

TRENDS

1. Review

The most important macroeconomic news from the second quarter (Q2) is that the Serbian economy came out of recession in which it was since the second half of 2013. Started economic recovery has been achieved in principle in a healthy way, thanks to the growth of net exports and investments - with no increase in external and internal imbalances. Current account deficit, as an indicator of external imbalance, was actually significantly reduced in Q2, and inflation, as an indicator of internal imbalance is still, for Serbia, extremely low. In addition, the fiscal deficit in Q2 was relatively low and under control. Started improvement of macroeconomic trends is very important, however, it is still at the beginning and therefore very vulnerable. The increase in economic activity of 0.5% which could be achieved in 2015 is better than expected (-0.5%), but even with that growth Serbia is among the European countries with the lowest economic growth and this will not compensate for the decline in GDP in 2014 from 1.8%; fiscal deficit of around 3.5% of GDP is significantly better than 5.9% of GDP, but Serbia is still in the group of European countries with the biggest fiscal problems; current account deficit is significantly reduced, partly because of some temporary circumstances, such as the favourable energy prices, but the financial part of the balance of payments is rather bad, as the inflows of “healthy” foreign capital through foreign direct investments (FDI) in 2015 is even lower than their historically very low levels from 2014. It would therefore be very dangerous for the Government to now overestimate and incorrectly interpret the first favourable economic trends in its mandate and withdraw from the most important fiscal consolidation measures and implementation of urgent reforms.

The economic activity in Q2 recorded a y-o-y growth for the first time since 2013 as it stood at 1%. More convincing indicator of economic recovery in Q2 is seasonally adjusted GDP growth compared to the previous quarter, which stood at 2.2%. Most contribution to the achieved economic growth was made by the increase in production of electricity and mining after the draining of last flooded coal mines in May, but even when we exclude these one-time factors economic trends in Q2 continued to be favourable - seasonally adjusted growth in the rest of the economy compared to Q1 amounted to a solid 0.7%. In addition, started economic recovery is driven by net exports and investments (public and private consumption are in decline), which is a sustainable model of economic growth in the medium term. A preferred structure of the economic recovery which started in Q2 is further confirmed by a solid growth of the manufacturing industry that produces tradable goods and construction, which is a good indicator of overall investments. The size and the structure of the seasonally adjusted GDP growth in Q2 were the key arguments based on which we concluded that the Serbian economy came out of recession in which it was since the second half of 2013, because of which we also corrected our forecast of GDP growth in 2015 up to 0.5% (v. section 2. “Economic Activity”).

Although mild growth which can be expected in 2015 is not quantitatively very different from the expected drop of 0.5%, qualitatively, this difference is quite large. The expected duration of the recession has been reduced and another year with the fall of GDP has been avoided, and all of this is being achieved in a year when the implementation of the fiscal consolidation is the strongest. The first good results of economic activity in Q2, however, do not give the Government the right to ignore the major structural problems of the domestic economy which must be removed in order to achieve a significantly higher economic growth of over 4% in the medium term (this is the central theme Review). Otherwise, Serbia could stay “trapped” in the achieved low rates of economic growth for years and further away from the development of the economies of other countries in Central and Eastern Europe which are growing significantly faster. That is why in this edition of QM we are reminding of some sobering data such as that despite the growth in 2015, economic activity will still be lower than in 2013, that almost all countries in the

region have higher growth than Serbia, but also that the part of the increase in economic activity in 2015 is based on the production of (problematic) state-owned enterprises (Smederevo Steel Plant, petrochemical complex, and a restart of production in MSK is announced), which can be easily proved to be unjustified and/or unsustainable. Perhaps the best illustration of the fact that Serbia is still structurally insufficiently well organized, commercially unattractive and that the investors are still largely reserved in the interpretation of the achieved macro-economic progress in the first half of 2015, is given by the movement of foreign direct investments. They are in 2015 at a very low level, lower even than in the very poor 2014 - despite the fact that the arrangement with the IMF is being carried out in 2015, fiscal trends are improving and the economies of most EU countries are recovering.

Balance of payments trends in Q2 in their current part have been favourable, because a very low value of the current account deficit of about 200 million euros was recorded (see. Section 4 "Balance of Payments and Foreign Trade"). During the same period of the previous year current account deficit was two and a half times higher (540 million euros). In the financial part of the balance of payments, however, trends were not as good. There was almost no inflow of foreign capital. FDI inflows amounted to only 343 million euros, of which 135 million euros was related to reinvested profit of foreign companies that are already in Serbia, 116 million euros were related to debt instruments, and almost insignificant 92 million euros represented real growth of new investments from abroad. Banks and businesses are still net repaying loans abroad for about 100 million euros, which is not a consequence of the dynamic difference between taking new loans and repayment of old, but it represents repayment of previously taken loans without starting new projects in the country. The State, during Q2, was net returning abroad about 340 million euros on the basis of portfolio investments and net borrowing on the basis of new loans for about 200 million.

Inflation remains very low in Serbia. At the end of August it was 2.1% y-o-y, while the same percentage of the increase in prices was also recorded from the beginning of the year. Inflation in Q2 and in July and August (for which data are available) was below the target corridor of the NBS (see Section 5 "Prices and the Exchange Rate"). August is actually already the eighteenth consecutive month in which NBS does not achieve its primary goal - which is keeping inflation within the target range of $4 \pm 1.5\%$. Since inflation still has not returned to the target corridor, despite the August increase in electricity prices of about 12%, and given that there are no other announcements of major price increases by the end of the year, it is unlikely that inflation will return and remain in the target corridor in the coming months. QM forecast is that the average price increase in 2015 will be around 1.5% instead of the projected 2.7%. Although low inflation has a positive connotation, lower than planned average inflation will influence the correction of nominal GDP downward and the lower growth in tax revenues, which will reduce the expected results of the implementation of fiscal consolidation.

Monetary policy has continued with gradual relaxation (see Section 7 "Monetary Flows and Policy"). National Bank of Serbia in Q2 and in the coming months has repeatedly reduced its key policy rate by 0.5 percentage points bringing it to 5% with the latest reduction in early September. This is also the lowest value of this rate since Serbia introduced inflation targeting. However, inflation in 2015 is at a record low level, so when compared to the current value of the key policy rate it is still 3 percentage points lower, which is why we consider it justified to further lower the key policy rate in the future. Reduction in the restrictiveness of monetary policy is the appropriate response of the NBS on expansive policy of the ECB since the NBS thus prevents harmful economic strengthening of the dinar against the euro. Lending to banks in Q2 was mainly increased by the purchase of REPO securities and rising net loans to households of 75 million euros. However, this growth was almost annulled by the repayment of loans of the economy of 121 million to domestic banks, with additional 31 million euros repayment of cross-border loans. Unfavourable trends continue in the movement of non-performing loans, which in Q2 according to Credit Bureau data have increased to 23% of total loans. Continuing repayment of loans of the economy and a large amount of non-performing loans represent a serious obstacle to future economic growth.

Unreliable and unconvincing statistical data on employment and wages is still the biggest obstacle for a serious analysis of labour market developments. That is why QM once again suggests that the SORS should pay more attention to labour statistics data and to revise them. According to the Labour Force Survey (LFS) in Q2 the number of employees compared to the same period of the last year has increased by more than 150,000 workers, which is not in line with the movements of GDP, consumer consumption, taxes and contributions on salaries and other related indicators (see section 3 “Employment and Wages”). It is particularly interesting that among sectors that recorded a large increase in employment in the past year were those in which the State is the employer. Thus completely state owned sector “Public administration and defence, compulsory social security” increased the number of employees y-o-y for 13,000, and the dominant state sectors, education and health for 24,000 and 15,000 respectively. Therefore, according to this official statistical data the number of public sector employees has increased by 50,000. On the other hand, the other state institutions, the Ministry of State Administration and Local Self-Government, published the data that the number of public administration employees (practically on the same sample) is significantly reduced compared to the previous year (for the more than 20,000). An independent review of the public expenditures for employees in 2015 shows that the number of employees in the public sector actually decreased compared to the previous year - because expenditures for employees decreased by 1.5% more than the average wage reduction in the public sector. This corresponds to the reduction in the number of employees who receive salaries from the state budget by about 10,000 people.

Fiscal deficit in Q2 and in July was relatively low and it is our expectation that in 2015 it could be between 3.5% and 4% of GDP. This is significantly lower than the state deficit of 6.6% of GDP which was recorded in 2014, and the planned deficit for 2015 which was 5.9% of GDP. During Q2 achieved improvements of fiscal trends from the end of 2014 and early 2015 are mainly stabilizing but are also being exhausted. Collection of excise duties and VAT is still slightly above planned, but there is no further strong improvement of their collection that marked the two quarters preceding the Q2 (see Section 6 “Fiscal Flows and Policy”). In addition, delays in payment to workers who lose their jobs in companies in the privatization process and execution of public investments are gradually recovering (despite somewhat accelerated execution of public investments in recent months the plan for the entire year 2015 will not be reached). The acceleration of the execution of these expenditures increases the deficit, but it is economically justified and desirable. Trends from the previous few months indicate that fiscal consolidation is slowly moving into its second phase when it will be less based on fast individual measures such as cuts in pensions and wages, introduction of excise duty on electricity, police actions aimed at smuggling of tobacco products, and others, and more on systemic reforms (reform of the tax administration, rationalization of the number of employees in the public sector, reform of public enterprises, resolving the fate of the companies in privatization, etc.). This second phase is likely to be the most challenging and professionally the most difficult for implementation.

Deficit of between 3.5% and 4% of GDP, which will be achieved in 2015, represents a success given the state of public finances with which we entered fiscal consolidation and in relation to the original plan for 2015. However this deficit is still very high and there is a small number of countries in Europe that have higher deficit than Serbia. At the European level, a deficit of 3% of GDP is considered as the upper limit of its sustainability, and Serbia is still above that level - and should reduce it significantly in the medium term, to below 1% of GDP. Therefore, the initial success in the implementation of fiscal consolidation is a good basis for faster and more powerful deficit reduction in the coming years, and not the reason for the easing of the fiscal policy. Any extraordinary fiscal space would be economically justified to use only for noticeably increase of public investments, which are currently very low, because they are the only segment of public expenditures that can give a significant boost to business growth. The announced increase of public sector wages and pensions would not contribute to an increase in economic activity (the results of the economy in 2015 clearly show that), and, since these payments are by far the largest share of public expenditures, this could increase the fiscal deficit in 2016 from a (high) level of around 3.5% of GDP in 2015. The increase of fiscal deficit in the second year of implementation

of fiscal consolidation, rather than its further reduction, would, we believe, ruin credibility of successfully started healing process of public finances in Serbia.

Public debt (including the debt of local self-governments) at the end of July amounted to 24.4 billion euros (around 75% of GDP) and slightly decreased compared to the end of Q1 when it was around 24.6 billion euros (75.5 % of GDP). The reason for this reduction of the public debt are exchange rate differences, as the dinar (and the euro) since late March to late July has strengthened against the dollar, the currency in which a significant part of Serbia's public debts denominated. On the other hand the fiscal deficit in the same period was relatively low, so that there was no need for new large borrowing from the state and therefore significant growth of public debt on this basis. By the end of the year (without any larger exchange rates fluctuations), we expect that the public debt could amount to about 78% of GDP. This is extremely high (and still growing) level of public debt for the economy at the level of development of Serbia, and further economic argument that better fiscal results than the plan achieved in 2015 should be used for faster deficit reduction and stopping the growth of public debt, not for the increase of pensions and wages in the public sector.

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
Economic Growth																
GDP (in billions of dinars)	1,751.4	2,055.2	2,355.1	2,744.9	2,880.1	3,067.2	3,407.6	3,584.2	3,876.4	3,884.0
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.1	2.6	-1.8	-0.2	-1.3	-3.6	-1.8	-2.0	1.0
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.5	1.1	1.6	-2.4	-0.2	-1.8	-4.7	-2.4	-1.8	2.6
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
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
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	44,717
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	1,716	1,715
Fiscal data																
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
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
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	-21.1	-14.2
Balance of Payments																
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	-3,860
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	2,602	2,986
Current accounts ⁵⁾	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-1,857	-496	-541	-384	-563	-520	-208
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	-2.5
Capital account ³⁾	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	1,517	478	414	217	596	377	30
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	332	343
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
Monetary data																
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
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
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
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909,912	933,839	998,277	937,875	949,418	976,865	998,277	1,004,948	1,010,179
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
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	2.2
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	49.2	48.9
Prices and the Exchange Rate																
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
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
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

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 than 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