TRENDS

1. Review

The macroeconomic results of 2005 are indicative of both the consolidation of the achievements of five years of stabilization policy, and of the increasing need to deepen structural changes in the economy in order to protect those achievements. Though last year's growth was certainly below that recorded in 2004, it appears to have been more deeply rooted. The 2004 growth marked a departure from the difficulties of 2003, and was spearheaded by a handful of enterprises that were among the first to be privatized. After a poor beginning owing to the introduction of the VAT at the start of the year and the slowdown of privatization in 2004, 2005 saw increasing growth driven by exports of a widening range of products and a fresh wave of privatization, and supported by the dynamic credit activity of domestic and foreign sources of financing.

On the other hand, after leaping when the VAT was introduced, inflation stabilized at a high rate of approximately 17%. The contributing factors were the VAT, administrative adjustment of prices in the public services sector, energy prices and, above all, high demand. In spite of some efforts, economic policy failed to have a restrictive effect. Fiscal transactions affecting the liquidity of the economy recorded a deficit, similar to the one in 2004. What is important in the long run, however, is the fact that for the second consecutive year, the size of government, measured by the share of consolidated public expenditures in GDP, were reduced. It was only in Q4 that monetary policy started having an effect on the raising of interest rates, i.e. become effectively restrictive.

In spite of the relatively tighter monetary and fiscal policies, demand pressure intensified in Q4 autonomously. The rise in retail prices – core, those under administrative control, and agricultural - accelerated mildly over the quarter, and ended the year 17.7% up on December 2004. Speedier economic growth relative to Q3 was present across almost all the manufacturing and services sectors. Imports and total exports accelerated mildly, especially exports excluding bulky goods (iron and sugar). These trends were underpinned by the strong expansion of bank credit, in particular to enterprises. In order to finance the expansion, bank borrowing increased by as much as in the first three quarters combined, despite the raising of reserve requirements on foreign borrowing. The fiscal result was positive, partly for seasonal reasons and partly because of the major rise in the governments' VAT-related liabilities.

The world recorded generally high growth in 2005 for the second year running and, in most countries, this was accompanied by relatively low inflation in spite of the surging energy prices. Nonetheless, cutting energy costs is a major preoccupation worldwide. The second part of *Trends* discusses the widening gap between the developed and developing countries in terms of contribution to world growth.

In contrast to the world and due to the administrative capping of the retail prices of energy products, their impact on the retail price index was relatively minor in Serbia. But they did have an indirect effect through the prices of services under administrative control, in particular utilities. The latter gave the biggest contribution to the rise of inflation, both annualized and in Q4 (Box 1 in the third part of *Trends*). In addition to the effect of energy prices, the increase in utility prices probably also reflects structural factors. Core inflation in Q4, which FREN will be computing as of this issue of *QM*, rose from 11.8% in September to 13.5% in December, and there was also a hefty increase in the prices of agricultural products.

Production growth was uneven. After the relatively sharp drop in Q1, particularly in the industry and construction, recovery was mainly linear over the year, with the exception of agricultural production. In Q4, the industry continued the growth from Q3 and surpassed last year's level in spite of the drop at the beginning of the year. Although the acceleration was particularly widespread, it was still weaker than the extraordinary growth recorded in Q4 2004. Hence, year-on-year comparison brings out a poorer picture, especially where production of investment goods is concerned. The high growth trend of services in the preceding period also continued, though it was probably weaker than reflected by the statistics. With its Q4 growth, the construction industry managed to make up for the steep fall at the beginning of the year and recorded positive growth at the annual level.

Foreign trade performed much better in 2005 than in the preceding year, not only because of the "shifting" of imports from 2005 to 2004 in anticipation of the introduction of the VAT in January 2005, but also because of positive underlying tendencies. At annual level, exports grew by more than 30% and imports, even after corrections for the VAT effect, rose about 10%, largely due to the hikes in energy prices. The corrected trade deficit remained virtually the same at annual level. It is particularly good news that the high growth rates of exports are steady and include an ever-increasing number of products. In Q4, when the effects of extraordinary factors are excluded, the underlying export growth was many times higher than the underlying import growth, which leads to a reduction of the deficit over the medium term. The export growth in Q4 as well as Q3 was marred by the poor performance of sugar, iron and steel, but other products did better than in the preceding quarters. It would appear, however, that the underlying trend of imports growth is accelerating mildly, as became evident in the first months of this year. In 2005, the balance of current transactions went back to the 2003 level (approximately 9% of GDP), but when the VAT effect is excluded, it was about two percentage points higher.

All of 2005, especially Q4, was characterized by a record growth of capital inflows (1390 mn euros in Q4 and 3644 mn over the year) and of the country's foreign currency reserves (690 mn euros in Q4 and 1627 mn over the year). The capital inflows consisted primarily of constantly increasing direct foreign borrowing by enterprises, which were joined in Q4 by the banking sector (543 mn euros). The inflow of foreign direct investments grew strongly over the year (1192 mn euros annualized), but slowed down in Q4 (236 mn euros).

At first glance, consolidation of past achievements and a relative reduction in the size of government seemed to have characterized 2005. A deeper analysis, however, indicates that the fiscal result of the year as a whole and its Q4 were not as successful as it initially appeared on the basis of unrefined official data. The government's unpaid VAT-related refunds and debt are increasing and, if this inflow is excluded, the balance was at best the same, and the liquidity effect of total fiscal transactions more expansive relative to 2004. The relatively mediocre performance of the VAT and a series of tax reduction measures taken by the government in 2004 and 2005 (the latter prompted by a mistaken impression that the VAT performance was very strong) reduced the share of public revenues in GDP by two percentage points (excluding the growth of the government's VAT-related liabilities). On the other hand, the rise in fiscal expenditures was curbed. The fact that this happened for two years running constitutes a major success. Nonetheless, caution should be exercised with regard to these conclusions since FREN was not in a position to eliminate all the inconsistencies in the presentation of official fiscal accounts.

After speeding up in Q2, annualized monetary expansion stabilized at slightly over 40%. Credit expansion was nominally even faster though similar to that in the previous year in real terms until Q4 when, owing to accelerated growth of credit to enterprises, the 12-month growth went up to 57% annualized. Monetary multiplication was triggered by banks' foreign borrowing whose conversion into dinars exerted constant pressure on monetary growth. The NBS endeavored to check the expansion with repo transactions and raising the reserve requirements on banks' foreign borrowing. Nonetheless, monetary policy was far less restrictive than perceived by the public, whose interest focuses on regulations governing retail loans. Up until the very end of the year, interest rates on repo operations did not reach a level that would to any meaningful extent entice banks to pull out of the credit market. At the year-end, the effective rate of reserve requirements was increased to about 31%, and the nominal rate on all foreign currency sources was equalized. We present a new table with details on the structure of the foreign currency reserves of the country and the NBS, which shows that while their growth was in good part due to the increased reserve requirements, NBS foreign currency reserves rose also at record pace.

Interest rates on the financial markets reflected the growing demand for liquidity caused by the raising of the reserve requirements in November. But when the year is viewed as a whole, it is obvious that yields on FFCDs tended to drop, probably due to the pressure of the continuous inflow of capital from abroad and the improvement in the country's credit rating. The shares market grew in Q4 2005 and, according to cumulative figures, exceeded the value of Q4 2004. The most important factors contributing to the upward trend were the intensified trading in newly listed bank shares and the growth of the discontinuous segment.

As of the next issue, *QM* will be regularly monitoring trends relating to wages and employment. The first *Spotlight On:* article in this issue analyzes in detail the methodology used by the Bureau of Statistics in observing this area. This analysis brings out that the growth of registered wages, though real, was overestimated in the past.

Until recently low level of investment in the country was among the macroeconomic parameters which raised the most concern. The latest official data for 2004, based on an improved methodology, upholds earlier research conducted by CEVES which indicates that investment was 60% higher than previously believed. The second article in the *Spotlight On:* section features FREN's estimate of investment in the 2003-2005 period based on these sources.

And, finally, in the last article in the section, we put the spotlight on the Serbian Oil Company (NIS). In keeping with QM's aim to provide quantitative information of use to economic decision-makers, we measure NIS' performance against three alternative standards of efficiency, and find that its inefficiency costs Serbia at least 300 mn euros a year. This finding is of particular importance in view of the upcoming expiration of the decree banning import of oil products. In the context of the privatization of NIS, an extension of the Decree would de facto enable the new owners to turn this inefficiency loss into windfall profits for themselves.