SERBIA

TEMPORARY HEADWINDS

The impact on Serbia's economy caused by the war in Ukraine is likely to remain moderate. However, the war will adversely affect all macroeconomic indicators. Growth forecasts have been downgraded because of sharply higher inflation, trade exposure to Russia and a weaker European economy. Serbia's central bank has carried out only moderate monetary tightening so far, expecting that the jump in inflation will be short-lived. External accounts are likely to deteriorate because of the wider current account deficit and a possible slowdown in foreign direct investment flows, but the central bank should still be able to defend the dinar stability. This is crucial for Serbia's macroeconomic stability given that commercial bank balance sheets and government debt are highly exposed to the euro. Current circumstances mean that it will take longer to shore up the publicsector accounts, but the rise in public sector debt should remain moderate.

WEAKER GROWTH PROSPECTS

The Serbian economy has been growing rapidly for several years, and has been moderately affected by the pandemic. GDP fell by only 0.9% in real terms in 2020. The sharp rebound in 2021 (7.5%) was mainly driven by robust domestic demand. Consumer spending (+7.7%) was supported by higher real wages (+4.6%), lower unemployment (9.8% at end-2021 versus 12.8% in March 2021) and credit growth (+11% for household credit). The government maintained several measures of direct support for households and corporates at around 2.3% of GDP in 2021. Investment also recovered strongly (+12.8%), due in particular to the construction sector.

For 2022, we have cut our growth forecast to 3.5%. The direct impact on output caused by the war in Ukraine is likely to be moderate. Serbia is mainly dependent on Russia for energy, since a quarter of its oil imports, two thirds of its gas imports and 10% of its coal imports come from Russia, which gives Serbia favourable prices. Serbia's energy mix is highly dependent on fossil fuels (87% versus the EU average of 72%) and particularly on coal, which accounts for half of the energy that the country consumes. For the time being, the Serbia government has not joined in with the sanctions against Russia and its energy supplies have not been disrupted. In terms of exports, Ukraine and Russia account for 6.5% of Serbian exports, mainly food and capital goods. Those exports could be affected by the conflict, at least in the near term.

The indirect consequences of the war in Ukraine are likely to be more significant. Sharply higher inflation is set to hold back growth in household purchase power, and the sharp increase in building materials prices will probably hamper the construction sector. Exports are likely to suffer from slower growth in Europe – Serbia's main trading partner – and particularly from difficulties in the automotive sector, which accounts for around 10% of total exports. The extent of the 2023 rebound will depend to a large extent on inflation. Our core scenario is that inflation will ease gradually in the second half of 2022, helping GDP growth to accelerate slightly to 4% in 2023.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	4.3	-0.9	7.5	3.5	4.0
Inflation, CPI, year average, %	1.9	1.6	4.1	10.3	4.0
Central Gov. balance / GDP, %	-0.2	-8.1	-4.3	-4.6	-3.2
Central Gov. debt / GDP, %	52	57	57	56	55
Current account balance / GDP, %	-6.9	-4.1	-4.5	-6.9	-3.9
External debt / GDP, %	66	71	71	68	65
Forex reserves, EUR bn	13.4	13.5	16.5	16.6	17.8
Forex reserves, in months of imports	5.7	6.1	6.0	5.6	5.9

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SERBIA: CONTRIBUTION TO REAL GDP GROWTH, %

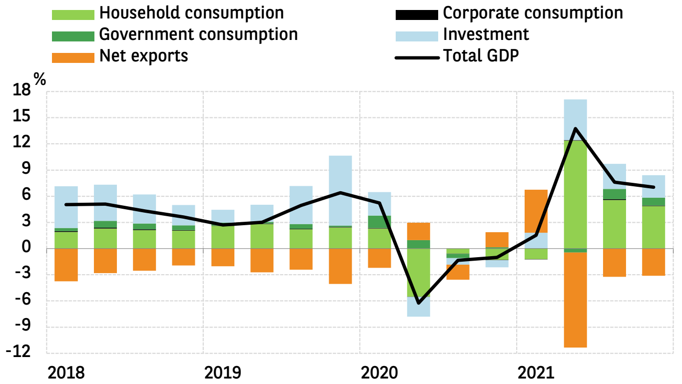

CHART 1

SOURCE: STATISTICAL OFFICE, BNPPARIBAS

MODERATE MONETARY TIGHTENING

Consumer price inflation has increased in the last six months, reaching 9.1% y/y in March, mainly because of higher food and energy prices. Producer prices are currently surging (+17% y/y in March), and this is likely to drive consumer prices higher in the next few months. However, core inflation remains moderate at the moment (4.4% in March). The central bank expects inflation to ease for the rest of the year, due in particular to the stable exchange rate and the deflationary impact on food prices caused by Serbia's own agricultural output. However, we expect inflationary pressure on commodity prices to remain in place for the whole of 2022. With regard to locally produced agricultural products, high fuel and fertiliser prices (made using natural gas) will keep food price inflation high. In addition, Serbia's agricultural output is vulnerable to water stress, and another year of drought (as in 2021) would have a major inflationary impact. In 2022, consumer price inflation is likely to average 10.3%.

Since this is well above the upper end of its target range (1.5-4.5%), the central bank has started tightening monetary policy. It raised its key interest rate by 50 basis points to 1.5% in April and has more than doubled its open market operations since the start of the year. This liquidity absorption policy was equivalent to 7% of the M2 money supply in March 2022, as opposed to 2.5% in December 2021. In addition, the recent rate hike has widened the gap relative to the ECB's deposit facility rate from 1.5 to 2 points. This will support the dinar at a time when its external accounts are expected to deteriorate. Given the euroisation of a large portion of Serbia's economy (more than 60% of bank balance sheets) and government debt (58% of total debt), maintaining a stable exchange rate against the euro is a major objective for Serbia's central bank. Monetary tightening is likely to continue in the near term, but should remain moderate.

DETERIORATING EXTERNAL ACCOUNTS

Serbia's current-account deficit is likely to increase fairly sharply this year, reaching 6.9% of GDP. Although prices of several commodities should remain stable – particularly Russian gas imports, the price of which should remain lower than the market price, at least in the first half of 2022 – prices of imported food, raw materials, metals and chemicals (around 35% of total imports) are set to rise sharply. With regard to exports, the economic slowdown in Europe and a possible decline in exports to Russia and Ukraine (6.4% of total exports in 2020) are likely to drag down income. Traditionally, Serbia's current account deficit has been covered by foreign direct investment (FDI) and issuance of foreign currency sovereign debt. So far, increased geopolitical tensions have not caused a sharp rise in risk aversion concerning Serbian assets. The risk premium on Serbian eurobonds has increased by a moderate 50bp since the end of February.

Net FDI has averaged 4% of GDP in the last five years and is likely to decline to around 3% of GDP this year because of the less favourable regional environment. Sovereign bond issuance is expected to remain substantial because Serbia is still showing a budget deficit, albeit a moderate one. Serbia's external accounts show fairly limited exposure to volatile capital flows: it is estimated that foreign investors hold the equivalent of around EUR 2 billion of short-term dinar-denominated government debt, equal to 13% of the central bank's currency reserves in late 2021. We expect a very slight increase in currency reserves, which should reach EUR 16.6 billion at the end of 2022, equal to 5.6 months of goods and services imports. This should help keep the dinar stable against the euro. The main risk to this scenario is a further sharp rise in commodity prices, which would widen the current account deficit and could cause a reduction in currency reserves.

DELAYED REDUCTION IN THE BUDGET DEFICIT

Serbia's budget deficit fell in 2021 because of the economic upturn and a 20% y/y increase in tax revenues. The latter were driven in particular by higher VAT receipts, also up 20%, which make up a quarter of the government's revenue. However, the budget deficit remained fairly large at 4.3% of GDP in 2021 because of ongoing exceptional pandemic-related expenditure. In 2022, the sharp slowdown in economic growth is likely to prevent the government reducing the deficit, which is expected to equal 4.6% of GDP.

SERBIA: CPI INFLATION, %

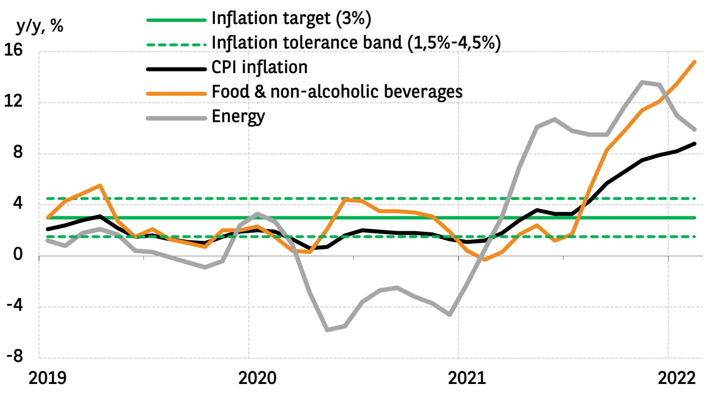

CHART 2

SOURCE: CENTRAL BANK OF SERBIA, BNPPARIBAS

Government debt was an estimated 57% of GDP in 2021 and is likely to fall very slightly in 2022 and 2023. Government debt service remains moderate, with interest payments equalling 4% of budget income in 2021. However, the composition of debt is a source of vulnerability, because 71% is denominated in foreign currencies, including 14% in currencies other than the euro. As a result, improvements in the public-sector accounts are dependent to a large extent on the central bank's ability to limit exchange rate volatility.

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Pascal DEVAUX
pascal.devaux@bnpparibas.com