31. SERBIA

Economic growth outlook remains bright

In 2018 economic growth is forecast to accelerate to its highest level in a decade. Domestic demand should strengthen further on the back of buoyant consumption and investment activity, supported by continuous foreign direct investment inflows. While export growth is expected to remain robust, net exports contribution to growth is likely to be negative again this year, given strong imports. Following a dip in 2018, inflation is foreseen to slowly return to the centre of the central bank target tolerance band. The budget balance is set to remain in surplus, amid still non-negligible fiscal risks.

Growth is picking up

A cold spell in the winter and a drought in the summer trimmed growth to just below 2% in 2017, well below initial expectations. However, economic expansion gathered pace in the fourth quarter with real GDP growing by 2.5% (y-o-y), sustained by a double-digit increase in gross fixed capital formation and strong contribution from changes in inventories. Household final consumption expanded steadily as gains in employment firmed up. Export growth decelerated in the last quarter of the year, while rising domestic demand drove import growth up, resulting in a sizable negative contribution of net exports to growth in the fourth quarter.

Short-term indicators point at an acceleration of growth in the beginning of 2018. In the first two months, industrial production grew strongly. Manufacturing activity, in particular, rose across the board with 21 out of 24 sub-sectors on a positive trajectory. Retail trade picked up as well, indicating rising domestic consumption.

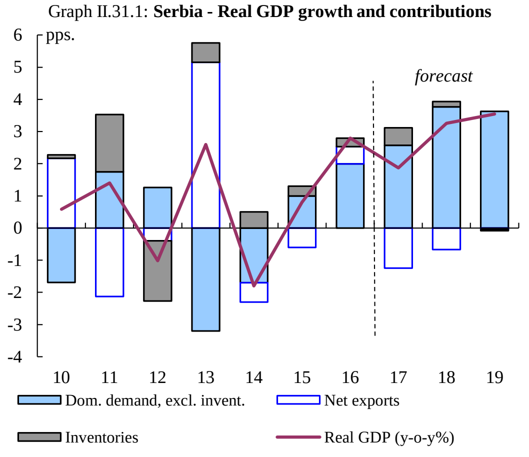
The new investment and growth cycle is in full swing

Gross fixed capital formation has increased steadily over the last three years. It was driven mainly by the private sector and supported by growing foreign direct investment, large part of which went into tradable sectors. Investment growth is forecast to remain robust as favourable financing conditions and improved confidence continue trickling down. The envisaged substantial increases in government capital spending will also contribute to a sustained recovery of investment.

Private consumption is expected to be the other major driver of domestic demand and economic growth. Employment gains and slowly rising wages and transfers have already propelled it to growth. Private consumption growth is forecast to further gather pace in 2018 before stabilising as the growth cycle matures. Given that the general government was in surplus last year, fiscal sustainability considerations should not constrain public consumption anymore and it will revert to a steady positive contribution to growth. Rising domestic demand would continue pulling imports up. As a result, net exports contribution to growth is expected to remain negative or close to zero over the forecast horizon, despite persistently strong export growth.

A more vibrant economic growth should continue to work its way to further increase formal employment. Unemployment, however, despite decreasing over the forecast horizon, is expected to remain large in view of significant structural problems on the labour market.

Graph II.31.1: **Serbia - Real GDP growth and contributions**



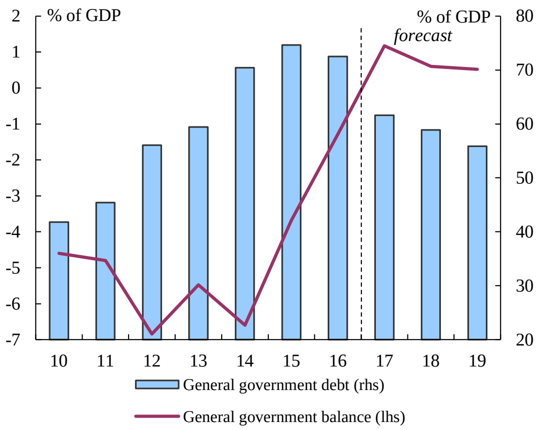
Contained price pressures – the new normal?

Inflation moved within the central bank target tolerance band last year before falling steeply in the beginning of 2018. Low price pressures are projected to persist throughout the forecast, underpinned by strong dinar exchange rate and limited administered price adjustments, cushioning also effects from higher demand.

External imbalances remain elevated

Following a widening of external imbalances last year, they are expected to remain broadly stable at a rather elevated level. Although fully covered by foreign direct investment, the size of the current account deficit is indicative of a major economic vulnerability. Fluctuations in commodity prices and international capital flow reversals remain the main risks to the forecast.

Graph II.31.2: **Serbia - Public finances**



Budget prospects good again

In 2017, for the first time in more than a decade, the consolidated government budget was in surplus. The outcome, at 1.2% of GDP, outperformed by far both initial and revised budget deficit targets. As in the previous two years, this result was mainly driven by strong revenue.

Preliminary data in the first quarter point to a continuation of better-than-expected revenue results. Given recent wage and pension increases, the forecast envisages smaller budget surpluses in the next two years. As a result, government debt, excluding possible restitution-related debt, is foreseen to fall and remain under 60% of GDP.

The good fiscal prospects and mounting spending pressures, however, would continue testing government resolve to maintaining strict control of current spending, in particular, over the public sector wage bill and pension expenditure. The expiration of the Stand-By Arrangement with the IMF and a dysfunctional system of fiscal rules also add to the uncertainty about the future course of fiscal policy. In addition, major reforms of the tax and public administration and in state-owned enterprises, with potentially significant budgetary impact, remain unfinished.

Table II.31.1

Main features of country forecast - SERBIA

		2016			Annual percentage change					
	bn RSD	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		4261.9	100.0	-	-1.8	0.8	2.8	**1.9**	**3.3**	**3.5**
Private Consumption		3085.0	72.4	-	-1.3	0.5	1.0	**1.8**	**3.1**	**2.9**
Public Consumption		681.4	16.0	-	-0.6	-1.5	2.2	**1.0**	**2.0**	**2.0**
Gross fixed capital formation		755.8	17.7	-	-3.6	5.6	5.1	**6.2**	**6.8**	**6.4**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		2132.0	50.0	-	5.7	10.2	12.0	**9.8**	**9.7**	**8.8**
Imports (goods and services)		2449.6	57.5	-	5.6	9.3	9.0	**10.7**	**9.4**	**7.6**
GNI (GDP deflator)		4020.9	94.3	-	-1.7	-0.2	2.1	**0.5**	**2.7**	**3.1**
Contribution to GDP growth:	Domestic demand			-	-1.7	1.0	2.0	**2.6**	**3.8**	**3.6**
	Inventories			-	0.5	0.4	0.3	**0.5**	**0.2**	**0.0**
	Net exports			-	-0.6	-0.6	0.5	**-1.2**	**-0.7**	**0.0**
Employment				-	10.8	0.6	5.6	**2.8**	**2.0**	**2.1**
Unemployment rate (a)				-	19.2	17.7	15.3	**13.6**	**12.1**	**10.0**
Compensation of employees / head				-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy				-	-	-	-	**-**	**-**	**-**
Real unit labour cost				-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				-	2.7	2.7	2.5	**2.8**	**2.0**	**2.7**
Consumer-price index				-	2.1	1.4	1.1	**3.2**	**1.7**	**2.7**
Terms of trade goods				-	0.4	3.5	2.8	**-1.7**	**-0.5**	**0.0**
Trade balance (goods) (c)				-	-12.3	-11.9	-10.0	**-11.4**	**-11.5**	**-11.4**
Current-account balance (c)				-	-6.0	-4.7	-4.0	**-6.2**	**-6.9**	**-6.9**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-	-	-	**-**	**-**	**-**
General government balance (c)				-	-6.6	-3.7	-1.3	**1.2**	**0.6**	**0.5**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	70.4	74.6	72.5	**61.6**	**58.9**	**55.9**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.