SERBIA: Walking a tightrope

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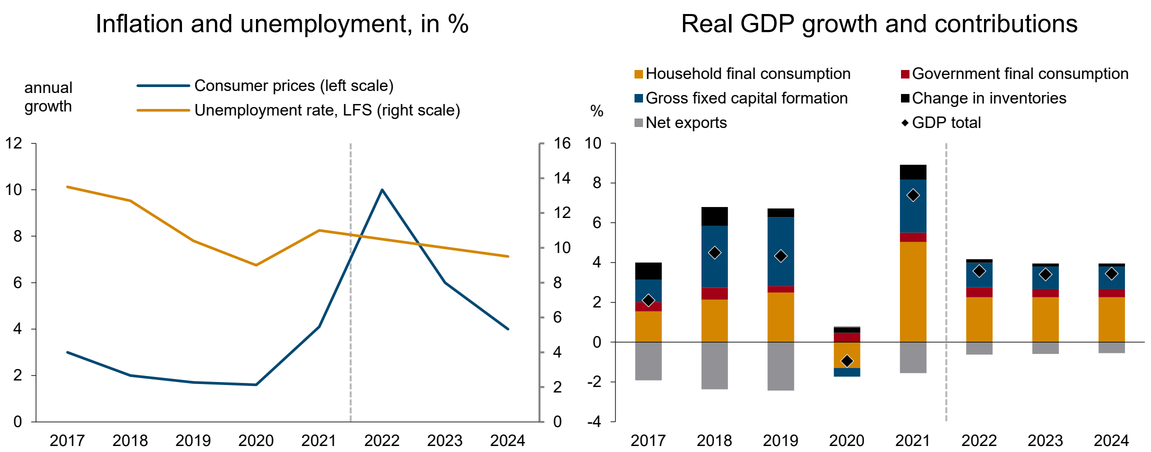
The war in Ukraine will be costly for Serbia, due to its close relations with Russia. In the short term, the country will face slower economic growth and higher prices: we are revising our GDP forecast for 2022 downwards to 3.6% (from 4.9%) and our inflation forecast upwards to 10% (from 4.5%). But the real challenges facing Serbia stem from its policy of attempting a balancing act between the EU and Russia, which will be hard to maintain in the coming years.

Figure 4.19 / Serbia: Main macroeconomic indicators



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

Serbia's economy weathered the pandemic rather well. GDP declined by just 1% in 2020, and then rebounded strongly in 2021, by 7.5%, making the country one of the best in Europe in terms of its current level of income vis-à-vis the pre-pandemic level. The good results were largely a consequence of the government's sensible economic policies during the pandemic: it spent promptly and it spent big, cushioning the decline in private spending. Total government spending in 2020 and 2021 averaged 48% of GDP, some 7 percentage points (pp) up on the pre-pandemic period. It also continued its ambitious programme of investing in infrastructure, with public investment averaging 6% of GDP during 2020 and 2021. Finally, the country managed to remain attractive to foreign investors even during the pandemic, receiving gross foreign direct investment (FDI) inflows of around 7% of GDP in 2020-2021 (mostly from the EU); this can also be attributed, at least partly, to the government's policies for attracting FDI.

But 2022 started badly. Industrial production contracted by 1.4% year on year in January and February, as a result of the energy crisis. Output in the energy sector (electricity, gas, steam and air conditioning) declined by 22% year on year in the first two months. Inflation reached 8.8% in February, eating away at real incomes. The real growth in the average wage fell to 3.9% in January, and the weaker purchasing power slowed retail trade growth to just 4.3% in January, in real terms (whereas as recently as July 2021 it was growing by 11.8%).

The government tried to tame inflation with price controls, but they do not seem to have had much success. The prices of basic foodstuffs have been frozen since November 2021, but the index of food prices still increased by 3.4% between November 2021 and February 2022. The prices of oil products were capped in February 2022, but the ceilings were set so high that they have not had any real impact.

On top of this came the war in Ukraine. It will affect Serbia more than most other Eastern European countries, due to its close economic and political ties to Russia. Russia ranks among Serbia’s top five partners in terms of both FDI and exports. Between 2010 and 2020, the country received EUR 1.5bn in FDI inflows from Russia, which accounts for around 7% of its total FDI. Serbia exported around EUR 900m of goods to Russia in 2021 (mostly food and agricultural products), which made up around 4% of Serbian exports. Both trade and investment flows related Russia will suffer in the coming period as a consequence of the economic downturn there. The fact that Serbia has not imposed sanctions on Russia will not change anything. Russian businesses are suffering right now, and are facing very hostile European markets, so it is unlikely that they will increase their presence in Serbia (away from other countries) or try to use Serbia as a back door to Europe.

Yet, the real challenges for Serbia stem not from these direct and immediate effects, but from its policy of balancing on a tightrope between the EU and Russia. That will be a hard trick to pull off in the coming period, although Serbia will try. Its refusal to impose sanctions on Russia did not receive a warm welcome from the EU; rather, it was regarded as undermining EU efforts to make Russia accountable for its actions. But still, no steps have been taken against Serbia – at least not yet. Serbia has also offered to host any negotiations between Russia and Ukraine, which can be read as an attempt to maintain its current ‘balanced’ position. It is hard to predict how the situation will evolve, but it is very easy to imagine a scenario in which Serbia will have to pick one side or the other.

Should that occur, the apparent dilemma of ‘Russia or the EU’ is actually a no-brainer for Serbia, at least from the economic point of view: Serbia derives much greater economic gain from the EU than from Russia. Russia may provide 7% of Serbia’s FDI inflows, but the EU supplies 66%; Russia may take 4% of Serbia’s exports, but the EU absorbs 65%. And Serbia may have received a favourable price on its Russian gas (USD 270 per 1,000 m^3), which, according to Serbia’s President Vučić, saves the country around EUR 300m, but between 2014 and 2020 it received around EUR 1.5bn from the EU’s Instrument for Pre-accession Assistance (IPA) II funds.

Of course, political decisions are not always made on economic grounds, and the close political ties between Serbia and Russia may eventually prevail. Russia has been Serbia’s biggest ally in the Kosovo dispute, and a large section of the public in Serbia is favourably inclined towards Russia. Because of that, Serbia may now decide to stand with Russia. But if it does, it will pay a hefty economic price – in both the short and the medium term, for it will lose its carefully crafted status as economic leader of the Western Balkans, which it has nurtured for years.

Even if Serbia decides to take the more pragmatic course, siding with the EU and imposing restrictions on Russia, it will still stand to lose. Its economic ties with Russia will be weakened, leading to lower FDI and exports, and higher gas prices. Thus, whatever the outcome of the Serbia-Russia-EU rope trick, it is certain that Serbia will lose out economically, both in the short and the medium term.

The main takeaway from the country's general election in April is that the political landscape remains largely unaltered, although things could start to change soon. As expected, the incumbent president, Aleksandar Vučić, triumphed in the first round of the presidential election; and the coalition he leads won most seats in parliament, so it is clear who will form the next government. But certain opposition parties that boycotted the previous elections have now entered parliament, which will give them greater visibility and voice – something that is very important, given the dire media situation in the country. Furthermore, at the time of writing, the outcome of the elections for the city of Belgrade remains undecided: it could be that the opposition eventually wins the capital, which could spark a turnaround in the political cycle. Thus, although Team Vučić will continue to lead Serbia in the immediate future, the political situation in the country is about to get much more interesting.

Fiscal policy will stay supportive, but less so than over the past two years. The planned deficit for 2022 is 3% of GDP, which signals an intention to achieve gradual consolidation, after the deficits in 2020 and 2021 reached 8.0% and 4.1%. Public spending was front-loaded, ahead of the general elections in April. Total public spending in January and February grew year on year by 20% in real terms (nominally, 30%). This was due to higher pensions and public-sector wages, but also to discretionary spending ahead of the elections (such as the programme to give EUR 100 to every young person in the country). This means that fiscal support in the remainder of the year will be weaker, both because of the end of the spending spree and because of higher inflation, which will erode the real value of the public spending.

For the first time since the start of the pandemic, the central bank raised its base interest rate in April – to 1.5% (from 1%) – prompted by the sharp surge in inflation. We see this as more of a symbolic gesture than a measure that will have any real impact on inflation, since current inflation is clearly supply-driven. Since the central bank has decided to act on inflation, however, we expect further hikes in the interest rate in coming months, as inflation picks up. Though this is unlikely to prevent a further rise in prices, it may have some adverse effects on economic activity.

Bearing all this in mind, we are revising our growth forecast for the coming period downwards and our inflation forecast upwards. GDP growth for 2022 is predicted to slow down to 3.6% (1.3 pp down on the previous forecast), and to continue to slide in 2023 to 3.4% (down 1.1 pp), where it will remain for 2024 (down 0.6 pp). Our inflation forecast for 2022 is revised upwards to 10% (6 pp up on the previous figure); for 2023 it is forecast to be 6% (up 3.5 pp) and for 2024 – 4% (up 1.5 pp). We also note the predominance of downside risks for both GDP and inflation: if there is any escalation of the war in Ukraine, or some EU measures against Serbia, growth will be lower and inflation higher.

Table 4.19 / Serbia: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023	2024
						Forecast	
Population, th. pers., mid-year	6,983	6,945	6,899	6,850	6,800	6,750	6,700
Gross domestic product, RSD bn, nom.	5,073	5,422	5,502	6,269	7,100	7,800	8,400
annual change in % (real)	4.5	4.3	-0.9	7.4	3.6	3.4	3.4
GDP/capita (EUR at PPP)	12,020	12,800	12,760	14,130	.	.	.
Consumption of households, RSD bn, nom.	3,463	3,637	3,604	4,035	.	.	.
annual change in % (real)	3.1	3.7	-1.9	7.7	3.5	3.5	3.5
Gross fixed capital form., RSD bn, nom.	1,017	1,218	1,180	1,409	.	.	.
annual change in % (real)	17.5	17.2	-1.9	12.5	5.5	5.0	5.0
Gross industrial production 2)							
annual change in % (real)	1.3	0.3	0.4	6.4	2.5	3.0	3.0
Gross agricultural production							
annual change in % (real)	14.3	-1.2	2.0	-6.0	.	.	.
Construction output							
annual change in % (real)	14.1	35.5	-2.5	13.8	.	.	.
Employed persons, LFS, th, average 3)	2,833	2,901	2,895	2,849	2,860	2,890	2,920
annual change in %	1.4	2.4	-0.2	.	0.5	1.0	1.0
Unemployed persons, LFS, th, average 3)	412	336	287	352	340	320	310
Unemployment rate, LFS, in %, average 3)	12.7	10.4	9.0	11.0	10.5	10.0	9.5
Reg. unemployment rate, in %, eop	20.3	18.7	17.9	17.4	.	.	.
Average monthly gross wages, RSD	68,629	75,814	82,984	90,784	101,900	111,300	120,400
annual change in % (real, gross)	3.9	8.4	7.8	5.2	2.0	3.0	4.0
Average monthly net wages, RSD	49,650	54,919	60,073	65,864	73,900	80,700	87,300
annual change in % (real, net)	4.4	8.5	7.7	5.4	2.0	3.0	4.0
Consumer prices, % p.a.	2.0	1.7	1.6	4.1	10.0	6.0	4.0
Producer prices in industry, % p.a.	0.9	0.6	-1.3	8.7	15.0	5.0	3.5
General governm. budget, nat. def., % of GDP							
Revenues	41.5	42.0	41.0	43.3	43.0	43.0	43.0
Expenditures	40.9	42.2	49.0	47.4	46.5	46.0	45.5
Deficit (-) / surplus (+)	0.6	-0.2	-8.0	-4.1	-3.5	-3.0	-2.5
General gov. gross debt, nat. def., % of GDP	54.4	52.8	57.8	56.5	58.5	60.0	61.5
Stock of loans of non-fin. private sector, % p.a.	9.9	8.9	11.1	10.2	.	.	.
Non-performing loans (NPL), in %, eop	5.7	4.1	3.7	3.5	.	.	.
Central bank policy rate, % p.a., eop 4)	3.0	2.3	1.0	1.0	2.0	2.5	3.0
Current account, EUR m	-2,076	-3,161	-1,929	-2,343	-3,900	-4,500	-5,100
Current account, % of GDP	-4.8	-6.9	-4.1	-4.4	-6.5	-6.8	-7.2
Exports of goods, BOP, EUR m	15,106	16,415	16,079	20,756	25,100	27,900	30,600
annual change in %	7.4	8.7	-2.0	29.1	21.0	11.0	9.5
Imports of goods, BOP, EUR m	20,191	22,038	21,280	26,685	33,100	36,900	40,400
annual change in %	11.8	9.1	-3.4	25.4	24.0	11.5	9.5
Exports of services, BOP, EUR m	6,061	6,934	6,191	7,801	9,300	10,400	11,400
annual change in %	15.5	14.4	-10.7	26.0	19.0	12.0	10.0
Imports of services, BOP, EUR m	5,066	5,922	5,090	6,380	7,500	8,300	9,200
annual change in %	18.4	16.9	-14.1	25.3	17.0	11.0	11.0
FDI liabilities, EUR m	3,464	3,815	3,039	3,863	.	.	.
FDI assets, EUR m	308	264	100	238	.	.	.
Gross reserves of CB, excl. gold, EUR m	10,526	12,042	11,732	14,523	.	.	.
Gross external debt, EUR m	26,662	28,254	30,787	36,536	43,300	48,700	53,600
Gross external debt, % of GDP	62.2	61.4	65.8	68.5	72.0	74.0	76.0
Average exchange rate RSD/EUR	118.27	117.85	117.58	117.57	118.0	118.5	119.0

1) Preliminary and wiiw estimates. - 2) Excluding arms industry. - 3) From 2021 the new LFS methodology is applied in line with the Integrated European Social Statistics Regulation (IESS). - 4) Key policy rate.

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