TRENDS

1. Review

The year 2015 is coming to an end, and from the perspective of macroeconomic trends we can assess it as favourable. Economic growth of about 0.8% will be achieved, although at the beginning of the year a slight decline in GDP was expected, throughout the year inflation was low and stable at the average level of about 1.5% and the current account deficit was reduced to below 5% of GDP. The two most favourable trends in 2015, which we particularly point out, are: 1) reduction of the fiscal deficit from unsustainable levels of 6.7% of GDP in 2014 to around 4% of GDP and 2) increase in investment activity in the private sector, which after two years of relatively deep fall finally started to recover. The results that are achieved and established trends represent a turnover in relation to the adverse macroeconomic developments in previous years, but in fact are only the announcement of possible more significant improvements in the following years - and that is why they are good, but not sufficient. Because, how would we generally rate the economy which is growing less than 1% a year, with a current account deficit of around 5% of GDP and the fiscal deficit of around 4% of GDP? Therefore, 2015 should be interpreted as the first step towards achieving medium-term objectives of high, sustainable and balanced economic growth, without internal and external imbalances and without large fiscal deficit. For achieving these objectives, grater part of problems and challenges will be met in the years ahead, compared to the obstacles and challenges that were successfully crossed in 2015.

Economic policies that were implemented in 2015 have produced results and because of that the initiative in implementing the key measures should not be lost, and those reforms that were late in 2015 should start more decisively or accelerate. The policies that we consider necessary in 2016 and subsequent years include: the continuation of fiscal consolidation, reforms of the public sector including state owned enterprises, consistent completion of privatization, improvement of the business environment, implementation of credible monetary policy and more. At this time last year the debate was whether the reduction of pensions and salaries in the public sector was practical and *QM* took a clear position that such measure was effective and necessary. Many opponents of this policy then argued that this will further deepen the recession (in which the Serbian economy was back then), and that expected reduction of the deficit will not happen because with the deepening decline of the economy tax revenues will be reduced. None of this, however, has happened. The fiscal deficit is strongly reduced and the negative impact on economic activity was almost negligible. In 2015 there was a beginning of the resolution of the situation of companies still in privatization process which for years represented a burden for the State and the private sector. The most problematic of these companies, however, are exempted from this process and resolution of their situation was postponed for 2016. The reform of state owned enterprises has also started, but also more was expected from them. Also, some organizational changes in EPS and Železnici (Railways) were made, while Srbija Gas has yet to comply with European directives. The main problems of state owned enterprises: surplus of employees, prices, low collectability for provided services and other; are far from resolved even though there was some progress (EPS has received only a small portion of the increase in electricity prices, Srbija Gas has increased the collectability for supplied gas, but primarily due to the decline in gas prices and not the successful restructuring of the largest debtor). The improvement of the business environment in 2015 also achieved mixed results. On the list of the World Economic Forum Serbia has maintained, poor, 94 place, and a solid rise of nine places (based on a comparable methodology) was recorded on the list of the World Bank (Doing Business), on which Serbia is now at 59th position.

Economic activity in Q3 temporarily stopped its recovery and seasonally adjusted GDP recorded a decline compared to the previous quarter of 0.4%. We still do not consider this delay worrying because it was expected, and came after an unusually high (and unsustainable) seasonally-adjusted growth of about 2% in Q2. When we look at these two quarters together, Q2 and Q3, the results of the economy are still satisfactory. What is positive is that the investment component of GDP in Q3 leads over all others, and investment growth is actually the most important for establishing high and sustainable economic growth in the coming years - investments not only directly increase GDP when executed, but also increase the capacity of the economy for future growth of production and exports. Investment growth in 2015 is a result of the growth of private investments, since the State this year almost did not increase the low efficiency in the execution of public investments. Although it is still early to talk about the causes of the increase in private investment in Q3 and throughout 2015, it is possible that it was affected by the improvement of the business environment in the past year. Some reform laws were adopted, such as the amendment of the Labour Law, the Law on Planning and Construction, there has been a global decline in interest rates, credit expansion of the ECB, economic recovery of the EU and neighbouring countries started, and other. Perhaps the crucial change in 2015 which, we believe, could affect the growing trend of investment in this year is the fiscal consolidation - because it is very difficult to expect an increase in investment in the country where there is a danger of the outbreak of a public debt crisis. In 2015 we expect overall growth of GDP of around 0.8%, which incorporates our expectation that in Q4 the re-acceleration of economic growth will occur, after a temporary halt in Q3. If this acceleration is absent, GDP growth in 2015 could be about 0.5%. In 2016, we expect improving economic trends to continue and the growth rate of GDP of about 2%. The growth of the economy in 2016 should be based on increased investment, for which we expect to be around 8% (which is similar to 2015). In addition, we expect further slight real decrease of state and private consumption (up 0.5%) primarily due to continuation of the fiscal consolidation, while net exports could give a slight contribution to GDP growth, which would not be greater than 1 percentage point.

Balance of payments trend were favourable in Q3 from the standpoint of the current account on the balance of payments, as well as from the perspective of the financing account (see. Section 4 “Balance of Payments and Foreign Trade”). Current account deficit in Q3 was reduced to about 300 million euros, which represents a reduction compared to the same period of the last year when it stood at 380 million euros. An even better result was achieved on the capital side of the balance of payments, because of a relatively strong increase of inflow of foreign direct investments (FDI), which were at the beginning of the year very low. In Q3 a net 470 million euros entered into Serbia, and in the same period last year the inflow was about 250 million euros. It is important to point out that the FDI inflow in Q3 was higher than the current account deficit and that such relationship between FDI and the current account deficit is likely to be achieved at the level of the year. This means that in 2015 the deficit in international transactions is covered by the more favourable structure of capital inflow than in previous years, all of that achieved with an increase in foreign exchange reserves.

Throughout the whole year, we expect the current account deficit to be at around 4.8% of GDP, which is a substantial reduction compared to 2014 when it stood at 6% of GDP. The reduction of the current account deficit in 2015 was positively influenced by: the fiscal consolidation, very low oil prices, economic recovery of the Eurozone as well as extremely favourable value of the terms of trade index. In 2016, we expect a mild decrease in the current account deficit compared to 2015. On the one hand it is likely that the current trend of export growth will continue, which may be somewhat lower because of the dry agricultural season in 2015, while the imports could have some increase due to the expected economic recovery and the growth in imports of equipment. Also, further acceleration of FDI in 2016 will hopefully continue in the financing account, and hopefully they will be primarily directed to tradable sectors of the economy.

Inflation has remained, for Serbia, very low and at the end of November stood at 1.3% compared to the same period of the last year. The increase in prices is, for almost more than two years, below the lower limit of the NBS target corridor of 4 ± 1.5% (excluding the two months immediately following the increase in the lower VAT rate), and it is not certain that it will return within that target band soon. The low inflation in 2015 was influenced by external and internal factors. On the one hand, low world prices of primary agricultural products and the low price of oil, and on the other - low aggregate demand and slow growth of regulated prices (see. Section 5 “Prices and the Exchange Rate”). The dinar exchange rate was stable and almost unchanged until the end of the year, which also influenced the low inflation.

Low level of inflation has allowed the NBS to continue to gradually ease the monetary policy with further reduction of the key policy rate, which after the last correction in October decreased to 4.5% (see. Section 7 “Monetary Flows and Policy”). Additional relaxation has been launched in mid-September when the NBS began reducing the rate of foreign currency reserve requirements by one percentage point, which will last the next six months. The banking sector records an increase in net loans to individuals but also to the economy. Lending activity thus recorded its highest level since mid-2012, which can represent a signal of its more substantial recovery. The encouraging fact is that the share of bad loans in total loans began to decrease in all categories of debtors (legal entities, entrepreneurs, private individuals). At the end of September, the share of non-performing loans has been reduced to about 20% compared to 23% from the end of Q2. Preliminary data for October and November suggest that the level of non-performing loans from the end of Q3 will probably not change until the end of the year. In 2016 we expect a continuation of the reduction trend of bad loans share in total loans, because in August 2015 the NBS adopted measures (with technical assistance from the IMF) which should accelerate the resolution of this problem, which will be fully implemented in the first half of 2016.

In the analysis of employment trends the biggest problem is still inconclusive and unreliable data published by the Statistical Office. However, there are indications that in the middle of the year certain methodological changes happened, which could ultimately improve the quality of the data (see. Section 3 “Employment and Wages”). First, the data from the Labour Force Survey (LFS) for 2014 were revised, so that, with this change employment growth in 2015 looks more credible. However, it would be good for SORS, with the revision of the data for 2014, to revise also all data from the LFS published since 2009, and possibly earlier. Because they indicate an unlikely decline in employment in the period 2009-2012, which was significantly higher than the fall of economic activity, and the increase in employment in the period 2012-2015 of almost 15% (300,000 more employees), although in the same period economic activity was at a standstill. In Q3 a methodology for monitoring formal employment (administrative data) was also changed by including data from the Central Registry of Compulsory Social Insurance (CROCSI). However, the quality of the obtained data for 2015 is still bad, because they show an unlikely growth of formal employment during the year of about 5%, which is not in accordance with the payment of employment contributions. Also, these data show a considerable increase in employment in the state sector in which we know for certain that during 2015 employment decreased. Statistical Office announced that at the beginning of 2016 it will make corrections of data on formal employment from 2015, as well as the revision of the time series for a period of at least ten years.

Fiscal trends are much improved compared to the previous year, and this is primarily reflected in a large reduction of the state deficit - which in 2015 could amount to 3.5-4% of GDP, compared to 6.7% of GDP from 2014 (see. Section 6 “Fiscal Flows and Policy”). The interpretation of these results, however, should be thoughtful, because one part of the deficit reduction in 2015 is a consequence of one-off factors, and so a permanent, structural, deficit reduction is slightly lower. Thus, the reduction of the deficit in 2015 was significantly contributed by large one-off payments in the budget from the state owned enterprises (EPS, EMS, Telekom), for which we believe are not fully economically justified and should not be repeated in a similar amount in the coming years. The second part of the temporary reduction of the deficit is related to inefficient implementation of public investments, and lower severance payments than planned, due to the delays in the implementation of the rationalization of the number of employees in the general state, but slightly slower resolving of the situation in the companies in privatization. But when we exclude these temporary factors, there is no doubt that in 2015 a great and lasting reduction of the deficit was achieved, on the basis of: cuts in pensions and public sector wages, improved tax collection and the introduction of excise duty on electricity - all of which together accounted for over 2% of GDP.

To successfully complete fiscal consolidation, i.e. halt the growth of public debt in relation to GDP, the fiscal deficit would have to be reduced to around 2.5% of GDP in the next two years - and that means that there is still need for very large fiscal adjustment, despite good first results in 2015. Even greater challenge for reduction of the deficit will be that in the coming years there are no plans for further cuts in pensions and public sector wages, as well as the significant increase in taxes, which means that savings will largely have to be achieved through structural reforms in late 2015. The original plan of fiscal consolidation estimated that the main savings in 2016 and 2017 will come from the reduction of employees in general state, and the other strong planned measure was the freezing of salaries and pensions. However: 1) the rationalization of the number of employees has not been successfully implemented in 2015 and there is a risk that it will not be successfully implemented in the following years, and 2) freezing pensions and salaries in the public sector was abandoned already in 2016 and there will certainly be a great pressure for a new increase in 2017. Certain guarantee that the fiscal consolidation will not be abandoned too early is a three-year arrangement with the IMF, which should prevent unjustified fiscal easing in the coming years. However, we believe that it is very dangerous to exaggerate undeniably good fiscal results from 2015, because a very large and risky path to healing of public finances in Serbia is still ahead.

Serbia: Selected Macroeconomic Indicators, 2005 - 2015

	Annual Data										Quarterly Data						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2014				2015		
											Q1	Q2	Q3	Q4	Q1	Q2	Q3
Economic Growth							y-o-y, real growth[1]										
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3407.6	3584.2	3876.4	3884.0	…	…	…	…	…	…	…
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	-1.8	0.4	-1.0	-4.5	-2	-1.8	0.9	2.2
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.5	0.6	-1.5	-5.8	-2.8	-1.7	2.5	3.9
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	-6.5	2.1	-4.8	-13.9	-9.5	-2.0	11.1	13.2
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	-1.4	3.6	-2.0	-5.6	-2.8	4.2	7.3	6.4
Average net wage (per month, in dinars)[2]	17,478	21,745	27,785	29,174	31,758	34,159	37,976	41,377	43,932	44,530	41,825	44,971	44,934	46,371	41,718	44717	…
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	1.750	1.728	1.715	1.702	1.696	1.701	1.706	1.706	1.934	1.965	2.003
Fiscal data							in % of GDP										
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	3.1	-0.8	4.3	3.5	5.4	7.6	4.2	4.5
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	5.0	4.4	3.7	-3.0	14.8	-5.1	-2.9	-1.3
							in billions of dinars										
Overall fiscal balance (GFS definition)[3]	14.8	-33.5	-58.2	-68.9	-121.8	-136.4	-158.2	-217.4	-178.7	-257.5	-68.1	-45.0	-39.8	-105.2	-21.2	-14.2	-15.8
Balance of Payments							in millions of euros, flows[1]										
Imports of goods[4]	-8,286	-10,093	-12,858	-15,917	-11,096	-12,176	-13,758	-14,028	-14,693	-13,393	-3,415	-3,762	-3,740	-3,834	-3,643	-3,864	-3,771
Exports of goods[4]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	9,732	2,512	2,767	2,664	2,698	2,601	2,987	2,879
Current account5[)]	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-496	-541	-384	-563	-521	-258	-304
in % GDP[5]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-12.3*	*-6.5*	*-6.1*	*-6.3*	*-6.3*	*-4.5*	*-6.9*	*-7.0*	*-3.1*	*-3.6*
Capital account[5]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	478	414	217	596	399	70	186
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	1,210	271	435	244	286	349	412	470
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	-1,332	-800	-370	509	-1,136	110	-32	300
Monetary data							in millions of dinars, e.o.p. stock[1]										
NBS net own reserves[6]	175,288	302,783	400,195	475,110	578,791	489,847	606,834	656,347	757,689	788,293	696,802	756,996	787,778	788,293	854,636	858,972	902526
NBS net own reserves[6], in mn of euros	2,050	3,833	5,051	5,362	6,030	4,609	5,895	5,781	6,605	6,486	6,015	6,513	6,641	6,486	7,094	7,125	7,509
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	1,870,916	1,927,668	1,815,004	1,842,407	1,888,471	1,925,584	1,919,958	1,918,917	1929573
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	998,277	937,875	949,418	976,865	998,277	1,004,948	1,010,179	995123
M2 (y-o-y, real growth, in %)	20.8	30.6	27.8	2.9	9.8	1.3	2.7	-2.2	2.3	6.7	1.9	3.5	4.3	6.7	6.4	5.8	2.6
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	-8.3	1.2	-8.3	-5.7	-3.3	1.1	3.7	2	0.7
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	54.0	52.4	54.7	48.3	49.5	48.5	46.8	48.6	49.7	47.9	47.6	47.6
Prices and the Exchange Rate							Y-o-y growth[1]										
Consumer Prices Index[7]	16.5	6.5	11.3	8.6	6.6	10.2	7.0	12.2	2.2	1.8	2.3	1.2	2.1	1.8	1.8	1.9	1.4
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	80.2	81.8	80.7	80.9	81.8	83.9	83.8	83.0	82.6
Nominal exchange rate dinar/euro[8]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	117.25	115.8	115.6	117.4	120.29	121.6	120.4	120.2

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