TRENDS

1. Review

Unfavorable macroeconomic trends continued and worsen in Q3: economic activity increases its decline, inflation is still considerably below the target corridor of the NBS, and the current account deficit is starting to increase noticeably. Only on the labor market economic indicators consistently show improvement - reduction of unemployment and employment growth - but they are in all probability poorly measured (such movements are impossible in the current macroeconomic environment). We believe that economic policy is not coping well enough with these problems. Not only that the reactions on the rapid worsening of economic trends are very late, although all signals pointing to it have been visible for a long time, but are also completely wrong and unfounded assessments of the impermanence of the current problems and high economic growth in the medium term are being sent to the public. We believe that the first correct step of economic policy would be to finally objectively perceive and recognize how bad is the situation in which the Serbian economy is at the moment, but also to say the real reasons behind it, and not only to place the blame on floods or unfavorable international environment. After that it will be much easier to make the right comprehensive measures, but also to assess the real possibilities of the economy and required number of years for healing.

The economic activity is already now in deep recession. Year on year fall of GDP in Q3 amounted to nearly 3.6%, which is partly a consequence of floods and inefficient repairs from floods, but also of much more durable and therefore more dangerous trends (see Section 2 „Economic activity"). Within the bad result in economic activity in Q3 most worrying is the fact that of all the components of GDP in the largest decline were the ones that are most important for future growth - net exports, and particularly investments. In order to come to the turning point of the unfavorable trend in economic activity, the first component of GDP that must start to record positive results are investments, because in the coming years reduction of domestic demand is inevitable, and the growth of net exports must be preceded by the investment growth. Therefore, we estimate that such structure of GDP fall in Q3 clearly indicates further continuation of worsening economic trends.

We estimate that the fall of economic activity in 2014 could amount to around 2%. Approximately 1.2% of this fall we can attribute to floods (but also to inefficient repairs from floods), which are onetime problems, while the durable trend of bad economic activity accounts to around 0.8% annually. Our estimates indicate that this durable and essential trend of economic activity will further worsen and deepen its fall in 2015 to around 2%. Overall fall of economic activity in 2015 will however be somewhat lower, and we currently estimate it to be around 1%. The reason for seemingly lower fall than the actual trends of the economy is the expected restoration of normal production of coal and electricity in the year following the floods, which will contribute to GDP growth in 2015 by about 1 pp of GDP.

Inflation remains very low and at the end of November its annual level was 2.4%. The actual level of inflation is, however, even lower, because this index also contains the increase of the lower VAT rate from 8 to 10% in January 2014. Therefore, somewhat better measure, which more clearly indicates stagnation in the increase of the prices, is inflation in the last six months of only 0.3%. Reasons for low inflation are recession, in which the economy is, accompanied by a decrease in domestic demand, low growth of food prices, low imported inflation, and still restrictive monetary policy (see Section 5 "Prices and the Exchange Rate"). It is interesting to note that the recent depreciation of the dinar has not been significantly affected by the rise in prices. The dinar in the last six months (June-November) depreciated against the euro by about 4%, and in relation to the dollar by as much as 13%, while the inflation in Serbia in the same period was only 0.3%.

Since October 2013 when inflation fell below the NBS target corridor of 4±1,5% it returned to that corridor just twice (January and February) and that was immediately after the aforementioned increase of the lower VAT rate. The NBS, however, reacted to that failure to meet its primary objective rather passive, and held on to the restrictive monetary policy. The reference interest rate, besides the last reduction from 8.5 to 8%, is still about 6 pp greater than inflation. Although this is a sort of curiosity, the impact of the interest rate channel on inflation in Serbia is quite limited, and the real restrictiveness of monetary policy is better reflected in the NBS attempts to prevent the depreciation of the dinar. Since the beginning of the year up to this review, NBS intervened with almost 1.7 billion euro of foreign exchange reserves to defend the dinar's value. In addition, the NBS changed the rules on the amount and the structure of bank reserve requirements in an attempt to increase the offer of euros with less negative impacts on the offer of dinars. By defending the dinar's value not only that the inflation was slowed down, because a larger increase in the prices of imported products was prevented, but also a great amount of dinars was sterilized (primarily the one the NBS bought on the interbank market). Therefore, this seems like the NBS changed its priority from inflation targeting to maintaining exchange rate stability, because otherwise it would allow depreciation of the dinar, at least until inflation returns to the target corridor.

From the beginning of the year to the end of November dinar nominally depreciated against the euro by 4.5%, and in real terms for just over 2%, which is not much. Attention this topic is given in the public, but also costly interventions of the NBS, we therefore do not see as fully justified. It is true that the depreciation of the dinar has a negative impact on the foreign currency liabilities of debtors, but it positively affects the price competitiveness of the domestic economy, which in the next step contributes to the growth of net exports and employment. We believe that the NBS should use the current depreciation pressures and allow controlled dinar depreciation, and that a good measure of the level to which the NBS should allow the depreciation is - the return of inflation to the middle of the target corridor of 4%. Such NBS policy would meet multiple objectives (other than its primary objective to return inflation in the target corridor): 1) the level of inflation of about 4% would be desirable to ease the recession and more efficiently implement fiscal consolidation measures 2) depreciation of the dinar of 5-10% would improve the competitiveness of the economy at an acceptable increase in the cost of servicing loans and 3) reduction of foreign exchange reserves, which is especially accelerated in the last months of 2014, would be slowed down.

Depreciation pressures from the previous months have been caused by different factors, and we as essentially the most important single out sudden and adverse changes in the current part of the balance of payments occurring from mid-2014 (see Section 4, "Balance of Payments and Foreign Trade"). The middle of the year saw completion of a two-year period of strong growth in exports and reduction of the current account deficit, for what was largely responsible car production in the FAS Company. But in the past two years, investments were in the significant decline, and with no new investments, continued high export growth, after completed expansion of exports of cars, could not be expected. Therefore, the deterioration export trend in Q3 was somewhat expected, and we have already announced it in previous issues of QM. In Q3 export not only stopped the growth but it passed in deep y-o-y decline of about 10%, which now leads to a considerable growth of the current account deficit. By the end of the year we expect the current account deficit to reach a level of about 7% of GDP, which is by 1 percentage point of GDP higher than in the previous year. While at first glance this does not seem much, we note that this relatively small change compared to the previous year is the result of two different trends in the first and second half of the year. In the first half of the year exports still had high growth and the current account deficit were reducing, and in the second half of the year the situation reversed and now not only that the reduction of the current account deficit was canceled but the overall result will annually be an increase in the current account deficit compared to 2013.

Capital and financial inflows in Serbia in 2014 are not sufficient to finance the current account deficit, which is particularly evident from the increase in the current account deficit in the second half of the year (depreciation pressures on the dinar and foreign exchange reserves decline).

Capital inflows from FDI are relatively low, the economy and the banks are returning loans abroad and the only large and stable inflows of funds are the result of government borrowing to finance the huge deficit. However, even that large and unsustainable government borrowing in 2014 was not enough for the balance of payments to be in equilibrium (for the inflows from abroad to be similar to the current account deficit), so the NBS foreign exchange reserves since the beginning of the year until the end of November fell by over 900 million euros.

In the next year we do not expect major changes in the balance of payments in relation to 2014. The capital and the financial part of the current account will probably be similarly reduced - on the one hand the implementation of fiscal consolidation will reduce net government borrowing abroad, and on the other hand we expect that the expected decline in domestic demand will affect certain reduction of the current account deficit (primarily due to the decrease in imports, and not due to the growth of exports). For now there are no suggestions of any significant increase in FDI in 2015, but it is possible that there will be certain improvements. Arrangement with the IMF could have a positive impact on investors, but probably only from the second half of the year, when not only conditions of the arrangement but also the first results of its implementation will be known. The successful privatization of enterprises in the restructuring could also lead to a certain increase in FDI in 2015.

Large fiscal deficit and associated fast-growing public debt remain the biggest problems of economic policy. The fiscal deficit in 2014 (with expenditures below the line included) we estimate at 7-7.5% of GDP, which is slightly smaller deficit than the one planned by the budget revision, but it is still very high (see Section 6 “Fiscal Flows and Policy”). The share of public debt to GDP will exceed 70% by the end of the year, which is an increase of almost 10 pp of GDP compared to the beginning of the year. The continuation of these trends would inevitably led to a public debt crisis, and the government was forced to adopt unpopular measures to reduce pensions and salaries in the public sector, but also to enter into negotiations on a new arrangement with the IMF. We will write in more details on this arrangement and the medium-term fiscal adjustment in future releases of QM, when all the details of the agreement with the IMF are known, and now we will briefly give a preliminary analysis of the published contours of fiscal consolidation.

Based on the available data about the fiscal consolidation plan in the next three years and the arrangement with the IMF (which are very limited) we conclude that the government has opted for the strategy of multi annual gradual reduction of the fiscal deficit – instead of a strong adjustment in the first year of the implementation of consolidation and some minor corrections in the coming years, which was the plan of the previous Minister of Finance. The announced fiscal deficit in 2015 of about 6% of GDP is actually a decrease compared to 2014 for only 1-1.5% of GDP (because the deficit in 2014 will be 7-7.5% of GDP). It is planned to gradually reduce the deficit in the next two years at the approximately same pace, so in 2017 it with be lowered to the level of just over 3.5% of GDP (with expenditures below the line included).

The implementation of such gradual reduction of the deficit is practically made possible by the arrangement with the IMF, without which it would hardly be sufficiently credible and therefore possible. The advantage of this approach is that it buys time in which the quality of a number of fiscal consolidation measures can be improved, whose largest effect is shifted to the medium term, such as, for example, dismissal of employees in the public administration - for which it will now be possible to perform detailed analysis and prepare good plans. In addition, a negative short-term impact of fiscal consolidation on the economy will be more evenly distributed throughout the years, which can also help and facilitate its implementation (we remind you of our analysis by which the Serbian economy in 2015 will be in a relatively deep recession). This approach, however, has some disadvantages which may not be sufficiently clearly shown, and which would be useful to point out to the professional and general public, but also to policymakers if they are not fully aware of them.

First, fiscal consolidation will practically have to be prolonged on to 2018. Preliminary QM analysis show that the planned overall fiscal deficit of more than 3.5% of GDP in 2017 (which would correspond to a deficit of between 3 and 3.5% of GDP without expenditures below the line), will just be enough to slow down the growth of public debt to GDP in that year, but insufficient to stop it. For the reversal of rising trajectory of the public debt and avoidance of the crisis it will therefore be necessary that fiscal consolidation takes longer than three years, and that in 2018 similar (unpopular) measures to reduce the deficit are conducted, as in 2016 and 2017. Second, total savings will actually have to be greater than that the ones if faster (front loading) fiscal consolidation was implemented. This is because the prolonged fiscal consolidation will allow longer and higher growth of public debt to GDP ratio - preliminary analysis suggests that public debt at the end of 2017 could easily come to as much as 85% of GDP. Such high public debt will cause the allocations for interest in public expenditure to rise from around 3% of GDP in 2014 to almost 4.5% of GDP in 2017, which would then have to be compensated by the additional savings elsewhere.

Serbia: Selected Macroeconomic Indicators, 2005 - 2014

	Annual Data									Quarterly Data						
										2013				2014		
	2005	2006	2007	2008	2009	2010	2011	2012	2013	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	…	…	…	…	…	…	…
GDP	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1	2.6	2.4	1.1	3.4	3.3	-0.2	-1.3	-3.6
Non-agricultural GVA	6.2	5.1	6.9	4.4	-3.3	0.2	1.521677838	1.1	1.6	2.2	-0.3	2.4	2.3	-0.2	-1.8	-4.7
Industrial production	0.6	4.2	4.1	1.4	-12.6	2.5	2.2	-2.9	5.5	5.2	3.0	10.8	3.3	2.1	-4.8	-13.9
Manufacturing	-1.0	4.5	4.7	1.1	-16.1	3.9	-0.4	-1.8	4.8	5.4	3.2	8.8	2.2	3.6	-2.0	-5.6
Average net wage (per month, in dinars)[2)]	17,478	21,745	27,785	29,174	31,758	34,159	…	…	…	41,419	44,248	43,939	46,185	41.825	44.971	…
Registered Employment (in millions)	2.056	2.028	1.998	1.997	1.901	1.805	…	…	…	1.724	1,724	1,720	1,705	1,697	1,697	…
Fiscal data					**in % of GDP**								**y-o-y, real growth**			
Public Revenues	42.1	42.4	42.1	41.5	38.6	-1.5	-4.6	0.6	-3.0	-5.8	-3.2	-2.7	0.1	-0.8	4.5	3.8
Public Expenditures	39.7	42.7	42.8	43.7	42.7	-1.7	3.3	3.6	-5.7	-10.8	-7.0	1.8	-6.2	5.8	2.2	-2.0
								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	-37.4	-44.1	-57.1	-40.2	-64.7	-39.1	-31.5
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	3,341	3,623	3,712	4,017	3,384	3,759	3,731
Exports of goods[4)]	4,006	5,111	6,444	7,416	5,978	7,402	8,440	8,394	10,540	2,151	2,578	2,979	2,832	2,510	2,769	2,656
Current account5)	-1,805	-3,137	-4,994	-7,054	-2,084	-2,082	-2,870	-3,639	-2,092	-668	-387	-381	-671	-503	-495	-502
in % GDP[5)]	*-8.6*	*-12.9*	*-17.2*	*-21.6*	*-7.2*	*-7.4*	*-9.1*	*-12.3*	*-6.5*	*-8.3*	*-4.4*	*-4.3*	*-7.8*	*-6.3*	*-5.8*	*-5.9*
Capital account[5)]	3,863	7,635	6,126	7,133	2,207	1,986	2,694	3,486	1,917	612	356	277	671	496	372	337
Foreign direct investments	1,248	4,348	1,942	1,824	1,372	860	1,827	669	1,229	171	264	446	347	316	397	334
NBS gross reserves (increase +)	1,675	4,240	941	-1,687	2,363	-929	1,801	-1,137	697	859	-886	-164	887	-800	-370	509
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	673,147	674,731	701,822	757,689	696,802	756,996	787,778
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	6,025	5,917	6,122	6,605	6,015	6,513	6,641
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	1,933,868	1,929,205	1,911,059	1,870,642	1,815,004	1,842,407	1,888,471
FX deposits of households	190,136	260,661	381,687	413,766	565,294	730,846	775,600	909912	933,839	907,288	924,684	933,170	933,839	937,875	949,418	976,865
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	-2.6	-4.7	1	2.5	1.9	3.510531203	4.3
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	-8.2	-9.2	-9	-6.5	-8.3	-5.7	-3.3
Credit to the non-government sector, in % GDP	29.6	28.6	35.0	42.0	45.8	53.8	56.2	59.9	50.7	57.3	60.3	53	50.7	48.5	48.7	48.2
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	11.2	9.7	4.8	2.2	2.3	1.2	2.1
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	79.5	79.5	80.8	81.2	80.7	80.9	81.8
Nominal exchange rate dinar/euro[8)]	82.92	84.19	79.97	81.46	93.90	102.90	101.88	113.03	113.09	111.69	112.15	114.2	114.3	115.8	115.6	117.4

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 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