SERBIA: Fiscal adjustment with recovery

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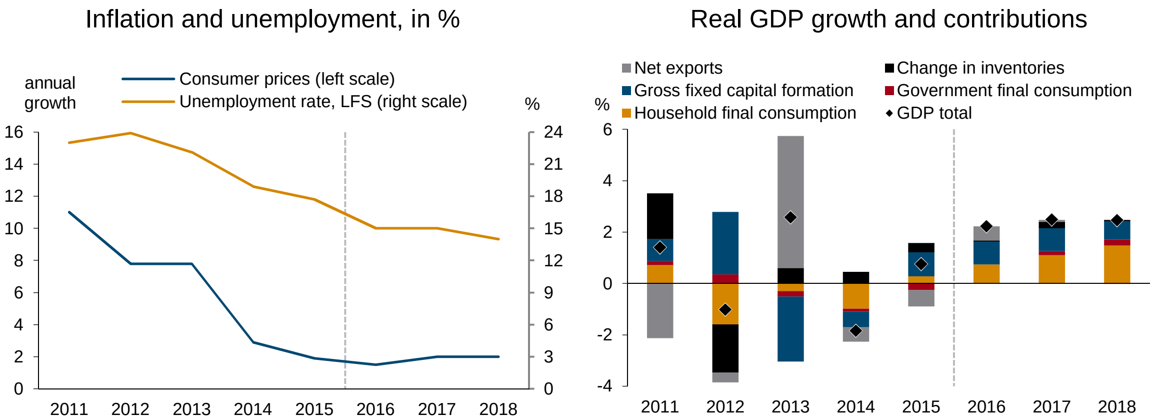
Macroeconomic balances are improving in terms of both the current account and fiscal deficits, while the rate of unemployment is dropping. The growth rate will pick up speed, attaining a level of 3% in the medium term. Prospects of the current government remaining in office for a full term are good.

Figure 40 / Serbia: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The second year into fiscal consolidation has seen surpluses on a cash basis and the government expects the year to end with a fiscal deficit as low as 2% of GDP. The final outcome will depend on the amount of debt and losses of the private sector that will have to be taken over by the budget. A realistic forecast of the final fiscal deficit may be about 4% of GDP, or somewhere in between the officially expected and the forecasted figure. The government counts with a growth rate of 2.5%, and is hoping for an even better outcome, and indeed the first half of 2016 has seen growth of 2.9%. In the second quarter, more importantly, all components of GDP showed positive contributions to growth. If indeed consumption continues to grow, while there is no significant deterioration in net exports, growth may surpass the forecast of 2.2%, which is on the pessimistic side of most forecasts.

Fiscal consolidation is key to the government's economic policy as public debt was growing rapidly before 2015. A significant part of public debt is in foreign currency (mostly dollars and euros), so it is somewhat sensitive to the changes in the exchange rates. The government believes that this year public debt will stabilise somewhere in the mid-70s in per cent of GDP and will start declining in the following years. This is achievable assuming that the dinar's exchange rate remains stable.

This is in fact the most important aspect of the macroeconomic developments. Due to a slowly growing economy and declining prices of imports (especially of oil and gas), inflation has decelerated to around 1% and may accelerate only slightly in the medium term. This, together with growing exports and declining current account deficits, has supported the stability of the currency in the last couple of years. A stable currency, in turn, supports subdued inflationary pressures. In addition, there is every indication that slow inflation has become a firmly established expectation at least in the medium term.

Most commentators and also the IMF argue that it is the fiscal consolidation that has made it possible for the monetary policy to support a stable, or rather de facto fixed, exchange rate, which has then stabilised prices with the help of declining oil prices supporting the stability of the exchange rate. The alternative explanation in fact makes more sense. Historically, the Serbian economy worked with inflationary expectations of above but close to 10%. That supported consumption and an expansion of services in periods of a stable exchange rate. Periodically, there were devaluations, with a new fixed exchange rate and some initial speed-up of inflation, which then slowed down before the start of the new cycle. That supported relatively low fiscal deficits and slow growth of public debt because the government benefited from the inflation tax while the tax payers delayed paying taxes as much as they could and looked for ways to evade them altogether. So, once the crisis hit in 2008-2009, revenues declined and expenditures increased and the fiscal deficit increased, pushing public debt up quite dramatically. Once the public debt development took an unsustainable path, devaluation became unavailable due to high foreign debt, the fixed exchange rate along with declining inflation deprived the government of the inflationary tax, and of measures of financial repression in general, but paying taxes early became advantageous for the tax payers. In addition, the policy rate was cut repeatedly and the interest rate declined generally. So, it has been price and exchange rate stability that has supported a better fiscal performance. In that context, it is questionable whether the cut in expenditures, which took place as a nominal cut in public wages and pensions, was useful or rather counterproductive given that it was a drag on recovery and still stands in the way of its speed-up.

The recovery, the way it has been unfolding, has been mostly based on investments and exports. This is continuing this year and is expected to be where growth should be coming from in the medium term. With a slow recovery of household consumption and also public investments, a medium-term growth rate of about 3% looks as the potential one. Even with slow growth, the unemployment rate has declined strongly, which is due to outward migration and also the recovery of low-paying jobs in services. Manufacturing is posting positive growth rates, but it is not clear how long that may last because of uncertainties e.g. in the viability of the automotive industry.

External imbalances are narrowing, which is partly due to a delayed recovery of imports. Low prices of oil have been quite helpful in that. Also, a strong growth of exports indicates that a small open economy can increase its exports even to markets that do not show strong growth, e.g. the EU market. This is true of other Balkan economies which either do not have a misaligned real exchange rate or were able to devalue nominally.

Political stability has been a problem in Serbia for decades and things are only somewhat different now. Early elections gave the government a strong mandate, so it does not need to waiver in its strategic economic and other policies. It is in its interest that it stays the course as it were. However, its legitimacy is not all that deep, though electoral support is, and it is in two minds on regional and European issues, so politics may prove challenging. However, with relative political stability, slow recovery, with a growth rate of around 3%, is in the cards in the medium run.

Table 23 / Serbia: Selected economic indicators

	2012	2013	2014	2015 1)	2015 January-June	2016 January-June	2016 Forecast	2017 Forecast	2018 Forecast
Population, th. pers., mid-year	7,201	7,167	7,132	7,095	.	.	7,010	7,000	7,000
Gross domestic product, RSD bn, nom.	3,584	3,876	3,908	4,043	1,872	1,937	4,200	4,400	4,600
annual change in % (real)	-1.0	2.6	-1.8	0.8	-0.3	2.9	2.2	2.5	2.5
GDP/capita (EUR at exchange rate)	4,400	4,800	4,700	4,700	.	.	4,900	5,100	5,300
GDP/capita (EUR at PPP)	9,800	10,100	10,200	10,500	.	.	.	.	.
Consumption of households, RSD bn, nom.	2,728	2,886	2,922	2,982	1,437	1,456	.	.	.
annual change in % (real)	-2.1	-0.4	-1.3	0.4	-0.7	1.1	1.0	1.5	2.0
Gross fixed capital form., RSD bn, nom.	759	668	652	715	333	353	.	.	.
annual change in % (real)	13.2	-12.0	-3.6	5.6	6.6	6.5	5.0	5.0	4.0
Gross industrial production 2)									
annual change in % (real)	-2.2	5.4	-6.4	8.2	5.2	4.5	6.0	5.0	4.0
Gross agricultural production									
annual change in % (real)	-19.5	21.7	2.1	-8.0	.	.	.	.	.
Construction output									
annual change in % (real)	-0.3	-20.0	2.4	20.9	15.1	10.3	.	.	.
Employed persons, LFS, th, average 3)	2,228	2,311	2,421	2,574	2587.8	2761.5	2,750	2,810	2,870
annual change in %	-1.1	3.7	4.8	0.6	1.6	6.7	1.0	2.0	2.0
Unemployed persons, LFS, th, average 3)	701	656	563	552	542	496	500	480	450
Unemployment rate, LFS, in %, average 3)	23.9	22.1	18.9	17.7	17	15	15.0	15.0	14.0
Reg. unemployment rate, in %, end of period 4)	28.6	29.1	28.4	26.8	27	26	.	.	.
Average monthly gross wages, RSD	57,430	60,708	61,426	61,145	59,444	62,012	64,200	66,800	69,500
annual change in % (real, gross)	1.0	-1.9	-1.7	-2.4	-2.1	3.2	3.0	2.0	2.0
Average monthly net wages, RSD	41,377	43,932	44,530	44,432	43,218	45,069	46,500	48,400	50,400
annual change in % (real, net)	1.1	-1.5	-1.5	-2.1	-1.7	3.3	3.0	2.0	2.0
Consumer prices, % p.a.	7.8	7.8	2.9	1.9	1.3	1.0	1.5	2.0	2.0
Producer prices in industry, % p.a.	6.8	2.7	1.3	1.0	1.7	-0.8	0.0	1.0	1.2
General governm.budget, nat.def., % of GDP									
Revenues	41.1	39.7	41.5	41.9	43.0	45.2	43.0	43.0	43.0
Expenditures	47.9	45.1	48.1	45.6	44.9	46.2	47.0	46.0	44.0
Deficit (-) / surplus (+)	-6.8	-5.5	-6.6	-3.7	-1.9	-0.9	-4.0	-3.0	-1.0
Public debt, nat.def., % of GDP	56.2	59.6	70.4	74.6	.	.	77.0	77.0	76.0
Central bank policy rate, % p.a., end of period 5)	11.25	9.50	8.00	4.50	6.00	4.25	4.00	4.00	4.00
Current account, EUR mn	-3,671	-2,098	-1,985	-1,577	-790	-635	-1,500	-1,600	-1,700
Current account, % of GDP	-11.6	-6.1	-6.0	-4.7	-5.1	-4.0	-4.0	-5.0	-5.0
Exports of goods, BOP, EUR mn	8,376	10,515	10,641	11,357	5,598	6,258	11,900	12,500	13,100
annual change in %	3.2	25.5	1.2	6.7	6.0	11.8	5.0	5.0	5.0
Imports of goods, BOP, EUR mn	14,011	14,674	14,752	15,350	7,518	7,925	16,000	16,600	17,400
annual change in %	2.9	4.7	0.5	4.1	4.8	5.4	4.0	4.0	5.0
Exports of services, BOP, EUR mn	3,093	3,422	3,810	4,273	1,932	2,061	4,500	4,700	4,900
annual change in %	2.2	10.6	11.3	12.2	15.0	6.7	5.0	5.0	5.0
Imports of services, BOP, EUR mn	2,981	3,109	3,344	3,548	1,681	1,691	3,700	3,900	4,100
annual change in %	3.8	4.3	7.6	6.1	9.3	0.6	5.0	5.0	5.0
FDI liabilities (inflow), EUR mn	1,009	1,548	1,500	2,114	932	970	1,200	.	.
FDI assets (outflow), EUR mn	256	250	264	310	151	130	150	.	.
Gross reserves of NB, excl. gold, EUR mn	10,295	10,734	9,351	9,812	9,694	8,585	.	.	.
Gross external debt, EUR mn 6)	25,645	25,644	25,679	26,374	26,408	25,926	29,000	30,000	31,000
Gross external debt, % of GDP 6)	80.9	74.8	77.1	78.8	79.0	76.0	85.0	85.0	84.0
Average exchange rate RSD/EUR	113.13	113.14	117.31	120.76	121.00	122.90	124	124	125
Purchasing power parity RSD/EUR	50.64	53.64	53.77	54.48	108.40	110.20	.	.	.

1) Preliminary. - 2) Excluding arms industry. - 3) Until 2013 survey of April and October, quarterly thereafter. From 2013 census 2011, from 2015 further adjustments according to ILO, Eurostat and EU-LFS. - 4) From 2015 new labour force potential. - 5) Two week repo rate. - 6) BOP 5th Edition.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.