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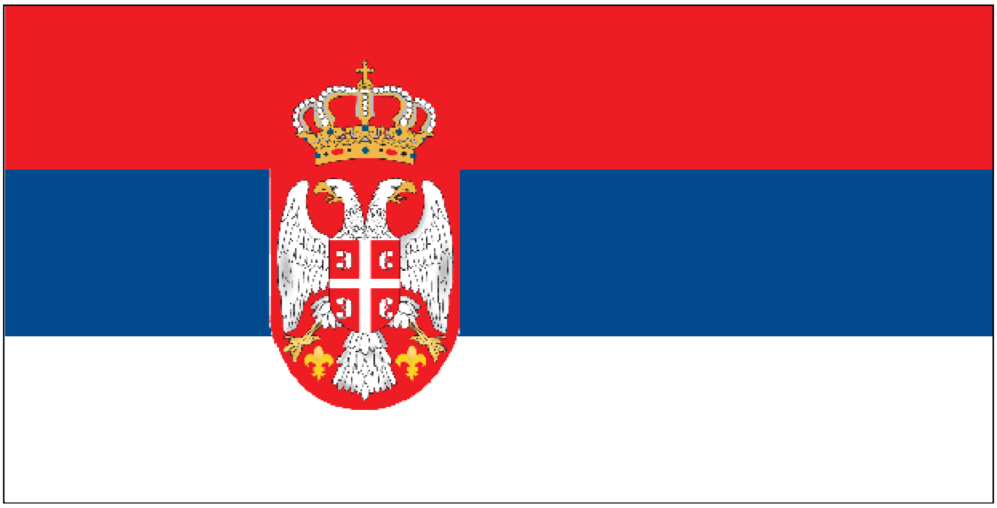
Country update **SERBIA**



Summary

Serbia's economic growth is expected to remain weak in 2012, resulting from low external demand, due to the European debt crisis, and weak domestic demand, on the back of high unemployment figures. Recently, Serbia was granted EU candidate status, but becoming an EU member is not expected before 2020. However, in the medium to long term the candidate status has the potential to foster trade, even before becoming a full-member, and thereby growth. Serbia's external position is relatively weak, reflected by large current account deficits and a high external debt, while the position of the government is also vulnerable, reflected by sizable fiscal deficits and public debt. The latter resulted in the IMF freezing a stand-by arrangement of EUR 1bn to Serbia in February 2012. After the presidential and parliamentary elections in May 2012, the IMF will decide about resumption of the stand-by arrangement. The outcome of the elections is still highly unknown and will influence the pace of EU progress and fiscal consolidation efforts, as well as the relations with Kosovo, which remains a sensitive issue.

Things to watch:

- Presidential and parliamentary elections in May 2012
- Sensitive relations between Serbia and Kosovo
- Weak external position
- Twin deficit on fiscal and current account balance

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Serbia

National facts		
Type of government	Republic	
Capital	Belgrade	
Surface area (thousand sq km)	77,474	
Population (millions)	7.3	
Main languages	Serbian (88%)	
	Hungarian (4%)	
Main religions	Serbian Orthodox (85%)	
	Catholic (6%)	
	Muslim (3%)	
Head of State (president)	Slavica Đukić Dejanović	
Head of Government (prime-minister)	Mirko Cvetković	
Monetary unit	Serbian Dinar (RSD)	

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	47	0.07
Nominal GDP at PPP	81	0.10
Export value of goods and services	16	0.07
IMF quotum (in mln SDR)	n.a.	n.a.
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.9	2.1
Agriculture (% of GDP)	11	11
Industry (% of GDP)	19	20
Services (% of GDP)	70	69
Standards of living	*USD*	*% world av.*
Nominal GDP per head	6427	60
Nominal GDP per head at PPP	11189	91
Real GDP per head	3881	48

Social and governance indicators	rank / total
Human Development Index (rank)	59 / 187
Ease of doing business (rank)	92 / 183
Economic freedom index (rank)	98 / 179
Corruption perceptions index (rank)	86 / 183
Press freedom index (rank)	80 / 178
Gini index (income distribution)	28.2
Population below $1.25 per day (PPP)	0.3%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Italy	12	Russia	11
Bosnia and Hercegovina	10	Germany	8
Germany	8	Italy	8
Romania	6	China	6
Main export products (%)			
Manufactured Goods			29
Food			18
Machinery, Apparatus & Transport Articles			16
Chemical Products			9
Main import products (%)			
Machinery, Apparatus & Transport Articles			18
Manufactured Goods			18
Mineral Fuels & Lubricants			18
Chemical Products			12
Openness of the economy			
Export value of G&S (% of GDP)			34
Import value of G&S (% of GDP)			50
Inward FDI (% of GDP)			5.9

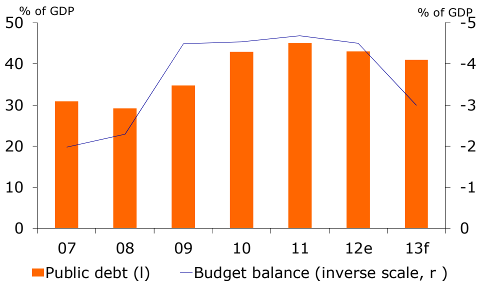
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

Serbia's economic growth came in at a weak 2% in 2011, resulting from subdued external demand from Germany and broader Europe, as well as subdued domestic demand. Growth is expected to remain slow at 0-1% this year, reflecting Europe's gloomy outlook. Another key concern is Serbia's rising unemployment rate, which has been increasing from below 14% in 2008 to 23% last year.

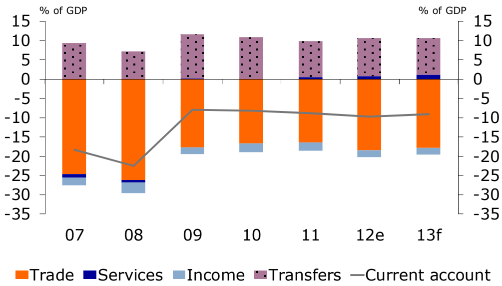
End-February 2012, the International Monetary Fund (IMF) froze a stand-by arrangement of EUR 1bn to Serbia, after the country broke spending promises made to the IMF to trim the fiscal deficit to 4.25% of GDP in 2012. Failing to trim the deficit to that level would lead to a breach of the country's self-imposed public debt ceiling of 45% of GDP. Although Serbia stated that it has taken measures to reduce budget expenditures by March 2012, an IMF official said to the press that these measures have not changed their plans to revisit the country only after a new government is elected (in May) and to afterwards decide on the resumption of the stand-by arrangement (SBA). Although the government sees the SBA as precautionary and only draws on the funds if necessary, the fact that the IMF has frozen the SBA increases the vulnerability of the country's external position. Serbia's external position remains weak, reflected by massive current account deficits of around 9% of GDP and foreign debt of around 80% of GDP.

Figure 1: Public finances



Source: EIU

Figure 2: Current account



Source: EIU

Below we will analyze Serbia's recent progress towards EU membership and the country's forthcoming presidential and parliamentary elections.

EU membership progress

Serbia has been attempting to join the European Union (EU) for a long time. In March 2012, Serbia's accession to the EU came somewhat closer, after the country was granted EU candidate status by the current 27 EU member states. The main factor in granting this status was that Serbia reached an agreement with Kosovo, which declared independence from Serbia in 2008, about Kosovo's status. The agreement entails that Kosovo may represent itself in regional meetings under the title 'Kosovo*'. Please note the *, this is not a typo but the result of heated debates and refers to a footnote outlining distinct international rulings on its disputed status. The deal is a major step, as until then Serbia walked out of meetings attended by Kosovo. However, the position of Kosovo remains a sensitive issue in Serbia (see also the analysis of the elections below), because Serbia continues to consider Kosovo as a province, while many others countries consider Kosovo as an independent state. Another important factor that opened the door to Serbia's candidate membership was the arrest of suspected war criminals by the country and the handing over of them to the International Criminal Tribunal in The Hague.

Although gaining candidate status is an important symbolic achievement for Serbia, the process to actual membership is still long. Further progress in bilateral talks with Kosovo and a wide range of reforms to implement are needed. Given the anti-enlargement sentiment among existing EU members and waning EU support among the Serbians, we do not expect the country to join the EU before 2020. In the short term, the impact of the candidate status for Serbia will be small, but in the medium to long term further European integration may foster trade and thereby economic growth.

Parliamentary and presidential elections

The Democratic Party (DS) and Serb Progressive Party (SNS) are expected to dominate the parliamentary and presidential elections of May 6, while other parties are not expected to gain enough votes for a leading role in the government. DS won the parliamentary elections of 2008 with 38.5% of the votes. President Boris Tadić's resignation as president of Serbia in April 2012 to join his parties' campaign is expected to give the party a boost in the parliamentary elections, as Tadić's personal popularity exceeds that of his party. Also, gaining EU candidate status may give DS a boost, but the recent anti-EU sentiment in Serbia may also erode support for the party. Anyway, DS will get strong resistance from SNS, the main opposition party, and their presidential candidate Tomislav Nikolić. Polls show that both parties may gain about 36% of the votes.

Therefore, it is expected to be a close contest and a second-round run-off for the presidential elections may be required. Whether won by the DS or SNS, most likely a coalition between the biggest party and one or more smaller parties will be formed. A coalition between DS and SNS cannot be excluded, but is not expected as the differences between DS and SNS on EU accession and relations with Kosovo are too large.

DS and SNS both promise lower taxes and higher spending (especially to create more jobs), which would increase Serbia's fiscal deficit and public debt. However, both were already barely sustainable before the campaign promises, as the fiscal deficit came in at 4.7% of GDP in 2011, while public debt hit its constitutional ceiling of 45% of GDP in 2011. Furthermore, growth projections have been lowered for 2012, which is expected to result in less revenues for the government. Therefore, higher taxes and reductions in public subsidies and investments will be required. This is also needed to get the IMF agreement back on track. However, fiscal consolidation will be a real challenge for the new government.

For businesses and investors, another DS-led government would be the best, as it would give the best prospects for moving Serbia into the EU and normalizing relations with Kosovo. Also, DS's technocratic capacity to formulate and implement reforms is likely to be beneficial. In an SNS-led government, further improving relations with Kosovo and thereby progress on EU accession could stall, while closer relations with Russia are likely to get a higher priority.

Serbia

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	5.4	3.8	-3.5	1.0	1.9	0.7	2.0
Consumer prices (average % change pa)	6.9	12.4	8.1	6.2	11.2	4.2	4.5
Current account balance (% of GDP)	-18.3	-22.5	-7.9	-8.2	-8.8	-9.7	-9.1
Total foreign exchange reserves (mln USD)	13892	11121	14750	12712	14875	15400	16800
Economic growth							
GDP (% real change pa)	5.4	3.8	-3.5	1.0	1.9	0.7	2.0
Gross fixed investment (% real change pa)	25.6	1.9	-9.3	-0.1	2.0	4.0	4.0
Private consumption (real % change pa)	3.1	7.9	-2.5	-1.8	0.2	2.0	3.0
Government consumption (% real change pa)	18.2	1.6	-5.1	-2.4	-1.2	-1.0	-1.0
Exports of G&S (% real change pa)	17.2	8.9	-12.4	19.1	13.0	7.0	10.0
Imports of G&S (% real change pa)	26.0	9.3	-21.8	4.1	8.0	8.0	8.0
Economic policy							
Budget balance (% of GDP)	-2.0	-2.3	-4.5	-4.5	-4.7	-4.5	-3.0
Public debt (% of GDP)	31	29	35	43	45	43	41
Money market interest rate (%)	4.4	9.6	10.3	14.2	11.5	10.6	8.6
M2 growth (% change pa)	42	10	22	13	10	8	10
Consumer prices (average % change pa)	6.9	12.4	8.1	6.2	11.2	4.2	4.5
Exchange rate LCU to USD (average)	58.2	55.8	67.6	78.6	72.5	83.4	85.0
Recorded unemployment (%)	18.8	14.4	16.9	20.1	23.4	23.6	20.0
Balance of payments (mln USD)							
Current account balance	-7154	-10743	-3178	-3115	-4122	-4130	-4050
Trade balance	-9649	-12518	-7130	-6344	-7669	-7850	-7960
Export value of goods	8720	10938	8361	9819	11777	12950	14510
Import value of goods	18369	23456	15491	16163	19446	20810	22470
Services balance	-354	-268	32	7	214	310	470
Income balance	-819	-1349	-706	-899	-1053	-790	-810
Transfer balance	3669	3393	4625	4122	4386	4200	4250
Net direct investment flows	2474	2715	1881	1152	2562	2500	2800
Net portfolio investment flows	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net debt flows	4336	4949	2412	820	576	1310	1820
Other capital flows (negative is flight)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Change in international reserves	2340	-2740	3741	-1909	2294	600	1470
External position (mln USD)							
Total foreign debt	26122	30406	33112	32222	33104	34390	36190
Short-term debt	2249	3687	3600	2798	1100	1300	1400
Total debt service due, incl. short-term debt	7426	9313	10875	10593	9533	7960	7680
Total foreign exchange reserves	13892	11121	14750	12712	14875	15400	16800
International investment position	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-24.6	-26.3	-17.8	-16.7	-16.4	-18.4	-17.9
Current account balance (% of GDP)	-18.3	-22.5	-7.9	-8.2	-8.8	-9.7	-9.1
Inward FDI (% of GDP)	8.8	6.3	4.8	3.5	5.9	6.1	6.7
Foreign debt (% of GDP)	67	64	83	85	71	81	81
Foreign debt (% of XGSIT)	158	155	189	175	154	148	142
International investment position (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	45	48	62	58	44	34	30
Interest service ratio incl. arrears (% of XGSIT)	10	10	10	9	6	5	4
FX-reserves import cover (months)	7.6	4.8	9.3	7.7	7.6	7.4	7.4
FX-reserves debt service cover (%)	187	119	136	120	156	193	219
Liquidity ratio	111	88	120	115	118	124	128

Source: EIU