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Serbia: in search of stability

The key developments of last year were growing exports with stagnating imports and accelerating inflation. GDP growth has been officially estimated at 6.5%, but that looks excessive. Industrial production has barely managed to post a positive growth rate, though it was declining during most of the year. Agricultural production declined because the previous, 2004, year saw a very strong recovery. Thus, all of the apparent high growth needs to be attributed to services, with especially high growth of construction.

Still, it is the growth of exports that is the most important. The recovery of exports started in the last quarter of 2004 and continued throughout 2005. This increase looks more like a jump in the level than a continuous improvement. Thus, it remains to be seen what the growth rates will look like this year given that the base is now much higher. With no improvement in industrial and agricultural production, exports may not continue to grow all that much in the short run. Unlike exports of goods, exports of services are not growing very strongly. Indeed, last year's services balance was around zero, which is a deterioration because Serbia usually records surpluses on the services account. Imports increased by about 6% for the first 11 months, and it is only when the December figure is added that they show a small decline for the year as a whole. Imports in December 2004 were exceptionally high ahead of the introduction of VAT at the beginning of 2005. If December 2004 imports were to be partly attributed to the early months of 2005, imports for the whole year would show significant growth. Similar problems exist with the figures for exports, because those may have been underreported prior to 2005. In any case, monthly data on exports show stability over the whole year, while imports are growing. Thus, there is some uncertainty about the development of the trade balance in 2006.

Because of the improvement in the trade balance, the current account has also improved in 2005. Given the uncertainty about the future development of the trade balance, and given that the balance of services is turning negative, the deficit of the current account may increase in 2006. This may prove to be unavoidable if foreign investments increase also. In the past two years, FDI inflows have not been all that impressive. Indeed, as has been the case in previous years, private transfers have continued to be higher than foreign direct investments.

Borrowing abroad has grown rather fast. This has started to worry the central bank and also the International Monetary Fund. As a consequence, the monetary squeeze has increased over the year and additional restrictive measures can be expected. These have been introduced apparently for two reasons. On the one hand, there is concern that the banks' balance sheets deteriorate with the accumulation of bad loans. There is no reliable study that actually documents that. The banking sector is rejecting the suggestion, however. On the other hand, it is believed that credit expansion is pushing prices and thus is accelerating inflation. That is not supported by the data, however, because the fastest growing prices were those of food in 2005.

This being an interesting issue and one that will be very much on the mind of economic policy makers in Serbia, a closer look at some of the claims and the data may be in place here. The monetary authorities, the IMF included, are especially worried by the fast growth of loans to households. The growth rate has indeed been high, over 60%, in 2005. Therefore, the central bank has started to restrict that expansion rather aggressively, at the same time favouring the extension of credit to enterprises. A check of the data on the growth of deposits, however, reveals that deposits of households are in fact growing faster than credits to that sector. This implies that the excess of credits over deposits is mostly due to growing borrowing by the enterprise sector. Thus, loans of the enterprise sector are being financed from the deposits of households. Given that these deposits are mostly short-term and in foreign currency while loans to the enterprise sector are mostly longer-term and in dinars, though indexed to the euro, there is a possibility that the policy of the central bank, to the extent that it is biased towards loans to enterprises and against loans to households, is contributing to the mismatch of the currency and term structure of loans.

It is also not clear what impact the restrictive monetary policy has on inflation. Credits taken by households mostly translate into imports, because those are used for consumer durables and for investments in housing. As long as the exchange rate is not depreciating due to growing demand for foreign currency, inflation should not be accelerated due to higher imports. In Serbia, the dinar depreciated less than the inflation, so it is more appropriate to speak about the failure of the exchange rate to provide an anchor to prices rather that seeing it as a cause of inflation.

Growing costs of lending, due to e.g. rising reserve requirements, could push the prices up especially if demand for loans by the enterprise sector is strong. Also, investments may be negatively affected and that may bring growth down, which could then have inflationary consequences as long as demand decreases as well. All this reliance on monetary policy both to put the external balance under control and to sap inflation does not inspire confidence anyway. In these circumstances, it is the fiscal policy that is probably the proper instrument to put demand under control and stabilize the trade balance as well as the rise of prices.

In the course of last year, fiscal policy was under constant pressure. The successful conclusion of the three-year IMF programme was postponed again and again because of the difficulties with coming to an agreement about the amount of the fiscal deficit that the general budget should be allowed to run. At the end of the year, the fiscal balance showed a surplus. This was mainly an artefact of the accelerating inflation. That allowed the government to spend more but still below the growth of GDP, thus reporting a falling public expenditure to GDP ratio. If inflation is brought down aggressively in the short run, the fiscal balance will again report a deficit especially because of the potential increase in political instability and in social pressures.

This year will indeed be a trying one in political terms. Montenegro is planning to hold a referendum on independence in mid-spring. In the second half of the year the Kosovo status will be determined, with independence of this province as the most likely outcome. Finally, there is increasing pressure on the Serbian government to intensify its cooperation with the Hague Tribunal by arresting the remaining people indicted of war crimes. The EU is threatening the break-up of the ongoing negotiations on the Stabilization and Association Agreement.

Each one of these issues separately and especially all of them together present a challenge to political stability in Serbia. In any case, it is quite likely that the government will decide to hold early parliamentary elections or may choose to consult the electorate about the proper policy towards the resolution of some of the issues mentioned above, in particular the one on the future status of Kosovo. These potential political shocks may have significant economic consequences, which may further destabilize the relatively fragile macroeconomic equilibrium.

If these shocks prove to be relatively mild and if political stability is preserved, the economy should continue to grow mainly on the basis of rising investments and private consumption. Public consumption may also expand if the political situation proves to require it. Serbia will not hurry to negotiate a new agreement with the IMF so it will not have to justify its expansionary fiscal policy if it decides to pursue one. Thus, GDP should expand by about 5% in the medium run and inflation should stay at a relatively high but stable level. Growth of exports may slow down, especially if restructuring of the public sector stalls as is likely. Once the key political uncertainties are resolved and new elections are held, it will be easier to make longer-term forecasts for the development of the Serbian economy.

Table Serbia

Serbia: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005 [1]	2006	2007
							forecast	
Population total [2]	7661.4	7736.4	7515.1	7532.6	7550	7570	.	.
Gross domestic product, CSD mn, nom.	355168	708423	919231	1095402	1330000	1650000	1890000	2260000
annual change in % (real)	5.2	5.1	4.5	2.4	9.3	6.5	4	4
GDP/capita (EUR at exchange rate) [3]	882	1540	2016	2236	2400	2600	.	.
GDP/capita (EUR at PPP - wiiw)	4290	4560	5010	5140	5740	6210	.	.
Gross industrial production [4]								
annual change in % (real)	11.4	0.1	1.8	-3.0	7.1	1.3	4	4
Gross agricultural production								
annual change in % (real)	-12.8	18.6	-3.4	-7.2	19.5	-5.3	.	.
Construction output total								
annual change in % (real) [5]	16.8	-14.3	-7.4	10.8	3.5	.	.	.
Gross fixed investment, CSD mn, nom.	50047	66765	122922	.	.	.	.	.
annual change in % (real)	13.2	-4.1	-0.8	.	.	.	.	.
LFS - employed persons, th. Oct [6]	3093.7	3105.6	3000.2	2918.6	2930.8	2900	.	.
annual change in %	-0.3	0.4	-3.4	-2.7	0.4	-1.0	.	.
Reg. employees in industry, th pers., avg.	.	704.5	648.1	605.3	562.0	532.6 I-X	.	.
annual change in %	.	.	-8.0	-6.6	-7.1	-5.4 I-X	.	.
LFS - unemployed, th pers., average [6]	425.6	432.7	459.6	500.3	665.4	.	.	.
LFS - unemployment rate in %, average [6]	12.1	12.2	13.3	14.6	18.5	20	22	23
Reg. unemployment rate in %,end of period [7]	.	.	30.5	31.9	32.4	33	34	34
Average gross monthly wages, CSD [8]	3799	8691	13260	16612	20555	25565	.	.
annual change in % (real, net)	5.5	16.5	29.9	13.6	10.1	5.7	.	.
Consumer prices, % p.a.	79.6	93.3	16.6	9.9	11.4	16.2	15	15
Producer prices in industry, % p.a.	102.6	87.7	8.8	4.6	9.1	14.2	15	15
General governm. budget, nat.def., % GDP								
Revenues	.	39.1	44.3	43.1	44.3	.	.	.
Expenditures	.	40.7	48.0	47.3	45.8	.	.	.
Deficit (-) / surplus (+), % GDP	.	-1.6	-3.7	-4.2	-1.5	.	.	.
Public debt in % of GDP	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	26.3	16.4	9.5	9.0	8.5	8.5	.	.
Current account [9]	-167	-354	-1348	-1362	-2233	-1800	-2000	-2000
Current account in % of GDP	-0.7	-3.0	-8.9	-8.1	-12.3	-9.1	-10.0	-10.0
Gross reserves of NB, excl. gold, EUR mn	429.9	1138.6	2076.8	2728.2	3008.0	4145.2 X	.	.
Gross external debt, EUR mn	11659	12609	10768	10858	10355	12046 IX	.	.
FDI net, EUR mn [9]	55	184	504	1204	779	1000	.	.
Exports of goods, BOP, EUR mn [9]	1794	2032	2348	2598	2993	3660	4030	4430
annual growth rate in %	.	13.3	15.5	10.7	15.2	22	10	10
Imports of goods, BOP, EUR mn [9]	3519	4608	5774	6409	8320	8540	9400	10340
annual growth rate in %	.	31.0	25.3	11.0	29.8	3	10	10
Exports of services, BOP, EUR mn [9]	459	685	795	906	1170	1300	.	.
annual growth rate in %	.	49.3	16.0	13.9	29.2	11	.	.
Imports of services, BOP, EUR mn [9]	305	413	657	720	1018	1300	.	.
annual growth rate in %	.	35.2	59.1	9.5	41.4	28	.	.
Average exchange rate CSD/USD	16.40	66.36	64.40	57.58	58.69	67.21	.	.
Average exchange rate CSD/EUR (ECU)	15.04	59.46	60.68	65.05	73.00	83.19	90	100
Purchasing power parity CSD/USD, wiiw	9.50	17.50	21.10	24.20	26.20	29.20	.	.
Purchasing power parity CSD/EUR, wiiw	10.80	20.10	24.40	28.30	30.70	35.10	.	.

Notes: 1) Preliminary. - 2) From 2002 according to census 2002. 2004-2005: wiiw estimate. - 3) In 2000 wiiw estimate using black market rate. - 4) From 2004 according to NACE and new weighting system. - 5) Gross value added. - 6) From 2004 according to census 2002 and revisions based on ILO and Eurostat methodology. - 7) In % of unemployed plus employment (excluding individual farmers), wiiw. - 8) From 2002 including various allowances. - 9) Converted from USD.

Source: wiiw Database incorporating national statistics; wiiw forecasts.