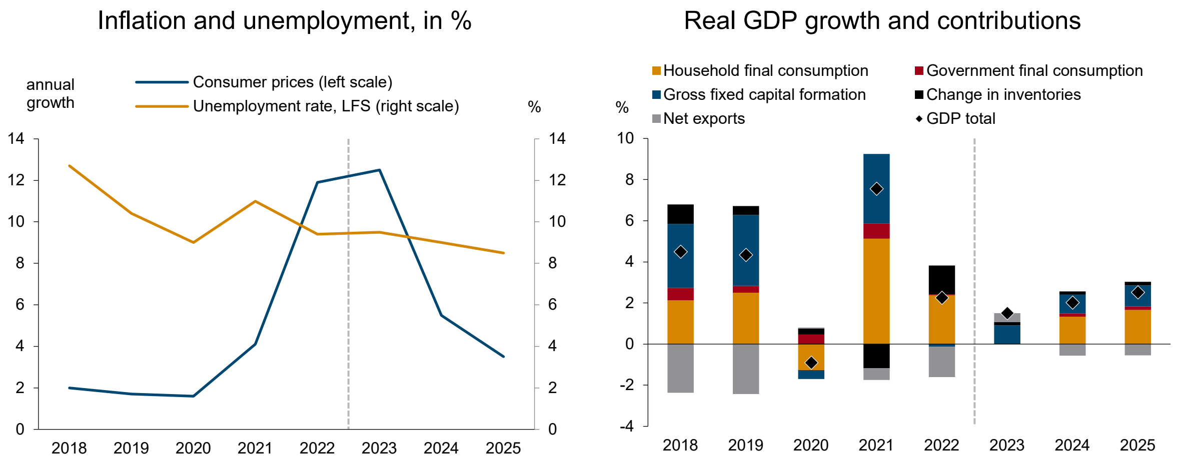
SERBIA: A lighter shade of grey

BRANIMIR JOVANOVIĆ

The economy grew solidly in Q2, but this is likely to be short lived. Inflation is showing signs of moderating, but is still among the highest in the CESEE region. The central bank is likely to keep interest rates unchanged for the rest of the year, while fiscal policy will probably become less restrictive. We are revising our GDP growth forecast for 2023 upwards to 1.5%, but for 2024 and 2025 downwards, due to the expected lower global growth.

Figure 6.19 / Serbia: Main macroeconomic indicators



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

The economy in Q2 outperformed expectations. GDP grew by 1.7% year on year, which, on an annualised quarter-on-quarter basis, exceeded 5%. This was accompanied by an upward revision of Q1 growth by the statistical office to 0.9% (from the previous 0.7%). The relatively good results for Q2 are likely to be short lived, though. Household and government consumption both declined by around 1%, while investment and exports grew only marginally, by around 4% and 2%, respectively (all in real terms). In such a situation, the primary driver of the growth in Q2 was the approximately 6% decline in imports. This drop is probably a consequence of reduced energy imports compared to the previous year, and is unlikely to be sustained.

Inflation is showing signs of moderating, but it still ranks among the highest in the CESEE region. In August, it stood at 11.5%, down from its peak of 16.2% in March. The high inflation is partly due to the government's decision to increase the price of electricity and gas at the start of the year, and to remove the price controls on basic foodstuffs that it introduced at the end of 2021. Recognising that the decision to lift these price controls was a mistake, the government agreed with several supermarket chains in September to reduce the prices of around 30 essential food and hygiene products for the remainder of the year. While this measure is expected to provide some relief for the public, its impact on the overall price level will be limited, since it applies to only a handful of products.

Not only is high inflation acting as a brake on the economy, but it is also damaging people's standard of living. While there are no official data on poverty trends after 2021, real wages stagnated in the first six months of 2023, while the unemployment rate increased in Q2 by 0.7 percentage points year on year, to reach 9.6%. The number of persons employed declined marginally, although the employment rate increased by 0.5 percentage points, due to a decline in the working-age population. The stagnation of real wages and the decline in employment at a time when real GDP is growing (even if only modestly) suggest that the labour share of income is shrinking while the profit share is rising. This also implies that inflation in the country is currently being driven by company profits, not wages.

The combination of monetary and fiscal policies in the first nine months of the year has been quite restrictive and has held back economic growth. Monetary policy took the lead (with the central bank steadily raising its interest rate) while fiscal policy followed (as the government kept spending low). The policy mix is likely to be less restrictive in the coming months, which will somewhat favour economic activity.

The cycle of interest-rate hikes appears to be over. The central bank has kept its rate unchanged for two months in a row (August and September), having raised it 15 times in the 16 months between April 2022 and July 2023. The base interest rate remains relatively high, though, at 6.5% as of September, significantly higher than the European Central Bank (ECB). While we believe the central bank is unlikely to raise rates again this year, much will depend on the actions of the major central banks, especially the ECB. If it continues to raise rates in the coming months, the Serbian central bank may do the same.

Fiscal policy has also been restrictive so far this year, but this is likely to change. The general government budget recorded a surplus of around 1% of GDP in the first six months, due to relatively weak expenditure. Spending was especially low on capital investment, which fell to around 5% of GDP in the first half of the year – some 15% below its level for the same period last year (in real terms). Public spending is likely to improve in the last few months of the year, as the government has announced higher pensions, an increase in public-sector salaries, and even one-off payments to certain groups of people. This will probably push the budget balance back into negative territory. The move will likely support economic activity somewhat, although over the medium term, fiscal policy will probably be much less supportive than in previous years, owing to higher interest rates.

Foreign direct investment (FDI), which has been the cornerstone of the country's economic model in recent years, remained solid in H1 2023. It grew by around 20% in real terms year on year, reaching 6.3% of GDP. There were also some interesting developments in the structure of the investments, which may indicate the direction in which the country is moving: in Q1 (the latest available data), 63% of inflows came from EU countries – almost double the share of the year before; at the same time, investment from China amounted to 15% of total inflows – around half its share in 2022. While it may be too early to draw any firm conclusions (since the data are for only one quarter and FDI data are notoriously volatile), these trends may indicate that Western investors are regaining confidence in the country.

The general impression is that the country is improving its relations with the West – something that is likely to be positive for FDI inflows and overall economic developments. In recent months, President Vučić has twice met Ukrainian President Zelensky, once in June in Moldova and once in August in Greece. There have also been media reports that weapons produced in Serbia are being used by the Ukrainian army. While President Vučić has denied that Serbia is selling weapons direct to Ukraine, he has acknowledged that Serbian weapons may be reaching the country through intermediaries. The West has also been quite supportive of Serbia in its recent squabbles with Kosovo. However, it is highly unlikely that Serbia will introduce sanctions against Russia or sever its economic relations with the country: more likely it will try to maintain good political and economic relations with both the West and Russia, in an effort to benefit from both sides. After all, Russian FDI in Serbia in the Q1 2023 was also significant, amounting to 6% of total FDI – equal to the German share. Several hundred thousand Russians have arrived in Serbia over the past year or so (although many have also left), and around 7,000 Russian companies have opened up, mainly in the IT and services sectors.

Considering all this, we are revising our GDP forecast for 2023 upwards to 1.5% (up 0.2 percentage points). We have taken this step for several reasons: the strong performance in Q2, the upward revision of growth in Q1, the announcements of greater fiscal support in the remainder of the year, and the country's improved relations with the West. However, on a longer-term horizon, it is clear that the economy is on a slower track than previously, due to both domestic and global factors, and that it is unlikely to return to growth rates of 3-4% any time soon. Accordingly, we are revising our forecasts for 2024 and 2025 downwards by 0.5 percentage points (to 2% and 2.5%, respectively).

As for inflation, we are revising our forecast upwards for both 2023 and 2024, on account of the price hikes over the past few months. For 2023, we now expect it to average 12.5%; for 2024, we now forecast 5.5% (both figures 0.5 percentage points up on the previous forecast).

Table 6.19 / Serbia: Selected economic indicators

	2020	2021	2022 [1]	2022	2023	2023	2024	2025
				January-June			Forecast	
Population, th. pers., mid-year [2]	6,899	6,834	6,664	.	.	6,614	6,564	6,514
Gross domestic product, RSD bn, nom.	5,504	6,270	7,091	3,280	3,734	8,100	8,700	9,200
annual change in % (real)	-0.9	7.5	2.3	3.9	1.3	1.5	2.0	2.5
GDP/capita (EUR at PPP)	12,810	14,350	15,530	.	.	.	.	.
Consumption of households, RSD bn, nom.	3,606	4,067	4,719	2,180	2,493	.	.	.
annual change in % (real)	-1.9	7.8	3.7	5.2	-0.4	0.0	2.0	2.5
Gross fixed capital form., RSD bn, nom.	1,180	1,448	1,620	725	784	.	.	.
annual change in % (real)	-1.9	15.9	-0.6	1.7	3.1	4.0	4.0	4.5
Gross industrial production [3]								
annual change in % (real)	0.5	6.4	1.6	3.3	1.5	2.0	2.5	3.0
Gross agricultural production								
annual change in % (real)	2.0	-5.6	-8.0	.	.	.	.	.
Construction output								
annual change in % (real)	-2.5	17.0	-11.5	-6.9	9.5	.	.	.
Employed persons, LFS, th, average [4]	2,895	2,849	2,913	2,912	2,857	2,900	2,930	2,960
annual change in %	-0.2	2.6	2.3	4.9	0.5	-0.5	1.0	1.0
Unemployed persons, LFS, th, average [4]	287	352	302	314	312	300	290	270
Unemployment rate, LFS, in %, average [4]	9.0	11.0	9.4	9.8	9.9	9.5	9.0	8.5
Reg. unemployment rate, in %, eop	17.9	17.4	15.4	.	.	.	.	.
Average monthly gross wages, RSD	82,984	90,784	103,316	100,622	116,126	117,400	126,300	134,600
annual change in % (real, gross)	7.8	5.2	1.7	3.5	0.1	1.0	2.0	3.0
Average monthly net wages, RSD	60,073	65,864	74,933	72,945	84,197	85,100	91,600	97,700
annual change in % (real, net)	7.7	5.4	1.7	3.4	0.1	1.0	2.0	3.0
Consumer prices, % p.a.	1.6	4.1	11.9	9.7	15.3	12.5	5.5	3.5
Producer prices in industry, % p.a.	-1.3	8.7	14.9	14.8	5.6	4.0	3.0	2.5
General governm. budget, nat. def., % of GDP								
Revenues	41.0	43.3	43.8	45.5	44.9	44.0	44.0	44.0
Expenditures	49.0	47.4	46.9	46.2	43.7	46.0	46.0	45.5
Deficit (-) / surplus (+)	-8.0	-4.1	-3.2	-0.6	1.2	-2.0	-2.0	-1.5
General gov. gross debt, nat. def., % of GDP	57.8	57.1	55.6	52.4	52.1	55.0	56.5	58.0
Stock of loans of non-fin. private sector, % p.a.	11.1	10.2	6.5	12.8	0.3	.	.	.
Non-performing loans (NPL), in %, eop	3.7	3.5	3.0	3.3	3.0	.	.	.
Central bank policy rate, % p.a., eop [5]	1.0	1.0	5.0	2.5	6.3	6.5	5.8	5.0
Current account, EUR m	-1,929	-2,266	-4,139	-2,898	-527	-2,400	-3,200	-3,500
Current account, % of GDP	-4.1	-4.2	-6.9	-10.4	-1.7	-3.5	-4.3	-4.4
Exports of goods, BOP, EUR m	16,079	21,018	26,913	12,971	14,183	30,400	33,600	36,900
annual change in %	-2.0	30.7	28.0	33.2	9.3	13.0	10.5	9.8
Imports of goods, BOP, EUR m	21,280	27,038	36,266	18,289	17,374	38,800	42,900	46,800
annual change in %	-3.4	27.1	34.1	48.7	-5.0	7.0	10.5	9.0
Exports of services, BOP, EUR m	6,191	7,800	11,087	4,717	6,031	12,500	13,800	15,200
annual change in %	-10.7	26.0	42.1	37.0	27.9	13.0	10.5	10.0
Imports of services, BOP, EUR m	5,090	6,402	8,771	3,820	4,516	9,400	10,400	11,400
annual change in %	-14.1	25.8	37.0	41.9	18.2	7.0	10.5	9.5
FDI liabilities, EUR m	3,039	3,886	4,416	1,612	2,147	4,450	.	.
FDI assets, EUR m	100	229	110	115	130	150	.	.
Gross reserves of CB, excl. gold, EUR m	11,732	14,523	17,311	12,642	20,410	.	.	.
Gross external debt, EUR m	30,787	36,488	41,885	.	.	48,500	52,900	56,900
Gross external debt, % of GDP	65.8	68.4	69.4	.	.	70.0	71.0	72.0
Average exchange rate RSD/EUR	117.58	117.57	117.46	117.59	117.31	117.0	116.8	116.5

1) Preliminary. - 2) From 2022 according to census 2022. - 3) Excluding arms industry. - 4) From 2023 according to census 2022. From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 5) Key policy rate.

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