SERBIA: Slowdown ahead after a strong 2018

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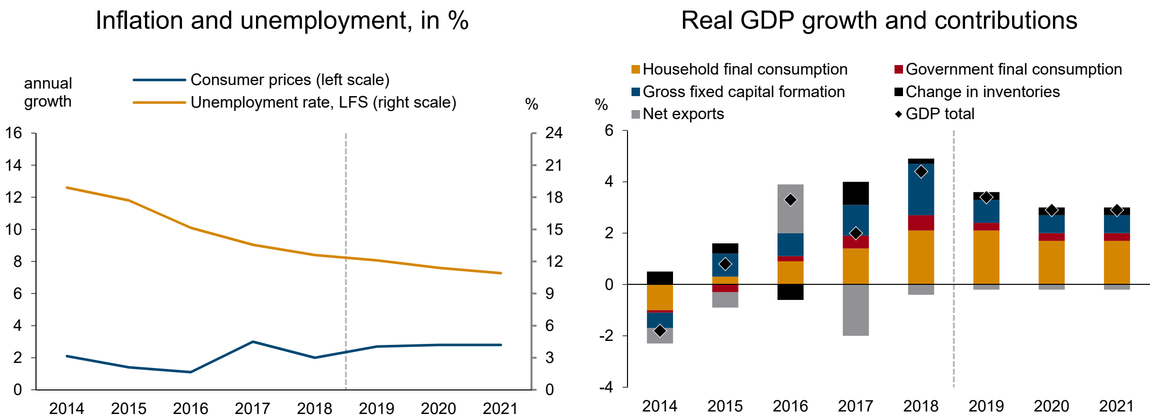
After a desperately weak post-crisis performance even by CESEE standards, the Serbian economy finally had a good year in 2018. Growth will weaken a bit in 2019, but remain fairly robust in the context of the last decade. A bigger slowdown is likely in 2020-2021. Domestic and international political risks have risen, which is an issue for an economy that relies so much on FDI. The EU reform process will continue to provide an important policy anchor, but accession is still many years away.

Figure 6.19 / Serbia: Main macroeconomic indicators



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

2018 was by some distance the best year for the Serbian economy since 2008, but the peak has already passed and growth in the forecast period will be more subdued. Base effects from agriculture, after the 2017 drought, had a major positive impact on overall growth last year. The partial unwinding of (now heavily criticised) austerity policies of recent years also helped (although overall the fiscal stance is still not especially loose: Serbia recorded a second consecutive budget surplus in 2018). External support was also important, particularly in the early part of the year, with still-robust activity in most key trading partners, and the increasingly large share of exports in Serbia's overall GDP, supporting activity. Meanwhile private consumption – which accounts for around 70% of GDP, one of the highest levels in the region – was pushed up by solid wage and employment trends. Real GDP growth was 4.4% for the year as a whole, a very decent outturn considering that average growth in 2010-2017 had averaged just 1.3%.

In 2019 growth will be slower than 2018 as temporary effects fade (a bit of a slowdown was already observed in the second half of last year). However, at around 3.5%, growth in 2019 will still be very healthy by post-crisis standards. Private consumption should make a significant contribution, reflecting higher employment and wages, and its overall large share of GDP. Strong recent growth and a consequent increase in labour demand appears to be sucking more people into the formal labour market, with recent data indicating an increase in participation rates. Real investment growth will also be positive, reflecting contributions from both private and public sources, helped by decent confidence levels and historically loose monetary conditions. The real CPI-adjusted central bank policy rate is currently at around 1%, down sharply from roughly 8% in 2013-2015.

While the outlook remains generally positive, Serbia will certainly not be immune from the deterioration in external conditions. Serbia's economy is much more open than it was ten years ago, reflecting both a ramping up of export capacity on the back of robust FDI inflows, and the persistent weakness of domestic demand in the post-crisis period. Weaker trends in the eurozone economy, led by Germany, are a particular concern, as Serbia has become increasingly integrated into regional value chains. Around 40% of Serbia's exports go to the EU15.

Strong recent growth is gradually eating up spare capacity, but we expect inflation to remain subdued by historical standards. Serbia has tended to have a high inflation rate in the CESEE context since the crisis, but in recent years price growth has increasingly converged with (low) regional levels and those of the eurozone. Moreover, unlike in 2018, energy prices will make little or no contribution to inflation in 2019. The weakness of inflation, even at a time when the labour market is performing well, suggests that there is still plenty of unused capacity in the economy. This will allow the central bank to maintain a relaxed policy stance, meaning that real interest rates will stay low, supporting domestic economic activity and helping to offset external weakness. Inflation will rise gradually, but only to around 3% by the end of the forecast period.

We expect FDI inflows to remain an important driver of growth. A mixture of reforms and incentives have had a positive impact on Serbia's ability to attract investment from abroad, and this should continue. However, the spike in tensions with Kosovo, and higher domestic political instability, could affect foreign investor sentiment somewhat. A large part of Serbia's FDI appeal is linked to perceptions of greater domestic and international stability in recent years. The EU reform anchor is also a key driver of foreign investors' willingness to commit to Serbia. Here, we expect further progress and the opening of new chapters in the EU accession negotiations. In economic terms, Serbia is also close to the convergence level (relative to Germany) that Romania and Bulgaria reached before their accession in 2007.

Political risk is probably higher than it has been for a while in Serbia, and from both a domestic and international perspective. In terms of foreign policy, the discussion of a land swap with Kosovo is unlikely to go anywhere, but has stirred up feelings on both sides. A 'normalisation' of relations will be necessary for EU accession, but that is unlikely to be achieved anytime soon. Tensions were heightened further at the end of 2018 by Kosovo's decision to impose 100% tariffs on imports from Serbia (this came after Kosovo's attempt to join Interpol was rejected, which Kosovo blames Serbia for). Broadly, Serbia has been quite successful in cultivating good relationships with various important international partners. The relationship with Russia is well known (and reinforced by a recent visit by Russian President Vladimir Putin to Belgrade), but Serbia has also been successful in cultivating ties with Turkey and China among others. Chinese support for Serbia in the dispute with Kosovo may turn out to be quite important.

Domestically, the government has come under increased pressure from a wave of protests across the country, which could threaten political stability. Protesters are unhappy with what they see as increased authoritarianism and state capture. The President, Aleksandar Vučić, is accused by his opponents of many of the same things seen in some EU Member States in CESEE: winning power by democratic means, but then using authoritarian measures to stay there. The Varieties of Democracy index for Serbia shows a marked deterioration in 2007-2017, one of the worst in the CESEE region. In addition, Transparency International has singled out Serbia as one of the CESEE countries where corruption has got worse in recent years.

These protests appear unlikely to go away anytime soon, although it is extremely questionable whether or not they will succeed. A key problem for the protesters is that the opposition is very broad, and only really united by its anti-government position. It also appears to lack effective leaders. For now, a key stability factor for Mr Vučić is that he still has legitimacy in the eyes of many key Western leaders. Western countries have generally refrained from commenting on the protests (incredibly in the eyes of many inside and outside of Serbia, Mr Vučić was even invited to speak on a panel about media freedom at Davos in January). Mr Vučić's stated desire to keep Serbia firmly on course for EU accession is a key part of this. As long as Mr Vučić is seen at home to have this 'external legitimacy', he will be very difficult to dislodge.

In 2020-2021, we expect growth to slow further, reflecting weaker external conditions, and various structural bottlenecks. The economy remains plagued by a legacy of structural weaknesses from the pre-crisis years, including loss-making state-owned companies that continue to pose contingent liability risks for the state finances (although public debt/GDP has fallen markedly in recent years, so the emergence of additional costs for the state would not be as problematic now as would have been the case a few years ago). Although positive reform momentum should continue under the umbrella of EU accession, the pace of progress will likely be underwhelming. We think a growth rate of around 3% is realistic for 2020-2021. This will mean further convergence with Western Europe, but at a disappointingly slow pace. Growth will continue to be primarily driven by private consumption and FDI-financed investment. We are still relatively positive above EU accession, but think that the target date of 2025 is very unrealistic.

Table 6.19 / Serbia: Selected economic indicators

	2014	2015	2016	2017	2018 1)	2019	2020 Forecast	2021
Population, th. pers., mid-year	7,132	7,095	7,058	7,021	6,986	6,950	6,920	6,880
Gross domestic product, RSD bn, nom.	4,161	4,312	4,521	4,754	5,100	5,400	5,700	6,000
annual change in % (real)	-1.6	1.8	3.3	2.0	4.4	3.4	2.9	2.9
GDP/capita (EUR at PPP)	10,800	11,200	11,400	11,600	12,300	.	.	.
Consumption of households, RSD bn, nom.	3,012	3,052	3,152	3,311	3,500	.	.	.
annual change in % (real)	-0.1	-0.5	1.3	2.0	3.0	3.0	2.5	2.5
Gross fixed capital form., RSD bn, nom.	664	723	766	844	1,000	.	.	.
annual change in % (real)	-3.4	4.9	5.4	7.3	11.0	5.0	4.0	4.0
Gross industrial production 2)								
annual change in % (real)	-7.3	7.3	5.2	3.9	1.3	3.5	3.3	3.3
Gross agricultural production								
annual change in % (real)	2.4	-8.4	8.3	-11.8	11.3	.	.	.
Construction output								
annual change in % (real)	2.5	20.7	7.2	8.5	13.3	.	.	.
Employed persons, LFS, th, average 3)	2,421	2,574	2,719	2,795	2,850	2,910	2,940	2,970
annual change in %	4.8	0.6	5.6	2.8	2.0	2.0	1.0	1.0
Unemployed persons, LFS, th, average 3)	563	552	489	435	410	400	380	360
Unemployment rate, LFS, in %, average 3)	18.9	17.7	15.2	13.6	12.6	12.1	11.4	10.9
Reg. unemployment rate, in %, eop 4)	28.4	26.8	25.7	23.0	20.3	.	.	.
Average monthly gross wages, RSD 5)	61,426	61,145	63,474	65,976	68,629	72,600	77,000	81,600
annual change in % (real, gross)	-1.7	-2.4	2.6	0.9	3.9	3.0	3.2	3.1
Average monthly net wages, RSD 5)	44,530	44,432	46,097	47,893	49,650	52,500	55,000	57,700
annual change in % (real, net)	-1.5	-2.1	2.5	0.9	4.4	3.0	2.0	2.0
Consumer prices, % p.a.	2.1	1.4	1.1	3.0	2.0	2.7	2.8	2.8
Producer prices in industry, % p.a.	1.3	1.0	0.0	2.3	0.9	2.9	3.3	3.3
General governm.budget, nat.def., % of GDP								
Revenues	39.0	39.3	40.8	41.5	42.0	44.0	43.0	43.0
Expenditures	45.2	42.8	41.9	40.4	41.8	45.0	45.0	45.0
Deficit (-) / surplus (+)	-6.2	-3.5	-1.2	1.1	0.2	-1.0	-2.0	-2.0
General gov.gross debt, nat.def., % of GDP	66.2	70.0	67.8	57.9	58.0	56.0	53.0	51.0
Stock of loans of non-fin.private sector, % p.a.	4.5	3.0	2.3	2.1	9.9	.	.	.
Non-performing loans (NPL), in %, eop	21.5	21.5	17.0	9.8	6.4	.	.	.
Central bank policy rate, % p.a., eop 6)	8.00	4.50	4.00	3.50	3.00	3.25	4.00	4.50
Current account, EUR mn	-1,985	-1,234	-1,075	-2,051	-2,223	-2,300	-2,300	-2,300
Current account, % of GDP	-5.6	-3.5	-2.9	-5.2	-5.2	-5.1	-4.8	-4.6
Exports of goods, BOP, EUR mn	10,641	11,454	12,814	14,066	15,238	16,300	17,600	19,000
annual change in %	1.2	7.6	11.9	9.8	8.3	7.0	8.0	8.0
Imports of goods, BOP, EUR mn	14,752	15,099	15,933	18,064	20,483	21,800	23,300	24,900
annual change in %	0.5	2.4	5.5	13.4	13.4	6.5	7.0	7.0
Exports of services, BOP, EUR mn	3,810	4,273	4,571	5,246	6,000	6,400	6,900	7,500
annual change in %	11.3	12.2	7.0	14.8	14.4	7.0	8.0	8.0
Imports of services, BOP, EUR mn	3,344	3,544	3,664	4,280	4,909	5,300	5,700	6,100
annual change in %	7.6	6.0	3.4	16.8	14.7	7.0	7.0	7.0
FDI liabilities, EUR mn	1,500	2,114	2,127	2,548	3,496	.	.	.
FDI assets, EUR mn	264	310	228	130	308	.	.	.
Gross reserves of NB, excl. gold, EUR mn	9,351	9,812	9,543	9,287	10,526	.	.	.
Gross external debt, EUR mn 7)	25,679	26,234	26,494	25,588	26,500	26,600	26,700	26,800
Gross external debt, % of GDP 7)	72.4	73.5	72.1	65.3	61.5	59.0	56.0	54.0
Average exchange rate RSD/EUR	117.31	120.73	123.12	121.34	118.27	119	120	120

1) Preliminary and wiiw estimates. - 2) Excluding arms industry. - 3) From 2015 adjustments according to ILO, Eurostat and EU-LFS. - 4) From 2015 new source for labour force potential. - 5) From 2018 based on tax administration data, before on wage survey data supplemented by tax administration data. - 6) Two-week repo rate. - 7) BOP 5th Edition.

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