Country report

SERBIA

Summary

Serbia's economy is still weak as it posts twin deficits. The balance of payments position is weak as the continuously large current account deficits require debt financing. Even so, Serbia's external position has improved since the nadir during the global financial crisis in 2008. Fiscal consolidation is expected to be implemented this year, but could be derailed by the upcoming elections in 2012. The political situation is stable but not without conflict. EU accession is a policy priority, but several obstacles make accession in the short term highly unlikely. These obstacles include the issue of the sovereignty of Kosovo and the loss of support from Greece. The economy has recovered after a contraction of 3% yoy in 2009. It is estimated to have grown by 1.7% yoy in 2010 and forecasted to grow by 3% yoy in 2011.

Things to watch:

- Continued discipline towards fiscal consolidation efforts
- Progress on removing the obstacles to EU accession
- Improvement of the external position

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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)	Boris Tadic
Head of Government (prime-minister)	Mirko Cvetkovic
Monetary unit	Serbian Dinar (RSD)

Economy	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	42	0.07
Nominal GDP at PPP	83	0.11
Export value of goods and services	14	0.07
IMF quotum (in mln SDR)	n.a.	n.a.
Economic structure	*2010*	*5-year av.*
Real GDP growth	1.7	4.0
Agriculture (% of GDP)	12	13
Industry (% of GDP)	23	25
Services (% of GDP)	65	62
Standards of living	*USD*	*% world av.*
Nominal GDP per head	5818	59
Nominal GDP per head at PPP	11351	97
Real GDP per head	4183	52

Social and governance indicators	rank / total
Human Development Index (rank)	60 / 169
Ease of doing business (rank)	89 / 183
Economic freedom index (rank)	101 / 179
Corruption perceptions index (rank)	78 / 178
Press freedom index (rank)	85 / 178
Gini index (income distribution)	28.18
Population below $1.25 per day (PPP)	0.02

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Italy	11	Russia	13
Bosnia	11	Germany	10
Germany	10	Italy	8
Romania	7	China	7
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)			32
Import value of G&S (% of GDP)			46
Inward FDI (% of GDP)			2.6

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

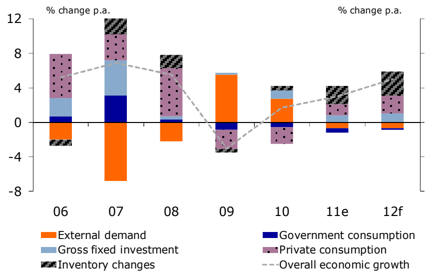
Economic structure and growth

The Serbian economy has been steadily recovering since 2000, the year when the people ousted President Slobadan Milosovic. The combination of economic mismanagement and devastating wars in the 1990s had left the Serbian economy in a terrible state. Serbia and Montenegro was created in 2002 as a looser union of the two republics, but in June 2006, Montenegro declared independence. Despite the fact that Montenegro only contributed 10% to Serbia-Montenegro’s GDP, the separation of the two countries has reduced Serbia’s flexibility. One of the largest disadvantages for Serbia is that the country is now cut off from sea access, which has a negative effect on tourism income while sea transport of imports and exports is more difficult.

Serbia has a diversified, services-based economy. The services sector contributes 65% to GDP, while industry and agriculture only make up 23% and 12% of the economic structure. The most buoyant sectors in the past years have been the transport, telecommunications, trade and banking sectors. Banking system risks have now been contained, after suffering a confidence shock during the global financial crisis. Foreign banks dominate the system, as they amount to 21 of 33 of the country’s banks and account for 75% of total assets. While this reduces the contingent liability of the government, it increases the risks to financial stability in case of a sudden increase in foreign investor risk aversion.

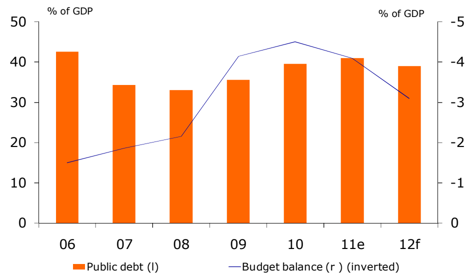
In 2009, the economy contracted by 3% yoy due to the adverse effects of the global financial crisis. It has recovered by growing 1.7% yoy in 2010 and is forecasted to grow by 3% yoy in 2011. The pick-up in economic activity will be boosted by private demand and an expected increase in gross fixed investment for the coming year.

Chart 1: Growth performance



Source: EIU

Chart 2: Fiscal position



Source: EIU

Serbia has a relatively closed economy, the combined value of exports and imports constitute only 78% of GDP. Its main export products are food, manufactured goods as well as machinery and transport articles. The latter two are also the country's main imports. Serbia's largest trading partners are Italy, Germany and Russia.

Political and social situation

Ever since the ruling coalition was formed in July 2008, the political situation has been surprisingly stable. The coalition is led by President Boris Tadic, leader of the reformist Democratic Party (DS). The coalition is completed by the more nationalist DSS, the socialist SPS and another reform-oriented party, the G-17 Plus. The coalition has pulled together throughout the economic downturn, demonstrating the ability to compromise and fuse divergent perspectives to push through unpopular policies, such as the freeze of pensions and public sector wages last year.

Despite the recent stability, downside risks remain present. The unpopular policies have resulted in a fall of the popularity of the ruling coalition and risks of inter-coalition friction is increasing. A factor which could destabilize the coalition is a possible cabinet reshuffle. While President Tadic has been tight-lipped about this matter, it is likely that Serbia's 26 ministries will be reduced to meet the need for increased efficiency and austerity in the public administration. A reshuffle could provoke tensions within the coalition as it threatens to leave some parties with less influence. Also, with new general elections coming up in May 2012, it is expected the main parties will distance themselves from any further unpopular measures, potentially slowing down progress on reforms and exacerbating frictions. Even so, we expect the government to stay in place at least until the 2012 general elections.

The government is pro-EU and has made significant strides since 2008. Its efforts have been rewarded with the implementation of the Interim Trade Agreement with the EU in February 2010. Also, the unblocking of the pre-membership Stabilization and Association Agreement (SAA), which is due to be ratified by all EU member states at end-2011, is a major boost for Serbia. The government aims for complete EU accession in 2014, but it is highly unlikely this target is met as several obstacles exist. The largest obstacle remains Kosovo, which declared independence from Serbia in 2008 but this is not recognized by Serbia. While China and Russia support Serbia in this matter, the International Court of Justice dealt a blow to Serbia by supporting Kosovo on a verdict regarding the legality of Kosovo's autonomy in July 2009. Since 22 states within the EU have recognized Kosovo and only 5 have not, this will continue to be an issue in the coming years. Another obstacle is the enlargement fatigue in the EU, which is still largely present. Also Greece, Serbia's strongest supporter, is too preoccupied with internal problems to push Serbia's case and has itself lost credibility within the EU. As such, EU accession remains far away for Serbia.

Economic policy

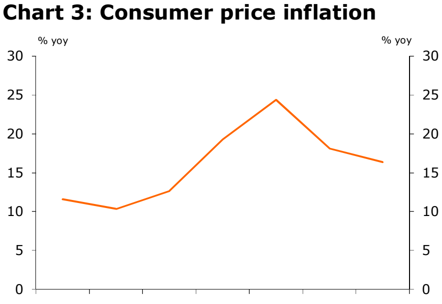
The IMF agreed with Serbia for a loan of EUR 3bn in March 2009 to support Serbia's fiscal position. Since then, it has successfully implemented measures to adhere to the fiscal austerity conditions of the IMF. Most of the burden of fiscal austerity has fallen on expenditure reduction and public sector restructuring, as the tax burden is already relatively high. A large-scale public reform has not yet been pushed through, but the freezing of public wages and pensions last year at January 2009 levels have been significant steps. The government also imposed short-term measures to boost revenues: it raised the excise tax on fuel and imposed a tax on mobile phones. However, these measures were only temporary, no permanent raise in the VAT was introduced. The IMF was positive on the progress made so far in its sixth review in December 2010, resulting in the release of a EUR 373m installment.

Going forward, we expect the path of fiscal consolidation to continue, even as the IMF loan of EUR 3bn expires in April 2011. Fiscal responsibility legislation approved in October 2010 aims to bind the government to a responsible fiscal policy once the IMF agreement expires. Also, as the government hinted it will seek a new arrangement with the IMF, a precautionary credit line, we believe it will maintain fiscal prudence. Also, the experience of previous years of successful deficit reduction gives confidence. The budget deficit stood at 4.5% of GDP in 2010, and is forecasted to decrease slightly to 4.1% in 2011. Downside risks to this goal are the upcoming general elections leading to a postponement of unpopular spending cuts. The rigid nature of government expenditures is a more structural risk. A high portion of spending is dominated by wages, pensions and subsidies, which require the continuation of high government revenues.

Public debt stood at 40% of GDP at end-2010, which is not particularly high. The risk lies in the fact that 84% of total government debt is denominated in foreign currency. Domestic financing options are limited, since the domestic bond markets are not developed, even though some progress is made.

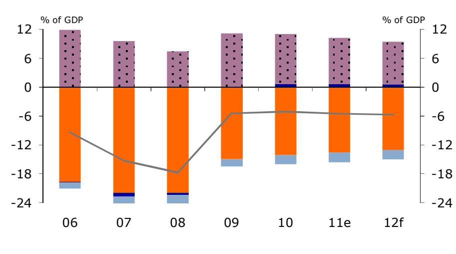
Cutting the budget deficit is also important to reduce exchange rate risk, given the high level of foreign currency denominated government debt. The Serbian dinar (RSD) has come under pressure in 2010: depreciating by over 10%. This is partly due to wider euro area concerns, but also as confidence in the RSD is fragile. The central bank, the National Bank of Serbia (NBS), has intervened frequently in the FX-markets to support the RSD. Confidence in the RSD is weak as inflation is a perennial problem in Serbia. Inflation averaged 9.1% yoy in the past five years and expected to average 9.5% yoy in 2011. It is a top priority of the NBS to fight inflation and attach credibility to the RSD. An unwanted effect of the low confidence in the RDS is a rising level of euroisation. A medium-term goal of the NBS is to reduce the level of euroisation, thereby increasing the traction of monetary policy and allowing the government to finance itself more easily in the domestic currency.

Chart 3: Consumer price inflation



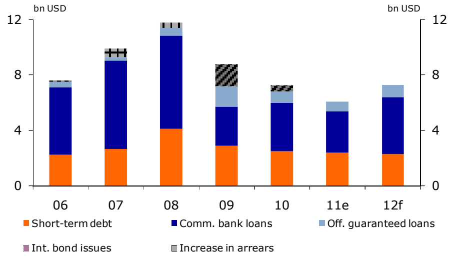
Source: EIU

Chart 4: Current account balance



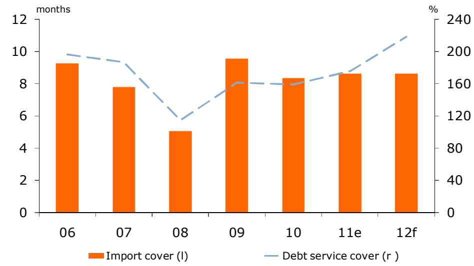
Source: EIU

Chart 5: Decomposition debt financing



Source: EIU

Chart 6: Liquidity position



Source: EIU

Balance of Payments

On the back of strong economic growth from 2003 to 2008, the current account deficit deteriorated markedly. It increased from a substantial 7% of GDP in 2003 to a worryingly high 17% of GDP in 2008. With the help of subdued economic growth, the current account deficit improved to 5.1% in 2010, and is projected to slightly worsen to 5.5% of GDP in 2011. The deficit on the trade balance is the main culprit for this high current account deficit while transfers have historically been the backbone of the current account. A small surplus on the services balances is expected to be maintained in 2011 at 0.6% of GDP and a moderate deficit of 2.1% of GDP is expected for the income balance as foreign companies in Serbia repatriate profits. The net foreign investment flows are not sufficient to cover the deficit on the current account, and as such debt-financing is required. Overall, the balance of payments position of Serbia remains weak.

External position

Serbia's external position is in moderate shape. The liquidity position has improved after reaching its nadir during the global financial crisis in 2008. Since then, import cover has improved from 5 months in 2008 to 8 months in 2010. The debt service cover ratio has also improved markedly from 114% in 2008 to 159% in 2010.

Total foreign debt amounted to USD 32bn in 2010, equivalent to 76% GDP, which is rather high. However, the fact that only 8% of total foreign debt is comprised of short-term debt alleviates refinancing risks. The majority of foreign debt is owed by the private sector, of which a substantial part is owed to foreign-owned banks. A downside risk lies in the fact that 15% of the banking sector is owned by Greek banks, given the problems in Greece. While it is unlikely that Greek banks will retreat, they are likely to be less forthcoming their daughters with funding, which could affect credit supply.

Rabobank

Serbia

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	5.2	6.9	5.5	-3.0	1.7	3.0	5.0
Consumer prices (average % change pa)	12.7	6.5	11.7	8.4	6.3	9.7	4.8
Current account balance (% of GDP)	-9.4	-15.2	-17.7	-5.4	-5.1	-5.5	-5.7
Total foreign exchange reserves (mln USD)	11639	13892	11121	14750	13503	14800	16000
Economic growth							
GDP (% real change pa)	5.2	6.9	5.5	-3.0	1.7	3.0	5.0
Gross fixed investment (% real change pa)	14.5	25.6	1.9	1.3	5.5	4.0	5.0
Private consumption (real % change pa)	6.9	4.0	7.6	-3.0	-2.5	1.8	3.0
Government consumption (% real change pa)	4.3	18.2	1.6	-5.0	-3.4	-3.0	-1.0
Exports of G&S (% real change pa)	4.9	17.2	8.9	-12.4	6.0	7.0	9.0
Imports of G&S (% real change pa)	7.8	26.0	9.3	-17.3	-2.4	6.0	7.4
Economic policy							
Budget balance (% of GDP)	-1.5	-1.9	-2.2	-4.1	-4.5	-4.1	-3.1
Public debt (% of GDP)	43	34	33	36	40	41	39
Money market interest rate (%)	10.2	4.4	9.6	10.3	10.0	8.0	6.0
M2 growth (% change pa)	38	42	10	22	17	28	18
Consumer prices (average % change pa)	12.7	6.5	11.7	8.4	6.3	9.7	4.8
Exchange rate LCU to USD (average)	66.8	58.2	55.8	67.6	78.6	81.8	82.3
Recorded unemployment (%)	20.9	18.1	14.0	16.6	17.2	16.7	15.9
Balance of payments (mln USD)							
Current account balance	-2987	-6344	-9003	-2413	-2144	-2430	-2710
Trade balance	-6271	-9140	-11129	-6663	-5988	-5960	-6220
Export value of goods	6442	8777	10949	8368	9795	10770	11850
Import value of goods	12713	17916	22078	15031	15783	16730	18070
Services balance	-52	-348	-266	36	254	250	270
Income balance	-415	-830	-1355	-710	-811	-930	-960
Transfer balance	3751	3974	3746	4925	4400	4200	4200
Net direct investment flows	4387	3045	3127	1866	1040	2550	2800
Net debt flows	3809	4723	5220	2259	860	150	2320
Change in international reserves	6130	2340	-2740	3741	-1110	1210	1210
External position (mln USD)							
Total foreign debt	19680	26378	30918	32559	32156	32540	34870
Short-term debt	2241	2653	4123	2900	2500	2400	2300
Total debt service due, incl. short-term debt	5923	7441	9721	9142	8480	8440	7330
Total foreign exchange reserves	11639	13892	11121	14750	13503	14800	16000
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-19.7	-22.0	-21.9	-14.9	-14.1	-13.6	-13.0
Current account balance (% of GDP)	-9.4	-15.2	-17.7	-5.4	-5.1	-5.5	-5.7
Inward FDI (% of GDP)	17.5	9.7	6.7	4.3	2.6	6.8	6.9
Foreign debt (% of GDP)	62	63	61	73	76	74	73
Foreign debt (% of XGSIT)	140	156	155	183	167	160	159
International investment position (% of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt service ratio (% of XGSIT)	42	44	49	51	44	41	33
Interest service ratio incl. arrears (% of XGSIT)	9	10	10	7	6	5	5
FX-reserves import cover (months)	9.3	7.8	5.1	9.6	8.3	8.6	8.6
FX-reserves debt service cover (%)	196	187	114	161	159	175	218
Liquidity ratio	123	114	91	129	125	126	132

Source: EIU