31. SERBIA

Growth is firming up supported by rising consumption

After a modest recovery last year, GDP growth accelerated markedly in the first half of 2016. While export growth is expected to remain solid, domestic demand and, in particular, stronger private consumption is forecast to pull the economy up. Nevertheless, the economy remains exposed to multiple external risks. Fiscal consolidation is foreseen to slow down but to be sufficient to turn around the trend of growing government debt.

Robust export and investment growth

After a modest recovery in 2015, GDP growth accelerated markedly to 2.9% (y-o-y) in the first half of 2016. The rebound of economic activity continued to be supported by base effects, low oil prices, and increased confidence as a result of implemented reforms and strong fiscal consolidation. Although the economy is not far from its pre-crisis level, there is a new growth momentum based on sounder fundamentals and robust investment and export performance. There are signs that consumption is also gathering pace, faster than expected. Public consumption grew strongly on the back of expanding government spending on goods and services. Underpinned by growing real wages, gains in employment and improved expectations, private consumption growth accelerated in the first half of the year. Net exports contributed negatively to growth as strong demand pushed imports up.

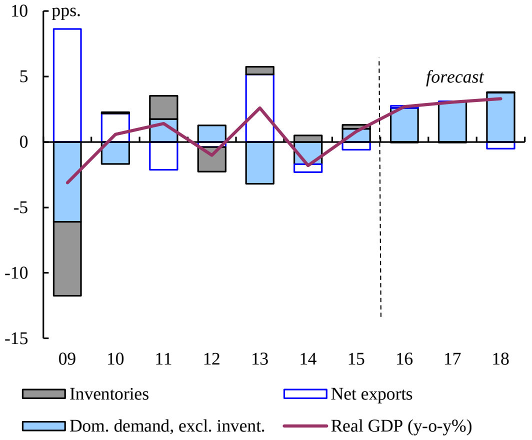
On the supply side, growth remained broad-based and most of the sectors continued expanding. High frequency indicators suggest that the economy's performance was strong in the third quarter as well, with growing domestic and external trade, and steady and broad-based manufacturing growth.

Domestic demand to pull the economy up

Export performance is expected to remain solid, supported by incoming foreign direct investments in tradable sectors and productivity gains as a result of domestic reforms. However, export growth is forecast to slow down due to base effects and idiosyncratic factors linked to a fall in production of a particular car model which is past its peak. Net exports are forecast to contribute only marginally or slightly negatively to growth as imports increase due to stronger domestic demand.

Investment is foreseen to be one of the main engines of growth, although its level remains relatively modest at below 20% of GDP. The investment cycle that started last year should be further supported by confidence effects from recent and ongoing reform efforts, past monetary easing, rising foreign direct investments, and higher public capital expenditure. Economic growth, however, is expected to be increasingly driven by private consumption. Following years of decline, it is forecast to accelerate, contributing most to the rising domestic demand. Steady gains in mainly private employment and wages, coupled with reinvigorated lending activity and overall macroeconomic stability should underpin the envisaged rebound in consumption.

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



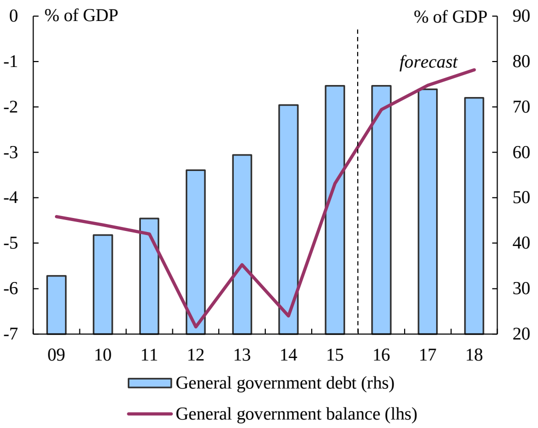
Better placed to face bumps on the road

Domestic and external imbalances have been reduced and the economy is better placed to face possible shocks. Inflation is foreseen to remain low, well within the central bank target tolerance band, aided by a relative stability in commodity prices and further reduction of the budget deficit. The current account deficit, which has come a long way down over the last years, is foreseen to expand slightly on the back of higher income outflows and stronger imports.

The economy, however, remains highly sensitive to international capital flow reversals and fluctuations in commodity prices. In addition geopolitical tensions are non-negligible and have the potential to growth via worsening investment prospects and weakening export demand. Major domestic risks to the forecast scenario stem from a potential reversal of fiscal consolidation or a relaxation of structural reform efforts.

Strong fiscal consolidation to bring a turnaround in government debt dynamics

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



Fiscal consolidation has been very strong and the budget deficit was reduced significantly over the last two years. Although the consolidation drive was partially supported by one-offs, rising economic activity and efforts to reduce the grey economy have led to sizeable revenue over-performance. Robust revenue growth is also the main contributor to an expected reduction of the deficit in 2016, while growth in expenditure on wages and pensions remains subdued. The pace of fiscal consolidation is forecast to slow down as of next year but the deficit levels would be sufficiently low to sustain a turnaround in government debt dynamics. Thus, after eight years of uninterrupted increase, government debt is expected to peak in 2016 before falling in the next two years.

However, fiscal risks remain elevated and the fiscal scenario continues to face a number of uncertainties. Government debt is high, refinancing needs and interest payments are significant and are sensitive to fluctuations in exchange and interest rates. Fiscally important structural reforms have been only partially implemented and would need to be advanced further in order to put public finances on a sounder footing.

Table II.31.1:

Main features of country forecast - SERBIA

	2015			Annual percentage change					
bn RSD	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	4043.5	100.0	-	2.6	-1.8	0.8	**2.7**	**3.0**	**3.3**
Private Consumption	3019.7	74.7	-	-0.6	-1.3	0.5	**1.2**	**2.2**	**3.1**
Public Consumption	655.9	16.2	-	-1.1	-0.6	-1.5	**3.3**	**1.3**	**2.0**
Gross fixed capital formation	715.5	17.7	-	-12.0	-3.6	5.6	**6.7**	**7.0**	**6.3**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	1887.2	46.7	-	21.3	5.7	10.2	**8.6**	**6.4**	**5.2**
Imports (goods and services)	2281.6	56.4	-	5.0	5.6	9.3	**6.8**	**5.5**	**5.4**
GNI (GDP deflator)	3842.4	95.0	-	1.8	-1.7	-0.2	**2.3**	**3.0**	**3.3**
Contribution to GDP growth:	Domestic demand		-	-3.2	-1.7	1.0	**2.6**	**3.1**	**3.8**
	Inventories		-	0.6	0.5	0.4	**-0.1**	**0.0**	**0.0**
	Net exports		-	5.2	-0.6	-0.6	**0.2**	**0.0**	**-0.5**
Employment			-	3.7	10.1	0.6	**1.6**	**0.8**	**1.0**
Unemployment rate (a)			-	22.1	19.4	17.9	**16.5**	**15.6**	**15.0**
Compensation of employees / head			-	-	-	-	**-**	**-**	**-**
Unit labour costs whole economy			-	-	-	-	**-**	**-**	**-**
Real unit labour cost			-	-	-	-	**-**	**-**	**-**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			-	5.4	2.7	2.7	**1.5**	**2.0**	**2.5**
Consumer-price index			-	7.8	2.1	1.4	**1.1**	**2.4**	**3.3**
Terms of trade goods			-	-2.3	0.4	3.5	**2.3**	**-0.7**	**-0.2**
Trade balance (goods) (c)			-	-11.6	-12.3	-11.9	**-10.9**	**-11.1**	**-11.5**
Current-account balance (c)			-	-6.1	-6.0	-4.7	**-4.4**	**-4.3**	**-4.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	-	-	-	**-**	**-**	**-**
General government balance (c)			-	-5.3	-6.6	-3.7	**-2.1**	**-1.5**	**-1.2**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	59.4	70.4	74.6	**74.6**	**73.8**	**71.9**

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