Public revenues were lower by about 1% of GDP in relation to the plan adopted at the beginning of the year. Public expenditures, on the other hand, were somewhat greater than planned, primarily due to high inflation rate seen in Q1 that caused inflation-indexed pensions and public-sector salaries to rise. In mid-2011 the parliament adopted amendments to the Law on Local Government Funding, which we have good arguments to claim to be fiscally irresponsible. This piece of legislation mandates an increase in the share of local authorities in wage tax revenue from 40% to 80% but did not provide for measures necessary to make up the shortfall in the central government's treasury (see Box 1, Section 6, Fiscal Flows and Policy).

As the growth forecast for 2011 was downgraded from 3% to 2%, under fiscal rules, in September the Fiscal Council allowed the 2011 consolidated general government deficit to rise from 4.1% of GDP to 4.5% of GDP. This increase was granted to enable an anti-cyclical policy to be pursued in an environment of lower tax revenues, and does not entail an increase in consolidated public expenditures.

A fiscal deficit of 4.25% of GDP is planned for 2012. Fiscal rules could make it possible for lower GDP growth, of 1.5%, expected in 2012 to allow a deficit of 4.5% of GDP in 2012. Nevertheless, the high and growing volume of public debt, which will in all likelihood exceed the statutory limit of 45% of GDP in 2012, will limit the fiscal deficit to a slightly lower level, i.e. 4.25% of GDP. We believe this is the first step in the right direction, and a significant one at that.

Public debt rose from 41% of GDP at the beginning of the year to over 44% of GDP in late September, thus coming close to the statutory limit of 45% of GDP. Owing to low economic growth and the fact that the deficit will exceed 4% of GDP, we believe that the debt threshold will be crossed. In that case the Government will be required to draw up a plan of credible measures to rein public debt back below the statutory limit in the medium term.

Country risk, not only of Serbia but also of all of Europe's transition economies, rose substantially as measured using the Emerging Markets Bond Index (EMBI). Serbia's EMBI currently stands at some 580 basis points, while in April it had stood at a mere 360bp. We have, however, noticed that Serbia's risk grew far less than that of other regional economies. Thus, for instance, Croatia's EMBI rose from 250bp in April to 620bp in early December; Hungary's risk grew from 250bp to 570bp. In its November assessment the Fitch rating agency kept the outlook on Serbia's credit rating stable. This further bears out the fact that the perception of Serbia by foreign creditors, although low, remains relatively stable. We believe, however, that we are facing challenging times and that the outlook for the country's economy will to a large extent depend on prudent economic policy and on the many decisions that need to be made as soon as possible.

Serbia: Selected Macroeconomic Indicators, 2004–2011

	Annual Data							Quarterly Data						
								2010				2011		
	2004	2005	2006	2007	2008	2009	2010	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Prices and the Exchange Rate								y-o-y[1]						
Consumer Price Index[2]	10.1	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
Real fx dinar/euro (avg. 2005=100)[3]	100.5	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
Nominal fx dinar/euro (period average)[3]	72.62	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
Economic Growth								y-o-y, real growth[1]						
GDP (in billions of dinars)	1,380.7	1,683.5	1,962.1	2,276.9	2,661.4	2,713.2	2,986.6	..	..	..	..	..	..	..
GDP	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	-0.2	1.0	1.7	1.2	3.7	2.4	0.7
Non-agricultural GVA	6.9	5.8	4.9	6.1	4.1	-3.2	1.7	-0.4	1.7	3.3	1.9	3.7	2.3	0.7
Industrial production	6.5	0.6	4.2	4.1	1.4	-12.6	2.5	1.1	7.3	4.3	-1.8	6.4	3.6	-1.8
Manufacturing	8.3	-1.0	4.5	4.7	1.1	-16.1	3.9	2.5	8.1	5.8	-0.4	5.8	0.6	-2.1
Average net wage (per month, in dinars)[4]	14,108	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
Registered Employment (in millions)	2.047	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
Fiscal data				in % of GDP							y-o-y, real growth			
Public Revenues	41.2	42.1	42.4	42.1	41.5	38.6	-1.5	-4,0	2.5	-3.6	-1.3	-2.8	-6.6	-3.6
Public Expenditures	40.0	39.7	42.7	42.8	43.7	42.7	-1.7	-1,4	-3.1	-3.2	0.3	-3.0	-4.9	0.1
								in billions of dinars						
Overall fiscal balance (GFS definition)[5]	17.5	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-24,1	-31.2	-28.8	-52.3	-26.4	-42.4	-40.1
Balance of Payments								in millions of euros, flows[1]						
Imports of goods[6]	-8,302	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-2,659	-3,032	-3,182	-3,303	-3,270	-3,392	-3,434
Exports of goods[6]	2,991	4,006	5,111	6,444	7,416	5,978	7,403	1,473	1,861	1,938	2,130	1,955	2,163	2,169
Current account[7]	-2,197	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-760	-615	-519	-189	-761	-621	-677
in % GDP[7]	*-11.6*	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.3*	*-11.5*	*-8.6*	*-7.1*	*-2.6*	*-10.4*	*-7.3*	*-8.1*
Capital account[7]	2,377	3,863	7,635	6,126	7,133	2,207	2,032	698	596	488	241	616	578	527
Foreign direct investments	773	1,248	4,348	1,942	1,824	1,372	860	284	136	176	265	307	259	661
NBS gross reserves (increase +)	349	1,675	4,240	941	-1,687	2,363	-929	-367	-321	-313	73	168	33	1,078
Monetary data								in millions of dinars, e.o.p. stock[1]						
NBS net own reserves[8]	103,158	175,288	302,783	400,195	475,110	578,791	490,534	563,529	547,249	493,899	489,847	460,348	484,971	514,453
NBS net own reserves[8], in mn of euros	1,291	2,050	3,833	5,051	5,362	6,030	4,616	5,652	5,287	4,684	4,609	4,455	4,860	5,083
Credit to the non-government sector	342,666	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
FX deposits of households	110,713	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
M2 (y-o-y, real growth, in %)	10.4	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
Credit to the non-government sector (y-o-y, real growth, in %)	27.3	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
Credit to the non-government sector, in % GDP	23.9	29.6	28.6	35.0	42.0	45.8	53.8	47.7	51.3	52.3	53.7	53.2	51.9	50.8
Financial Markets														
BELEXline (in index points)[9]	1,161	1,954	2,658	3,831	1,198	1,312	1,283	1,307	1,238	1,226	1,283	1,425	1,387	1,082
Turnover on BSE (in mil. euros)[10]	423.7	498.8	1,166.4	2,004.4	884.0	443.7	222.0	49.4	46.3	39.5	86.8	89.3	64.1	37.9

Source: FREN.

1) Unless indicated otherwise.

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

3) The calculation is 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 the calculation of an average wage. Thus, the nominal wages for 2008 are comparable with nominal values for 2009 and 2010, but not 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 to calculate foreign trade. As of 01.01.2010, Serbia started implementing the general system of trade, in line with recommendations from the UN Statistics Department, which represents a wider concept than the previous one, offering better adjustment to criteria given in the Balance of Payments and the System of National Accounts. For a more detailed explanation see QM 20, Section 4, Balance of Payments and Foreign Trade.

7) The National Bank of Serbia changed its Balance of Payments methodology in Q1 2008. The change in methodology has led to a smaller current account deficit and a smaller capital account balance. For a more detailed explanation see QM12, section 6, Balance of Payments and Foreign Trade.

8) NBS net own reserves represent a difference between net foreign exchange reserves of NBS and the sum of foreign exchange deposits of commercial banks and foreign exchange deposits of the government. See section Monetary Flows and Policy for more detail.

9) The value of index on the last day of the monitored period.

10) The total turnover value at the Belgrade Stock Exchange includes the values of traded shares and foreign currency savings bonds. The mid-exchange rate for the monitored period was used to convert the dinar turnover values in the stock market into euros.