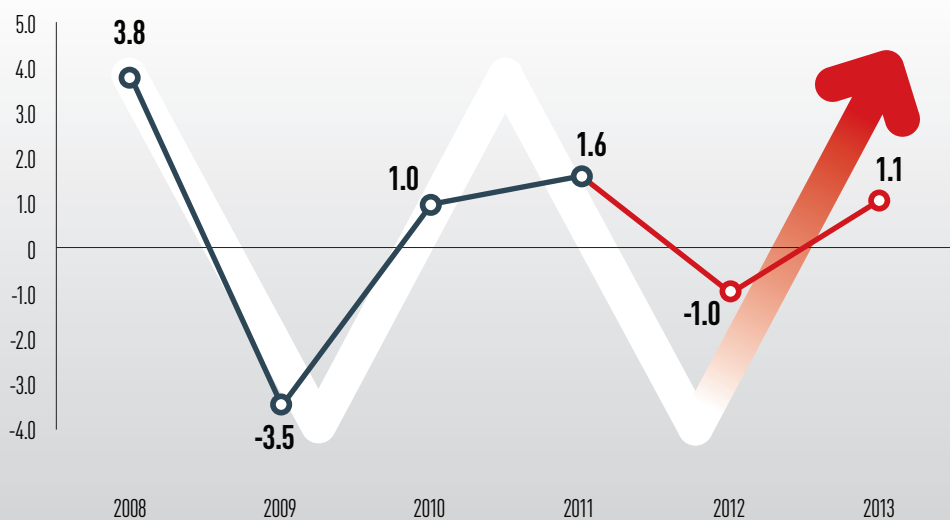


Economic forecast for Serbia 2012 and 2013

W shaped European crisis reflected on the Serbian economy



GDP, REAL GROWTH (%)

— FORECAST

Economic Forecast for Serbia 2012 and 2013

W-shaped European crisis reflected on the Serbian economy

Issue 1

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This publication comprises the economic forecast for Serbia for the period 2012 and 2013. The forecast has been generated using a macroeconomic model, which was developed in cooperation between Vojvodina CESS, the Institute for Advanced Studies - IHS from Vienna and the Institute for Economic Research “Economica” from Vienna. The generation of forecasts, as well as the publication *Economic Forecast for Serbia*, has been taken over by the **Agency for Balanced Regional Development of AP Vojvodina**, the legal successor of Vojvodina-CESS.

Taking into account that Serbia is a small open economy, directions of the main macroeconomic indicators in the country depend on the situation in the international environment. In accordance with the aforementioned, before presenting the economic forecast for Serbia, we will first assess the situation and future trends in the countries which represent major economies, and afterwards also in the countries with which Serbia has developed foreign trade connections.

LIST OF ABBREVIATIONS

BRICS	▸ Economic alliance including Brazil, Russia, India, China and South Africa
CEE	▸ Central and Eastern Europe
CEFTA	▸ Central European Free Trade Agreement
EC	▸ European Commission
FDI	▸ Foreign direct investment
GDP	▸ Gross domestic product
GVA	▸ Gross value added
IHS	▸ <i>Institut für Höhere Studien</i> Institute for Advanced Studies
ILO	▸ International Labour Organization
IMF	▸ International Monetary Fund
OECD	▸ Organization for Economic Co-operation and Development

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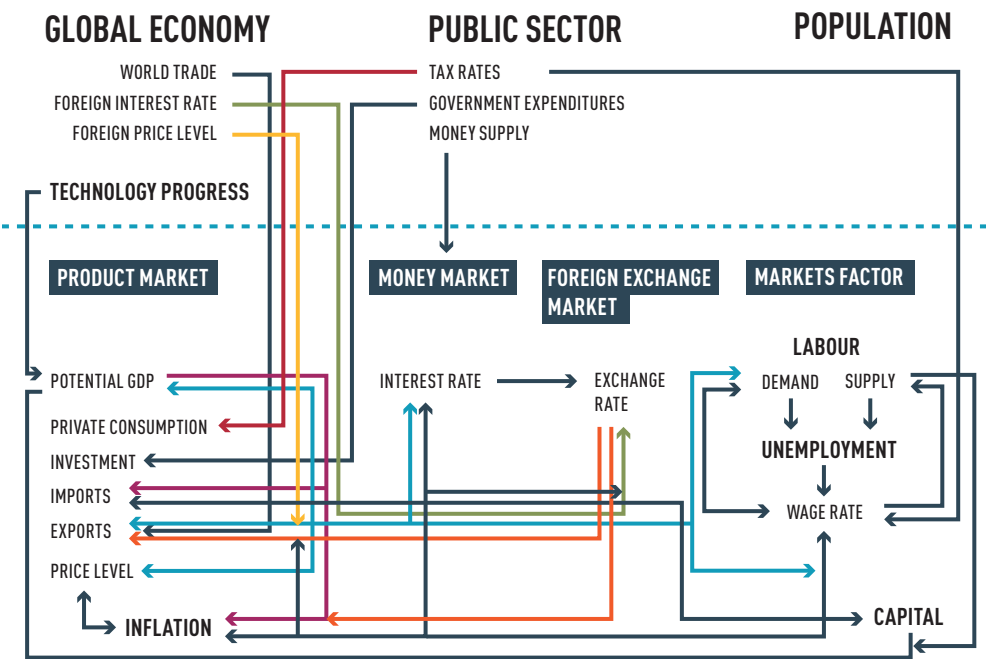
Macroeconomic model for Serbia analyzes directions in major macroeconomic markets, namely the labour market, commodity market, monetary and foreign exchange markets. Therefore, the model contains equations for GDP and its expenditure components (consumption of private households, public spending, new investment in fixed assets, exports and imports), prices, salaries, employment and unemployment rates, interest rates and exchange rates. Additionally, the state sector is been modeled in detail. The given part of the Model includes the most important items (revenues and expenditures) consolidated public finances, which includes revenues and expenditures of all levels of government: the budget of the Republic, independent agencies, social security funds, autonomous provinces, cities and municipalities reduced by mutual transfers. Fiscal policy measures affect the majority of items of both revenues and expenditures. Important examples of fiscal policy instruments that are controlled by the government encompass tax rates, social security contributions and public consumption.

Behavioural equations are econometrically estimated. Therefore, relationships between the relevant endogenous and explanatory variables are based on the economic theory and historical data for a particular variable. Due to the fact that consistent and reliable macroeconomic data for Serbia are only available for the period following the economic crisis that occurred after the breakup of the former Yugoslavia, i.e. starting sometime in 1997, only a limited amount of data is available for most macroeconomic variables.

In order to increase the degree of freedom, it has been decided that estimates of the model equations would be based on data on a quarterly basis. Unfortunately, quarterly data are not available for all macroeconomic indicators for Serbia. In such cases, quarterly data have been obtained based on data on an annual basis, with the help of related indicators available for shorter intervals.

Figure 1 shows the scheme of the model with all included relevant variables and relationships between them.

Figure 1: Structure of the macroeconomic model



1. INTERNATIONAL ENVIRONMENT

1.1. Regions and countries

since the beginning of 2012, after two-year recovery, the world economy, as well as the economies of European countries, is weakening again. The economic situation in the European Union is worsening and the crisis is starting to spread not only to the industrialized countries, but also to the emerging economies, as reflected in:

- ▶ Stock prices decline and an increase in risk premiums on government bonds of the European countries in crisis, whereas commodity prices are falling (financial markets);
- ▶ Low international capital market, particularly the cross-border interbank market;
- ▶ Extremely unfavourable situation in the labour market of most countries.

To ensure economic recovery, it is necessary to implement monetary policy measures at the global level. If tensions in financial markets reduced, recovery of the world economy could be expected in 2013.

The debt crisis in the Euro area negatively affects global economic development. Budget consolidation measures in highly indebted countries weaken demand, although they are necessary to ensure long-term financial market stability in these countries.

Up to March 2012, economic indicators indicated an improvement of the economic situation. However, in light of the confidence crisis in the Euro area, business climate indicators have significantly deteriorated since April. Thus, for an example after two successive increases, the Ifo World Economic Climate Indicator¹ fell in the third quarter.

In the part of the publication referring to *Regions and countries*, the countries that have the most impact on the global macroeconomic environment are considered, as well as the countries of the region which the Republic of Serbia is part of; those that have a direct impact on Serbia through channels of foreign trade exchange. Above all, conditions in the United States of America are analyzed, as well as in the BRICS countries because of their great importance in the creation of global macroeconomic environment, and consequences of the global economic crisis in these countries, as well as forecasts of macroeconomic indicators for these countries in the current and the following year. Afterwards, the economy of the European Union and the countries of Central and Eastern Europe is observed in order to determine the disparity between the Republic of Serbia and these countries and point to problems Serbia is facing in comparison to the neighbouring countries. For all these countries, most relevant forecasts

¹ Ifo Institute, Center for Economic Studies (CES), www.cesifo-group.de

are taken into account which should indicate the direction the economies of these countries will take, and consequently potentials for Serbia should be recognized, since some of these countries are Serbia's important trade partners.

Indicators that are analyzed in order to obtain a full impression of the macroeconomic environment of these countries are related to the gross domestic product and the categories that generate it, labour market indicators, monetary and fiscal indicators, as well as any indicators whose direction in the observed period from 2011 to 2013 has recorded a specific trend that needs clarifying.

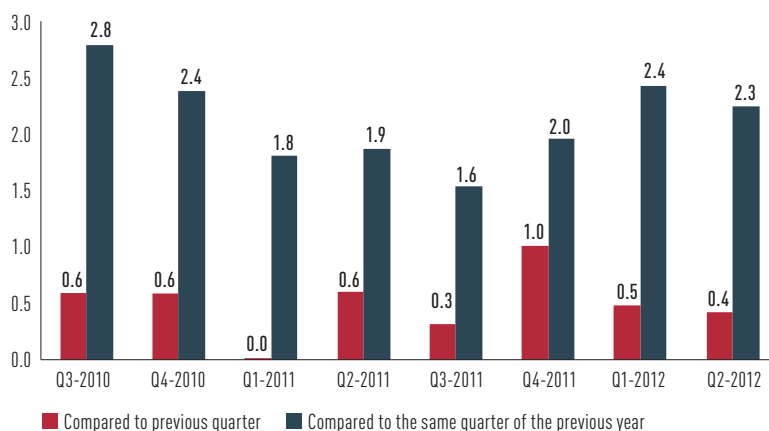
1.1.1. United States of America

GDP growth rate in the following period
2012: 2.0 - 2.4%
2013: 2.1 - 2.6%

Recovery of the US economy that began in the second half of 2009 continued in 2011, although at a slower pace (Figure 1). **GDP growth rate** reached an annual average of 1.7%, after 3.0% in 2010 and the recorded recovery of the US economy in this period was driven by private sector demand. In 2011, private consumption continued increasing by 2.2%. According to the OECD (Organization for Economic Co-operation and Development) projections, private consumption will continue to grow in 2012 (2.3%) and 2013 (2.6%). Due to a private consumption increase and a slower recovery of the real estate market, influencing a more modest recovery of the construction sector, real GDP of the US economy will accelerate throughout 2012 and 2013 (Table 1).

In 2011, moderate **employment** growth was recorded, contributing to salary rising, which was to some extent decelerated by the rise in energy prices. The biggest problems for the US citizens are the situation in the labour market, insecure jobs, excessive debt and an insufficient salary increase compared to higher prices of basic food products and raw materials. The current situation in the labour market suggests that the US economy is recovering only very gradually and still has a long road to economic recovery.

Figure 1: USA - Real GDP growth (changes in %)



Source: Organization for Economic Co-operation and Development (OECD)

Inflation rate

2012: 2.1 - 2.5%

2013: 1.9 - 2.0%

Unemployment rate

2012: 8.1 - 8.2%

2013: 7.6 - 8.0%

In 2011, the average **inflation rate**² in the US was 3.2%. Due to a noticeable decline of energy prices, the annual inflation rate in June 2012 remained at the same level as in the previous month and amounted to 1.7%, which was the lowest level in 2012. In comparison to June 2011, energy prices declined by 3.9%, while food prices rose by 2.7%. In 2012 and 2013 a lower inflation rate is expected on an annual basis (Table 1).

According to the data of the Secretariat for Labour³, in 2011 in the US the average **unemployment rate** amounted to high 9.0% (13.7 million unemployed persons). However, the unemployment rate decreased continuously throughout 2012, indicating that the economy is slowly recovering. High long-term unemployment represents a serious challenge for the US economy, given that in 2011 long-term unemployed persons accounted for 43.8% of the total number of the unemployed.

In June 2012 the unemployment rate amounted to 8.2% (12.8 million unemployed persons), and in the first six months of 2012 around 902 thousand jobs were newly created. Long-term unemployment remained a problem in 2012 considering that 42.1% of the unemployed were without a job for more than six months. International Monetary Fund predicts that the unemployment rate in 2012 and 2013 will be at a lower level compared to 2011 (Table 1).

Table 1: Forecasts for the USA for 2012 and 2013 (%)

Institution / Year	Real GDP growth rate				Annual inflation rate				Unemployment rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	3.0	1.7	2.0	2.3	1.6	3.1	2.1	1.9	9.6	9.0	8.2	7.9
EC*	3.0	1.7	2.0	2.1	1.6	3.2	2.5	2.0	9.6	9.0	8.2	8.0
OECD*	3.0	1.7	2.4	2.6	1.6	3.1	2.3	1.9	9.6	8.9	8.1	7.6
IHS*	3.0	1.7	2.3	2.1								

*IMF - International Monetary Fund, EC - European Commission, OECD - Organization for Economic Co-operation and Development, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; OECD, Economic Outlook, May 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

The trade deficit⁴ of the United States at the end of 2011 was the highest in the past three years (558 billion dollars), which represents an increase of 11.6% compared to 2010. Economists expect that the trade deficit will continue to grow throughout 2012, as the debt crisis in Europe, as well as slower growth in Asia will limit US exports, while stronger economic growth in the USA could boost imports.

² Trading Economics, www.tradingeconomics.com

³ United States Department of Labour, www.bls.gov

⁴ Trading Economics, www.tradingeconomics.com

Real estate prices fall
of 34.0% in the period
2006 - 2011

The US trade deficit in June 2012 amounted to 42.9 billion dollars, down by 19.2% since June 2011. As the US economy is predicted to grow faster than the economies of the Euro area, and due to the European debt crisis, the dollar can be expected to appreciate against the euro in the months to come. Stronger US dollar could contribute to a widening trade deficit, since it makes US exports more expensive in the world market, while domestic production is crowded out by relatively cheaper imports.

The real estate market has gone through a brief recovery period, which began in the middle of 2009, returning almost 5.0% of earlier losses. However, after tax reliefs for homebuyers expired in April 2010, the US real estate market began to weaken again. The real estate prices in the USA have fallen on average by about 34.0% since 2006 when they reached their maximum, and January 2012 was the fifth consecutive month that prices dropped in most US cities. With each successive drop of real estate prices, property is worth less and banks face growing losses, given that due to stricter lending rules and high unemployment, fewer people can qualify for a loan.

The US **budget deficit** in the current fiscal year, which ends on September 30, 2012, amounts to about 1.2 trillion dollars. Hence, the deficit exceeds the limit of one trillion dollars for the fourth consecutive year. The national debt of the United States is growing from year to year, and in the middle of 2011 it reached a record of 14.3 trillion dollars, representing over 96.0% of GDP. For the first time in history, the USA faced a threatening situation of not being able to fulfil their daily spending obligations, but at the beginning of August 2011 they reached an agreement on raising the national debt limit and reducing spending. The agreement envisaged a reduction of budget expenditures by 2.1 trillion dollars over the next 10 years.

In 2011 public debt amounted to almost 103.0% in relation to GDP, and by June 2012 the ratio rose to about 105.0%.

The International Monetary Fund (IMF) warns that it is of crucial importance that the US Congress makes a compromise on tax reliefs at the beginning of 2013 in order to avoid a tax increase and government spending reduction. At the beginning of 2013 temporary tax provisions expire and austerity measures enter into force, as well as **fiscal cliff** that relates to a significant reduction in the budget deficit through tax increases and spending cuts. If the US lawmakers cancelled some or all of the scheduled tax increases and austerity measures, it would add to the deficit and boost the debt burden. Should the fiscal cliff materialize, i.e. if a tax increase and government spending reduction occur, the IMF warns that it could have severe consequences for the US economy and bring it to a new recession. Therefore, the authorities need to ensure that the pace of deficit reduction does not run down the economic recovery. The IMF also emphasises the importance of timely raising the debt ceiling to forestall the risk of financial market turmoil.

1.1.2. BRICS

BRICS⁵ is an economic alliance including Brazil, Russia, India, China and South Africa and they are connected by the fact that these are the countries with the fastest growing economies in the world. The BRICS alliance is becoming recognizable in the world and is getting a more significant economic and political role. In 2011 the BRICS countries, which occupy nearly 26.0% of the world territory and are inhabited by about 41.0% of the world population, contributed 26.0% to global GDP in PPP (Map 1). BRICS' economies are currently the main drivers of world economic growth and they are expected to achieve high growth during the forecast period.

Map 1: Economic and political role of BRICS countries



BRICS alliance

- 26.0% share in global GDP in PPP,
- 26.0% of the world territory,
- 41.0% of the world population.

GDP growth
rate, Brazil
2012: 3.2%
2013: 4.2%

Due to high inflation and low demand for raw materials, the economy of **Brazil** recorded a decrease of 2.7%⁶ in 2011. According to the OECD predictions,

⁵ On April 13, 2011 South Africa became a member of BRIC countries, thus it is quite normal now that this alliance is known as BRICS. By South Africa's accession, the alliance was enriched, not only by the market of South African, but of the entire continent, whose market accounts for about one billion people.

⁶ OECD, Brazil - Economic forecast summary (May 2012), www.oecd.org

GDP growth rate, India
 2012: 7.1%
 2013: 7.7%

GDP growth rate, South Africa
 2012: 3.3%
 2013: 4.2%

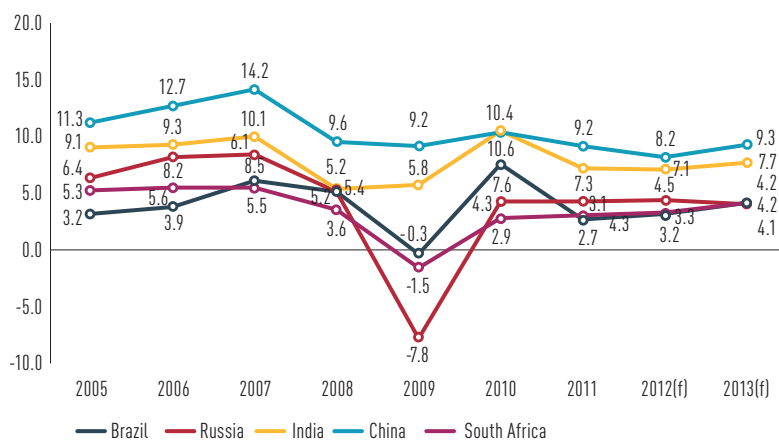
in 2012 and 2013 the Brazilian economy will record a growth, 3.2% and 4.2%, respectively (Figure 2). According to the same source, the inflation in Brazil in 2012 will amount to 4.9% and 5.3% in 2013 (Figure 3).

In the forthcoming period, investment reduction is expected in **India**, which will affect a slightly slower economic growth of 7.1% in 2012 and 7.7% in 2013 (Figure 2). Although the inflation in India was reduced to a single-digit amount in 2011 (8.6%), it is still at a high level (Figure 3) and it is not expected to drop significantly in 2012 (8.2%)⁷. Inflation is expected to affect the oil-related products, thus generating additional pressure on household consumption.

According to the OECD, **South Africa** will record a GDP growth of 3.3% in 2012 and 4.2% in 2013 (Figure 2). Although in South Africa there are currently inflationary pressures, mainly because of increases in food and fuel prices, it is expected that the average inflation rate will amount to 5.6%⁸ yoy, which is the range of permitted deviation from the target inflation (Figure 3).

Recognizing their increasingly important economic, but also political role, the BRICS countries are in the process of setting up a Development bank. The Development bank should finance projects related to infrastructure and sustainable development of the countries in the group, as well as of other developing countries. The BRICS countries take the view that the (Development) bank has to support the existing efforts of multilateral and regional financial institutions for global growth and development. Aware of threats to the stability of the economic situation worldwide due to the Euro area crisis, in the middle of June 2012 the BRICS countries decided to contribute USD 75 billion to the IMF⁹ (which amounts to USD 430 billion) to assist in regard to the impact of the economic crisis. China will have the largest contribution with USD 43 billion, while Russia, Brazil and India will provide USD 10 billion each, and South Africa USD 2 billion.

Figure 2: GDP, real growth in the BRICS countries (%)



Source: Organization for Economic Co-operation and Development (OECD) Note: (f)=forecast

⁷ IMF, World Economic Outlook Database, April 2012

⁸ OECD, South Africa - Economic forecast summary (May 2012), www.oecd.org

⁹ BRICS Information centre, University of Toronto, www.brics.utoronto.ca

Russia, from which 12.1% of Serbian *imports* originated and to which 7.0% of *exports* was directed in the first half of 2012, and **China** from which 7.2% of Serbian *imports* originated, are most significant among the BRICS countries for the economic development of Serbia. Hence, more attention is paid to the economic perspectives of these two countries.

1.1.2.1. Russia

GDP growth rate

2012: 4.0 - 4.5%

2013: 3.9 - 4.1%

Driven by oil prices increase and domestic demand, **GDP** growth in Russia amounted to 4.3% in 2011 (Figure 2, Table 2). According to the OECD, the Russian economy is expected to achieve growth in excess of 4.0% in the current and next year (4.5% in 2012 and 4.1% in 2013)¹⁰. A predicted increase in oil prices will continue to have a positive impact on the economic growth. Revenues from oil exports could be used for accelerating fiscal consolidation and restoring the fiscal rules that were suspended during the global crisis in 2008-2009.

Even though the Russian economy has not yet fully exploited the opportunities from the rise in oil prices, strong revenues, including those from oil and gas ensured a budget surplus in 2011 (0.4% of GDP¹¹). Taking into account expected oil prices in the following period, a surplus is expected to be recorded during 2012 and 2013. Excluding the surplus created by oil revenues, the Russian economy created the deficit of above 4.7% of GDP.

Inflation rate

2012: 4.6 - 4.8%

2013: 5.8 - 6.4%

Due to the strengthening of the rouble in the last quarter of 2011, a moderate food price rise due to last year's strong harvest and a delay of administrated price increases from January to July, **inflation** in Russia is currently below targeted. The average annual inflation is expected to reach 4.6%, a new record low level in the last 10 years (Figure 3, Table 2). The Central Bank of Russia expects that this low inflation will be reached by allowing more exchange rate fluctuation and narrowing the corridor between lending and borrowing rates. According to the OECD, inflation will amount to 5.8% in 2013.

Table 2: Forecasts for Russia for 2012 and 2013, in %

Year / Institution	Real GDP growth rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	4.3	4.3	4.0	3.9	6.9	8.4	4.8	6.4
OECD*	4.3	4.3	4.5	4.1	6.9	8.4	4.6	5.8
IHS*	4.3	4.3	4.0	4.0				

*IMF - International Monetary Fund, OECD - Organization for Economic Co-operation and Development, IHS - Institute for Advanced Studies. Note: (f)=forecast

Source: IMF, *World Economic Outlook*, April 2012; OECD, *Economic Outlook*, May 2012; IHS, *Prognose der Österreichischen Wirtschaft 2012-2013*, June 27, 2012

¹⁰ OECD, *Economic outlook*, May 2012 No. 91

¹¹ Central Intelligence Agency, CIA, www.cia.gov

Unemployment rate
2012: 6.0%
2013: 6.0%

Poverty rate
2012: 11.6%

Unemployment in Russia is not at a concerning level, taking into account that it amounted to 6.5% in 2011. However, major regional imbalances represent the biggest problem considering the unemployment rate through regions ranges from 1.4% to 47.5%. Measures of raising salaries in the public sector and pensions, as well as increasing the subsidies for the unemployed have had a significant impact on the improvement of situation with regard to unemployment and poverty. According to the World Bank projections, the unemployment rate will drop from 6.5% in 2011 to 6.0% in 2012 and 2013, while the poverty rate will drop from 12.6% in 2010 to 11.6% in 2012¹².

Although in the last 5 years there have been attempts to reduce the dependence of the economy on the exports of natural resources, the Russian government has not succeeded, proved by the fact that in the recent years the share of these products in Russian exports has increased from half to two-thirds of exports. Considering this, the oil price remains the main swing factor for Russia. If the oil price reached a much higher value than 121\$ per barrel (Brent, predictions for 2012), fiscal and external surpluses would be higher than the projected. On the other hand, a much lower oil price would undercut consumption and investment.

1.1.2.2. China

GDP growth rate
2012: 8.2%
2013: 8.5 - 9.3%

After rapid economic growth during the global financial crisis, the Chinese economy slightly slowed down in 2011 and recorded a **GDP** growth of 9.2%. The slowdown from the end of 2011 continued at the beginning of 2012 as well, being driven by a fall in exports and inventories. According to the OECD, an economic growth of **8.2%** is expected in 2012 and of **9.3%** in 2013¹³ (Figure 2, Table 3).

Overall debt drop
from 54.0% in 2010 to
44.0% in 2012

To support growth, interbank interest rates have been reduced and the growth of money and bank lending has been encouraged. Banks have also been encouraged to lend to first-time house buyers. Similar to monetary policies, fiscal policies are no longer as restrictive. Large increases in pension payments could reduce the pension security surplus, leaving a small overall budget deficit. In addition to this and according to the OECD, the overall debt will drop to 44.0% of GDP by the end of 2012 compared to 54.0% two years ago. An increase in economic activity is expected in the second half of 2012.

12 World Bank (2012), Russia overview, www.worldbank.org

13 OECD, Economic outlook, May 2012 No. 91

Table 3: Forecasts for China for 2012 and 2013, in %

Year / Institution	Real GDP growth rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	10.4	9.2	8.2	8.8	3.3	5.4	3.3	3.0
OECD*	10.4	9.2	8.2	9.3	3.2	5.5	3.3	2.8
IHS*	10.4	9.2	8.2	8.5				

*IMF - International Monetary Fund, OECD - Organization for Economic Co-operation and Development, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; OECD, Economic Outlook, May 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

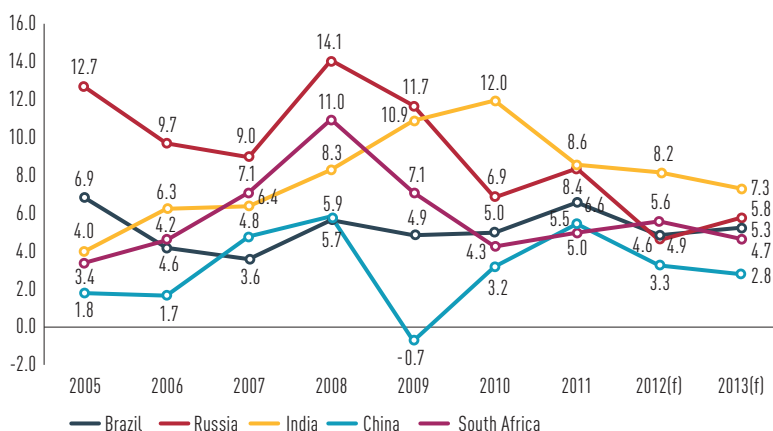
Inflation rate

2012: 3.3%

2013: 2.8 - 3.0%

Although in the past decade China did not have high **inflation** problems, it reached 5.5% in 2011, a high level for Chinese standards. According to the OECD predictions, inflation in China will reach **3.3%** in 2012 and **2.8%** in 2013 (Figure 3, Table 3). China has the lowest inflation of all BRICS countries, thus fighting inflation is in the pipeline of other countries in the BRICS alliance.

According to the OECD predictions, the BRICS countries will control inflation in the following two years, reducing it below the level which was reached in the period since the beginning of the global economic crisis and until 2011 (Figure 3).

Figure 3: Average annual inflation rates in BRICS countries (%)

Source: Organization for Economic Co-operation and Development (OECD)

International Monetary Fund (IMF)

Note: (f)=forecast

Given that low inflation is expected in the next two years, uncertainty in the real estate sector will be a major concern of the Chinese economy in the coming years. Although there is a great need for new residential construction, a large number of these housing units could remain unsold due to high prices. In this

situation, a potential drop of real estate prices could reduce construction activity and slow economic growth. Furthermore, the decline in the real estate market would reduce local government revenues from land sale. These problems could spill over in the banking sector and reduce the ability of banks to finance other investment projects. Besides the risks of reduced residential investment, China is facing the problem of low overall investment. Even though investment in manufacturing is at a high level at the moment, lower overall investment could be caused by a fall in profits (especially of exporting companies), as a result of strong salary growth and inflation decrease.

The unemployment rate in China amounted to 6.5% in 2011, which represents an increase compared to 2010 when the unemployment rate was 6.1%. At the end of 2011, China had more than a billion people between 15 and 64 years of age (1.0024 billion), of which 795.5 million constituted the workforce, thus making China the country with the largest workforce in the world¹⁴.

Exports growth rate
2012: 5.8%
2013: 10.6%

As expected by the OECD, due to the world economy growth, exports of China, as the world's largest export economy, will grow faster (5.8% in 2012 and 10.6% in 2013) than the expected growth of world trade (4.5% in 2012 and 7.0% in 2013¹⁵). However, due to the exceptional growth of the overall economy of China, import growth is expected to surpass export growth. Strengthening of the Chinese currency will also contribute to this.

1.1.3. Europe and European Union

Most countries in the European Union recorded positive economic growth in 2010 and 2011. After an increase of 2.1% in 2010, **GDP** growth of the EU countries decelerated to 1.5% in 2011. GDP growth was uneven among the European countries. While in the Euro area GDP growth amounted to 2.0% in 2010 and 1.5% in 2011, the economic recovery of the new EU members was faster, indicated by a GDP growth of 2.3% in 2010 and 3.0% in 2011.

Production in the Euro area is expected to decline in 2012. Economic recovery differs significantly at the country level. While GDP growth is expected to be positive in Germany and France, in highly indebted countries like Italy, Spain and especially Greece the economy will continue to weaken. The lack of confidence of entrepreneurs and measures aiming at budget consolidation have burdened the economic development in the Euro area. Creditworthiness of some countries has downgraded. This particularly applies to Spain, Italy, Ireland, Portugal, Cyprus and Slovenia.

Inflation is expected to decrease throughout 2012, but on average, it is still above the European Central Bank (ECB) target of just below 2.0%. To boost economic growth, the ECB prime rate was lowered in July, from 1.0 % to 0.75 %. A

¹⁴ CIA, The World Factbook, www.cia.gov

¹⁵ According to the predictions of ABRD

better international environment will slowly improve the economy of the Euro area, which is expected to achieve a GDP growth of 1.0% in 2013. The confidence crisis is expected to recede, whereas demand acceleration will probably be export driven. Investment should increase, and the unemployment growth should come to an end.

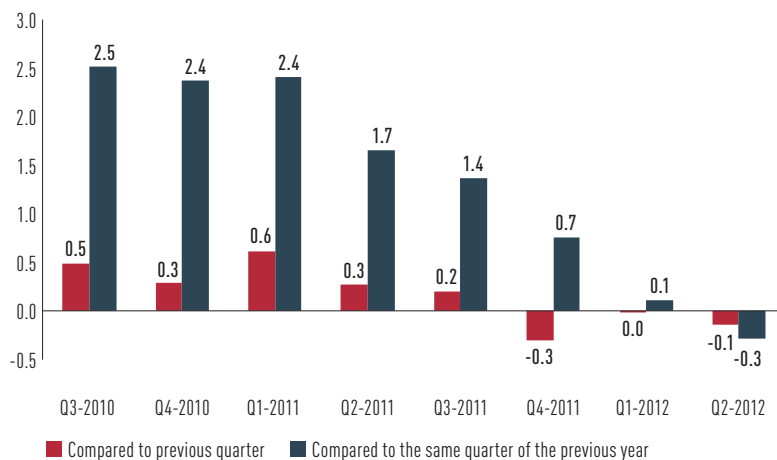
GDP growth rate in EU

2012: (-0.1%) - 0.0%

2013: 1.0 - 1.3%

Slower economic recovery in 2012 was influenced by several factors: a decline in GDP at the end of 2011 (Figure 4), fiscal adjustment and the debt crisis. In the first quarter of 2012, GDP in the Euro area and the European Union remained unchanged in comparison to the previous quarter and the same quarter of the previous year. Positive impulses came only from the external sector (foreign trade, foreign direct investment), consumption stagnated and investment declined. In the second quarter of 2012, economic recovery slowed when compared to the previous quarter, the GDP growth rate amounted to -0.2% in the Euro area and -0.1% in the European Union. Compared to the same quarter of the previous year, the decline of GDP amounted to 0.5% in the Euro area and 0.3% in the EU-27. According to the European Commission's forecasts, economic recovery in the EU will stagnate in order to speed up in 2013 (Table 4).

Figure 4: EU-27 – Real GDP growth (changes in %)



Source: Organization for Economic Co-operation and Development (OECD)

According to the European Commission's *confidence indicator*, the economic performance in the Euro area has declined further in recent months. In August 2012 the *Economic Sentiment Indicator (ESI)* fell by 2.0 points (to 87.0) in the EU and by 1.8 points (to 86.1) in the Euro area¹⁶. Confidence among consumers, construction managers and in retailing has decreased. In the service sector confidence reduction has been more prominent in the Euro area than in the EU. In industry, on the other hand, confidence has decreased in the EU, but remained stable in the Euro area.

¹⁶ EC, Business and Consumer Surveys, August 2012, ec.europa.eu

According to the Statistical Office of the European Union (Eurostat)¹⁷, a yoy decline in GDP during the second quarter of 2012 was particularly evident in Greece (-6.2 %), Portugal (-3.3%), Slovenia (-2.2%), Italy (-2.5%), Cyprus (-2.4%), and Spain (-1.3 %).

Member states of the European Union that were under the financial crisis, have adopted fiscal adjustment measures which are mostly unpopular ones, such as freezes of pensions and salaries of public employees, an increase in value added tax and other taxes, layoffs, or a reduction of public investment. High public debt may constitute a potential threat to the economic recovery of most European countries. Hence, its sustainability is among the main priorities of these countries, so that they could increase confidence and thus the economic recovery.

Inflation rate in EU
2012: 2.3 - 2.6%
2013: 1.8 - 1.9%

In 2011 **inflation** in the EU¹⁸ reached an average annual rate of 3.1%, which is by 1.0 percentage point higher than in 2010, when it amounted to 2.1%. In 2011 the highest inflation rates among the European Union member states were recorded in Romania (5.8%) and Estonia (5.1%), while the lowest ones were recorded in the Ireland (1.2%) and Sweden (1.4%). In 2012 and 2013 the annual rate of inflation is expected to reduce in the EU member states (Table 4).

According to the Eurostat, annual inflation in the EU in June 2012 was 2.6%, which represents a decrease compared to June 2011 when inflation amounted to 3.1%. In June the lowest inflation rates were recorded in Sweden (0.9%), Greece (1.0%), Bulgaria (1.6%) and Spain (1.8%), while the highest annual inflation rates were recorded in Hungary (5.6%), Estonia, Malta (both 4.4%), and Poland (4.2%).

Table 4: Forecasts for the EU for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	2.0	1.6	0.0	1.0	2.0	3.1	2.3	1.8
EC*	2.0	1.5	0.0	1.3	2.1	3.1	2.6	1.9
IHS*	2.1	1.5	-0.1	1.2				

*IMF - International Monetary Fund, EC - European Commission, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

¹⁷ Eurostat; epp.eurostat.ec.europa.eu

¹⁸ Eurostat; epp.eurostat.ec.europa.eu

Large regional
disparities in
unemployment
rate in 2011
Spain: 21.7%
Norway: 3.3%

Regional
disparities in youth
unemployment rate
in 2011
Spain: 46.4%
Netherlands: 7.6%

The unemployment rate in the EU¹⁹ was 9.7% in 2011, thus keeping the level from 2010. Observing the EU member states, unemployment rates differed significantly. In 2011 the highest unemployment rates were recorded in Spain (21.7%), Greece (17.7%), Latvia (16.2%) and Lithuania (15.4%), while the lowest unemployment rates were recorded in Norway (3.3%), Austria (4.2%) and the Netherlands (4.4%). High unemployment rates were also observed in the Ireland (14.4%), Slovakia (13.6%), Portugal (12.9%) and Estonia (12.5%). Many EU countries have adopted strict measures of budget consolidation, including layoffs of state employees. Thus, the number of the unemployed will rise, which may adversely affect economic recovery.

Youth unemployment is currently high in many European countries. The most difficult situation is in Spain and Greece where youth unemployment rates in 2011 were at a very high level of 46.4% and 44.4%, respectively. The situation at the EU level is slightly better, as the youth unemployment rate is 21.4%. The most favourable situation in terms of youth unemployment in 2011 was found in the Netherlands (7.6%), Austria (8.3%) and Germany (8.6%).

In June 2012 the unemployment rate at the level of the EU amounted to 10.2%. Compared to June 2011 when it accounted for 9.3%, the unemployment rate rose by almost one percentage point. In June 2012 the lowest unemployment rates were recorded in Austria (4.5%), the Netherlands (4.9%), Luxembourg (5.0%) and Germany (5.2%), while the highest unemployment rates were found in Spain (24.3%) and Greece (the latest available data are from May: 23.1%).

At the end of June 2012 under the pressure of the financial crisis, the heads of government of the EU member states agreed that *the European Stability Mechanism*²⁰ would enter into force. The objective of the Mechanism, in addition to the existing *European Financial Stability Facility*²¹, is to secure financial stability by providing assistance to countries of the Euro area that are or will be in a financial crisis. *The European Financial Stability Facility* and *the European Stability Mechanism* will contribute to the recapitalization of the Euro area banks and the government bonds redemption of the Euro area countries with problems. The European Stability Mechanism has an authorized capital of EUR 700 billion, from which nearly EUR 290 billion has already been used through the help of the European Financial Stability Facility given to Greece, Ireland, Portugal and Spanish banks (thus, EUR 410 billion remains available).

¹⁹ Eurostat, epp.eurostat.ec.europa.eu

²⁰ European Stability Mechanism, www.esm.europa.eu

²¹ European Financial Stability Facility, www.efs.europa.eu

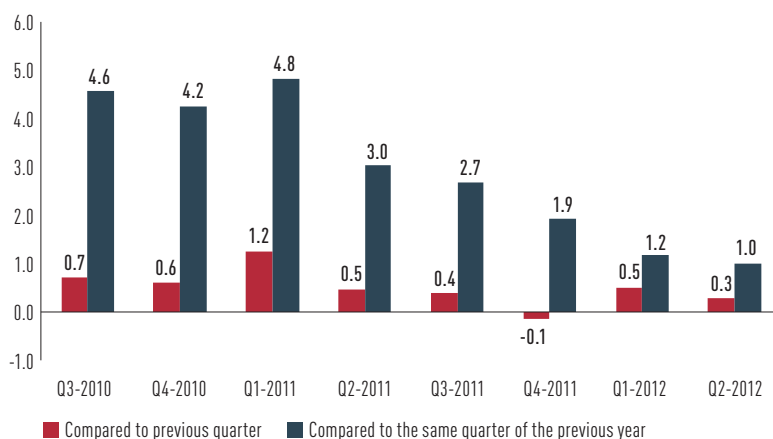
1.1.3.1. Germany

Germany is the main generator of economic recovery in Europe. The state in the labour market, low budget deficit (1.0% of **GDP** compared to the limit of 3.0% in the EU) and stable financial conditions form a solid foundation for future economic recovery. In 2012 private and public consumption, as well as investment are expected to increase. However, their increase will not be sufficient to reach the level in 2011. On the other hand, foreign trade contributes to economic growth to a lesser extent. Austerity measures, salary cuts and tax increases due to the debt crisis in some countries have affected German exports as well. In 2012 export growth is expected to be significantly below the long-term average.

After negative economic growth in 2009 (-5.1%) and the recovery of the economy in 2010 (4.2%), the German economy continued its recovery in 2011 (3.0%). According to the European Commission²², the German economy may reach the level of 0.7% in 2012 (Table 5). In the first quarter of 2012 German GDP rose by 0.5% compared to the previous quarter and by 1.2% compared to the same quarter of the previous year. In the second quarter of 2012 growth slightly decelerated, to 0.3% in comparison to the previous quarter and 1.0% in comparison to the same quarter of the previous year (Figure 5). During the first half of 2012, GDP growth was mainly driven by exports and private consumption, while equipment and construction investment declined.

GDP growth rate
2012: 0.7 - 1.0%
2013: 1.4 - 2.0%

Figure 5: Germany - Real GDP growth (changes in %)



Source: Organization for Economic Co-operation and Development (OECD)

Inflation rate
2012: 1.9 - 2.3%
2013: 1.8%

According to Eurostat²³, annual **inflation** in 2011 was 2.5%, which is more than twice the amount of the inflation rate from 2010, 1.2%. Since mid 2011 the price

22 EC, European Economic Forecast, spring 2012, ec.europa.eu

23 Eurostat, epp.eurostat.ec.europa.eu

pressure has considerably reduced and in June 2012 consumer prices in Germany increased by 2.0%. On an annual basis, inflation will decelerate in 2012 and 2013 (Table 3).

Unemployment rate
2012: 5.5 - 5.6%
2013: 5.3 - 5.5%

The unemployment rate in Germany in 2011 was 5.9%, and the number of the unemployed was 2.5 million. Compared to 2010, the number of unemployed persons decreased by 15.1% (445 thousand persons).

Decrease in the number of unemployed persons has continued in 2012. In June 2012 the number of unemployed persons amounted to 2.2 million, and the unemployment rate was 5.2%. Compared to June 2011, the number of the unemployed decreased by 12.9% (325 thousand persons).

Previous labour market reforms, salary increase and the favourable development of the German economy have significantly brought down unemployment in the last years, contributing to the positive development of public finances. The unemployment rate in 2012 and 2013 is predicted to be at a lower level compared to 2011 (Table 5).

Table 5: Forecasts for Germany for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Annual inflation rate				Unemployment rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	4.2	3.0	1.0	1.4	1.2	2.5	1.9	1.8	7.1	6.0	5.6	5.5
EC*	4.2	3.0	0.7	1.7	1.2	2.5	2.3	1.8	7.1	5.9	5.5	5.3
IHS*	4.2	3.0	1.0	2.0								

*IMF - International Monetary Fund, EC - European Commission, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

After a jump of 11.5% in 2011 compared to 2010, German exports exceeded the level of EUR 1,000 billion. German enterprises exported EUR 1,061.2 billion worth of goods during 2011, which resulted in Germany's trade surplus of EUR 158.7 billion, despite an increase in imports of 13.2%. The trade surplus rose by 2.5% in 2011 compared to 2010 when it amounted to EUR 154.9 billion. In June 2012 Germany had a trade surplus of EUR 17.9 billion, which was 43.2% more than the surplus recorded in June 2011.

Budget deficit in
Germany in 2011:
1.0% of GDP -
significantly below
the EU limit of 3.0%

Strong economic growth and high tax revenues brought down **the budget deficit** in Germany in 2011. The German government expected the budget deficit to amount to EUR 48.4 billion in 2011, but it was at an almost three times lower level, amounting to EUR 17.3 billion. After 2010 when the budget deficit amounted to 4.3% of GDP, in 2011 it fell to only 1.0% of GDP, which is significantly below the limit of 3.0% set by the EU. The German government predicts²⁴ that the

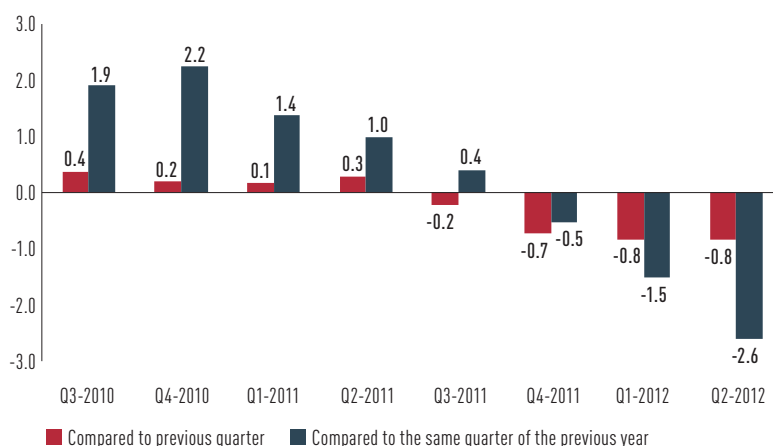
24 Bundesministerium der Finanzen, www.bundesfinanzministerium.de

budget deficit will reach EUR 34.8 billion in 2012. Initial expectations were that in 2012 net lending would be EUR 26.1 billion, but it increased by additional EUR 8.7 billion, the amount that Germany would pay into the European Stability Mechanism.

1.1.3.2. Italy

After a significant drop in the previous years, in 2010 economic recovery picked up and **GDP** growth amounted to 1.8%. However, although it was expected that the recovery would continue at the same pace in 2011, Italy was caught up in a new recession during the second half of the year. In the third and fourth quarter of 2011 GDP declined by 0.2%, and 0.7%, respectively (Figure 6). These declines during the second half of the year contributed to a quite modest economic growth of only 0.4% in 2011. The recession continued during the first quarter of 2012 when GDP dropped by 0.8% compared to the fourth quarter of 2011. In the second quarter of 2012 GDP decreased by 0.8% compared to the previous quarter and by 2.6% compared to the same quarter of the previous year (Figure 6). This economic development was influenced by a contraction in equipment and construction investment and a decrease in private and public consumption.

Figure 6: Italy - Real GDP growth (changes in %)



Source: Organization for Economic Co-operation and Development (OECD)

GDP growth rate

2012: [-1.4%] - [-1.9%]

2013: [-0.3%] - 0.4%

According to the European Commission²⁵, economic output is expected to decline by 1.4% in 2012 (Table 6). Recovery of the Italian economy is expected only in 2013 when the decline of the economy will decelerate and the export sector is expected to contribute to a positive recovery (Table 6). Italy currently has the second highest debt ratio in the Euro area, after Greece. The downgrading of the

25 EC, European Economic Forecast, spring 2012, ec.europa.eu

creditworthiness has led to high costs, making it difficult to reduce public debt and borrowing; domestic demand has decreased. Because of the necessary consolidation measures public spending has been reduced, which is reflected in the contraction of the construction industry, dependent on public procurement. Investment activity in the private sector is expected to decline because of the high cost of borrowing and subdued earnings. As a result, the conditions in the labour market will continue to deteriorate, thus negatively effecting household consumption. Italian exports will stagnate in 2012.

Inflation rate
2012: 2.5 - 3.2%
2013: 1.8 - 2.3%

Despite the economic crisis, **inflation**²⁶ was at 2.9% in 2011 (1.6% in 2010), whereas the VAT rate increased from 19.0% to 21.0%. An inflation rise continued in 2012 and in June the annual inflation rate was 3.6%. The inflation rate in Italy will slightly slow down in 2012 and 2013 (Table 6).

Unemployment²⁷ has significantly risen in Italy, especially since the economy began to stumble under the burden of the recession. However, there were 2.1 million unemployed persons in Italy in 2011, and compared to 2010, the number of the unemployed remained unchanged. The unemployment rate in 2011 was 8.4%, at the same level compared to 2010. A very high rate of youth unemployment in Italy is of particular concern, since it was at a very high level of 29.1% in 2011.

Unemployment rate
2012: 9.5%
2013: 9.7%

The unemployment rate continued to rise in the first six months of 2012, reaching 10.4% in June. In June 2012 the number of the unemployed increased by 44.0% (819 thousand persons) compared to June 2011. Youth unemployment also continued to rise, amounting to 31.8% in June 2012. Italy will continue to have problems of unemployment that will increase over the next two years (Table 6).

Table 6: Forecasts for Italy for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Annual inflation rate				Unemployment rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	1.8	0.4	-1.9	-0.3	1.6	2.9	2.5	1.8	8.4	8.4	9.5	9.7
EC*	1.8	0.4	-1.4	0.4	1.6	2.9	3.2	2.3	8.4	8.4	9.5	9.7
IHS*	1.8	0.4	-1.7	0.0								

*IMF - International Monetary Fund, EC - European Commission, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, *World Economic Outlook*, April 2012; EC, *European Economic Forecast*, Spring 2012; IHS, *Prognose der Österreichischen Wirtschaft 2012-2013*, June 27, 2012

Budget deficit
amounted to 3.9%
of GDP in 2011

In 2011 Italian **budget deficit** fell to 3.9% of GDP, from 4.5% in 2010. The former Italian government promised in summer 2011 that the budget would be balanced in 2013. In April 2012 the new Italian government, which came to power at the peak of the debt crisis (November 2011), stated that they would delay the plan to balance the budget for a year, due to the weakening of the economy. The target deficit²⁸ for 2012 is 1.7% of GDP, while for 2013 it is 0.5% of GDP. This

26 Eurostat, epp.eurostat.ec.europa.eu

27 Eurostat, epp.eurostat.ec.europa.eu

28 Governo Italiano, www.governo.it

Budget deficit2012: 2.4% of GDP2013: 1.5% of GDP

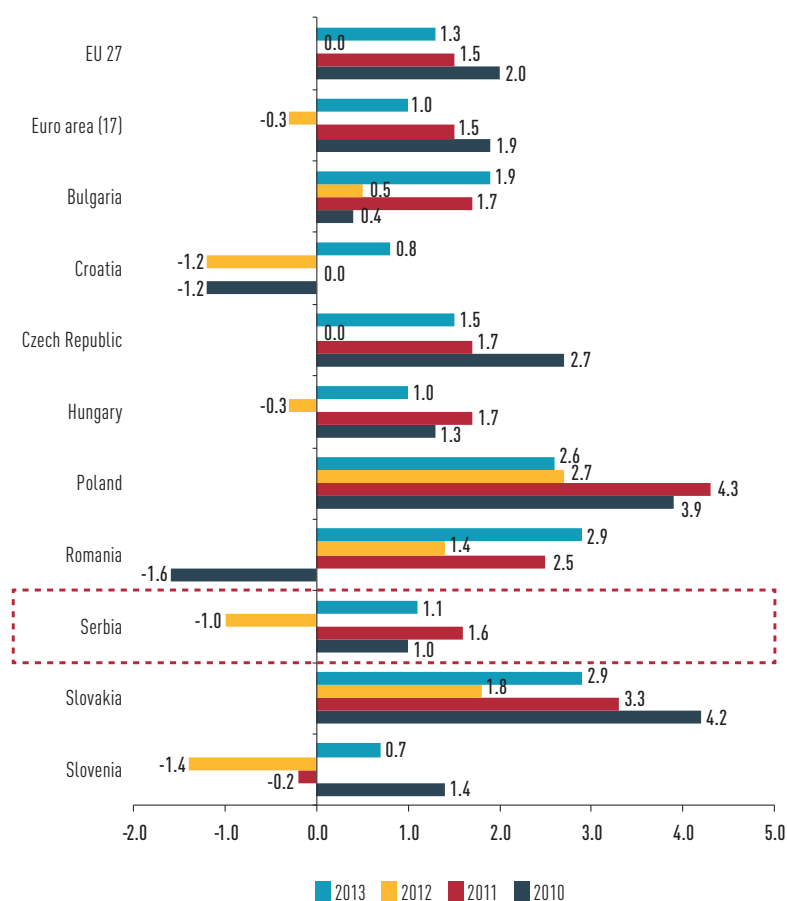
target for 2013 is in line with the European Fiscal Compact that requires the member states national budget to be in balance or the deficit to be less than 3.0% of GDP. Nearly balanced budget of 0.1% is now targeted for 2014. On the other hand, the IMF forecasts a budget deficit²⁹ amounting to 2.4% of GDP in 2012 and 1.5% of GDP in 2013. It is expected that the public debt of Italy will fall to 120.3% of GDP this year and to 110.8% of GDP by 2015. Measures to reduce the high deficit and debt burden the economic recovery of Italy in the short-term. Layoffs and salary cuts in the public sector affect public consumption, and hikes of taxes and excise duties limit private consumption.

29 IMF, Fiscal Monitor, April 2012, www.imf.org

1.1.4. Central and Eastern Europe

Dynamics of GDP growth in 17 Central and Eastern Europe (CEE) countries is diverse (Figure 7), but the projections for 2013 are positive for all the observed countries. In the following text, the countries from the CEE region, which have the direct and indirect influence on the economy of the Republic of Serbia, will be analyzed. Main macroeconomic indicators presented by the growth rate of GDP and the components that generate it, inflation rate and labour market indicators are analyzed for the selected countries of CEE (Croatia, Hungary, Romania, Slovenia), as well as members of CEFTA.

Figure 7: Dynamics of GDP growth in the CEE countries



Source: European Commission, Ministry of Finance and Economy, Republic of Serbia, ABRD

1.1.4.1. Croatia

GDP growth rate

2012: (-0.5%) - (-1.2%)

2013: 0.8 - 1.2%

After a sharp decline by 6.0% in 2009, the development of the Croatian economy remained negative in 2010, resulting in a fall of **GDP** by 1.2%. In 2011 economic output stagnated. According to the European Commission³⁰ forecasts, in 2012 GDP growth rate will be negative **(-1.2%)**, while a positive rate is expected in 2013 **(0.8%)**, Table 7.

Contribution of domestic demand in GDP generation

2012: (-1.6%)

2013: 1.6%

In terms of generating GDP in 2011, the contribution of domestic demand was negative (-1.7%), while net exports contributed positively to GDP growth (0.4%). According to the European Commission projections, domestic demand will reduce its contribution in the generation of GDP in the value of -1.6%, whereas no sooner than in 2013 a positive contribution of 1.6% is expected. Net exports are expected to achieve a positive contribution of 0.4% in 2012, whereas in 2013 this contribution will be negative, -1.0% (Table 7).

Contribution of net exports in GDP generation

2012: 0.4%

2013: (-1.0%)

The Croatian economy is confronted by a high indebtedness of households and companies, bad credit conditions, but also the fact that the major trading partners of Croatia (Italy and Slovenia) are in recession. Positive expectations for 2013 are the result of the Croatian accession to the European Union which should contribute to a positive economic environment and an increase of economic activity. The implementation of economic policy reforms including a labour market reform and the reduction of the budget deficit represent the main challenges for 2013 recognized by the European Commission.

In the first quarter of 2012 GDP in Croatia declined by 1.3% compared to the same quarter of the previous year. In this period investment fell, private consumption remained at a low level due to unfavourable labour market conditions (low employment rate and rising unemployment). On the other hand, net exports were positive despite depressed external demand.

Inflation rate

2012: 2.2 - 2.4%

2013: 2.0 - 2.4%

According to the International Monetary Fund, the **inflation rate**³¹ amounted to 2.3% in 2011 and the projections of the same source show that in 2012 it will fall to **(2.2%)**³² followed by a slightly higher level than the level from 2011 **(2.4%)** in 2013, Table 7.

Number of employed persons

2012: (-1.3%)

2013: 0.0%

According to Eurostat³³, the **employment rate** for persons from 15 to 64 years of age amounted to 52.4% in 2011 (54.0% in 2010). Based on the European Commission forecasts, the number of employed persons will continue to decrease in Croatia in 2012 (-1.3%), in order for the employment of working age people to stop decreasing no sooner than in 2013 when a positive change in GDP is expected.

³⁰ European Commission, European Economic Forecast, Spring 2012

³¹ Inflation is measured by consumer prices.

³² The International Monetary Fund, World Economic Outlook, April 2012

³³ Eurostat, epp.eurostat.ec.europa.eu

Unemployment rate
2012: 13.4 - 13.5%
2013: 12.7%

The unemployment rate increased in the period from 2008 to 2011, and in 2011 it amounted to 13.9% (an increase of 5.3 percentage points compared to 2008 when it was 8.6%). The European Commission forecasts show that the unemployment rate will record a decrease both in 2012 (13.4%) and 2013 (12.7%). Table 7. A poor situation in the labour market will have negative implications for household income, possibly leading to a fall in domestic demand which is expected to generate GDP growth in 2013.

Table 7: Forecasts for Croatia for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Unemployment rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	-1.2	0.0	-0.5	1.0	12.2	13.2	13.5	12.7	1.0	2.3	2.2	2.4
EC*	-1.2	0.0	-1.2	0.8	11.8	13.2	13.4	12.7	1.1	2.2	2.4	2.0
IHS*	-1.2	0.0	-1.0	1.2								

*IMF - International Monetary Fund, EC - European Commission, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

Croatia signed the Treaty of Accession to the European Union on December 9, 2011 according to which it should become its 28th full-fledged member on July 1, 2013. The accession will have positive implications for the Croatian economy. This is a significant factor in the recovery and growth of the Croatian economy, which will provide additional development incentives through a stronger inflow of foreign direct investment which is a significant growth generator, as well as through the access to the Structural and Cohesion Funds of the European Union. According to the EU financial framework for the period 2007-2013³⁴, EUR 687.5 million is earmarked for Croatia from the Cohesion and Structural Funds and this is only for the first six months of the membership.

³⁴ Accession Conference at Ministerial level closed negotiations with Croatia: Chapter 33 – Financial and Budgetary Provisions (European Council, Brussels, 12332/11, PRESSE 219), June 30, 2011, pg. 3.

1.1.4.2. Hungary

GDP growth rate

2012: (-1.5%) - 0.0%

2013: 1.0 - 1.8%

The economic recovery of Hungary in 2010 was based on a strong export activity and the strengthening of domestic demand, thus achieving a **GDP** growth of 1.3%. This growth continued in 2011, amounting to 1.7%³⁵ and it was driven by export growth. The European Commission³⁶ predictions show that in 2012 the GDP growth rate will be negative and amount to **-0.3%**, while a positive change is expected in 2013 (**1.0%**), Table 8.

Contribution of domestic demand in GDP generation

2012: (-1.8%)

2013: (-0.3%)

Domestic demand contributed negatively to the generation of GDP in 2011 (-1.1%), and the European Commission predictions show that the negative trend will continue both in 2012 (-1.8%) and 2013 (-0.3%). According to the same source, in 2012 and 2013 domestic demand will be negatively affected by an expected fall of real income due to the introduction of new taxes and higher inflation.

Contribution of net exports in GDP generation

2012: 1.6%

2013: 1.3%

An important fact is that net exports contributed positively to the generation of GDP in 2011 (2.2%), and that a positive contribution is also expected in 2012 (1.6%), as well as 2013 (1.3%). Foreign demand will remain at a low level in the forecast period, but imports will also be weak due to subdued domestic demand. Because of high unemployment, increase in social spending and the continued debt reduction, long and weak household consumption are expected. In 2013 a positive impulse is expected to come from a half a billion euro investment, co-funded from the EU Cohesion Fund.

In the first and second quarter of 2012 GDP contracted by 1.0% and 0.2%³⁷, respectively compared to previous quarters, and declined by 1.2% and 1.0% compared to the same quarters of the previous year. The trade balance recorded a surplus due to a fall in imports, whereas net exports contributed positively to GDP growth. Due to the continued decline in transfer payments, consumer spending contracted. There was also an investment activity decrease.

Inflation rate

2012: 5.2 - 5.7%

2013: 3.5 - 3.9%

According to the International Monetary Fund, an **inflation rate**³⁸ of 3.9%³⁹ was recorded in Hungary in 2011. Projections of the same source are not optimistic for the next year. The IMF predicts that the inflation rate will drastically rise to **5.2%** in 2012. However, the situation will change in 2013 when inflation should decline to **3.5%** (Table 8).

Unemployment rate

2012: 10.6 - 12.0%

2013: 9.6 - 12.2%

According to Eurostat⁴⁰, the **unemployment rate** in 2011 slightly declined to 11.0% (compared to 11.2% in 2010), whereas a modest employment growth rate was recorded (from 55.4% in 2010 to 55.8% in 2011). The European Commis-

³⁵ The International Monetary Fund, World Economic Outlook, April 2012

³⁶ European Commission, European Economic Forecast, Spring 2012

³⁷ Eurostat, Newsrelease euroindicators, August 14, 2012

³⁸ Inflation is measured by consumer prices

³⁹ International Monetary Fund, World Economic Outlook, April 2012

⁴⁰ Eurostat, epp.eurostat.ec.europa.eu

sion⁴¹ predictions for 2012 and 2013 show that the unemployment rate will continue to decline, amounting to 10.6% in 2012 and 9.6% in 2013 (Table 8). According to the same source, the number of employed persons will rise by 1.0% in 2012 and 1.4% in 2013.

Table 8: Forecasts for Hungary for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Unemployment rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	1.3	1.7	0.0	1.8	11.2	11.0	11.5	11.0	4.9	3.9	5.2	3.5
EC*	1.3	1.7	-0.3	1.0	11.2	10.9	10.6	9.6	4.7	3.9	5.5	3.9
OECD*	1.2	1.7	-1.5	1.1	11.2	11.0	12.0	12.2	4.9	3.9	5.7	3.6
IHS*	1.3	1.6	-0.5	1.0								

*IMF - International Monetary Fund, EC - European Commission; OECD - Organization for Economic Co-operation and Development, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, *World Economic Outlook*, April 2012; EC, *European Economic Forecast*, Spring 2012; OECD, *Economic Outlook*, May 2012; IHS, *Prognose der Österreichischen Wirtschaft 2012-2013*, June 27, 2012

The package of structural reforms and other fiscal measures announced in the *Convergence Programme of Hungary 2011-2016*⁴² is expected to be implemented. In the context of this programme, additional corrective steps are foreseen, including changes in the domain of „green taxes“ and expanding the base of the corporate income tax, a nominal freeze of salaries in the public sector and operational expenditures of central budget institutions in 2012, as well as further reductions in the employment tax credit. The Convergence Programme is based on the improvement of the labour market, pension system, public transport, higher education, subsidies in the pharmaceutical system, the work of local governments, as well as easing administrative barriers when starting a business. The aim of these structural reforms is to achieve economic growth in the medium and long run.

⁴¹ European Commission, *European Economic Forecast*, Spring 2012

⁴² www.kormany.hu

1.1.4.3 Romania

GDP growth rate

2012: 1.3 - 1.5%

2013: 2.7 - 3.0%

After a negative trend in two consecutive years, GDP recorded a growth of 2.5%⁴³ in 2011, based on the growth of investment, as well as a slight increase in private consumption, while public consumption and net exports were negative. According to the European Commission⁴⁴, in the next two years the GDP growth rate will be positive (1.4% in 2012 and 2.9% in 2013, Table 9). GDP growth should be primarily driven by domestic demand. Expectations are also optimistic in terms of investment that will have a positive influence on GDP growth. Financing of the current account and the budget deficit represents the biggest challenges for the Romanian economy in 2012.

Contribution of domestic demand in GDP generation

2012: 2.1%

2013: 3.6%

In 2011 domestic demand contributed positively to GDP growth in the value of 1.8%, while net exports made a negative contribution (-0.8%). The European Commission predicts that domestic demand will have a positive contribution in the forecast period (2.1% in 2012 and 3.6% in 2013), while net exports will have a negative one (-0.6% in 2012 and -1.1% in 2013).

Contribution of net exports in GDP generation

2012: -0.6%

2013: -1.1%

In the first and second quarters of 2012 GDP in Romania fell by 0.1% and increased by 0.5%⁴⁵ compared to the same quarters of the previous year and rose by 0.8% and 1.7%, respectively year on year. Increase in private consumption and investment - particularly in the infrastructure sector - contributed to this growth. At the same time, public consumption significantly declined, and a slowdown in external demand was reflected in the negative growth in exports and imports.

Inflation rate

2012: 2.9 - 3.1%

2013: 3.1 - 3.4%

According to the International Monetary Fund, in 2011 the inflation rate⁴⁶ in Romania amounted to 5.8%. Based on the same source, projections show that in 2012 the inflation rate will be reduced by half, namely it will amount to 2.9%, while in 2013 it will rise to 3.1% (Table 9).

Unemployment rate

2012: 7.2%

2013: 7.1%

The labour market shows improvement signs which were visible in the second half of 2011 as a result of the reforms undertaken in April 2011 in the area of social dialogue and the reform of the *Labour Law*. According to Eurostat, the employment rate for persons aged 15 to 64 amounted to 58.5% in 2011 (representing a decrease of 0.3 percentage points compared to 2010). According to the European Commission predictions, employment will increase in the current and following year, by 0.4% in 2012 and 1.1% in 2013. The unemployment rate amounted to 7.7% in 2011 and is expected to decline to 7.2% in 2012 and 7.1% in 2013 (Table 9).

43 The International Monetary Fund, World Economic Outlook, April 2012

44 European Commission, European Economic Forecast, Spring 2012

45 Eurostat, Newsrelease Euroindicators, August 14, 2012

46 Inflation is measured by consumer prices.

Table 9: Forecasts for Romania for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Unemployment rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	-1.6	2.5	1.5	3.0	7.3	7.2	7.2	7.1	6.1	5.8	2.9	3.1
EC*	-1.6	2.5	1.4	2.9	7.3	7.4	7.2	7.1	6.1	5.8	3.1	3.4
IHS*	-1.6	2.5	1.3	2.7								

*IMF - International Monetary Fund, EC - European Commission, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

As a measure to reduce budget expenditures and thus divert the funds to investment activities of the state, *the Law on Pension Insurance* has been adopted which increases the retirement age and defines a more effective measure to prevent the abuse of early retirement possibilities.

1.1.4.4. Slovenia

After a sharp fall of real GDP in 2009, Slovenia experienced an export-led recovery in 2010. However, currently the export prospects are gloomy due to the geographical orientation of exports to trade partners from the European Union and Western Balkans with little presence of fast growing emerging markets. Another factor that slowed down growth during 2011 and 2012 is the reduced availability of credit towards the real economy driven by the efforts of banks and non-financial corporations to improve their balance sheet positions, which deteriorated due to the collapse of the construction sector. This required capital injections to banks by the government, which deepened public debt (in 2011 public debt amounted to 47.6% of GDP⁴⁷). Hence, Slovenia might become the next country to ask for assistance from the European Financial Stability Facility. Weakened external demand, reflected in the sharp slowdown in exports and the measures for fiscal consolidation will have a negative impact on growth in 2012 and 2013.

In 2010 **GDP** growth amounted to 1.4%, mainly due to net exports. However, the aforementioned collapse of the construction sector together with a weakened labour market, high indebtedness of the corporate sector and the decrease in bank sector activities contributed to a decline in domestic demand. According to the European Commission, a GDP decrease in the value of -0.2% was recorded in Slovenia in 2011. Based on the predictions of the same source, GDP will decrease by -1.4% in 2012, whereas in 2013 it will achieve an increase of 0.7% (Table 10).

The contribution of domestic demand to GDP growth in 2011 was negative (-2.7%) and according to the European Commission forecasts, it will remain

GDP growth rate
2012: (-1.0%) - (-2.0%)
2013: (-0.4%) - 1.4%

Contribution of
domestic demand in
GDP generation
2012: (-2.5%)
2013: (-0.2%)

47 European Commission, European Economic Forecast, Spring 2012

Contribution of net
exports in GDP
generation
2012: 1.3%
2013: 0.8%

negative in the current and following year (-2.5% in 2012 and -0.2% in 2013). The contribution of net exports to GDP generation has been positive since 2009, despite the recession. However, its decrease is noticeable (from 2.3% recorded in 2009 to 1.4% in 2011). According to the European Commission, the contribution of net exports to GDP growth will amount to 1.3% in 2012 and 0.8% in 2013.

Slovenian GDP fell by 0.7% yoy in the first quarter of 2012 and by 2.2% in the second quarter compared to the same quarters of the previous year. The negative development of GDP in the first two quarters of 2012 is due to a decline in investment and private consumption.

Inflation rate
2012: 2.2 - 2.4%
2013: 1.4 - 1.8%

According to the International Monetary Fund, **the inflation rate**⁴⁸ amounted to 1.8%⁴⁹ in 2011. According to the same source, the projected inflation rate for 2012 is slightly higher and amounts to **2.2%**, while the projection for 2013 shows that inflation will return to **1.8%** (the level from 2011), Table 10.

Number of employed
persons
2012: -1.7%
2013: -1.0%

The labour market reacted to the recession by a negative movement of employment, reflected in a decrease in the employment rate from 68.6% in 2008 to 64.4% in 2011. According to the European Commission forecasts (Table 10), the number of employed persons will continue to decrease over the next two years, by 1.7% in 2012 and 1.0% in 2013.

Unemployment rate
2012: 8.7 - 9.1%
2013: 8.9 - 9.4%

The unemployment rate amounted to 8.3% in 2011, and the forecasts show that the growing trend will continue (**9.1%** in 2012 and **9.4%** in 2013). Compared to 2008, the unemployment rate in Slovenia has doubled, indicating serious structural problems the labour market is facing.

Table 10: Forecasts for Slovenia for 2012 and 2013 (%)

Year / Institution	Real GDP growth rate				Unemployment rate				Annual inflation rate			
	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f	2010	2011	2012 ^f	2013 ^f
IMF*	1.4	-0.2	-1.0	1.4	7.3	8.1	8.7	8.9	1.8	1.8	2.2	1.8
EC*	1.4	-0.2	-1.4	0.7	7.3	8.2	9.1	9.4	2.1	2.1	2.2	1.7
OECD*	1.4	-0.2	-2.0	-0.4	7.2	8.2	8.8	9.2	2.1	2.1	2.4	1.4
IHS*	1.4	-0.2	-1.0	1.2								

*IMF - International Monetary Fund, EC - European Commission; OECD - Organization for Economic Co-operation and Development, IHS - Institute for Advanced Studies.

Note: (f)=forecast

Source: IMF, World Economic Outlook, April 2012; EC, European Economic Forecast, Spring 2012; OECD, Economic Outlook, May 2012; IHS, Prognose der Österreichischen Wirtschaft 2012-2013, June 27, 2012

The Slovenian economy is highly exposed to international risks, since its growth is based on exports. Slovenia is also facing a recapitalization of the three largest banks which, according to estimates, could amount to 8.0% of Slovenian GDP. According to the latest information, parties in the Government of Slovenia

48 Inflation is measured by consumer prices.

49 International Monetary Fund, World Economic Outlook, April 2012

will discuss the introduction of the Law on the Fiscal Rule, the Law on the Slovenian State Holding, as well as the Law on the Agency, namely the Fund for Banks Recovery.

1.1.5. CEFTA

CEFTA (Central European Free Trade Agreement) represents a trade agreement among Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia, UNMIK (on behalf of Kosovo and Metohija), Croatia and Montenegro, and defines a unique zone of free trade among the members constituting a joint market of around 24 million consumers. This agreement provides conditions for a harmonized exchange among the members and thus secures them a privileged position reflected in benefits of entering markets that used to be less accessible, hence in the medium and long term making every member more successful in the process of attracting foreign capital. The accession of Croatia to the European Union in 2013 will significantly alter the situation for the members constituting CEFTA, since Croatia is leaving it. Thus, when trading with Croatia, other CEFTA members will have to apply the same trade regime that is used with the European Union.

On one hand, Croatia leaving CEFTA will have positive implications for Serbia because both its role in the regional market and the surplus that it makes within CEFTA will increase. On the other hand, there will be a slight increase in the trade deficit with the EU. When Croatia becomes a member, exports to CEFTA members will activate tariffs, particularly on agricultural products, which is why Croatian products will be less competitive in the market of CEFTA members, which in turn is an additional opportunity for Serbia. Foreign trade of the Republic of Serbia with Croatia after the Croatian accession to the European Union will be conducted under the provisions of the *Interim Agreement on Trade and Trade-Related Issues*⁵⁰ that is an integral part of the *Stabilisation and Association Agreement between the European Communities and their Member States*, signed by the Republic of Serbia on April 29, 2008.

29.7%⁵¹ of Serbian total exports in 2011 were realized with CEFTA members, while this percentage is lower regarding imports, amounting to 8.5%. With regard to foreign trade of Serbia with other CEFTA members, Serbia exports most to the markets of Bosnia and Herzegovina (32.8% of total exports to CEFTA), Montenegro (24.5%) and Macedonia (14.5%). Given the importance of these countries for the Republic of Serbia, it is necessary to pay particular attention to their basic economic indicators, as well as to the predictions referring to them.

⁵⁰ Chamber of Commerce and Industry of Serbia, www.pks.rs

⁵¹ CEFTA Statistics, www.cefta2006.com

GDP growth rate, Bosnia and Herzegovina
2012: 0.0%
2013: 1.0%

According to the International Monetary Fund, real GDP growth of **Bosnia and Herzegovina** has been positive since 2010 and amounted to 1.7% in 2011. According to the same source, projections show that the GDP growth rate will remain unchanged (0.0%) in 2012, whereas in 2013 it will increase to 1.0%. It is forecasted that an increase in real domestic demand, real private consumption, and real exports will record positive rates in 2012 (2.2%, 2.0% and 5.9%, respectively). The increase of these categories implies a forecasted GDP increase in the medium term.

After two years of growth in export activity, the foreign trade of Bosnia and Herzegovina decreased in 2012 under the influence of economic pessimism in the Euro area and the countries of Southeast Europe. The decline in exports in the first quarter of 2012 could be primarily explained by the fall in demand of CEFTA members and the countries belonging to the Euro area.

GDP growth rate, Montenegro
2012: 0.4%
2013: 2.0%

According to the European Commission⁵², the GDP growth rate of **Montenegro** has been positive since 2010. It was 2.8% in 2011 and it is forecasted to amount to 0.4% in 2012, in order for the increase to be more pronounced and amount to 2.0% as soon as in 2013. Net exports (2.7%) contributed most to positive GDP growth in 2011, whereas the contribution of domestic demand was negative (-0.2%). It is forecasted that the contribution of domestic demand will remain unchanged in 2012, while in 2013 it will achieve a positive rate for the first time since 2009, amounting to 1.9%. Net exports are also forecasted to continue contributing positively to GDP growth. However, it will be decreasing (0.5% in 2012 and 0.1% in 2013).

GDP growth rate, Macedonia
2012: 1.7%
2013: 2.5%

According to the European Commission⁵⁴, the GDP growth rate of the **Macedonia** was positive in 2011 (3.0%), and will remain positive in the following years (1.7% and 2.5% in 2012 and 2013). Exports and private consumption, followed by investment were the main sources of growth in 2011. GDP growth should be driven by positive domestic demand in 2012 and 2013 (2.3% and 4.0%, respectively).

52 European Economic Forecast, The European Commission, Spring 2012

2. CURRENT ECONOMIC SITUATION IN THE REPUBLIC OF SERBIA AND FORECASTS FOR THE PERIOD 2012-2013

Current situation in the Republic of Serbia is based on the analysis of:

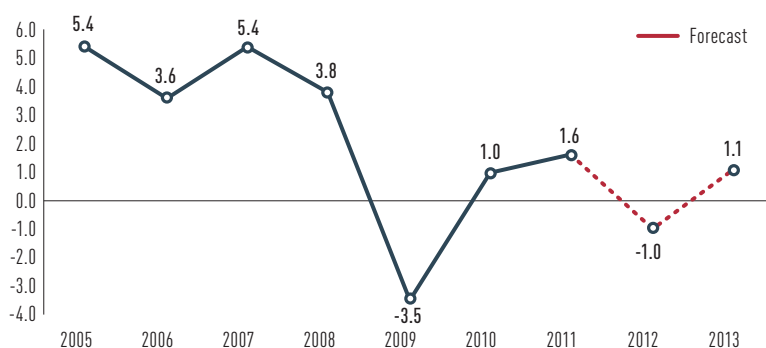
- 2.1. Economic activity,
- 2.2. Foreign direct investment,
- 2.3. Fiscal policy,
- 2.4. Monetary developments and the financial sector,
- 2.5. Foreign trade and
- 2.6. Employment and salaries.

In this section of the publication, we analyze the current state of the aforementioned indicators, as well as forecasts of the ABRD covering the period 2012—2013 and referring to: real GDP growth rate, gross salary growth rate, employment growth rate, administrative unemployment rate, inflation rate measured by consumer prices, as well as the consolidated budget balance.

Overview

According to the estimates of the Agency for Balanced Regional Development of AP Vojvodina, due to the headwind from the international environment (mainly the European debt crisis and confidence crisis), **real GDP** of the Republic of Serbia will decline by 1.0% in 2012 and increase by 1.1% in 2013 (Figure 8).

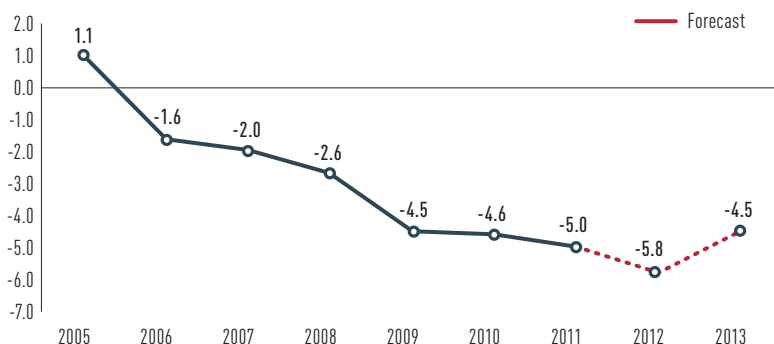
Figure 8: GDP, real growth (%)



Source: Ministry of Finance and Economy, Republic of Serbia (2005-2010), ABRD (2011-2013)

The consolidated budget deficit of the Republic of Serbia increased in 2011 compared to 2010, as well as both public revenues and expenditures that comprise it. Public debt of the Republic of Serbia also increased in 2011 compared to the previous year, exceeding the upper limit of 45.0% of GDP. The ABRD predictions show that the highest consolidated budget deficit will be recorded in 2012, while in 2013 it is expected to decrease (Figure 9).

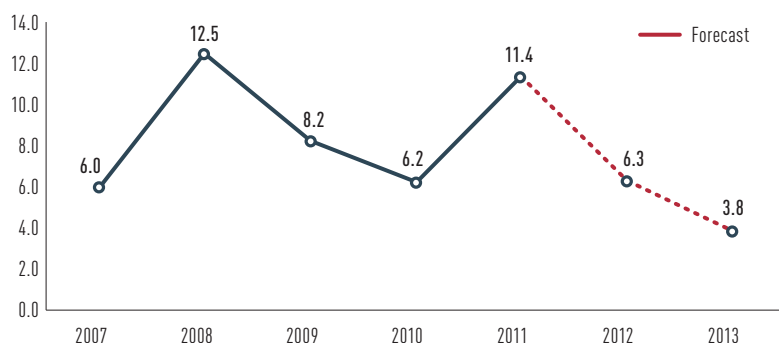
Figure 9: Consolidated budget balance (% of GDP)



Source: Ministry of Finance and Economy, Republic of Serbia (2005–2010), ABRD (2011–2013)

Inflation rose in the second quarter of 2012 due to an increase in prices of unprocessed food and products which are linked to the dinar exchange rate, which has led to an increase in prices of food and non-alcoholic beverages. Higher inflationary pressures over the following period are expected, not only due to the food prices increase, but also due to an increase in import prices, regulated prices and the still existing uncertainty regarding fiscal consolidation and the implementation of structural reforms. Disinflationary pressures in the form of low aggregate demand, expected due to a slower recovery of the Euro area economy will not manage to counteract inflationary pressures arisen from rising food prices due to a long-lasting drought, thus an increase in inflation is to be expected in the third quarter of 2012. Accordingly, inflation growth is anticipated to continue even after the third quarter, until mid 2013, when inflation is expected to reach its maximum, followed by a fall to the inflation target tolerance band by the end of 2013.

Figure 10: Average annual inflation rate (%)*

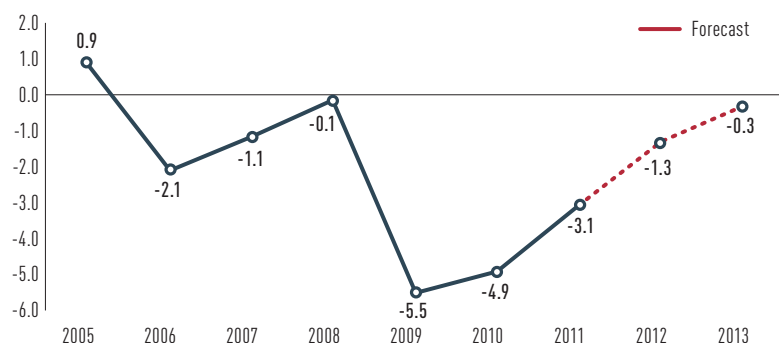


Source: National Bank of Serbia (2007–2010), ABRD (2011–2013)

* Due to changes in the methodology of monitoring inflation, the data for 2006 and 2005 are not presented. In the period before 2007 the National Bank of Serbia tracked changes in retail prices and after 2007 changes in consumer prices have been tracked.

The labour market of the Republic of Serbia is characterised by an unfavourable situation. In 2011 the unemployment rate increased, while the employment rate and the total number of formally employed people declined compared to 2010. This supports the fact that the labour market in the Republic of Serbia faces deep structural problems. The biggest threats to the labour market are an unfavourable sectoral structure of employment, reflected in the low percentage of persons employed in industry and high long-term unemployment which has direct social consequences in increasing poverty. According to the predictions of the Agency for Balanced Regional Development of AP Vojvodina, **the administrative unemployment rate** will continue its upward trend from previous years in the period covered by the forecast, whereas **employment** will decelerate its falling trend no sooner than in 2013.

Figure 11: Formal employment, growth rate (%)



Source: Statistical Office of the Republic of Serbia (2005–2010), ABRD (2011–2013)

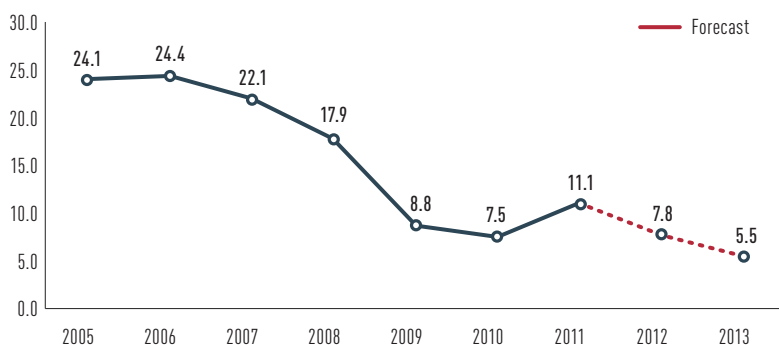
Figure 12: Administrative unemployment rate (%)



Source: National Employment Service of Serbia (2005-2010), ABRD (2011-2013)

According to the ABRD, **the nominal growth rate of gross salary** will decrease in the forecast period (Figure 13), while **the real growth rate** will increase (Figure 14).

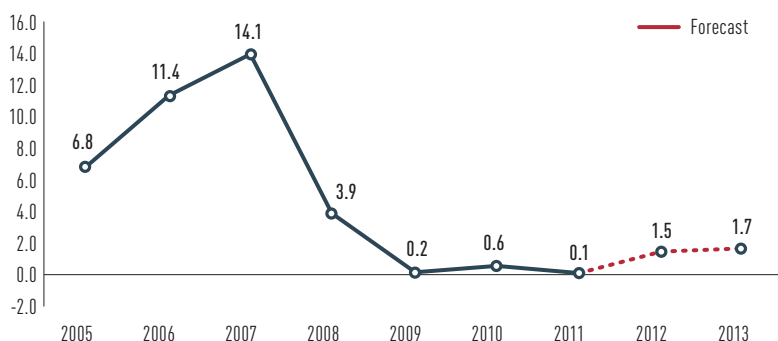
Figure 13: Nominal growth rate of the average gross salary⁵³



Source: Statistical Office of the Republic of Serbia (2005-2010), ABRD (2011-2013)

⁵³ Since 2008 rates have been adjusted to the changed methodology

Figure 14: Real growth rate of the average gross salary⁵³



Source: Statistical Office of the Republic of Serbia (2005-2010), ABRD (2011-2013)

Table 11: Summary of forecasts for the Republic of Serbia, the Agency for the Balanced Regional Development

	2011 ¹⁾	2012	2013
GDP per capita, current prices (dinar)	436,669	471,824	520,736
GDP, real growth (%)	1.6	-1.0	1.1
Monthly gross salary per employed person (dinar)	52,767	56,904	60,033
Nominal growth rate of the average gross salary (%)	11.1	7.8	5.5
Real growth rate of the average gross salary (%)	0.1	1.5	1.7
Labour productivity growth rate (%)	4.8	0.3	1.4
Employment, growth rate (%)	-3.1	-1.3	-0.3
Administrative unemployment rate (%)	27.4	28.3	28.6
Average annual inflation rate (%)	11.4	6.3	3.8
Budget balance (% GDP)	-5.0	-5.8	-4.5

¹⁾ Partially estimated in 2011

Source: Statistical Office of the Republic of Serbia, ABRD

2.1. Economic Activity of Serbia - GDP

Non-seasonally
adjusted data, GDP
growth rate

Q1 2012: (-2.5%)

Q2 2012: (-0.8%)

In 2011 GDP increased by 1.6%, recording growth in each of the four quarters compared to the corresponding quarters in 2010. After four quarters of continuous growth, according to the non-seasonally adjusted data, a fall in GDP of 2.5% was recorded in the first quarter of 2012, while a fall of 0.8%⁵⁴ was recorded in the second quarter.

Nevertheless, some sectors registered an increase in gross value added in the first quarter of 2012. The highest growth of GVA was recorded in the information and communications sector (11.7%), the transport sector (4.2%), the sector of financial and insurance activities (4.2%) and the manufacturing sector (3.2%). The largest decline in gross value added was recorded in the sector of electricity, gas and steam supply (14.6%) and the sector of mining and quarrying (7.7%).

In 2011 industrial production was by 2.1% higher compared to the previous year. The sector of electricity, gas and water supply (an increase of 9.7% compared to 2010) together with the sector of mining and quarrying (an increase of 10.4% compared to 2010) contributed most to the growth of industrial production in 2011. After a slight recovery in the last quarter of 2011, in the first quarter of 2012⁵⁵ industrial production recorded a decline of 5.9% compared to the same quarter of the previous year. This decline was mostly caused by a significant drop in production in February, caused by low temperatures and a reduction in the power consumption for the economy, as well as a temporary cessation of work of a large steel plant (*Železara Smederevo*).

Industrial production

January - June 2012:
(-4.2%)

In the second quarter of 2012 the decline in industrial production continued. Thus, in June 2012 industrial production in Serbia was by 4.0% lower compared to the same month of the previous year and by 2.0% lower compared to the average in 2011. Consequently, in the first six months of 2012 a decline in industrial production of 4.2% was recorded compared to the same period of the previous year. This decline was caused by a decrease of 8.4% in the sector of electricity, gas, steam and air conditioning supply, a fall of 2.6% in the sector of mining and quarrying, and of 3.1%⁵⁶ in the manufacturing industry.

Seasonally adjusted
data, GDP growth rate

Q1 2012: (-1.9%)

Q2 2012: 2.1%

According to the seasonally adjusted data, GDP in Serbia recorded a decline in the second, third and fourth quarter of 2011 (0.6%, 0.7% and 0.6%, respectively). Strictly following the definition according to which the economy which has recorded two consecutive quarters of decline is in a recession, we could say that the effects of the second hit of the crisis have already spilled over to the Serbian economy. The decline of seasonally adjusted GDP continued in the first quarter of 2012 (-1.9%). However, there was an increase of 2.1% in the second quarter of the same year.

⁵⁴ Statistical Office of the Republic of Serbia, Statistical Release NR40 – 2nd quarter 2012

⁵⁵ Statistical Office of the Republic of Serbia, Statistical Release IN10 – Industrial production indices in the Republic of Serbia, March 2012

⁵⁶ Statistical Office of the Republic of Serbia, Statistical Release IN10 – Industrial production indices in the Republic of Serbia, June 2012

The decline in the first quarter of 2012 cannot be considered unexpected, taking into account unfavourable weather conditions affecting the agriculture and the current freezing of the arrangement with the IMF, which has had a negative impact on the exchange rate and a reduction in investment. In the second quarter of 2012 GDP was positively affected by an expansionary fiscal policy and the fact that in the first half of the year the consolidated budget deficit amounted to about 110 billion dinars (more than 70% of the deficit projected for 2012). In the following period, by the end of 2012 an unfreezing of the arrangement with the IMF is expected.

A new factory of Fiat Automobiles Serbia in Kragujevac was officially opened in the second quarter of 2012. A new car model is Fiat Automobiles Serbia manufactured, primarily intended for foreign markets. The commercial sale of this model in the European and other markets is expected to start in the last quarter of 2012 and the Government of the Republic of Serbia⁵⁷ expects a positive impact on production, exports and hence on economic growth. On the other hand, as a result of the drought, agricultural production will negatively affect economic growth this year.

It is expected that the Serbian economy will drop by 1.0% in 2012, whereas a growth of 1.1% is expected in 2013 (Figure 15).

GDP growth rate*

2012: (-1.0%)

2013: 1.1%

Figure 15: GDP, real growth, (%)



Source: Ministry of Finance and Economy, Republic of Serbia (2005 – 2010), ABRD (2011-2013)

⁵⁷ Official presentation of the Government of the Republic of Serbia, www.srbija.gov.rs

* The findings in boxes are the predictions of the Agency for Balanced Regional Development of AP Vojvodina

2.2. Foreign Direct Investment in Serbia (FDI)

Investment growth

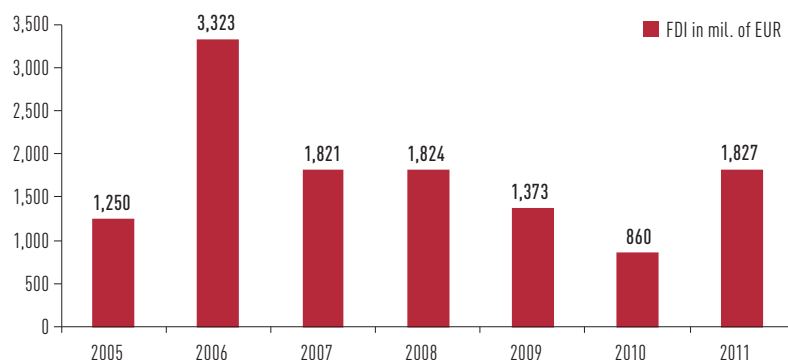
2011: 112.4%

FDI, net amount

2011: 1,826.9 mil. EUR

According to the Ministry of Finance and Economy, in 2011 the inflow of foreign direct investment significantly increased compared to 2010. In 2010 the level of investment was below a billion EUR (EUR 860.1 million) for the first time since 2004, hence the growth rate of 112.4% in 2011 (EUR 1,826.9 million) was primarily the result of the low base in 2010⁵⁸ (Figure 16). The low level of investment in 2010 was caused by the effects of the first hit of the global economic crisis, which is clearly becoming a W-shaped one. Thus, it is becoming more evident that a new wave of the global economic crisis will once again bring down the level investment in Serbia. Along with the global economic crisis, the fact that only few companies remain to be privatized is expected to cause smaller inflows of FDI.

Figure 16: Foreign direct investment in Serbia, in the period 2005-2011, net amounts



Source: Ministry of Finance and Economy, Republic of Serbia

Net outflow of foreign

direct investment

January - May 2012:

(-189.3) mil. EUR

The fact that in the first five months of 2012 a net outflow of foreign direct investment (EUR -189.3 million) was recorded supports the aforementioned. The net outflow of foreign direct investment was caused by the purchase of shares of "Telekom Srbija" by the Greek operator "OTE", but also by the withdrawal of another mobile operator's capital ("Telenor"). After buying back the shares, "Telekom Srbija" is again fully owned by the state of Serbia (the state owns 80% of shares, while "Telekom Srbija" owns the remaining 20%).

Unfavourable

allocation of FDI

2005 - 2011:

75.9%

non-tradable sectors

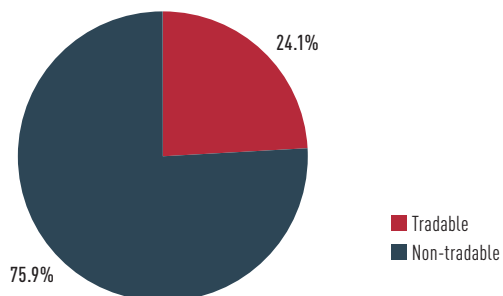
24.1%

tradable sectors

However, much more important than the volume of investment is their allocation. Taking into account the importance of foreign direct investment in increasing competitiveness, it is essential that FDI is allocated in the tradable goods sector (agriculture, industry). The structure of foreign direct investment in Serbia is unfavourable and in the period from 2005 to 2011 three-quarters of foreign direct investment was attracted to the non-tradable sector, while only a quarter of total FDI was invested in the tradable sector (Figure 17).

⁵⁸ Ministry of Finance and Economy, Republic of Serbia, Table 1, Basic macroeconomic, www.mfp.gov.rs

Figure 17: Allocation of FDI to tradable and non-tradable sectors in the period 2005-2011



Source: National Bank of Serbia

2.3. Fiscal Policy of the Republic of Serbia

Consolidated
fiscal deficit
January - June 2012:
57.6% higher
compared to
January - June 2011

According to the Ministry of Finance and Economy of the Republic of Serbia, the consolidated fiscal deficit of the Republic of Serbia in the period from January to June 2012 amounted to RSD 110.3 billion, which in the absolute value is RSD 40.3 billion more than the consolidated deficit recorded in the same period of 2011 (RSD 70.0 billion). In this time frame the consolidated deficit recorded an increase of 57.6% in nominal terms compared to the same period in 2011.

Based on the Draft Law on the Budget of the Republic of Serbia for 2013⁵⁹, fiscal consolidation in 2013 is based on: tax reform, limited growth of salaries in the public sector, pensions and savings through the implementation of reforms and increased efficiency of the public sector. According to the same source, a reduction of the fiscal deficit and limiting the issuance of government-guaranteed borrowing are indicated as key measures to stop the growth of public debt.

Growth rate of VAT
from 18.0% to 20.0%

In the period January-June 2012, *public revenues* amounted to RSD 652.4 billion, thus representing an absolute increase of RSD 47.4 billion compared to the same period in 2011 (the growth rate of 7.8% in nominal terms). Concerning individual categories of public revenues, the most important ones are social contributions, the value added tax and personal income taxes, which together generate more than 74.4% of total revenues.

In 2012, an increase in the revenues from excise taxes and the value added tax is expected, given that there has been an increase in the excise tax on tobacco products and the general VAT rate has increased from 18.0% to 20.0%. According to the Fiscal Council of the Republic of Serbia, the VAT increase represents the key tax policy measure for the short-term reduction of the deficit.

If individual components of the consolidated balance sheet are analyzed, excises and customs recorded a nominal decrease (0.1% and 9.8%, respectively) in current income, while the corporate income tax recorded the highest increase (54.0%). Starting October 1st, 2011, according to the Law on amendments and supplements to *the Law on the Financing of Local Government*, local governments in Serbia get 80% instead of previous 40.0% of income taxes generated on their territory. According to the analysis of the Fiscal Council and considering the fact that there is no transfer of responsibilities and functions from the republic to the local level and consequently no reduction of republic budget expenditures, this will lead to a decrease in the republic budget revenues by around 1.1% of GDP. This will require a significant fiscal adjustment. Otherwise, it would lead to a violation of the fiscal rule, and the allowed deficit in 2012 would be exceeded by one third.

Nominal growth of
public expenditures
January - June 2012:
13.0% compared to
January - June 2011

Public expenditures amounted to RSD 762.7 billion in the period January-June 2012 and recorded an absolute increase of RSD 87.8 billion (nominal growth rate of 13.0%) compared to the same period in 2011. The largest current public expenditure items belong to social assistance and insurance (44.6%), expenditure for employed persons (25.5%) and expenditure for purchase of goods and

59 Ministry of Finance and Economy, Republic of Serbia, www.mfp.gov.rs

services (19.0%). In the period January-June 2012 all three expenditure components increased in nominal terms. The expenditure for the purchase of goods and services recorded the biggest increase (37.6%), followed by the expenditures for employed persons (11.1%) and the expenditures for social assistance and insurance (6.7%). The increase in the expenditures for employed persons is a consequence of the individual wage indexation during 2011 and the dynamics of employment rate in the public sector.

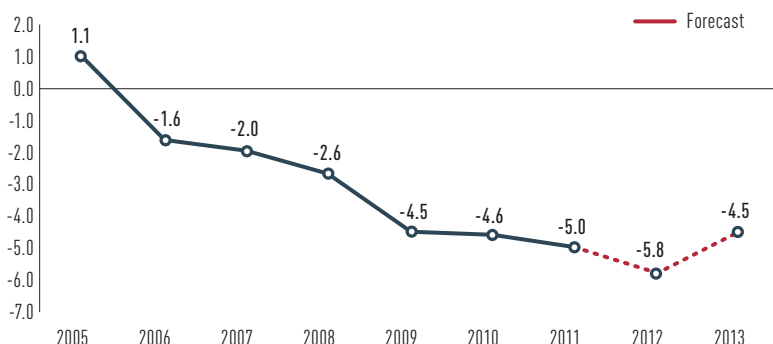
Consolidated fiscal deficit

2012: (-5.8%)

2013: (-4.5%)

According to the projections of the Agency for Balanced Regional Development of AP Vojvodina, the consolidated fiscal result will be negative in the forecast period (-5.8% in 2012 and -4.5% in 2013). If we consider the overall series of data included in the model (2005-2013), the projected deficit for 2012 is the highest (Figure 18).

Figure 18: Consolidated budget balance (% of GDP)



Source: Ministry of Finance and Economy, Republic of Serbia (2005–2010), ABRD (2011–2013)

Public debt

2011: 47.7% of GDP,
exceeded the upper
limit of 45.5%

Public debt in the Republic of Serbia in 2011 amounted to EUR 14.5 billion, representing 47.7% of GDP. Considering the fact that the upper limit of public debt is 45.0% of GDP, it is seen that the generated public debt in 2011 was by 2.7 percentage points higher than the allowed one. If the ratio between GDP and public debt is further analyzed, it is necessary to consider the fact that GDP is largely formed in dinars, whereas the largest part of public debt is denominated in foreign currencies, hence the ratio movement of public debt to GDP is dependable on the oscillations of dinar exchange rate⁶⁰. Compared to 2010 there has been an absolute increase in public debt by EUR 2.3 billion due to increased public borrowing in dinars and foreign currencies in the domestic market. Direct liabilities are dominant in the structure of public debt with 85.4%, while indirect liabilities contribute with 14.6% in the generation of public debt.

In the proposed fiscal consolidation measures until 2016, the Fiscal Council pointed to the necessity and speed of fiscal consolidation measures implemen-

60 Fiscal Council of the Republic of Serbia, Fiscal development in the Republic of Serbia in the first quarter of 2011 and the achievement of fiscal rules

tation, taking into account that Serbia is currently threatened by a public debt crisis. The latest analysis of the National Bank of Serbia shows that the public debt share in GDP increased by 3.4 percentage points, to 51.1%⁶¹ during the first quarter of 2012. Unless serious measures are taken, the public debt share might increase to 55.0% by the end of 2012. These trends would lead to a public debt crisis in Serbia, manifested in a strong devaluation of the dinar and an increase in inflation on the one hand and a decline in production and rise of unemployment on the other hand⁶².

⁶¹ Public debt according to the Ministry of Finance and Economy and GDP estimates by the National Bank of Serbia; Analysis of the Republic of Serbia's Debt, March 2012, the National Bank of Serbia

⁶² Fiscal Council of the Republic of Serbia, Proposed Fiscal Consolidation Measures for 2012-2016, May 2012

2.4. Monetary Developments and Financial Sector

2.4.1. Inflation

Inflation rate
Q2 2012: 3.1%

Although at the end of 2011 inflation significantly decreased, to 7.0% compared to the end of 2010, it was still above the upper bound of deviations from the inflation target ($4.5\% \pm 1.5\%$ ⁶³). In the first two months of 2012 inflation ranged above the target, but within the tolerance band, while in March and therefore at the end of the first trimester, year-on-year inflation was at the lower bound of the deviation tolerance band and amounted to 3.2% (the target band being $4.4\% \pm 1.5\%$). According to the Inflation Report by the National Bank of Serbia, the minimum year-on-year inflation of 2.7% (below the lower bound of tolerance band) was recorded in April. However, by June there was an increase in inflation to 5.5%, thus the total inflation amounted to 3.1% in the second quarter of 2012. The inflation target of the National Bank of Serbia amounts to $4.0\% \pm 1.5\%$ at the end of 2012.

Increase in prices
of unprocessed food
Q2 2012: 14.7%

An increase in prices of unprocessed food and products, which are linked to the dinar exchange rate contributed most to the rising inflation in the second quarter of 2012. In the period from April to June an increase in prices of unprocessed food (14.7%) was recorded, which led to a rise in prices of food and non-alcoholic beverages (5.8%)⁶⁴. Of the total increase in inflation of 2.8 p.p, the contribution of the increase in food prices was 2.5 p.p. At the end of the second quarter there was an increase in prices of primary agricultural products due to bad weather conditions and long-lasting drought, which will add further pressure on domestic prices.

Increase in prices
of food and non-
alcoholic beverages
Q2 2012: 5.8%

Inflation rate
2012: 6.3%
2013: 3.8%

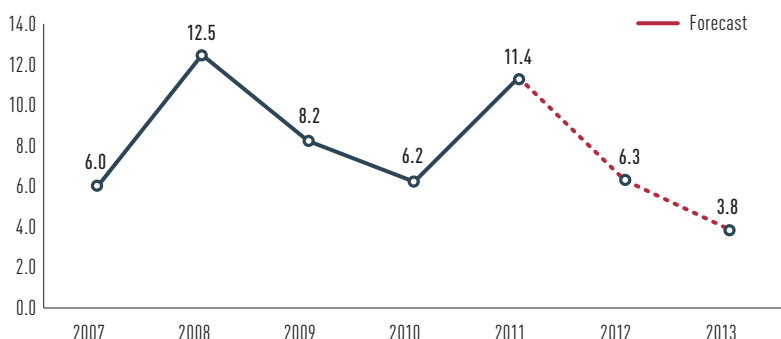
Higher inflationary pressures are expected in the following period, not only due to rising food prices, but also due to an increase in import prices, regulated prices and still existing uncertainty regarding fiscal consolidation and the implementation of structural reforms.

However, inflation will also be affected by disinflationary pressures in the form of low aggregate demand, expected due to a slow recovery of the Euro area economy, which will result in a reduction in economic activity in Serbia. Nonetheless, inflationary pressures are expected to prevail in the next period, which, together with the rise in food prices due to long-lasting drought, will cause an increase in year-on-year inflation in the third quarter of 2012. Accordingly, an increase in inflation is anticipated to continue after the third quarter, until the middle of 2013 when it is expected to reach its maximum, followed by a fall to the inflation target tolerance band at the end of 2013.

63 National Bank of Serbia, National Bank of Serbia's Memorandum on Inflation Targets until 2014

64 National Bank of Serbia, Inflation Report - August 2012

Figure 19: Average annual inflation rate (in %)*



Source: National Bank of Serbia (2007–2010), ABRD (2011–2013)

* Due to changes in the methodology of monitoring inflation, the data for 2006 and 2005 are not presented. In the period before 2007 the National Bank of Serbia tracked changes in retail prices and after 2007 changes in consumer prices have been tracked.

The largest risk, when it comes to achieving the inflation target, lies in the uncertainty of the recovery of the international environment and the EU from the effects of a new wave of the global economic crisis, especially of those countries that are major trade partners of the Republic of Serbia. In addition to this, the achievement of projected inflation values will be affected by the process of the accession to the EU and the realization of planned fiscal frameworks.

Key interest rate
August 2012: 10.5%

One of the key roles of the National Bank is to ensure monetary stability, meaning a stable and predictable inflation rate and confidence in the currency. The main objective of monetary policy is to achieve and maintain price stability, namely the inflation target, in order to maintain financial system stability. This is defined in the *Memorandum on Inflation Targets*, which defines the formal implementation of inflation targeting regime since January 1, 2009. In order to reduce inflationary pressures and preventively affect inflation expectations, in August 2012 the Executive Board of the National Bank increased the key interest rate from 10.25% to 10.50%. The key interest rate serves as a starting interest rate, since the amount of basic interest rates in the money market is determined by the amount of this interest rate.

2.4.2. Foreign Exchange Reserves

Increase in foreign
exchange reserves
June 2012: 1.9%

According to the National Bank of Serbia, at the end of June 2012 foreign exchange reserves amounted to EUR 10,160.8 million, representing an increase of 1.9% compared to the end of June 2011. Due to excessive daily exchange rate fluctuations, in order to secure an undisturbed operation in the foreign exchange market, NBS intervenes in the interbank foreign exchange market. In June 2012, the volume of foreign exchange trading realized in the interbank

foreign exchange market amounted to EUR 1,820.3 million, and in first half of 2012 the trade volume accounted for EUR 8,251.0 million. The official exchange rate reached its historic low of 119.07 dinars for one euro on August 9, 2012. Having in mind that it is impossible to predict with certainty the movements of the exchange rate in the future, a practice applied when it comes to forecasting is to introduce the assumption that the exchange rate remains unchanged during the period covered by the prediction. This implies an exchange rate of 113.4 RSD/EUR in 2012 and 114.8 RSD/EUR in 2013.

2.4.3. Credit Activity

The credit activity of the banking sector can positively influence real economic developments and affect economic growth. On the other hand, a large drop in credit may lead to a fall in domestic demand and negatively affect economic growth. Growth in borrowing could be identified as one of the main indicators of financial crisis. Strong growth in borrowing, especially if it is intended for consumer loans, could fuel domestic demand growth to unsustainable levels, which may encourage inflationary pressures. Additionally, the expansion of borrowing could overburden capacities of banks for risk management and thus, might threaten the stability of the banking sector. One of the consequences of excessive credit activity is a possible growth in prices of non-tradable goods, leading to an increase in domestic inflation and may result in a real depreciation of the domestic currency.

Increase in net loans
of the banking sector
Q1 2012: 5.1%

According to the National Bank, total net loans of the banking sector amounted to RSD 1,757.9 billion at the end of the first quarter of 2012. In comparison to the last quarter of 2011, loans were by 5.1% higher. A dominant category of loans was corporate loans amounting to RSD 917.3 billion (52.2% of total placements), in which loans to public enterprises participate with 11.0% and loans to companies with 89.0%. At the end of the first quarter 2012 corporate loans recorded a growth of 6.9%.

The second important category includes loans to individuals (30.8% of total loans) with an increase of 4.4% compared to the last quarter of 2011. This was followed by loans to the finance and insurance sector (8.4%), public sector (3.8%) and loans to foreign entities and foreign banks (1.3%). The currency structure of loans was dominated by foreign currencies, which made up more than two thirds of placements (71.1%), while 28.9% of loans were placed in dinar. Euro had the most dominant contribution in foreign currency loans, with 84.5%, followed by Swiss franc with 10.0% and other currencies with 5.5%.

Increase in non-
performing loans
Q1 2012: 13.1%

At the end of the first quarter of 2012 gross non-performing loans amounted to RSD 387.5 billion, or 20.4% of total granted (gross) loans. Compared to the end of the fourth quarter of 2011, non-performing loans increased by 13.1%. Non-performing loans may negatively affect the asset quality of banks, the re-

sults of the banking sector and the prices of banking products and services. When the contribution of non-performing loans is high, banks have to allocate huge funds to cover risky loans. Finally, increase in non-performing loans may lead to the necessity of government interventions in the form of capital injections, which increases public debt.

In early August 2012 the credit rating agencies Standard and Poor's, S&P and Fitch assessed the long-term foreign and local currency sovereign credit rating of the Republic of Serbia with a "BB-", and the outlook was changed from stable to negative. The credit rating for short-term borrowing remained at "B". The lowering of the credit rating was explained by an increase in fiscal and external deficits in the first half of 2012, the deterioration of the current account, outflow of foreign currencies (in the amount of about 1.5% of GDP), as well as amendments to *the Law on the National Bank of Serbia*⁶⁵, for which they believe will negatively affect the independence of the National Bank of Serbia, and therefore monetary stability. The lowering of the credit rating of Serbia will reduce the inflow of foreign capital, which will adversely affect the economic recovery. "BB-" rating belongs to non-investment ratings since it is estimated that the risk is high when investors invest in the countries with such a rating. This means that Serbia is facing borrowing at high interest rates since bad rating suggests less reliable debt repayment.

65 At the beginning of August 2012 the Law on amendments and supplements to the Law on the National Bank of Serbia was adopted. Key novelties introduced by the amendments to the law are the supervision of the National Assembly over the National Bank will increase, all officials of the National Bank will be elected in the National Assembly, the Administration for Supervision of Financial Institutions will be set up within the National Bank of Serbia.

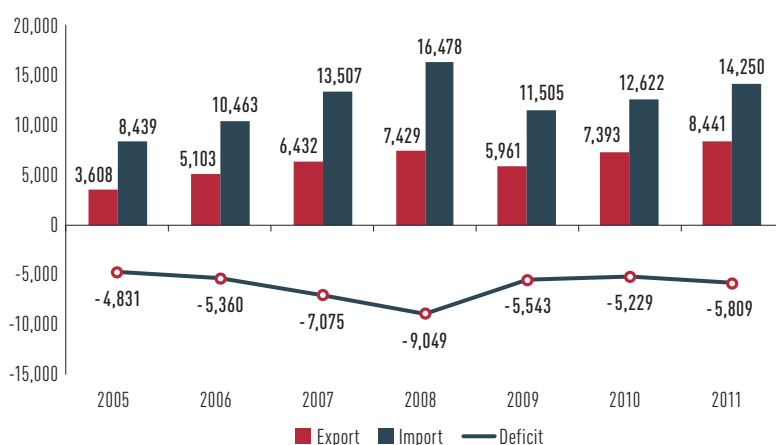
2.5. Foreign Trade

Trade deficit

2011: 18.7% of GDP

According to the preliminary data of the Statistical Office of the Republic of Serbia, in 2011 overall foreign trade (exports + imports) amounted to EUR 22,691.4 million⁶⁶, which represents an increase of 13.4% compared to the previous year. In 2011 exports recorded a slightly higher growth than imports compared to 2010, 14.2% compared to 12.9%. The increase in exports was primarily caused by an increase in external demand. However, the trade deficit in 2011 was by 11.1% higher than in 2010, amounting to EUR 5,808.6 million (Figure 20), representing 18.7% of GDP.

Figure 20: Foreign trade, in mil. EUR, in the period 2005-2011



Source: Statistical Office of the Republic of Serbia

Although there was a significant growth in imports and exports in 2011 in comparison to 2010, in the first half of 2012 there was an almost imperceptible increase in exports of only 0.6%, while imports increased by 5.7% compared to the corresponding period of the previous year. Overall foreign trade expanded by only 3.8% in the observed period. Due to such trends of imports and exports, the foreign trade deficit was the only one to keep a high growth in the first two quarters of 2012 and in the observed period rose by 13.6% compared to the same period of the previous year.

⁶⁶ Statistical Office of the Republic of Serbia, Statistical Release ST13-G, External trade of Serbia - December 2011

Non-diversified
exports

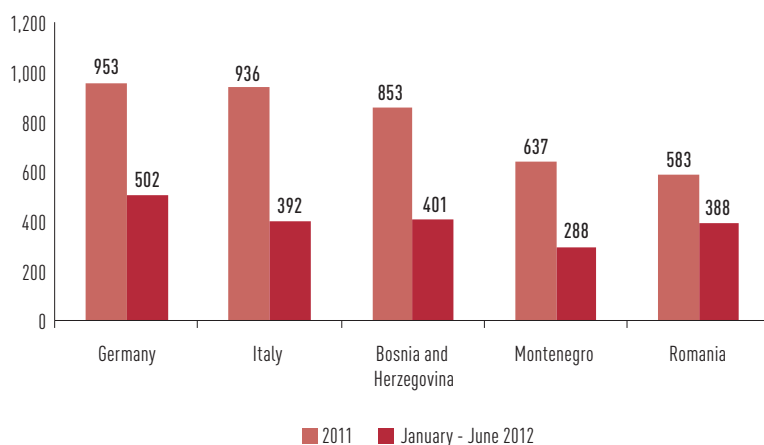
Top 5 products
in total exports
January - June 2012:
31.3%

2.5.1. Exports

In 2011 the products with the largest share in exports of Serbia belonged to the sections of iron and steel (decreased by 1.5% compared to 2010), non-ferrous metals (a decline of 19.5% compared to 2010), electrical machinery and apparatus (an increase of 19.7% compared to 2010), cereals and cereal preparations (a growth of 21.1% compared to 2010) and fruits and vegetables (a growth of 18.6% compared to 2010). In the first half of 2012, the top five export products were slightly different (cereals and cereal preparations, electrical machinery and apparatus, non-ferrous metals, metal products not mentioned anywhere and iron and steel). However, this difference does not indicate that exports diversified, especially considering the fact that the contribution of the top five products to exports was 31.3%⁶⁷, which is close to the contribution in previous years.

Together with the percentage of contribution of the most significant export products, the major export partners also did not change compared to 2010, hence in 2011 Serbian export products (Figure 21) found their place in the markets of Germany, Italy and Bosnia and Herzegovina and a similar trend was visible in the first half of 2012.

Figure 21: Major export partners, in mil. EUR, 2011 and the first half of 2012



Source: Statistical Office of the Republic of Serbia

⁶⁷ Statistical Office of the Republic of Serbia, Statistical Release ST13, External trade of Serbia - June 2012

2.5.2. Imports

Although Germany and Italy represent quite important import partners as well, the most important import partner of Serbia in 2011 was Russia (Figure 22) due to the extremely high imports of oil and oil derivatives and natural gas.

Energy dependency

Imports of oil and oil derivatives in total imports
2011: 11.3%

Imports of natural gas in total imports
2011: 6.0%

Figure 22: Major import partners, in mil. EUR, 2011 and the first half of 2012



Source: Statistical Office of the Republic of Serbia

The share of imports of oil and oil derivatives in total imports amounted to 11.3% (an increase of 20.0% compared to 2010). Imports of natural gas made up a 6.0% share in total imports of the Republic of Serbia in 2011 (an increase of 21.3% compared to 2010). Along with these products, in 2011 Serbia mostly imported road vehicles (a rise of 7.0% compared to 2010), industrial machinery (a growth of 54.2% compared to 2010), non-ferrous metals (an increase of 7.7% compared to 2010) and electrical machinery and apparatus (an increase of 16.3% compared to 2010).

An increasing share of the imports of industrial machinery and electrical apparatus is a good sign in the structure of imports. This should ensure the quality improvement of products and the competitiveness of the Serbian economy and consequently of exports, in which the share of products of higher processing stages, with higher added value would increase. The structure of imports of the Serbian economy was very similar in the first six months of 2012. However, there was a small decline in the share of imports of electrical machinery and apparatus and industrial machinery, from 8.1% in the first six months of 2011 to 7.7% in the first six months of 2012.

2.6. Employment and Salaries

2.6.1. Employment

Main problems which the labour market in the Republic of Serbia is facing are⁶⁸:

- ▶ High unemployment rate,
- ▶ Labour market duality,
- ▶ Unfavourable structure of sectoral employment,
- ▶ Mismatch between supply and demand in the labour market,
- ▶ High unemployment rate among women and young people,
- ▶ High long-term unemployment.

The labour market in Serbia experienced significant short-term and long-term shocks, both in the transition process and as a consequence of spillover effects of the global economic crisis that started showing its impact on the Serbian labour market in the last quarter of 2008. The restructuring and privatization of companies led to layoffs in state and public enterprises and the labour market has not been able to generate enough workplaces for their re-employment. The increase in the total number of small and medium enterprises at the level of Serbia (from 75,218⁶⁹ in 2004 to 89,860⁷⁰ in 2010) was also insufficient to overcome this problem.

Since 2004 the highest unemployment rate (26.1%) and the lowest employment rate (44.2%) were recorded in April 2012

According to the *Labour Force Survey*, it can be seen that from 2010 to 2011 the number of employed persons of the working age 15-64 (total employment = formal + informal) decreased by 4.7% (106,817 persons), while the number of the unemployed increased by 15.2% (102,085 persons). Accordingly, in the observed period there was a decrease in the employment rate by 1.8 percentage points (from 47.2% in 2010 to 45.4% in 2011), and an increase in the **unemployment rate** by 3.6 percentage points (from 20.0% in 2010 to 23.6% in 2011). It is disturbing that in the period from 2004 to April 2012 the highest rate of unemployment (26.1%) and the lowest rate of employment (44.2%) were recorded no sooner than in April 2012.

Formal employment decrease 2011: by 2.8% compared to 2010

According to the *RAD Survey* of the Statistical Office of the Republic of Serbia, formal employment decreased by 2.8% (around 49,637 persons) in 2011 compared to 2010. From this drop, the largest part refers to entrepreneurs and the persons employed by them (37,892 persons, i.e. 8.6%). The RAD Survey includes only formally employed people, hence the data differ from the employment according to the *Labour Force Survey*, which in addition to the formally employed people covers the informally employed as well.

In the analysis of the crisis impact on the labour market and in terms of employment, it is necessary to observe how the number of employed persons is

68 National Employment Strategy, 2011 – 2020

69 Serbian Business Registers Agency

70 National Agency for Regional Development

changing according to the work type⁷¹. In 2011 there was an increase in the number of persons employed on a fixed-term basis by 1.2 percentage points (from 8.7% to 9.9%) compared to 2010, while the number of persons employed on a permanent basis decreased by 1.0 percentage points (from 88.5% to 87.5%), indicating that employers opt to hire people on a fixed-term basis due to the uncertain future.

Labour market duality
2011: number of persons employed in the public sector decreased by 1.5% in the private sector by 19.2%

According to the Labour Force Survey from April 2012, the structure of employed persons is the same; the number of persons employed on a permanent basis is decreasing, 86.5%, whereas there is an increase in the number of fixed-term ones, 11.3%. In addition to this, the number of persons employed in the public sector decreased by 1.5% in 2011 compared to 2008, while during the same period the number of persons employed in the private sector decreased by 19.2%, indicating a pronounced **labour market duality**. It is shown in the sense that people employed in the public sector have a high degree of job security and respond to the crisis by a delay and freeze of salaries, whereas the private sector responds faster, by decreasing the number of employees, rather than by salary cuts.

Unfavourable sectoral employment structure
April 2012:
17.9% in agriculture,
27.2% in industry and
54.9% in service sector.

Employment in Serbia is characterized by an **unfavourable sectoral employment structure**. According to the data from the April Labour Force Survey for 2012, 17.9% of the total number of working age employed persons is employed in agriculture, 27.2% in the industry and 54.9% in the service sector. It is evident that the share of employed persons in the industry is low, implying a negative sectoral employment structure. A favourable sectoral structure implies high share of employed persons in sectors with a high level of productivity.

Employment growth rate
2012: (-1.3%)
2013: (-0.3%)

According to the Agency for Balanced Regional Development of AP Vojvodina, employment will drop in the forecast period. In 2012 the employment growth rate will be negative (-1.3%), while in 2013 the decrease will decelerate and amount to -0.3%. (Figure 23).

Figure 23: Formal employment, growth rate (%)



Source: Statistical Office of the Republic of Serbia (2005-2010), ABRD (2011-2013)

⁷¹ According to the Labour Force Survey of the Statistical Office of the Republic of Serbia, the division according to the work type includes four categories: fixed-term, permanent, seasonal and casual employment.

There is a high **mismatch between labour supply and demand** in terms of required skills and abilities in the labour market of the Republic of Serbia. This is indicated by the fact that 67.2%⁷² of the total number of working age unemployed people finished high school, while at the same time there is a high demand for labour with high school degrees, proved by the data that in 2011 53.7%⁷³ of the total number of newly created workplaces required secondary education.

Employment rate

April 2012:

for women 37.1%,

April 2012:

for men 51.1%

Unemployment rate

April 2012:

for women 26.7%,

April 2012:

for men 25.6%

Youth

unemployment rate

April 2012: 50.9%

Share of long-term unemployed persons in the total number of unemployed people

2011: 73.7%

As stated in the Employment Strategy, one of the main **vulnerable groups in the labour market are women** who, despite a higher education level, suffer from higher unemployment in comparison to men. If the surveyed employment rate of working age population is observed from April 2012, the employment rate for women was 37.1%, by 14.0 percentage points lower than that for men (51.1%). One of the reasons for the great difference in employment rates between men and women is the difference in activity rates of 18.0 percentage points (68.7% for men and 50.7% for women). Of the total number of inactive women, as many as 85.4% is with lower and middle levels of education, and the main causes of the inactivity of women (with the exception of female students) are personal, family reasons, or “other” reasons, because they take care of the family and household and delay entering the labour market. Women are in a worse position with regard to unemployment as well. According to the same source, the unemployment rate for women is 26.7%, compared to 25.6% for men.

Besides women, **the young** are also a vulnerable group in the labour market of the Republic of Serbia, as indicated by the data from the Survey for April 2012 showing that the unemployment rate of youth (aged from 15 to 24) is 50.9%, while the unemployment rate of adults (25-64) is 23.8%. When we observe the structure of unemployed youth by educational level, it is seen that as many as 77.4% of young people have completed high schools, and the already stated mismatch between supply and demand in the labour market primarily has a negative impact on young people. It is also important to mention a very high rate of youth inactivity of 70.9%. Such a high inactivity rate is mostly the result of prolonged school attendance and the fact that most students do not work while studying.

One of the serious problems in the labour market is **long-term unemployment**, since there is a risk that long-term unemployed persons will become discouraged and thus stop contributing to labour supply. According to the duration of unemployment and based on the Labour Force Survey, there was an increase in the share of long-term unemployed persons by 4.6 percentage points (from 69.1% to 73.7%) in 2011 compared to 2010. The highest growth rate was recorded in the category of unemployed persons who were out of work for 4 to 6 years (an increase of 2.6 percentage points).

72 Statistical Office of the Republic of Serbia, Labour Force Survey, 2011

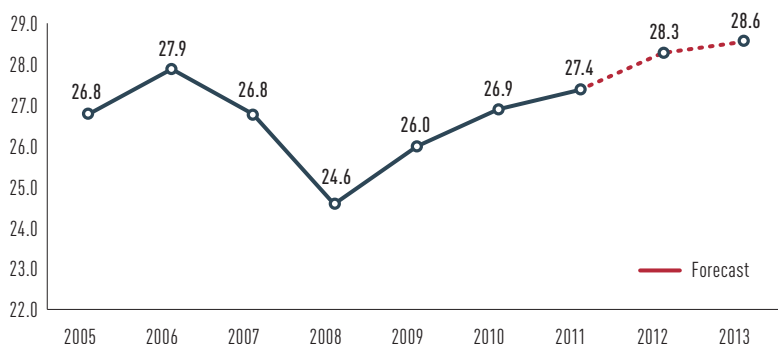
73 National Employment Service, 2011

According to the April Survey for 2012 and based on the analysis of the unemployment structure in Serbia, according to the duration of unemployment, there is a decrease in the possibility of finding a job in proportion to the duration of unemployment, which could lead to serious social implications in the form of exclusion from the labour market and hence, the increasing risk of poverty.

Administrative unemployment rate
2012: 28.3%
2013: 28.6%

According to the predictions of the Agency for Balanced Regional Development of AP Vojvodina, the administrative unemployment rate will slightly rise in the following years. Considering the characteristics of the labour market, which reacts to the changes in the macroeconomic environment with a delay, the forecasted administrative unemployment rate will be 28.3% in 2012 and 28.6% in 2013 (Figure 24).

Figure 24: Administrative unemployment rate (%)



Source: National Employment Service of Serbia (2005-2010), ABRD (2011-2013)

2.6.2. Salaries

Year-on-year increase in net salaries

June 2012:
7.7% in nominal terms
June 2012:
2.1% in real terms

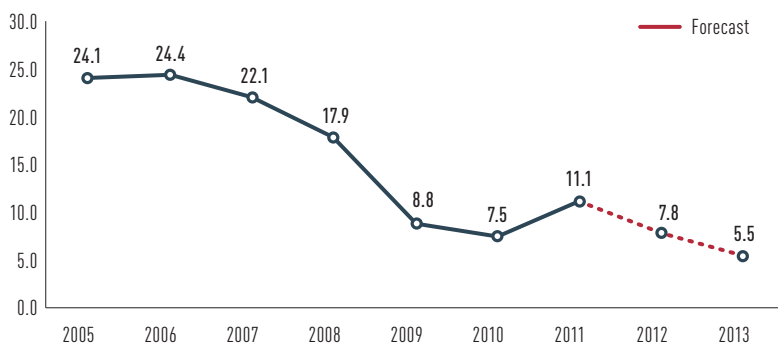
According to the Statistical Office of the Republic of Serbia, average net salaries followed an upward trend from January to April 2012, followed by a drop in May, for the first time since the beginning of the year. After the drop in May, net salaries resumed their upward trend and in June amounted to 42,335 dinars. In June 2012 compared to June 2011, the average salary without tax and contributions increased by 7.7% in nominal terms and by 2.1% in real terms.

The highest average net salary in June 2012 was registered in the Sector of Financial and Insurance Activities (RSD 84,494), followed by the Sector of Electricity, Gas, Steam and Air Conditioning Supply (RSD 69,657) and the Sector of Mining and Quarrying (RSD 62,117). The lowest average net salary was recorded in the Sector of Accommodation and Food Service Activities (RSD 23,428).

According to the Agency for Balanced Regional Development of AP Vojvodina's projections for 2012 and 2013, salaries will continue to rise in nominal terms, but at a lower rate compared to 2011 (by 7.8% and 5.5%, respectively).

Nominal growth rate of gross salary
2012: 7.8%
2013: 5.5%

Figure 25: Nominal growth rate of the average gross salary⁷⁴

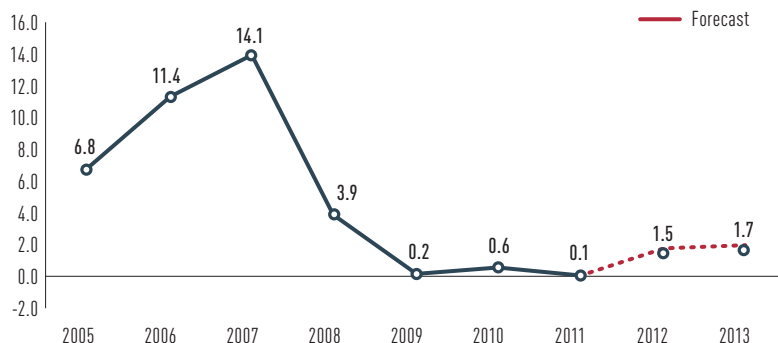


Source: Statistical Office of the Republic of Serbia (2005-2010), ABRD (2011-2013)

Real growth rate of
gross salary
2012: 1.5%
2013: 1.7%

According to the forecast for 2012 and 2013, the real rate of the average gross salary will increase and the highest rise is expected in 2013 (1.7%).

Figure 26: Real growth rate of the average gross salary⁷⁴



Source: Statistical Office of the Republic of Serbia (2005-2010), ABRD (2011-2013)

⁷⁴ Since 2008 rates have been adjusted to the changed methodology

Mini dictionary

Administrative unemployment rate	Administrative unemployment rate represents the share of registered unemployed persons in the sum of registered unemployed and employed persons, including individual farmers who pay contributions for pension and disability insurance.
Allocation of foreign direct investment	Allocation of foreign direct investment is the distribution of foreign direct investment into the relevant sectors.
Behavioural equations	Behavioural equations describe how variables behave in the econometric model.
Confidence indicator	Confidence indicators are arithmetic means of seasonally adjusted balances of answers to a selection of questions closely related to the reference variable they are supposed to track (e.g. industrial production for the industrial confidence indicator). Surveys are defined within the “Joint Harmonised EU Programme of Business and Consumer Surveys”.
Consolidated balance	Consolidated balance is the difference between current revenues and income from the sale of non-financial assets (i.e. capital income) and current expenditures and expenditures for the purchase of non-financial assets (i.e. capital expenditures). In addition to this, expenditures also include an item which includes repayment of domestic debt - pensions, budget lending and recapitalization.
Credit rating	Credit rating is a forward-looking opinion about credit risk and an assessment of the ability and willingness of an issuer to meet its financial obligations in full and on time. Ratings are provided by institutions, commonly known as credit rating agencies, which specialize in evaluating credit risk. The main task of a credit rating agency is to provide analysis and opinion about the creditworthiness of companies and states. Three leading rating agencies in the financial market are: Standard&Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings (Fitch). S&P, Moody's and Fitch express credit ratings as letter grades (A, B, C, D) where “AAA” is regarded as the best and “D” as the worst rating. Ratings from “AA” to “CCC” may be modified by the addition of a plus “+” or minus “-” sign to indicate their relative positive within the main rating categories. Rating agencies also provide outlooks that indicate the potential direction of rating in the future. The outlook may be positive, negative, stable and developing. Positive outlook means that a rating may be raised. A negative means that a rating may be lowered and stable means that it is not likely to change. Developing outlook, assigned rarely, suggests a change in rating in the coming 1–3 year period. As investors and issuers keep a close eye on ratings, credit rating agencies have a significant impact on financial markets. When making investment decisions, investors analyse the ratings of financial instruments and the level of risk associated with those instruments that they find acceptable. Issuer or bond rating affects the issuer's cost of borrowing. Credit rating of a country affects the credit ratings of other issuers headquartered in the country. In addition, investment criteria are often connected with the minimum credit rating a security and/or its issuer must have.

Diversified export	Diversified export is the export of products which significantly differ on the technological basis, market purpose and sale manner. Greater diversification enables: 1) stability of sales and revenue, 2) more efficient use of resources, 3) adjustment to changes, needs and preferences of the market, 4) wider market coverage, etc.
Economic sentiment indicator	The Economic Sentiment Indicator (ESI) is a composite indicator made up of five sectoral confidence indicators with different weights: Industrial confidence indicator, Services confidence indicator, Consumer confidence indicator, Construction confidence indicator and Retail trade confidence indicator. ESI is calculated as an index with mean value of 100 and standard deviation of 10 over a fixed standardised sample period. Data are compiled according to the "Statistical classification of economic activities in the European Community" (NACE Rev.2).
Employment rate	According to the Labour Force Survey, the employment rate represents employed persons as a percentage of the total number of working age population.
Endogenous variable	Endogenous variables within the econometric model are those whose value is necessary to determine using the model. The solution to the model predicts and explains an economic phenomenon represented by an endogenous variable.
Exchange rate	Exchange rate is the price of foreign currencies expressed in units of the domestic currency. Exchange rate enables the comparison of prices in the country and abroad, calculation and conversion from one currency to another.
Exogenous variable	Exogenous variables are those whose value is known in advance and given outside the given econometric model. Their purpose is to explain the endogenous variables determined by the model.
Fiscal consolidation	Fiscal consolidation is a set of measures to be applied in order to reduce the fiscal deficit.
Fiscal policy	Fiscal policy is a part of an overall economic policy which includes the use of the totality of public revenues, public expenditures, budget and public loans to achieve appropriate objectives in micro and macro plans.
Formal employment	Formal employment is the number of employees reported by the employer.
Gross domestic product	Gross domestic product is the value of all final goods and services expressed in market prices in a country in a given period of time.
Gross value added	Gross value added is the difference between the gross value of output and intermediate consumption.
Ifo indicator	Ifo indicator is an assessment of general economic situation and expectations based on key economic indicators. The survey which generates it is conducted quarterly, through a questionnaire by the Ifo Institute from Germany.

Industrial production	Industrial production is a measure of output of the industrial sector of the economy.
Inflation target	Inflation target is the inflation rate which the National (Central) bank expects to be achieved in a certain period (usually a year).
Labour market	The labour market is the market in which workers seek paying work, employers find workers and where wages as the price of labour are determined. The labour market is a market in the conventional sense, because it is balanced if labour supply and demand are equal and is driven by principles like profit making.
Labour market duality	Labour market can express its dual character in the following relations: public and private employment, formal and informal, modern and traditional, self-employment and wage employment, standard and vulnerable, paid and unpaid work. The dimension of duality has implications for the status of employed persons. Greater degree of duality results in increased structural problems in the labour market.
Long-term unemployment in the USA	According to U.S. Bureau of Labour Statistics, long-term unemployment is defined as the number of persons unemployed for 27 weeks or longer. The long-term unemployment rate is defined as the share of a particular group's labour force total that has been unemployed for 27 weeks or more.
Monetary policy	Monetary policy is a part of the economic policy that uses various instruments to influence the supply of and demand for money. Instruments of monetary policy are: open market operations, interest rate management, determining the required reserve ratio, interventions in the foreign exchange market. It can be restrictive and expansionary.
Non-performing loans	A loan is nonperforming when payments of interest and principal are past due by 90 days or more.
Non-tradable sectors	Tradable sectors are those in whose outputs have export or import potential. On the other hand, some goods are non-tradable, either because of the nature of these products, high transportation costs per unit of product or other restrictions. These goods are called non-tradable and sectors in which they are made are called non-tradable sectors. Non-tradable sectors are: Construction; Retail and wholesale trade; Repair of motor vehicles, motorcycles and personal and household goods; Transport, storage and communications; Financial intermediation; Real estate, renting and business activities; Public administration and defence, compulsory social security; Education; Health and social work; Other community, social and personal service activities; Private households with employed persons; Extraterritorial organizations and bodies.
Number of degrees of freedom	Estimates of statistical parameters can be based upon different amounts of information or data. The number of independent pieces of information that go into the estimate of a parameter is called the number of degrees of freedom. In general, the degrees of freedom of an estimate of a parameter are equal to the number of independent scores that go into the estimate minus the number of parameters used as intermediate steps in the estimation of the parameter itself. The form of a specific statistical distribution depends on the number of degrees of freedom.

Recession	The recession is a slowdown in economic activity of a country followed by simultaneous deterioration of the general economic climate (decline in real income, rising unemployment, a low level of production capacity utilization, etc).
Seasonally adjusted data	Seasonally adjusted data are time adjusted data from which seasonal effects have been removed.
Structural Funds and Cohesion Fund	The Structural Funds and the Cohesion Fund are financial tools set up to implement cohesion policy, as the policy of the European Union dealing with the regional policy. There are two Structural Funds: the European Regional Development Fund and the European Social Fund. The purpose of the Cohesion Fund is to grant financing to capital infrastructure projects in the least developed EU member states (with gross national income less than 90% of the Community average) in the area of environment and construction of the Trans-European Road Network.
Unemployment rate	According to the Labour Force Survey, the unemployment rate represents unemployed persons as a percentage of the total number of active working age population.
W-shaped crisis	Economic crisis, in this case recession, is usually described by economists in letters of alphabet. The most common terms are V-form, U-form, W-form and L-form. There is no distinctive economic theory or the classification system, but such notation is used as an informal way of describing the economic recession and economic recovery. A recession marked W implies scenario of a “double-dip recession”. In a W-shaped economic crisis, the economy falls into recession, recovers with a short period of growth, then falls back into recession before finally recovering.
Youth unemployment	According to the International Labour Organization, youth unemployment is defined as the unemployment of working age persons between the age of 15 and 25. The unemployment rate is defined as the number of unemployed youth (persons between the age of 15 and 25) in the total number of the youth labour force.

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