

# Strategic report – Serbia

5 November 2010

Area (km <sup>2</sup> )	88.361
Population (in mln)	7,33
GDP per capita	4.400 EUR (2009)
President	Boris Tadić
Prime minister	Mirko Cvetković



## Serbian economy on the path to the recovery

### Important news

At the meeting of the Executive Board at the end of September, the International Monetary Fund gave a positive assessment of the implementation of the agreed economic programme of Serbia and thus released the funds of the fifth tranche of the stand-by loan in the amount of EUR 366.5 million. It also issued a recommendation for further implementation of structural reforms and improvement of business environment, thus attracting new foreign direct investments which would definitely contribute to the strengthening of the economic growth in the mid-term period. They also proposed the amendment to the Budget Act in order to improve the stability in the field of fiscal policy. In September, the Government supported the bill which foresees that the public debt cannot exceed 45% of GDP and that budgetary deficit on average cannot exceed 1%. Serbia was given the green light to increase salaries and pensions in January 2011, which were frozen in 2009 as part of the EUR 3 billion worth agreement on the stand-by loan made with the International Monetary Fund. So far Serbia used around EUR 1.45 billion of assistance provided by the International Monetary Fund.

*IMF recommended further implementation of structural reforms*

Serbia decided to sell a 51% state's stake in Telekom Srbija. The Government of the Republic of Serbia, which owns 80% of the company's shares (the remaining 20% stake is held by the Greek OTE), will keep a 30% stake and divide 15% of the remaining shares among people. The Government expects proceeds in the amount of EUR 1.4 billion and plans to invest the money in the degrading infrastructure from the time of international isolation resulting from the war in the 1990s.

*Sale of state operator Telekom Srbija*

On 1 November, the 10<sup>th</sup> **economic summit** of the Republic of Serbia started, at which more than 30 speakers presented their papers in two days. The economic summit will discuss the priority activities of the Government, trying to stimulate the regional stability, the economy, improve the procedure of the European Union's approach as well as attract foreign investors and partners.

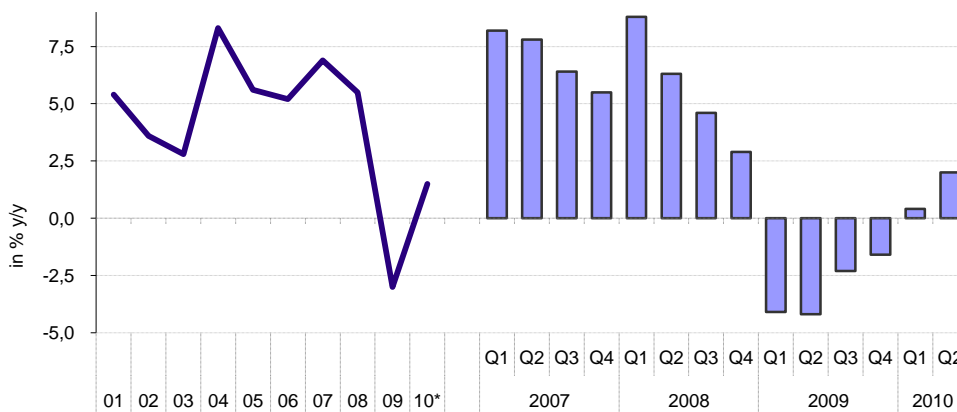
### Macroeconomic indicators

In the second quarter of the year, the **gross domestic product** increased by 2% (y-o-y), while the quarterly growth increased to 0.8% from 0.3% in the first quarter. In the first six months of the year, the average economic growth was 1.2%, which is slightly less than originally planned, but on the right track to reach the expected growth in the amount of 1.5% (y-o-y), assuming that the current speed of recovery is preserved and that the growth in industrial production continues. The main growth factor was increased export activity which resulted from the gradual economic recovery in Serbia's principal trading partners and depreciation of dinar. Increased economic activity in the second quarter is the result of increased services in

*At the current speed of recovery, expected growth of 1,5%*

combination with the financial intermediation and high level of growth in the transport branch. In the period under scrutiny, the industrial production strengthened because of the growth in the mining and manufacturing industry which grew by 6% (y-o-y). This year, the Government expects the economic growth to be around 2%, while the expectations of the IMF are slightly lower, namely 1.5%.

**Picture 1** GDP growth QoQ and YoY



Source: NBS

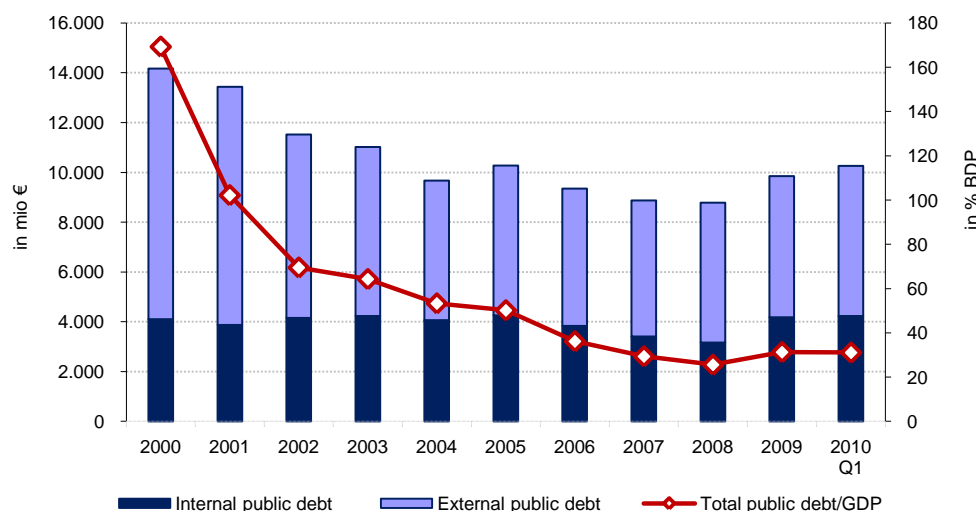
Public finance is still under pressure as a result of slow economic recovery, which required a significant reduction in capital costs. Since the middle of August 2009, the current expenses were limited by the nominal freezing of salaries and pensions in the public sector. In the first nine months of the year, budget revenues totalled RSD 505.4 billion and budget expenditure RSD 576.6 billion. **Budgetary deficit** thus totalled RSD -71.2 billion which accounts for approximately 2.3% of GDP and the planned level at the end of the year is 4.8% of GDP.

The balance of Serbia's **external debt** at the end of the second quarter totalled RSD 23.8 billion. The increase is mainly due to the exchange rate differences arising from euro depreciation compared to other currencies in the structure of external debt. The ratio between external debt and GDP increased by 1.8 percentage point in the second quarter compared to the first quarter, reaching 78.1%, i.e. slightly below the level of high indebtedness, which is 80%. Increase in external debt in the structure of GDP is mostly the result of the above reduced value of euro compared to other currencies, as well as slower growth in GDP, expressed in euros and the real depreciation of dinar against euro. The bulk of the external debt (75.2%) is denominated in EUR, followed by dollars (11.5%), SDR (6.2%) and Swiss francs (5.8%). The remaining 1.2% of external debt is denominated in other currencies. The public sector's external debt increased by 10.1% compared to the first quarter, totalling EUR 8.3 billion, while the external debt of the private sector reached EUR 15.5 billion at the end of the second quarter, of which nearly 70% can be attributed to companies and the rest to banks.

*Greater attention to the repayment of debt*

According to the provisions of the IMF and the World Bank, Serbia is still just below the upper limit of countries with lower indebtedness. The indicators used by the above organisations are the ratio public debt/GDP and the share of public debt in exports that may not exceed 48% or 132% of GDP. At the end of September, **public debt** totalled EUR 11.6 billion or 38.5% of GDP. Since the end of the last year, it grew by more than EUR 1.5 billion or 6.4 percentage point when it stood at EUR 9.8 billion (32.1% of GDP). The amount of public debt is not worrying yet but Serbia is nevertheless approaching the upper limit, in view of the increasing trend of borrowing in the recent period, which is why the Government will have to pay special attention not only to the amount of debt but also to the purpose of borrowing and thus the ability to repay the debt in due time. For this purpose, it is expected that the amended Budget Act will be adopted which foresees the ratio public debt/GDP in the amount of 45% in order to ensure better financial stability.

**Picture 2** Public debt

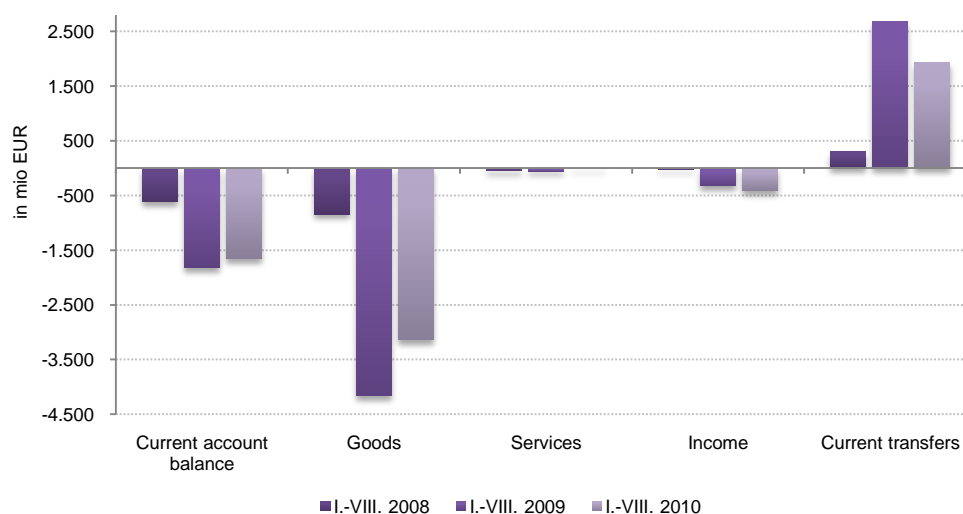


Source: Ministry of Finance

In the first eight months the **current account of the balance of payments** recorded a deficit of EUR 1,645.7 million, which is more than 15% higher than in the respective period last year. The principal reason is reduced inflow in current transfers, which totalled EUR 1,924.9 million or 15% less than in the same period last year and a higher deficit in the income balance. It amounted to EUR -414.5 million which was 45.8% more than in the same period last year when it totalled EUR -284.3 million. The total **foreign trade** amounted to EUR 12.6 billion in the first eight months of the year, i.e. 11.5% more than in the same period last year. The value of exports totalled EUR 4.6 billion, i.e. a 20.3% y-o-y growth, while imports increased by 8.9% y-o-y, totalling EUR 8.0 billion. Since exports grew more than imports, the foreign trade balance decreased accordingly and equalled EUR -3.4 billion in the period concerned, while the export-to-import ratio was 57.2%. In the January-August period this year, the export growth rate increased significantly. This was mainly due to increased exports of metallurgic and agricultural products. Dinar depreciation also stimulated the increase in exports in the period concerned. The bulk of Serbia's exports go to Italy, Bosnia and Herzegovina and Germany and the bulk of imports come from Russia, Germany and Italy.

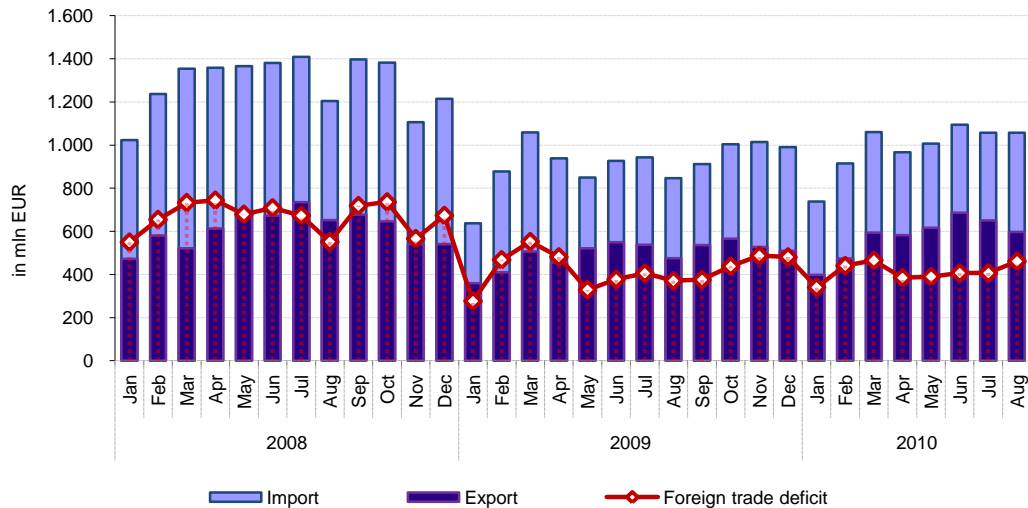
In the first six months, the inflow of **foreign direct investments** totalled EUR 419.5 million. The bulk of investments was recorded in production (EUR 167 million), followed by investments in financial intermediation (EUR 158.5 million) and investments in wholesale (EUR 103 million). The goal in this year is to attract around EUR 1.4 billion of foreign direct investments, which is slightly less than last year, when the amount was EUR 1.8 billion.

**Picture 3** Current account balance



Source: NBS

**Picture 4** Foreign trade and foreign trade deficit



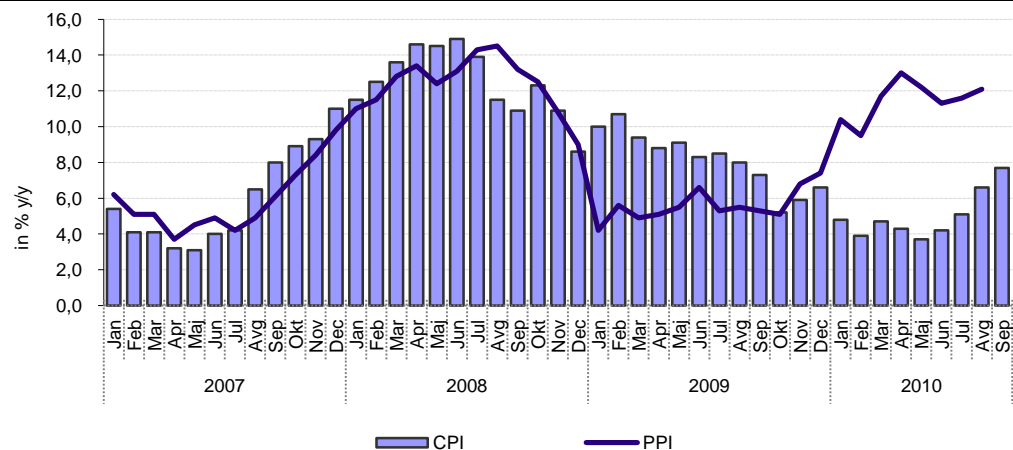
Source: NBS

*In the rest of the year, the strengthening of inflationary pressures is expected*

In the first half of the year a downward trend in **consumer price index** was recorded. In July, the inflation pressures again strengthened due to increased prices of food, dinar depreciation as well as expectations on the strengthening of domestic demand with gradual recovery of economic activity and increased credit activity of banks. In August and September, the annual rate of inflation was 6.6% or 7.7%, with the cumulative rate of inflation increasing to 5.0% in the beginning of the year. Later in the year, inflation pressures are expected to increase, particularly because of increasing producer prices of products. The growth in regulated prices is expected to range between 9-13%, as planned, since the government rejected the second increase in the prices of electricity; nevertheless, their increase is subject to the movement in the prices of gas on the global markets. At the end of the year, we can expect that inflation will move around the upper limit, with the target area of 4-8%, adopted by NBS in relation to the commitment on stability of prices.

In the first eight months, a slightly growing trend was noticed in the **prices of producer products, which reached the value of 12.3% (y-o-y)**. At the monthly level, a slightly falling trend was noticed in the same period. The biggest price increase was recorded in mining (73.6%) and supply of electricity and water (19.0%).

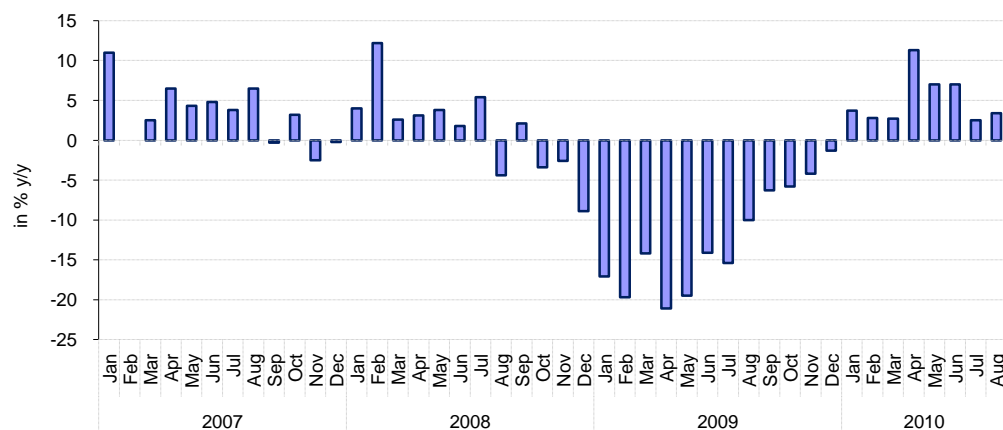
**Picture 5** Consumer price index and producer price index



Source: Statistical office of the Republic of Serbia

While the **industrial production** index reached the highest level in April (11.0% y-o-y) this year, it again dropped drastically in May and then stayed low. Industrial production grew by 3.4% (y-o-y) in August. The greatest contributor to this was the growth in the activity of mining (11.5%), manufacturing (5.0%) and electricity, gas and water supply (5.0%). In the first eight months of the year, industrial production was by 4.7% higher than in the respective last year's period.

**Picture 6** Industrial production



Source: Statistical office of the Republic of Serbia

In spite of the gradual economic recovery, the labour market remains weak. According to the data from the survey on the labour force, conducted in April this year, the **unemployment rate** in Serbia totalled 19.2%. In April, unemployment rose by 3.6% (y-o-y), while the rate of employment fell by 3.5% (y/y). Compared to the previous month, the average gross salary in Serbia in August decreased by 2.5% in nominal and by 4.1% in real terms and amounted to RSD 47,190. In the January - August period the salaries increased by 6.8% and 2.3% in nominal and real terms, respectively, compared to the same period last year.

## Banking system and Central bank regulation

According to the NBS, the Serbian banking sector has sufficient liquidity and capital adequacy. This is also confirmed by the increased level of credit activity, high rate and modest growth in capital adequacy and the change from falling to slightly improving sector profitability. **The stress tests of the banking sector** for the first quarter have shown that in case the most pessimistic scenario, relating to the movement of prices, GDP, exchange rate, etc., came true, the capital adequacy would drop from the present 21.5% to 16.8% by the end of September 2011. The banking system would thus still be able to resist the internal and external shocks.

Because of other macroeconomic trends, i.e. favourable movement of inflation and aggregate demand in the middle of the year, the NBS reduced the **reference interest rate** on 11 May by 50 basis points from 8.5% to 8.0%. In the beginning of August, the monetary policy was tightened a bit as a result of inflationary pressures and the reference interest rate was increased by 50 basis points back to 8.5%, then to 9.0% in the beginning of September (7 September 2010) and to 9.5% in October (14 October 2010). Thus the NBS introduced a more stringent monetary policy with the aim of preserving the mid-term inflation within the set limits; this year, it is 6%+/-2 b.p., next year 4.5% +/-1.5 b.p., and in 2012 4.0% +/-1.5 b.p. Poor agricultural season and growth in the prices of agricultural products contributed greatly to the significant increase in the prices of food on the domestic market and accordingly to the increase in inflation in the last few years. Thus, the future movement of the reference interest rate will mainly depend on the future economic trends. It is thus not excluded that if the financial situation deteriorated, the interest rates could increase or decrease, if the pressures on the prices are lifted.

The Serbian Government is considering the **issue of its first Eurobond** in the amount of EUR 200 million (USD 278 million). The raised financial assets would be used for financing the budgetary deficit. According to the Ministry of Finance, the interest rate was supposed to range around 6%, with maturity period of 15 years. The date of issue has not yet been determined; negotiations are underway with different financial institutions about this matter.

The Serbian Parliament adopted the amendments to the National Bank Act which stipulates that the Governor is elected by the National Assembly, upon the proposal of the President of Serbia. The Governor is elected for the term of office of 6 years, with the possibility of re-election. The amended act stipulates that the NBS is independent in its implementation of tasks, but supervised by the Serbian Parliament, which is responsible for its actions. It has been confirmed that the NBS has two to four vice-governors. The Executive Board, consisting

*Stress tests have shown the capital adequacy of banks*

*Tightening of monetary policy*

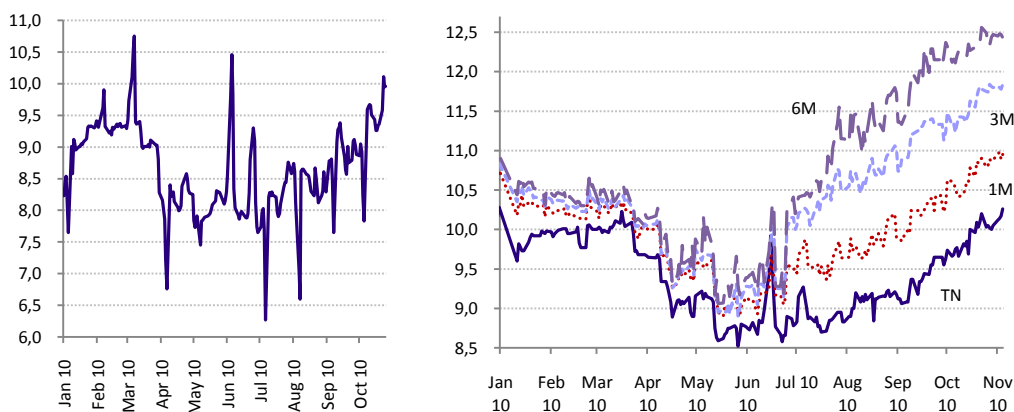
of the Governor and the Vice-Governor, shall assume the responsibilities of the Monetary Board.

At the end of September, the **FX reserves of the NBS** were reduced by EUR 136.7 million, totalling EUR 9,875.5 million, while net FX reserves totalled EUR 5,060 million. Loans were drawn in September, creating an inflow of EUR 225.5 million, of which EUR 53.6 million based on the IMF's credit tranche. On the interbank market, the volume of trade in foreign currencies amounted to EUR 677.9 million in September, which was EUR 186.2 million less than in the previous month. In the first nine months the total turnover on the interbank market amounted to EUR 6.9 billion.

## Money market and capital market

The movement of **interbank reference interest rates – BELIBOR** was rising again, in the recent period. Thus, the values of all maturities kept increasing from the second half of June until the beginning of November. The six-month Belibor increased by almost 3 percentage points while the 3-month Belibor grew by 2.37 percentage points. The values of short-term maturities “TN” and the one-month Belibor increased by 148 or 185 basis points. The **interbank reference interest rate for overnight deposits – BEONIA** ranged between 7.7% and 9.5% in the recent period.

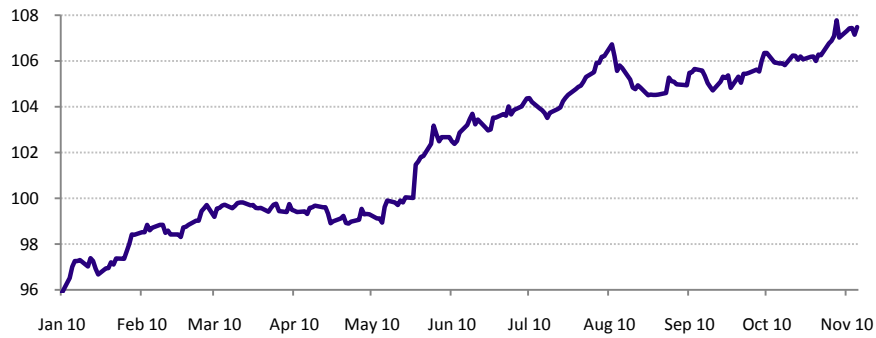
**Picture 7** The movement of interbank reference rates – Beonia and Belibor



Source: Thomson Reuters

**The value of dinar against euro** keeps deteriorating, in spite of the interventions of the central bank, aimed at preventing the negative oscillation of the value. Thus, the value of EUR 1 as at 12 October was RSD 106.29. According to some analysts, the depreciation of dinar is the result of poor capital flows in the beginning of the year as well as the fall in the value of sold central bank bills in June and July. At the end of October, a further drop in domestic currency triggered the increased demand for foreign currency. It is expected that the central bank will influence the stabilisation of dinar through its interventions on the FX market. The value of dinar was RSD/EUR 107.45 in the beginning of November, which is the record low value. Past experience shows that companies purchase more foreign currencies than usually in the fourth quarter, which is reflected in exchange rate fluctuation. A similar trend can be expected in the next weeks. From the beginning of the year and until the beginning of October, the NBS sold a total of EUR 2,037.0 million, while it bought EUR 10 million.

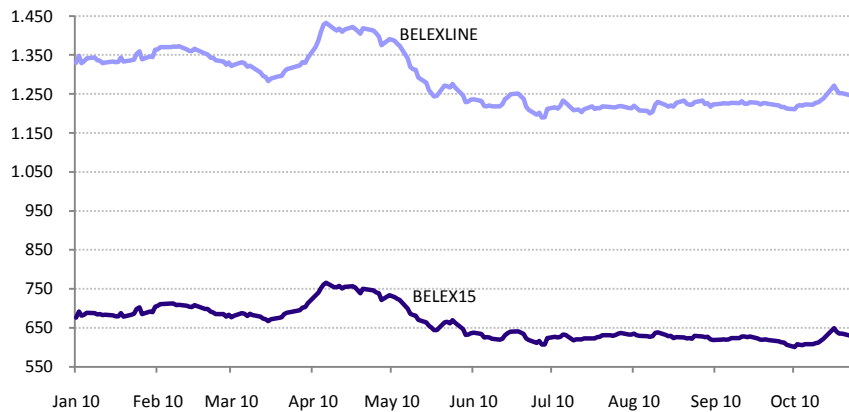
**Picture 8** The movement of RSD/EUR exchange rate



Source: Thomson Reuters

In the first ten months of the year, the total turnover on the **Belgrade Stock Exchange** was EUR 171 million, which means that poor activity continues also this year. The **BELEX15** index, consisting of 15 most liquid shares at the Belgrade Stock Exchange, stayed under 700 index points throughout the third quarter, like in the first quarter. It reached the bottom on 8 October 2010, namely 599.86 points. The **BELEXline** index ranged around 1,225.0 index points in the same period.

**Picture 9** The movement of stock indices on Belgrade Stock Exchange



Source: Thomson Reuters

## Credit rating and macroeconomic indicators of Serbia

**Table 1** Credit ratings

	S & P	Moody's	Fitch	Main disadvantage
Serbia	BB-	-	BB-	
	Stable (21.9.2009)	-	Negative (21.5.2009)	

**Table 2** Data and forecast of macroeconomic indicators

Serbia		Government	BMI		UniCredit bank		IMF	
	2009	2010E	2010E	2011F	2010E	2011F	2010E	2011F
GDP - real growth in %	-3,1	1,5-3,0	2,7	4,2	1,5	2,7	1,5	3,0
GDP per capita (in €)	4.093,4	4.138,0	4.882,0	4.614,0	4.128,0	4.060,0		
Inflation - dec/dec	6,6	/	6,0	7,0	/	/		
Inflation - average	8,6	6% +/-2OT	5,0	7,0	5,8	7,2	4,6	4,4
Current Account deficit in % GDP	-7,6	-8,0	/	/	-7,8	-9,2		
Current Account deficit in mln €	-2.266,0	-2.500,0	/	/	-2.300,0	-2.700,0		
Budget balance in mln €			/	/	/	/		
Budget balance in % GDP		-4,8	-4,1	-3,1	-4,7	-4,0	-8,5	-8,0
FDI (in mln €)	1.372,5	1.400,0	/	/	1.000,0	2.500,0		
Unemployment rate - ILO	16,9	17,4	26,0	27,0	20,0	18,8		

**Table 3** Main macroeconomic indicators

Serbia	GDP real growth	Industrial output	Inflation (RPI)	HCPI	PPI	Gross wages - nominal growth	Unemployment rate	Current account	Trade balance	
<i>12 month average index (in %, I-XII / I-XII)</i>								<i>S<sup>a</sup> in mio EUR</i>		
2001	5,40	0,10	91,80		29,00	129,60	13,36	-700,81	-2.852,65	
2002	3,60	1,80	19,50		6,20	51,70	14,47	-1.649,20	-3.371,76	
2003	2,80	-3,00	11,70		4,60	25,30	16,00	-1.531,86	-3.750,99	
2004	8,30	7,10	10,10		12,00	23,70	19,53	-2.155,19	-5.204,31	
2005	5,60	0,80	16,50		15,40	24,10	21,83	-1.763,51	-4.830,24	
2006	5,20	4,70	12,70		13,30	24,42	21,56	-2.861,00	-5.110,64	
2007	6,90	3,70	6,80	6,50	5,90	22,05	18,80	-4.615,00	-6.668,72	
2008	5,50	1,10	10,90	11,70		17,89	14,40	-5.793,00	-8.152,20	
2009	-3,00	-12,10	10,10	8,40			17,4**			
<i>Annual indeks (in %, y/y)</i>								<i>S<sup>a</sup> in mio EUR</i>		
2008	Jan		4,00	10,70	11,50	11,00	16,47		-316,80	-549,61
	Feb		12,20	11,30	12,50	11,50	22,71		-452,70	-654,50
	Mar	8,80	2,60	11,80	13,60	12,80	18,60		-530,30	-732,90
	Apr		3,10	12,00	14,60	13,40	22,19	13,30	-592,20	-744,10
	Maj		3,80	11,60	14,50	12,40	19,03		-517,00	-678,90
	Jun	6,30	1,80	12,10	14,90	13,10	17,20		-648,30	-708,70
	Jul		5,40	11,60	13,90	14,30	19,12		-592,20	-672,80
	Avg		-4,40	10,50	11,50	14,50	17,61		-373,10	-551,40
	Sep	4,60	2,10	9,90	10,90	13,20	17,06		-511,00	-719,00
	Okt		-3,40	10,50	12,30	12,50	19,46	14,00	-359,30	-735,90
	Nov		-2,60	9,20	10,90	10,80	14,47		-310,00	-565,90
	Dec	2,90	-8,90	6,80	8,60	9,00	11,96		-590,00	-673,50
2009	Jan		-17,10	8,90	10,00	4,20	14,10		-203,40	-276,70
	Feb		-19,70	10,70	10,70	5,60	12,50		-373,60	-467,90
	Mar	-4,10	-14,20	9,90	9,40	4,90	11,10		-375,90	-552,10
	Apr		-21,10	10,00	8,80	5,10	12,30	15,60	-138,57	-481,40
	Maj		-19,50	10,40	9,10	5,50	8,90		27,14	-329,20
	Jun	-4,20	-14,10	9,80	8,30	6,60	9,30		-64,03	-377,20
	Jul		-15,40	9,50	8,50	5,30	10,70		-94,30	-405,50
	Avg		-10,00	9,40	8,00	5,50	6,30		-71,33	-371,10
	Sep	-2,30	-6,30	9,50	7,30	5,30	6,30		-112,28	-375,40
	Okt		-5,80	8,00	5,20	5,10	3,90	16,60	-130,97	-437,90
	Nov		-4,20	9,20	5,90	6,80	5,20		-172,91	-487,00
	Dec	-1,60	-1,30	10,40	6,60	7,40	6,90		-168,50	-481,00
2010	Jan		3,70	8,00	4,80	10,40	3,50		-140,80	-340,30
	Feb		2,80	6,30	3,90	9,50	3,50		-306,90	-445,10
	Mar	0,40	2,70	7,40	4,70	11,70	10,10		-313,46	-465,20
	Apr		11,30	7,40	4,30	13,00	7,10		-135,88	-384,60
	Maj		7,00	6,80	3,70	12,20	7,60		-188,49	-390,10
	Jun	2,00	7,00	6,40	4,20	11,30	7,30	19,2		
	Jul		2,50	7,00	5,10	11,60	1,90			
	Avg		3,40	7,90	6,60	12,10				
	Sep				7,70					

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