SERBIA

FAVOURABLE PROSPECTS

The Serbian economy was only moderately affected by the consequences of the Covid-19 pandemic in 2020. Activity barely contracted, whilst the central bank maintained an adequate level of foreign-currency liquidity against a background of significant euroisation of the economy. These good performances can be linked to the economy's attractiveness for international investors, as well as to past fiscal consolidation measures, which meant that the government had more scope to support the economy last year. In the short term, the recovery is likely to be strong, in particular thanks to exports, and inflation should remain under control. Looking further ahead, the ability of the authorities to maintain the economy's competitiveness will be crucial in reducing currency risk.

A RESILIENT ECONOMIC ACTIVITY

In 2020, economic activity withstood the fallout from the pandemic quite well, and the early signs of recovery in 2021 are encouraging. Real GDP contracted by only 0.9% in 2020. This good performance can be explained by three factors: the modest drop in household consumption (-2.5%) given the limited lockdown measures, various government measures to support corporates and household income (equivalent to more than 10% of GDP), and the strength of goods exports. Meanwhile, unlike other countries in the Western Balkans, the small share of tourism in GDP limited the drop in service sector activity.

In the first quarter of 2021, dynamic growth in investment (+10% y/y) and exports (+7.9% y/y) enabled real GDP to increase by 1.7% y/y, despite the fact that household consumption (-1.9% y/y) was still dented by the fallout from the pandemic. The short-term outlook is fairly positive due to a relatively high vaccination rate and an export sector that should benefit from the economic recovery in the Eurozone. Real GDP is likely to grow by around 5% this year.

In recent years, the Serbian economy has become more reactive to international economic conditions due to the growing weight of exports in GDP. Exports accounted for 52% of GDP in 2019, up from 23% in 2004, and are concentrated in the manufacturing sector. In the meantime, the role of the domestic market as an engine of growth has diminished – for both household consumption and public spending (from 13% of GDP in 2004 to 9% in 2019).

INFLATION SHOULD STAY UNDER CONTROL

In 2020, the National Bank of Serbia (NBS) adopted measures that allowed the country to avoid liquidity constraints. In addition to cutting its policy rate by 125bp to 1%, bank liquidity was boosted by an increase in currency swap transactions, repo transactions and purchases of public and private-sector securities. Even so, since March 2020, the central bank's balance sheet has only grown by the equivalent of 5% of GDP.

In the short term, the conduct of monetary policy is likely to prove more delicate. First, the health situation remains uncertain, meaning that monetary easing could continue to be necessary. Secondly, inflationary pressures have increased since the beginning of the year. The Consumer Price Index (CPI) rose by an annualised 3.6% in May 2021, compared to average inflation of 1.6% in 2020. Unsurprisingly, energy prices (and to a lesser extent food prices) were the main driver of inflation in the first half of 2021. CPI inflation is currently above the central bank's target of 3%, but remains below the 4.5% upper bound of its tolerance interval. We estimate that inflation will remain within this interval and fall back below the target rate in the second half of the year. The base effect that is driving up energy prices will gradually fade and we are not expecting a significant increase in oil prices on global markets in the second half. Overall, inflation is likely to remain moderate and reach 2.5% on average in 2021. Against this background, the central bank remains in a position to pursue an accommodating monetary policy that will help support domestic liquidity.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.2	-0.9	5.0	4.5
Inflation (CPI, year average, %)	1.9	1.5	2.5	2.5
Cent. Gov. balance / GDP (%)	-0.2	-8.1	-7.0	-2.5
Cent. Gov. debt / GDP (%)	53	57	60	59
Current account balance / GDP (%)	-6.9	-4.2	-5.3	-5.6
External debt / GDP (%)	66	71	65	62
Forex reserves (EUR bn)	13.4	13.5	15.1	15.7
Forex reserves, in months of imports	5.7	6.1	6.2	5.9

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

CONTRIBUTION TO REAL GDP GROWTH

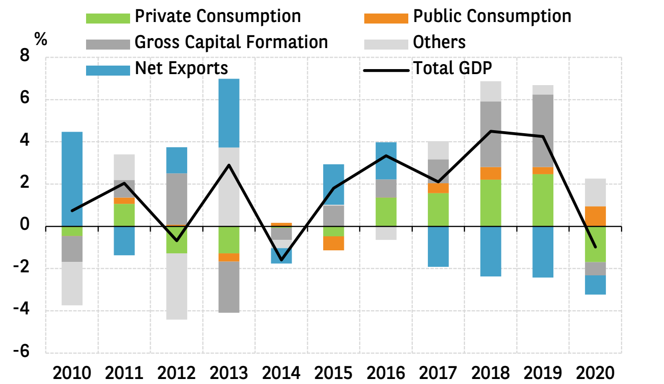

CHART 1

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

FISCAL CONSOLIDATION REMAINS RELEVANT

Due to the contraction in economic activity and policy stimulus measures, the government recorded a substantial deficit in 2020 (8.1% of GDP). The deficit is likely to remain high in 2021 (at an expected 7%

of GDP) given the persistence of the epidemic and the associated spending. However, public finances remain sound. As a matter of fact, when the Covid-19 crisis started last year, public accounts were in much better shape than a decade before. Fiscal consolidation efforts, helped by financial and technical support from the IMF, allowed the government to run budget surpluses in 2017 and 2018 and an almost balanced budget in 2019. The primary surplus averaged 2.5% of GDP between 2016 and 2019, compared to an average deficit of 2.9% of GDP between 2011 and 2015.

Government debt is nevertheless relatively high, at 57% of GDP in 2020, and thus represents a source of vulnerability given the high level of exposure to currency risk. Around 70% of debt is denominated in foreign currency, with 51% in euros and 12% in US dollars. The government has adopted a strategy of dinarisation of its debt in recent years. The issuance of medium-term and long-term debt (up to 20 years) in the local market is increasing – whereas the market was dominated by short-term debt securities up to 2017. The share of debt denominated in dinars has increased from 22% to 30% of the total since 2015.

A GOOD EXPORT PERFORMANCE

In 2020, Serbian exports stood up well to the economic contraction in the European Union (EU). Whilst EU imports of goods fell by 6% in volume terms, Serbian exports fell by only 3% in volume and 1.8% in value. According to the central bank, there were two explanations for this good performance. First, strong exports of agricultural products: although these represent only 7% of total exports, they grew by more than 11% in value in 2020, in part due to rising global prices. Secondly, strong FDI inflows in export-oriented sectors have supported a robust performance of exports of manufactured goods.

FOREIGN-CURRENCY LIQUIDITY PRESERVED

The ability of the central bank to limit foreign exchange volatility in periods of turbulence in international markets is particularly important for macroeconomic stability given the euroisation of a substantial part of the economy. In addition to the high portion of government debt that is denominated in foreign currency, around 60% of banks' balance sheets are also denominated in foreign currency, exposing banks to significant credit risks in the event of a major fall in the dinar.

Foreign-currency liquidity remained satisfactory in 2020, despite the slight fall in remittances from expatriate workers and in foreign direct investment. Principally thanks to the sharp reduction in repatriation of profits by international companies and the government's issue of Eurobonds, the NBS's forex reserves increased slightly (to EUR 13.5 billion by end-2020) and now cover more than six months of imports. The healthy level of forex reserves has allowed the NBS to intervene in the foreign exchange market to maintain the dinar's stability against the euro.

In the short term, the expected increase in forex reserves should allow the NBS to continue to manage exchange rate volatility. The current account deficit is likely to remain relatively high, but FDI inflows and government debt issues on international markets will cover this financing requirement. In addition, the European Central Bank has extended to March 2022 the availability of the EUR 1 billion precautionary line to help tackle any pressure on the currency.

FOREX RESERVES AND EXCHANGE RATE

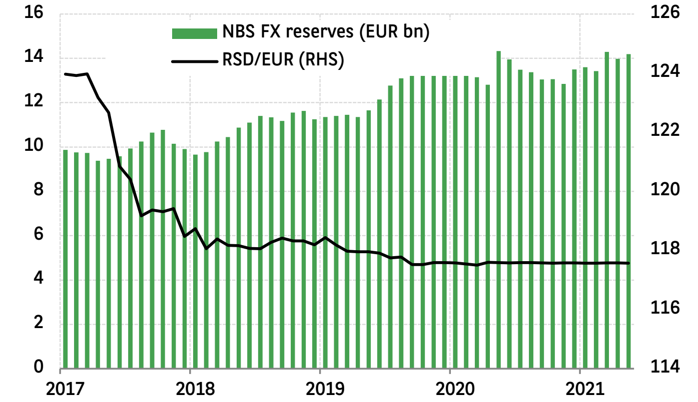

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

Serbia remains attractive to foreign investors. Since 2015, net FDI inflows have exceeded 6% of GDP on average. Over this period, coverage of the current account deficit by net FDI has averaged 140%. The bulk of FDI relates to the manufacturing sector (30% of the total since 2014) and, to a lesser extent, the financial sector (17%), where inflows have been driven notably by the privatisation of some state assets.

Prospects for external accounts are favourable, and the exchange rate policy adopted by the monetary authorities should continue to help to deal with international turbulence. However, some vulnerabilities remain. External debt remains high (71% of GDP in 2020) and debt servicing (interest and principal) has represented an average of 28% of exports of goods and services since 2014. With this in mind, Serbia's ability to continue to attract FDI and maintain its international competitiveness will be crucial for macroeconomic stability.

Completed on 5 July 2021

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