31. SERBIA

Domestic demand to drive growth

Driven by stronger domestic demand and double-digit export growth, GDP expanded again in 2016. Economic growth is forecast to pick up further on the back of rising private consumption and to be supported by continuously robust export and investment. Despite increasing pressure from stronger demand and higher international oil prices, price stability is expected to be preserved. Fiscal consolidation is envisaged to slow down, but to remain sufficient to sustain a further reduction of government debt.

Double-digit export growth and rising domestic demand supported firming up of growth

GDP growth accelerated from 0.8% in 2015 to 2.7% (y-o-y) in the first three quarters of 2016. The economic recovery continued to be supported by surging exports which maintained double-digit growth rates, beating expectations again in 2016. Export benefitted from recent inflows of manufacturing FDI and a solid demand from major trading partners in the EU. It continued to be well-diversified both in terms of sectors and destination countries. Economic growth was also increasingly underpinned by rising domestic demand. In particular, the robust investment performance continued largely unabated, supported by a better business environment, improved expectations, the easing of financing conditions, and a marked increase in government capital expenditure. Private consumption went up as well on the back of increased employment, incomes, and consumer lending, although its strength has been sapped by a fall in remittances.

Domestic demand is seen to strengthen further

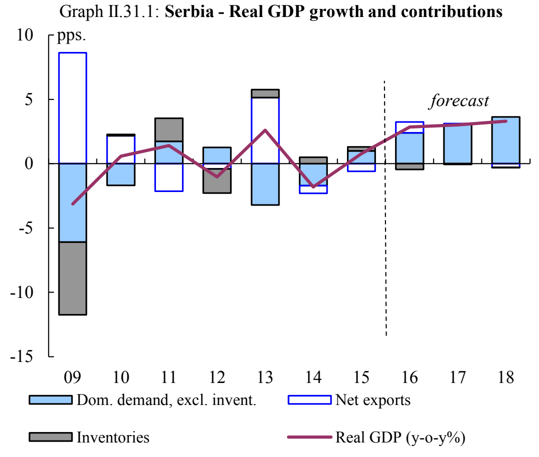
Economic growth is expected to pick up on the back of stronger private consumption. After years of decline or marginal growth, private consumption is forecast to rebound soundly and to increasingly contribute to the rising domestic demand. The envisaged acceleration of private consumption growth should be supported by continuous gains in private employment and wages, buoyant lending and markedly improved expectations. Although its level is still relatively modest, investment is also expected to remain an important engine of growth. There is a significant room for its further expansion, which is foreseen to be driven by the same factors that have bolstered its recent surge – improvements in the business environment, better financing conditions, and government capital spending.

Export growth is forecast to slow down but to remain robust and continue outpacing import growth. As domestic demand strengthens further, the gap between export and import growth is envisaged to shrink and the contribution of net export to growth to become marginal.

Price stability is likely to be preserved

Following a recent reduction of the inflation target from 4% ± 1.5 to 3% ± 1.5 pps., inflation is expected to move within the new tolerance band. Price pressures are foreseen to increase a bit due to higher international oil prices and stronger demand. However, they should be contained due to a good agricultural season last year and limited adjustments of administered prices.

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



Risks remain elevated

Although the economy is in much better shape to face challenges due to recent reforms and reduced domestic and external imbalances, risks to the forecast baseline are non-negligible. Besides being sensitive to exogenous factors like the effects from tighter US monetary policy and fluctuations in commodity prices, there are still major risks related to incompletion or reversal of the fiscal consolidation drive and relaxation of structural reform efforts.

Putting public finance on a sustainable path

Fiscal consolidation has been very strong. Budget execution continued to outperform and the 2016 deficit fell significantly below both initial and revised targets. Expenditure remained under control and revenue growth turned out much better than expected due to favourable macroeconomic developments, improved tax collection, and unplanned one-offs. This created space for additional spending by the end of last year and a limited wage and pension indexation to be implemented in 2017. Following the recent steep reduction of the budget deficit, the fiscal stance is expected to become more supportive of growth. Under the no-policy change assumption, the 2017 budget deficit is projected to decline only marginally in comparison to the previous year outcome.

In 2016, as a result of fiscal consolidation efforts, the government debt fell for the first time after years of constant increase. The pace of fiscal consolidation is forecast to slow down as of 2017 but the deficit levels would be sufficient to sustain a further lowering of government debt. Fiscal risks, however, remain elevated and the fiscal scenario continues to face a number of uncertainties. Government debt is high, refinancing needs and interest payments remain significant. Debt payments 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.

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

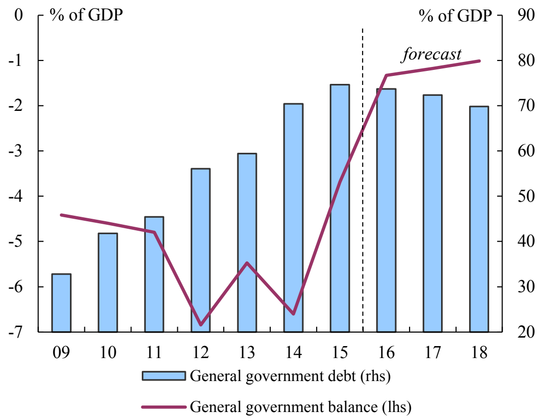


Table II.31.1:
Main features of country forecast - SERBIA

	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	**2.8**	**3.0**	**3.3**
Private Consumption	3019.7	74.7	-	-0.6	-1.3	0.5	**1.2**	**2.1**	**3.0**
Public Consumption	655.9	16.2	-	-1.1	-0.6	-1.5	**2.7**	**2.5**	**2.4**
Gross fixed capital formation	715.5	17.7	-	-12.0	-3.6	5.6	**6.1**	**6.4**	**5.8**
of which: equipment	-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)	1887.2	46.7	-	21.3	5.7	10.2	**10.9**	**7.0**	**6.7**
Imports (goods and services)	2281.6	56.4	-	5.0	5.6	9.3	**7.5**	**6.0**	**6.3**
GNI (GDP deflator)	3842.4	95.0	-	1.8	-1.7	-0.2	**2.2**	**2.9**	**3.2**
Contribution to GDP growth: Domestic demand			-	-3.2	-1.7	1.0	**2.4**	**3.1**	**3.6**
Inventories			-	0.6	0.5	0.4	**-0.4**	**0.0**	**0.0**
Net exports			-	5.2	-0.6	-0.6	**0.8**	**0.0**	**-0.3**
Employment			-	3.7	10.8	0.6	**4.7**	**1.1**	**1.5**
Unemployment rate (a)			-	22.1	19.2	17.7	**16.1**	**14.3**	**12.6**
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	**1.0**	**1.7**	**2.9**
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	**2.2**	**-0.8**	**0.0**
Trade balance (goods) (c)			-	-11.6	-12.3	-11.9	**-10.7**	**-11.0**	**-11.0**
Current-account balance (c)			-	-6.1	-6.0	-4.7	**-4.0**	**-4.2**	**-4.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	-	-	-	**-**	**-**	**-**
General government balance (c)			-	-5.3	-6.6	-3.7	**-1.3**	**-1.2**	**-1.0**
Cyclically-adjusted budget balance (d)			-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)			-	-	-	-	**-**	**-**	**-**
General government gross debt (c)			-	59.4	70.4	74.6	**73.7**	**72.3**	**69.8**

(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.