SERBIA: Investment surge driving growth

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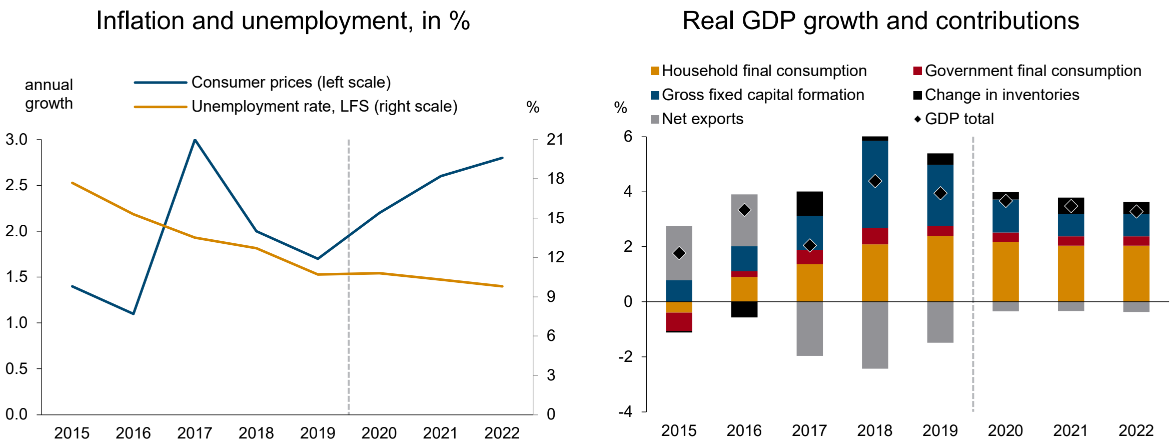
The Serbian economy is performing strongly, and after a robust 2019 outturn we have made an upward revision to our 2020 forecast. Growth is being driven above all by strong private consumption and investment, the latter supported by the construction of the TurkStream gas pipeline and FDI inflows. The outlook for regional stability is more positive after intensive US mediation, but the upcoming parliamentary election could mean somewhat higher domestic political risk.

Figure 6.19 / Serbia: Main macroeconomic indicators



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

The economy strengthened in the middle of last year, and Q3 2019 real GDP growth was better than expected (to a large extent due to construction of the Serbian section of the TurkStream gas pipeline). An initial estimate from the Statistics Office shows that real GDP growth was 4% in 2019, implying that the Q4 outturn was also very strong. Given the robust activity in the second half of last year, and the announcement of a major investment programme ('Serbia 2025' – see below), we now expect expansion of around 3.7% in 2020. Growth will be driven by firm increases in private consumption (3.2%), government spending (2%) and investment (6.5%).

The domestic drivers of growth continue to look solid, in particular private consumption and investment. Private consumption is being supported by wage increases on the back of a tighter labour market. Although the unemployment rate is high by CESEE standards, there are increased reports of labour shortages in some sectors and regions. Serbia has experienced substantial outward migration over recent years, and this is skewed towards people of working age. Loose credit conditions will also continue to support consumption, with year-on-year growth of loans to households in the high single digits. Meanwhile fiscal policy is also again set to add a bit to growth this year, reflecting a looser stance ahead of the parliamentary election.

Real income growth will continue to receive an extra boost from weak inflationary trends. We see inflation averaging around 2.2% this year, up slightly from 2019 but still low in the historical context. Having bottomed out at 1% in October, consumer price growth has firmed a bit, reaching 1.9% in December (latest data available). The volatility of the oil price on the back of developments in China creates a certain degree of uncertainty about future price trends, but our core outlook is for a very moderate firming of price pressures in the coming 12 months. Inflation is likely to remain towards the lower end of the central bank's target range, and so monetary policy will remain loose (1-2 more cuts to the policy rate are possible this year). The real CPI-adjusted policy rate is barely in positive territory (0.4% in December 2019), which is an extraordinarily supportive stance by Serbian standards.

Despite the loose monetary policy stance, pressure on the dinar has generally been appreciatory, and we do not think this will change in 2020-2022. Ultimately, the main driver of developments across CESEE, including in Serbia, is the ECB. We do not expect any dramatic moves from the ECB in the coming years, and see monetary tightening as highly unlikely during the forecast period. We expect further upward pressure on the dinar, and the central bank may well continue to intervene to curb appreciation (as it has been doing for some time). In addition, financing conditions in government bond markets will remain highly supportive, and portfolio investors are likely to take on ever more risk in return for a positive yield. Serbia may be upgraded to investment grade by at least one major ratings agency this year, which could further spur portfolio inflows.

Investment has been a key driver of growth in Serbia in the last two years, and we expect this to continue, albeit at a somewhat slower rate. Real gross fixed capital formation increased by an average 8.9% in 2015-2018, and we estimate that it grew by around 11% last year. This reflected activity on the TurkStream gas pipeline, as well as another excellent year for FDI inflows. Although 2020 may struggle to match last year in terms of investment, we still forecast a healthy growth rate of around 6.5% for gross fixed capital formation. The government announced a new investment plan called 'Serbia 2025', to be started this year. It plans to invest EUR 14 billion in total (equivalent to around 30% of 2018 GDP), to be financed by domestic and international borrowing. The government intends to invest in the upgrading of transport infrastructure, environmental protection, hospitals and schools.

The external challenges are significant, but Serbia has so far weathered this fairly well. Overall, the country has not been as badly affected by global trade tensions and problems in the German automotive industry as some of its regional peers. Industrial output posted positive year-on-year growth in every month during the second half of 2019, including an 8.3% expansion in December (although this was at least partly influenced by specific factors in the chemical industry). We expect exports to continue growing at a healthy rate, with potential help from a removal of tariffs on exports to Kosovo (as pledged by Kosovo Prime Minister Albin Kurti). However, robust domestic activity will also suck in imports. Overall, we see net exports making a small negative contribution to growth in both 2020 and 2021.

Serbia's balance of payments position is likely to remain fairly stable by Western Balkan standards. We expect a current account deficit of almost 6% of GDP this year. However, this will be comfortably covered (as in previous years) by net FDI inflows, rather than less stable forms of financing.

Serbia will continue to post a hefty merchandise goods deficit, which will be partially offset by the services surplus and secondary income inflows (remittances).

Following intense US mediation, there have recently been key (positive) breakthroughs in the deadlock between Serbia and Kosovo. First, the two countries agreed to resume the Pristina-Belgrade air link. Second, Kosovo agreed to drop its 100% tariff on imports from Serbia (and Bosnia and Herzegovina). These developments are economically and politically positive, and also show the continued centrality of the US as a mediator in the region.

Ahead of the upcoming parliamentary election, the polls show a strong lead for the ruling coalition. This reflects the good performance of the economy, but is further helped by the advantages the coalition enjoys in media access and coverage. Talks between opposition and government mediated by the European Parliament led to the upcoming election being postponed from March to April. The opposition is considering a boycott. However, it lacks a core base, is divided on many issues, and is seriously disadvantaged in terms of media representation.

Serbia is still on course for EU accession, but this is likely to be many years hence. It is not yet clear how French opposition to starting accession talks for North Macedonia and Albania will affect those that have already started (Serbia and Montenegro), but the overall impact is likely to be negative. We do not regard the European Commission target of accession in 2025 as realistic. The Commission has presented a new proposal and this will be discussed at the European Council at the end of March.

In many ways, Serbia is moving away from the EU, including in its foreign policy stance and sources of FDI. Serbia has quite strong alliances with Russia and China, both of which have been supportive over Kosovo. Links with Russia are long-standing, but were cemented by Serbia's signing of a free trade agreement with the Eurasian Economic Union last year (economically insignificant, but politically important). Meanwhile ties with China are developing strongly, emphasised above all by joint military exercises in Serbia in 2019 (the first for China anywhere in Europe). If the apparent economic and political reorientation of Serbia away from the EU continues, it may make EU accession somewhat harder in the future. It is an open secret that parts of the local elite view EU membership for Serbia as a threat to their interests.

Beyond 2020, we retain quite a cautious outlook on Serbia's growth prospects. The economic model focused on attracting FDI is unlikely to change significantly, and probably has further room to run. However, it is unlikely to be able to deliver the same returns as in the last couple of years. Moreover, negative demographic trends are already weighing on growth, and this will only intensify over time.

Table 6.19 / Serbia: Selected economic indicators

	2015	2016	2017	2018	2019 1)	2020	2021	2022
							Forecast	
Population, th. pers., mid-year	7,095	7,058	7,021	6,983	6,950	6,920	6,880	6,811
Gross domestic product, RSD bn, nom.	4,312	4,521	4,754	5,069	5,400	5,700	6,100	6,500
annual change in % (real)	1.8	3.3	2.0	4.4	4.0	3.7	3.5	3.3
GDP/capita (EUR at PPP)	11,200	11,400	11,600	12,400	13,100	.	.	.
Consumption of households, RSD bn, nom.	3,052	3,152	3,311	3,453	3,600	.	.	.
annual change in % (real)	-0.5	1.3	2.0	3.0	3.5	3.2	3.0	3.0
Gross fixed capital form., RSD bn, nom.	723	766	844	1,017	1,100	.	.	.
annual change in % (real)	4.9	5.4	7.3	17.8	11.0	6.0	4.0	4.0
Gross industrial production 2)								
annual change in % (real)	7.3	5.2	3.9	1.3	0.3	2.5	2.7	2.5
Gross agricultural production								
annual change in % (real)	-8.4	9.0	-11.9	14.3	0.0	.	.	.
Construction output								
annual change in % (real)	20.7	7.2	8.5	14.1	35.2	.	.	.
Employed persons, LFS, th, average	2,574	2,719	2,795	2,833	2,890	2,920	2,950	2,980
annual change in %	0.6	5.6	2.8	1.4	2.0	1.0	1.0	1.0
Unemployed persons, LFS, th, average	552	489	435	412	350	350	340	320
Unemployment rate, LFS, in %, average	17.7	15.3	13.5	12.7	10.7	10.8	10.3	9.8
Reg. unemployment rate, in %, eop	26.8	25.7	23.0	20.3	18.6	.	.	.
Average monthly gross wages, RSD 3)	61,145	63,474	65,976	68,629	75,200	79,300	83,900	88,900
annual change in % (real, gross)	-2.4	2.6	0.9	3.9	7.8	3.2	3.1	3.1
Average monthly net wages, RSD 3)	44,432	46,097	47,893	49,650	54,400	56,700	59,300	62,200
annual change in % (real, net)	-2.1	2.5	0.9	4.4	7.8	2.0	2.0	2.0
Consumer prices, % p.a.	1.4	1.1	3.0	2.0	1.7	2.2	2.6	2.8
Producer prices in industry, % p.a.	1.0	0.0	2.3	0.9	0.6	2.8	3.3	3.0
General governm.budget, nat.def., % of GDP								
Revenues	39.3	40.8	41.5	41.5	42.2	44.5	44.5	44.5
Expenditures	42.8	41.9	40.4	40.9	42.4	45.0	45.0	45.0
Deficit (-) / surplus (+)	-3.5	-1.2	1.1	0.6	0.7	-0.5	-0.5	-0.5
General gov.gross debt, nat.def., % of GDP	70.0	67.8	57.9	53.7	52.0	51.5	48.5	45.0
Stock of loans of non-fin.private sector, % p.a.	3.0	2.3	2.1	9.9	8.9	.	.	.
Non-performing loans (NPL), in %, eop	21.6	17.0	9.8	5.7	4.8	.	.	.
Central bank policy rate, % p.a., eop 4)	4.5	4.0	3.5	3.0	2.3	2.0	2.0	2.5
Current account, EUR mn	-1,234	-1,075	-2,051	-2,223	-2,850	-2,730	-2,710	-2,700
Current account, % of GDP	-3.5	-2.9	-5.2	-5.2	-6.2	-5.7	-5.2	-4.9
Exports of goods, BOP, EUR mn	11,454	12,814	14,066	15,238	16,600	17,500	18,400	19,300
annual change in %	7.6	11.9	9.8	8.3	8.9	5.3	5.1	5.0
Imports of goods, BOP, EUR mn	15,099	15,933	18,064	20,483	22,300	23,400	24,500	25,600
annual change in %	2.4	5.5	13.4	13.4	8.9	4.8	4.6	4.5
Exports of services, BOP, EUR mn	4,273	4,571	5,246	6,000	7,020	7,600	8,200	8,900
annual change in %	12.2	7.0	14.8	14.4	17.0	8.0	8.0	8.0
Imports of services, BOP, EUR mn	3,544	3,664	4,280	4,909	5,900	6,200	6,600	7,100
annual change in %	6.0	3.4	16.8	14.7	20.2	5.0	7.0	7.0
FDI liabilities, EUR mn	2,114	2,127	2,548	3,496	3,600	3,640	.	.
FDI assets, EUR mn	310	228	130	308	250	250	.	.
Gross reserves of NB, excl. gold, EUR mn	9,812	9,543	9,287	10,526	12,042	.	.	.
Gross external debt, EUR mn 5)	26,234	26,494	25,574	26,829	28,000	28,100	28,200	28,300
Gross external debt, % of GDP 5)	73.5	72.1	65.3	62.6	59.0	58.0	55.0	51.0
Average exchange rate RSD/EUR	120.73	123.12	121.34	118.27	117.86	118	118	118

1) Preliminary and wiiw estimates. - 2) Excluding arms industry. - 3) From 2018 based on tax administration data, before that survey data supplemented by tax administration data. - 4) Two-week repo rate. - 5) BOP 5th Edition.

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