Serbia

More progress towards convergence

Economic growth in Serbia has accelerated since 2017, fuelled by consumption and investment. Inflation is still mild thanks to the appreciation of the dinar. This favourable environment has produced a fiscal surplus that gives the government some flexibility. The public debt is narrowing, even though it is still relatively high and vulnerable to exchange rate fluctuations and the appetite of international investors. Several factors continue to strain the potential growth rate of the Serbian economy, including unfavourable demographic trends, the slow pace of public sector reforms, and a tough political environment.

Strong economic rebound

The acceleration in economic growth observed in 2017 was confirmed in 2018. GDP growth reached 3.8% in real terms in Q3 2018. The main growth engine is still domestic demand, and productive investment in particular, which follows its rising trend with growth rate of 6.9% y/y. Investment is buoyant in both the public and private sectors. One of the main beneficiaries is construction, which rose 18% in real terms compared to the same period in 2017. The Serbian economy is still highly attractive for foreign investors. Foreign direct investment (FDI) rose 9% in value in the first 10 months of 2018, and should reach the equivalent of 6% of GDP in 2018. The sector breakdown of FDI is rather diversified, and about a third is devoted to export activities.

Private consumption (+3.3% y/y in Q3 2018) is the other growth engine. The unemployment rate continues to fall, even though it is still relatively high (11.3% in Q3 2018). Meanwhile, real wage growth is averaging above 3% y/y. Remittances from expats are another support factor. Remittances were up 18% y/y in October 2018 and accounted for more than 8% of GDP. Household lending continued to accelerate (+12% y/y in November 2018) and made a favourable contribution to consumer trends. The significant improvement in the public accounts paved the way for a more affirmed increase in public spending (+4% y/y in Q3 2018).

Unsurprisingly, foreign trade continued to make a negative contribution to GDP growth given domestic demand's gearing effect on imports of consumer goods and capital goods. Imports rose 11% y/y in Q3 2018 while exports were up by about 9%. Exports were driven by dynamic sales of intermediate goods (notably metals and plastics) as well as car parts for the automotive industry.

According to the preliminary estimates of the Serbian statistics office, real GDP growth should reach 4.4% in 2018, after 2% in 2017. Although the outlook is somewhat less favourable in the short term, GDP growth is expected to hold above 3.5% in 2019. Favourable labour market trends, purchasing power gains and the decline in real interest rates should boost domestic demand. Yet the slowdown in European growth (to an expected 1.5% in the eurozone in 2019 after an estimated 2.2% in 2018) is likely to hamper exports. The European Union accounts for about two thirds of Serbia's exports.

Cautious monetary policy

Despite buoyant growth, price inflation is still subdued and has fallen compared to 2017. Consumer price inflation averaged 2% in 2018, down from 3.2% in 2017. The main inflation drivers are food and energy prices. Excluding energy and food, core inflation slipped to an average annual rate of 1.3% in 2018. The dinar levelled off against the euro in 2018 (+0.2%), which might have helped hold down inflation.

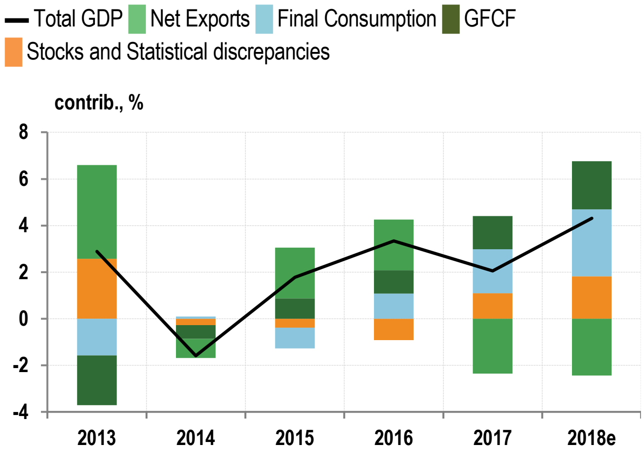
Since 2009, the central bank has officially pursued an inflation-targeting monetary policy. Currently the CPI target is an average annual rate of 3%, with a fluctuation band of +/- 1.5%. Short-term inflation expectations are about 3%. In this environment, and given the uncertainty concerning the pace of eurozone monetary tightening on the one hand and global pricing trends for energy on the other, the central bank decided to maintain the monetary status

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	2.0	4.3	3.8	3.5
Inflation (CPI, year average, %)	3.2	2.0	2.9	3.0
Cent. Gov. balance / GDP (%)	1.2	0.5	-0.3	-0.5
Cent. Gov. debt / GDP (%)	62	56	54	52
Current account balance / GDP (%)	-6.2	-5.9	-7.4	-7.9
External debt / GDP (%)	68	61	57	53
Forex reserves (EUR bn)	10.4	11.3	12	12.5
Forex reserves, in months of imports	4.9	4.7	4.5	4.3
Exchange rate EURRSD (year end)	118.5	118.2	120	123

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth



Source: Statistical Office of the Republic of Serbia, BNP Paribas quo at its 10 January monetary policy meeting and held its key policy rate at 3% (unchanged since April 2018). The central bank also intervened in the forex market to reduce the volatility of the exchange rate (albeit without setting a target price). Euroisation of bank balance sheets is high (about 70% of credit and deposits) and a very significant share of the public debt is denominated in foreign currencies.

Cleaning up public finances

Thanks to a fiscal consolidation effort conducted under IMF supervision (*Stand-By Arrangement* completed in February 2018) as well as strong revenue growth, the public accounts reported a surplus for the second consecutive year. After reaching 1.2% of GDP in 2017, the fiscal surplus is expected to narrow to 0.5% of GDP in 2018 due to noticeable increases in both current spending and investment. The primary balance (excluding interest payment) should exceed 3% of GDP. Based on expectations of a slight slowdown in economic growth and ongoing policies to stimulate growth, Serbia is expected to report a slight fiscal deficit in 2019 (0.3% of GDP).

This favourable fiscal environment has helped reduce the public debt ratio. It slipped to 56% of GDP in 2018 (from 69% of GDP in 2016), and is expected to narrow to 54% in 2019. The medium-term risk premium applied to external sovereign debt in foreign currencies has steadily declined. It is currently below 110 bp, down from more than 200 bp at year-end 2016. Yet the composition of government debt is still a source of vulnerability. At year-end 2017, about 42% of total government debt was denominated in euros and 19% in USD. All in all, more than 77% of government debt is denominated in foreign currencies (36% of domestic market issues), even though the government has pursued a debt dinarisation strategy since 2012. Serbia is highly dependent on non-resident investors, which hold more than 70% of the debt.

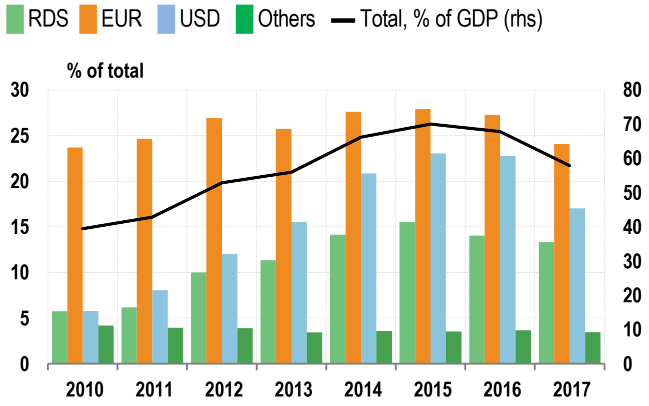
Several factors limit refinancing risk. Thanks to long-term securities issued in the domestic market, the residual maturity of almost half of the locally-issued securities (in foreign currency and dinars) is longer than 3 years. Several factors also limit currency risk, including the central bank's conservative forex policy, the use of hedging products, and the improvement in the external accounts, which supports the dinar's appreciation. In 2018, the central bank increased its foreign reserves by 14% to EUR 11.3 bn, the equivalent of more than 4.7 months of imports of goods and services.

Persistent structural weaknesses

Despite a favourable cyclical environment and rather upbeat growth prospects, a number of structural weaknesses persist that have a negative impact on Serbia's economic growth potential.

With about 7 million inhabitants in 2018, Serbia's population has been shrinking for several years. The population is declining at an annual rate of 0.5%, and the country has lost about 480,000 residents since 2002. Labour productivity is also low compared to the average for other countries in the region, and value added per employee is even lower than in the western Balkans countries.

3- Government debt



Source: Ministry of Finance, BNP Paribas

The restructuring of state-owned companies remains a key factor in the economic transition. Although real progress has been made in this area, it is still insufficient. According to EBRD, state-owned companies (excluding the financial sector) account for about two thirds of GDP and are active in all sectors of the economy. In 2012-15, the average profitability of these companies was barely positive, which represents a potential risk for the consolidation of public finances. Yet given the ongoing privatisation programme (more than 45 companies have been privatised since 2015), their weight on public finances has diminished. Government guarantees amounted to 3.7% of GDP in October 2018, down from 7.8% of GDP in 2013.

Lastly, the political and institutional environment is another factor straining Serbia's growth potential. Indicators of governance are not really good (notably concerning the application of the rule of law and the control of corruption) and the regional political situation could potentially become a major source of tension. All of these factors are holding back the acceleration of Serbia's accession to the European Union.

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