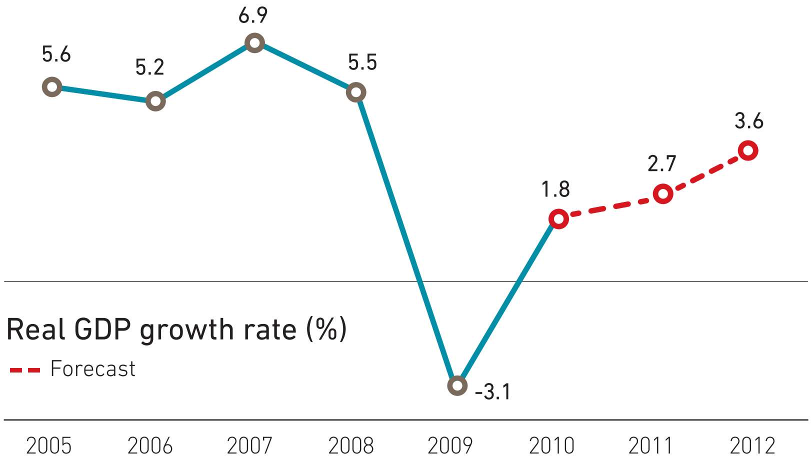
Economic forecast
for Serbia 2011 and 2012

Recovery underway, but challenges for economic policy remain topical



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This report comprises the economic forecast for Serbia for the period 2011 to 2012. This forecast has been generated with a macroeconometric model, which has been developed in cooperation between Vojvodina CESS and the Institute for Advanced Studies (IHS) Vienna and Economica, Institute for Economic Research, Vienna[1]. For Serbia as a small open economy, the international environment is important for the domestic development. Therefore, the forecast for Serbia starts with an assessment of the international economic perspectives.

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[1] Details on the model can be found in "ECONOMIC FORECAST FOR SERBIA 2009 AND 2010-Slow recovery follows sharp downturn"

Content

Tables

Figures

INTERNATIONAL ECONOMIC ENVIRONMENT

1

Overview

Throughout 2010, the economic recovery was proceeding faster than expected. According to the IMF World Economic Outlook (WEO) from January 2011, world output is expected to have risen by 5.0% in 2010 and to grow by 4.4% in 2011, with a temporary slowdown during the second half of 2010 and in the first half of 2011. In 2012 growth should remain robust and reach 4.5%. The recovery in most advanced and some emerging economies is proceeding at a slow pace, with unemployment remaining elevated and posing major social challenges. On the other hand, many emerging and developing economies are seeing strong growth, as they did not experience major financial or real estate imbalances prior to the economic and financial crisis. Thus, the output of the emerging and developing economies is forecasted to rise by 6.5% in 2011 and 2012, after recording a growth of 7.1% in 2010. Advanced economies may grow at a slower pace with only 2.5% per year in 2011 and 2012 after attaining a GDP increase of 3,0% in 2010.

The recovery is based on two rebalancing acts: internal rebalancing (which implies strengthening of private demand in advanced economies and allowing for fiscal consolidation), and external rebalancing (which implies an increase in net exports in deficit countries and a decrease in net exports in surplus countries). These two pillars interact in strong ways. Increased net exports in advanced economies imply higher demand and higher growth, allowing more room for fiscal consolidation. On the other hand, those economies that are facing high external imbalances due to past losses in competitiveness need to undergo a painful process of low price and hence wage growth, weighing on domestic demand and impeding the necessary budgetary consolidation.

During the first half of 2010 world industrial production recorded a growth rate of about 15.0%. Global trade recovered at a rate of 18.0%, which is a consequence of a surge in inventories and fixed investment. World trade expanded particularly strongly in emerging economies (e.g. 30.0% during the first half of 2010 in Asia). In advanced economies employment began to grow, and retail sales are slowly recovering. However, unemployment remains at comparatively high levels in many countries, among which the United States is one of the most prominent examples.

Asian economies enjoyed a strong rebound, and their output is already above the pre-crisis level. The output of the United States is also close to the pre-crisis level, but medium-term growth is far below the pre-crisis trends. Japan and the Euro area are still appreciably below the pre-crisis levels of output and remain dependent on foreign demand.

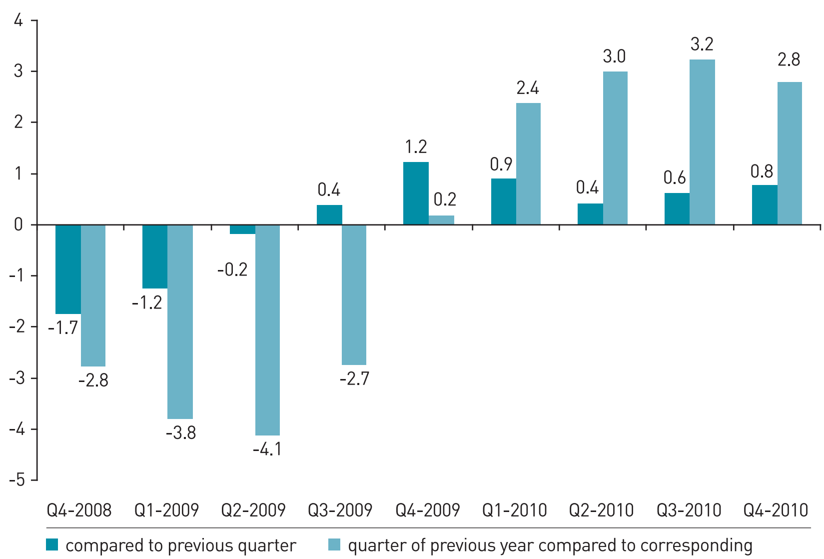
Emerging economies expanded by about 8.0% during the first half of 2010. Robust domestic demand spread from China, India, and Indonesia to the other Asian economies. In emerging Asia growth accounted for 9.5%. In Latin America, the recovery is led by Brazil, where real GDP growth reached near 10.0% since the third quarter of 2009. Available data for the African and Middle East economies point also to a robust growth.

Regions and countries

USA

Thanks to a massive and sustained macroeconomic policy stimulus, financial stabilization measures, and a modest cyclical upswing, the economy of the United States (U.S.) has continued to recover from the worst recession since the Great Depression. During the first quarter of 2010, the U.S. economy grew by 2.4% compared to the same quarter of the previous year. During the second and the third quarters growth accelerated, and the U.S. economy expanded by 3.0% and 3.2% respectively, before slowing down somewhat to 2.8% in the final quarter. Growth in 2010 was to a large extent driven by a pick-up in investment, but also supported by expansionary fiscal policies (Fig. 1).

Figure 1: USA – Real GDP Growth (% change)



Source: OECD, IHS, Vojvodina-CESS.

Compared with previous business cycles, the recovery of the U.S. economy is slow due to sluggish private consumption as the largest component of the U.S. GDP. There are several reasons for this. First, household net wealth sharply deteriorated as house prices have fallen by more than 25.0% since 2007. Second, unemployment in the U.S. is high. In November 2010 the unemployment rate amounted to 9.6% of the workforce. Third, banks are still reluctant to lend to consumers, restricting credit for larger purchases, as they struggle to reduce leverage and restore balance sheet equilibrium. On the other hand, private investment in software and equipment grew significantly, as firms improved productivity, while unit labour costs declined sharply.

After the economic downturn recorded in 2009, the U.S. economy is slowly recovering with projected GDP growth rates of 2.1% in 2011 and 2.7% in 2012, after a 2.8% growth in 2010. Unemployment is expected to remain high with a projected rate of 9.7% in 2010 and 9.6% in 2011. Inflation should remain low during 2011 (1.0%, after 1.4% in 2010). The key macroeconomic goal is to ensure that public debt is put on a sustainable path without endangering the recovery. Under current policies, the general government budget deficit is projected to amount to about 10.0% of GDP in both 2010 and 2011, while gross general government debt will increase to about 110,0% of GDP by 2015.

Latin America and the Caribbean

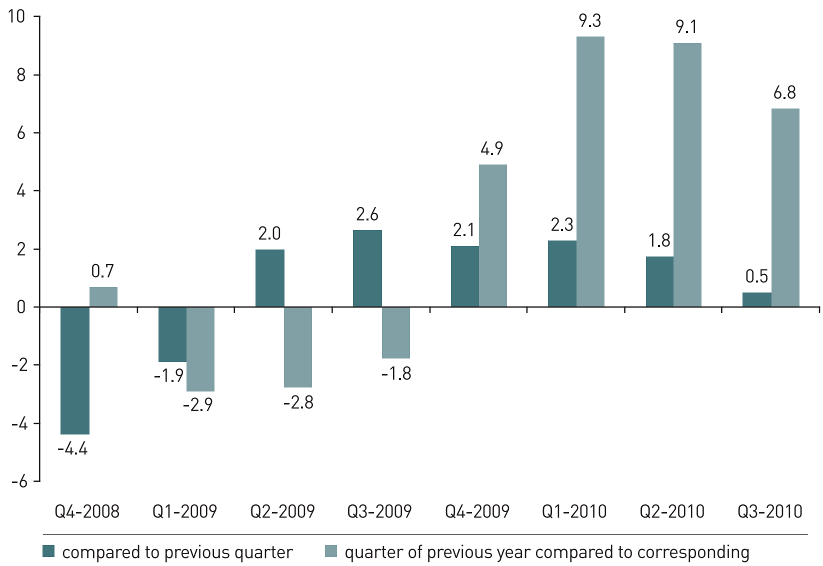
During the first half of 2010, the economic recovery in Latin America and the Caribbean (LAC) was faster than expected, driven by a strong rebound in private consumption and investment. This reflects stimulating policies, a build-up of inventories, favourable external financing conditions, and strong commodity revenues. Following the downfall in 2009, average growth in the region is projected to reach 4.3% in 2011 and 4.1% in 2012, after recording a 5.9% growth in 2010.

Forecast risks for the LAC region emerge from both external and domestic factors. External downside risks reflect mainly a weaker than projected recovery in the advanced economies. This is especially true for the economies with stronger linkages to the U.S. and the other advanced economies, which may encounter new financial challenges. Domestic risks relate to the possibility of continued fast growth of domestic demand fuelled by favourable external conditions and a continuation of the stimulus policies. This could be problematic for those economies where output has already reached its potential level and demand pressures threaten to increase inflation.

Country differences correlate with the broad geographic division of the LAC region. The South America sub-region as a whole is relatively less dependent on trade relationships with the U.S. or other advanced economies. A number of these economies have important trade linkages with each other, particularly with Brazil as regional giant. Brazil recovered quickly after the recession and registered during 2010 high growth rates. However growth slowed down during the second half year (Figure 2). Mexico and Central America are characterized by their strong real linkages with the U.S. economy and a relatively high degree of openness. Countries in the Caribbean region are generally highly dependent on tourism from the U.S. and the other advanced economies.

South America's earlier and stronger recovery is to some extent due to weaker trade links with the advanced economies, which are growing slower, as well as favourable raw material prices (raw materials represent a substantial share of total export of South American countries). The recovery in Mexico and Central America is somewhat slower, since these economies depend on U.S. import demand and remittances from migrant workers. The Caribbean continues to lag somewhat behind, reflecting tourism links to employment growth in the advanced economies, which remains sluggish.

Figure 2: Brazil – Real GDP Growth (% change)



Source: OECD, IHS, Vojvodina-CESS.

Asia

Asia is leading the global recovery, as Asian countries entered the global crisis on a strong footing. In most parts of the region, resilience in domestic demand has offset the drag from net exports. Industrial production and retail sales have been particularly strong in China and India. China's high and sustained growth over the past several years has served as a support for global trade, benefiting exporters of commodities and capital goods. Moreover, a turnaround in private capital inflows has bolstered domestic demand by providing access to external financing.

Strong foreign investment into Asian stock and bond markets has lifted some of the stock markets to new highs and brought bond yields down significantly. The new wave of capital inflow has started as the fears of a worldwide economic slowdown have diminished. Most Asian economies are back to the pre-crisis output levels or even higher due to the V-shaped upturn after the crisis. Output gaps have been closed or nearly closed. Investment activity is very strong and private domestic demand has been increasing as well. Exports have recovered well and interest rate cycles have turned upwards, although the pace of this transition has been very slow in some countries.

A massive fiscal stimulus and credit expansion has boosted domestic demand in China. The National Bureau of Statistics released a series of economic data for the third quarter 2010, which confirmed that the economy is headed towards a slight slowdown. After an expected growth of 10.0% in 2010, economic activity is forecasted to slow to 9.0% in both 2011 and 2012. Growth will be driven by private domestic demand, while tighter quantitative limits on credit growth, measures to cool off the property market and limit bank exposure to this, and the planned unwinding of fiscal stimulus in 2011 are going to slow the expansion.

Nevertheless, the asset bubbles issue in China has been on the market's mind for the last two years or so. Strong growth, low interest rates, brisk lending growth and abundant liquidity have pushed real estate prices and equity prices higher. The efforts of the central bank to rein in these developments and place restrictions on the real estate market were a constant issue in 2010, but so far these efforts have only shown limited impact. The desired result of these measures is, first and foremost, to achieve solid real growth.

Some of the undesired side-effects include the inflation developments. At 4.4%, the increase in consumer prices has edged to a 2-year high (the Central Bank's target is 3. %). Although the increase in consumer prices can mainly be traced back to higher food prices, inflation expectations have shot higher again due to an excess liquidity, and this had a detrimental impact on the financial markets. China is undoubtedly trying to avoid making the same mistakes that Japan made in the past. This pertains mainly to the real estate bubble.

In India, low reliance on exports, accommodative policies, and strong capital inflows have supported domestic activity. GDP growth is forecasted to slow to about 8.0% this and next year after recording 9.7% in 2010. In contrast, Japan's economic prospects remain weak, given lacklustre domestic demand and a lack of fiscal room to further boost the economy. After strong growth in 2010 with 4.0%, the economic expansion may decelerate to about 1.5% in 2011 and 2012. Prospects are also weak for the economies at the lower end of the quality ladder in manufacturing exports and for those with macroeconomic and financial uncertainty (e.g. Vietnam). A significant cooling off of the Chinese economy would result in a deceleration of growth in these economies.

European Union

The effects of the most severe economic and financial crisis in the post-war period have practically annihilated the positive growth and employment outcomes realised within the last decade in the European Union (EU). The consequences of the world economic crisis concern the crash of the construction sector, brought about by the bursting of real estate bubbles in some countries, problems in the banking sector, the rise of unemployment that tends to become structural unemployment, as well as the increase of public deficits and hence debt that threatens the overall financial stability. GDP recorded a sharp downturn and it cannot be expected to reach the pre-crisis level in the period encompassed by this forecast.

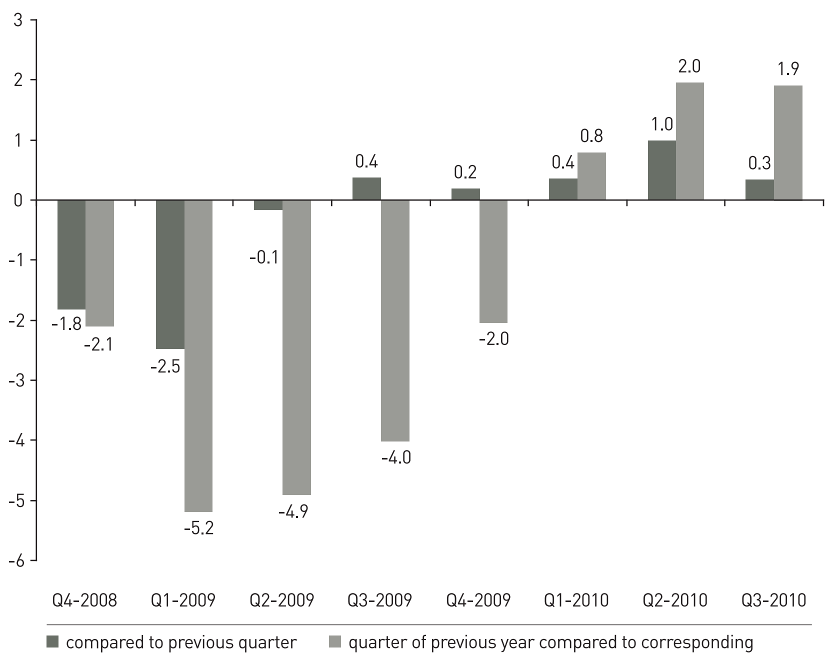
The EU economy continues the recovery that started in 2010. After a contraction of 4.2% in 2009, growth in the EU-27 turned positive, and for 2010 a GDP expansion of 1.7% is estimated. For 2011, a growth rate of 1.7% is to be expected. In 2012 growth should accelerate and record a rate of 2.0%. The expected economic expansion is largely the result of the recovery of industrial production. This has been driven by the increase of exports due to the dynamic global demand in 2010. In addition, domestic demand, including both private consumption and investment, has shown the first signs of recovery. However, this picture does not reveal the significant differences among the Member States.

While Germany and some small open economies, especially those with strong economic ties to Germany, recorded significant growth in 2010, peripheral countries such as Greece, Ireland, and

Spain did not yet overcome the crisis. The differences regarding the performance can be explained by factors such as openness of the economies, trade orientation, exposure of the financial sector to external impacts, as well as existence or absence of internal and external imbalances. However, the recovery does not show the problems that are still in place. E.g. industrial production is still by 12,0% lower in relation to the level from April 2008, which points to the fact that the recovery of the European economy has still some way to go.

The Euro area (EA17)[1] started the recovery in 2010. However, GDP growth slowed down in the second half of the year (Figure 3). GDP is projected to grow by 1.6% in 2011 and 1.9% in 2012, after expanding by an estimated 1.8% in 2010. In the new EU member states (NMS-12) GDP growth should accelerate to 2.6% in 2011 and 3.6% in 2012, after amounting to 1.9% in 2010.

Figure 3: Euro area – Real GDP Growth (% change)



Source: OECD, IHS, Vojvodina-CESS.

Among the large Euro area economies, Germany recorded in 2010 with 3.6% the highest GDP growth rate. This is twice as high as the average growth in the Euro area. In other countries the expansion pace remained at the Euro area average, while in some countries, e.g. Greece, Ireland, Italy, Cyprus, Portugal, and Slovenia growth was below the average. Outside the Euro area, Poland recorded the second highest growth of 3.5%, after already having been the only EU country that avoided a

1 Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, and Finland. Since 1 January 2011 Euro area (EA17) includes also Estonia.

recession in 2009. Among the smaller countries, significant growth was registered in Slovakia (4.0%) and Sweden (4.4%). It is expected that all European Union countries will overcome the recession until the end of 2011, except for Greece where a negative growth rate of 3.0% is expected.

In the second half of 2010 labour markets started to stabilise. The deceleration in job reduction began already in the second quarter of 2010, while the employment rate remained stable in the Euro area in the third quarter compared to the second quarter of 2010. In addition, a mild growth of the employment rate could be observed, starting from the third quarter (from 63.8% in Q2 to 64.4% in Q3 in 2010). Accordingly, the unemployment rate remained relatively stable – around 9.5% in the EU-27 and around 10.0% in the Euro area. However, labour market developments record significant cross-country differences. The employment rate ranges from more than 70.0% in the Netherlands, Germany, Sweden, and Austria to 56.0% in Hungary. The unemployment rate also records significant differences – from 20.0% in Spain up to less than 5.0% in the Netherlands and Austria. Taking the forecasted real economic development into account, employment is expected to grow by about 0.5% in the EU-27 and by about 0.7% in the Euro area in 2011, while unemployment will drop by about 0.5 percentage points. The differences in the labour market performance among the European countries are the consequence of the speed of economic recovery, the policies that have been implemented on the labour market, and of the economic structure.

Inflation rate, measured by the increase of the Harmonised Index of Consumer Prices (HICP), has been projected at around 2,0% in the EU-27 in 2010 and 2011, while a mild decline to about 1.7% is expected in 2012. In 2010, the highest average annual inflation rates were registered in Romania (6.1%), Hungary, and Greece (4.7% in both countries), while the lowest positive inflation rate was observed in Slovakia (0.7%). Latvia (-1.2%) and Ireland (-1.8% in the year till November) recorded a deflation. In Poland and Romania inflation was fuelled by the increase in the value added tax rate (VAT). However, the estimates for most countries show that inflationary pressures are rising, mainly due to high energy prices and pick up of prices of agricultural products on the world market. Additionally, higher indirect taxes and administrative prices contribute in some countries also to increasing inflation pressures.

The European banking system still relies on government support and it is sensitive to changes in economic activity, possible shocks, and limitations connected with financing. In the medium-term, the main risks to the economic outlook include fiscal imbalances and differences in competitiveness, in particular in the peripheral countries. The stability of the banking sector is crucial for providing external financing to companies. The Committee of European Banking Supervisors introduced the "stress test" in order to disclose the status of the banks in the European Union. This test also provides information on the need for re-issuing of stocks, restructuring, or vulnerability of banks.

It is expected that the general government budget deficit in the EU-27 will drop from 6.8% of GDP in 2010 to around 5.0% in 2011 and to 4.2% in 2012. Similar forecasts refer to the Euro area with somewhat lower deficit values (4.6% in 2011 and 3.9% in 2012). However, the debt ratio continues to grow and it is expected that it will reach around 83.0% of GDP in the EU-27 in 2012, up from 74.0% in 2009 and 79.0% in 2010. In the Euro area, the debt-to-GDP ratio is expected to grow to almost 88.0% by 2012, up from 79.0% in 2009 and 84.0% in 2010. If public debt is not reduced in the years to come, such a situation may have strong negative impacts on long-term fiscal sustainability and stability. As the experience of Greece and Ireland has shown, in the end countries with perceived unsustainable public finances may find themselves excluded from access to financial markets. Hence, a need for financial support by international organisations may arise for these countries. At present, Portugal and also Spain are at risk of such developments, and for Serbia as well as other Eastern European countries, which are not yet EU Member States it is of paramount importance to avoid such a development.

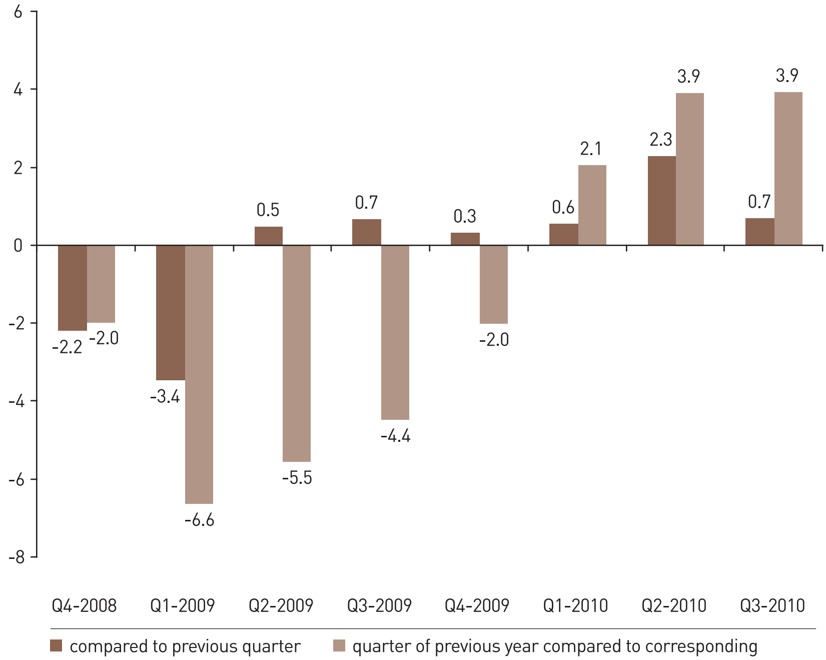
Having these considerations in mind, one main priority for most European countries in the next years is to attain fiscal sustainability by reducing public debt, which in many countries has become uncomfortably high. This necessitates the tightening of fiscal policies, in particular on the expenditure side. In addition, the reduction of unemployment and inflation will be high on the agenda of economic policies. The crisis has shown that problems in a country's financial sector can spill over to the European level very fast and easily. After Greece and Ireland, Portugal may become the next member of the currency union to need an emergency rescue plan. Also Spain, which is the third largest economy of the Euro area, is getting increasingly under pressure. The need for fiscal consolidation and structural reforms remains high and all countries of the Euro area, except for Finland, Estonia and Luxembourg, are required to consolidate their budgets by limiting the deficit so that it does not exceed 3.0% of GDP, i.e. the limit set in the Stability and Growth Pact (SGP). Over the forecast period, i.e. until 2012, in addition to the three countries just mentioned, Germany and Austria are also expected to fulfil the deficit target of the SGP. However, the debt level which has risen substantially during the economic and financial crisis, is projected to stay above the 60.0% threshold of the SGP in all Euro area countries, except for Luxembourg, Finland, Estonia, Slovenia, and Slovakia.

In the early phases of the crisis, central banks reduced the interest rates significantly. The European Central Bank (ECB) cut the reference interest rate from 4.25% in July 2008 to 1.00% in May 2009 and has kept it at that level since then. An increase of the reference interest rate may already take place in the second half of 2011, earlier than expected, due to rising inflationary pressures.

Contrary to the expected slow recovery, the German economy recorded fast and strong growth in 2010 with a GDP growth rate of 3.6%. This was the highest growth rate since unification in 1990. In 2009 Germany recorded the deepest recession after World War II, when GDP dropped by 4.7%. The reason for both the steep fall and the subsequent fast rebound of economic activity in Germany can be seen in its dependence on external trade. While the sharp drop in world trade quickly translated into a plummeting of exports, industrial production and hence investment in Germany, the sharp rebound in world trade, in particular fuelled by high import demand from Asian economies, benefitted the German industry with its regional focus (strong footing in emerging Asia) and its sectoral export structure (focus on high-tech investment goods such as machinery, equipment, and vehicles).

After a sharp decline in 2009, in 2010 exports rose by 14.2%, while imports expanded by 13.0 . Net exports contributed 1.1 percentage points to GDP growth. The strong growth of imports was caused by a pick-up in investment as well as by the import content of rebounding exports. For the forecast period, it is expected that the growth of exports and hence the growth contribution of net exports will moderate somewhat, given the slowdown of external demand. GDP growth may slow down as the quarterly GDP dynamics already suggests (Figure 4) and amount to 2.2%, both in 2011 and 2012.

Figure 4: Germany – Real GDP Dynamics (% change)



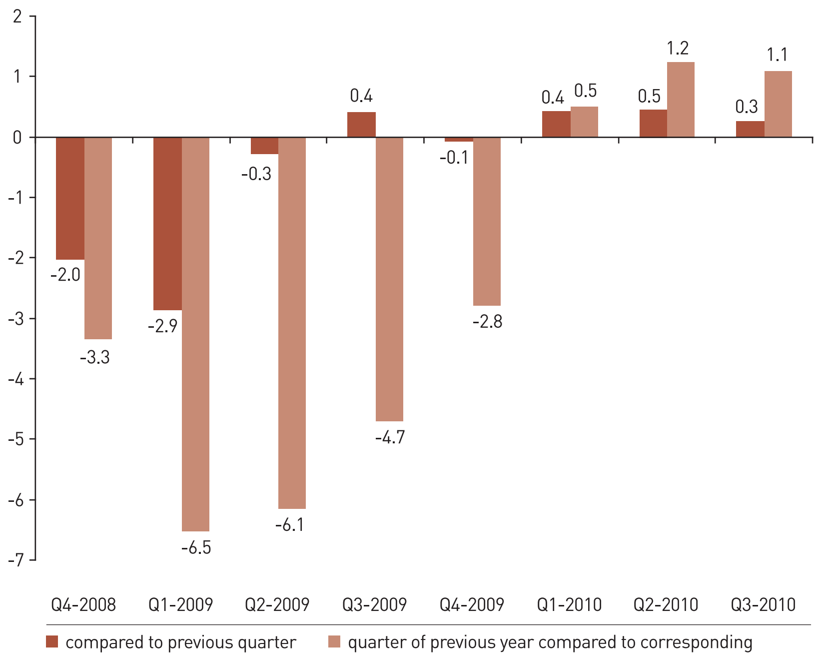
Source: OECD, IHS, Vojvodina-CESS.

The German labour market was surprisingly resistant to the impact of the world economic crisis. After a mild decline in employment and growth of unemployment in 2009, employment picked up and grew by about 0.5% in 2010. The number of unemployed people declined by 9.2%. These developments are primarily the consequence of an increased utilisation of flexible working hours in companies as well as of the use of shorter working hour schemes. In addition, the previous labour market reforms have reduced the level of structural unemployment, in particular in the service sector. The unemployment rate amounted to 6.6% in December 2010. This was the lowest unemployment rate since 18 years. The recorded economic growth in 2010 as well as the anticipated growth in the forecast period shall enable a further decline in unemployment so that it can be expected that the unemployment rate will reach about 6.0% at the end of 2012.

The annual inflation rate as measured by the increase of the Harmonised Index of Consumer Prices (HICP) was 1.2% in 2010. It is expected that inflation will rise somewhat to 1.7% in 2011 and around 2.0% in 2012, on account of increasing energy prices as well as higher wage growth due to the favourable labour market development.

After negative growth rates in 2008 and 2009 (-1.3 % and -5.0%, respectively), the Italian economy recovered gradually and grew by 1.0% in 2010 (Figure 5).

Figure 5: GDP Dynamics – Italy (% change)



Source: OECD, IHS, Vojvodina-CESS.

The manufacturing sector, the decline of which was primarily responsible for the decline of GDP in the previous year, currently contributes to the growth of economic activity, mainly thanks to the increase of exports. In the forecast period, exports will continue to represent one of the key drivers of the Italian economy. After a decline of 19.0% in 2009, exports expanded by 8.0% in 2010. Imports grew by 6.8%, following a drop of 14.5 % in 2009. It can be expected that exports will grow by about 5.5% both in 2011 and 2012. In contrast to exports, private and public consumption should remain sluggish, and gross fixed capital formation will also remain comparatively weak for a recovery phase. Overall, GDP growth should remain positive and amount to 1.1% in 2011 and 1.3% in 2012.

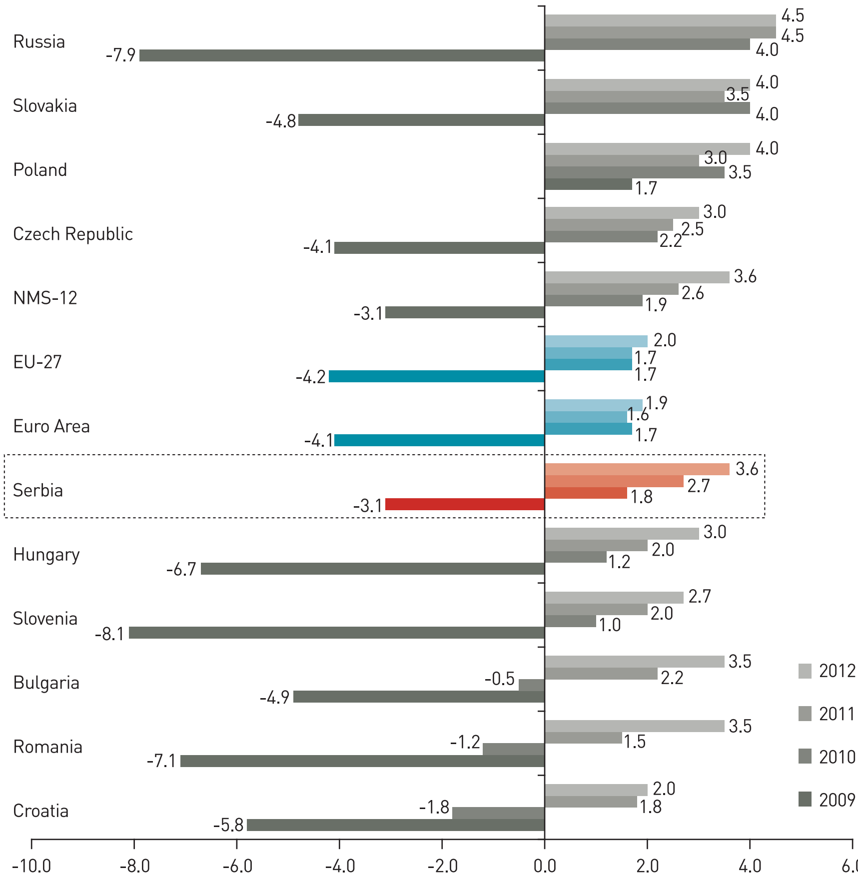
During the first nine months of 2010, employment in Italy was by 0.6% lower compared to the same period of the previous year. In 2010 as a whole, the average unemployment rate climbed to 8.5% and was by 0.7 percentage points higher than in 2009. It is anticipated that employment will grow slowly by 0.4% in 2011 and by 0.9% in 2012, while the unemployment rate will decline slightly to 8.2% in 2012.

The inflation rate increased from 0.8% in 2009 to 1.6% in 2010, mainly as a result of the increase in prices of basic materials and energy. Over the forecast period, inflation will rise a bit further, coming close to the 2,0% target rate of the ECB.

Central and Eastern Europe

After a decline in GDP of 3.1% in 2009, in 2010 the twelve new EU member states (NMS-12) in Central and Eastern Europe recorded a growth of 1.9%. According to the IHS / Vojvodina-CESS forecast, growth will accelerate to 2.6% in 2011 and 3.6% in 2012 (Figure 6).

Figure 6: GDP Dynamics – NMS-12 (% change over previous year)



Source: Eurostat, IHS, Vojvodina-CESS.

Hungary recorded a GDP growth of 0.9% in the first three quarters of 2010. The advancement of economic activity was mainly driven by exports, as a result of the improvement of external demand and especially of the German economy. For 2010 as a whole a GDP growth rate of around 1.0% is expected. In the period from January to November 2010, exports grew by 21.0%, while imports recorded a lower increase of around 19.0%. After seven quarters of declines, in the third quarter private consumption recovered with a rise of 1.2%. Fixed investment, however, declined further. High unemployment (in 2010 the unemployment rate was 11.2%, up from 10.0% in 2009) and the depreciation of the Hungarian currency with its negative impact on real disposable income via higher inflation contributed to sluggish domestic demand. The rise in consumer prices was 4.7% on average in 2010, up from 4.0% a year before. While external demand will gradually weaken, private consumption will recover in 2011, as a result of the income tax reform. The reduction in wage costs and corporate income taxes in conjunction with announced new foreign direct investment, mainly in the automotive industry, will contribute to a decline in unemployment. On the other hand, the necessary policy measures to reduce the budget deficit may dampen growth in the coming years. In 2011 and 2012 a GDP increase of 2.0% and 3.0%, respectively, is expected.

Supported by rising foreign demand, Slovenia, similarly to the other EU countries, recorded a mild increase of economic activity of around 1.0% in 2010. While imports grew by 5.6%, exports increased by 7.0%. However, domestic demand continued to shrink as a result of the bad situation in the construction sector, difficulties in financing investment, and problems on the labour market. Economic growth in 2010 can be attributed to the increase of exports and investment in machinery and equipment that are characterised by a significant import component.

Under the assumption that foreign demand will continue to grow and domestic demand will slowly recover, the GDP growth rate should accelerate to 2.0% in 2011 and 2.7%, in 2012. Foreign debt, which amounted to 115.0% of GDP in 2009, and the necessary budget consolidation, to be implemented in the forecast period, will have a temporary dampening effect on domestic demand.

The recession led to an increase in unemployment. Although in the course of 2010 the unfavourable trend on the labour market slowed down, the number of employed persons is still by 2.3% lower than in 2009. Unemployment continues to grow, and the unemployment rate amounted to 7.2% in 2010. A mild negative trend in the labour market indicators (reduction of employment by about 0.3% compared to 2010 and a marginal reduction of the unemployment rate to 7.1%) is expected for 2011. A more significant improvement may be recorded in 2012, with an increase of employment by 0.2% and a reduction of the unemployment rate to below 7 %.

The average annual inflation rate was 2.1% in 2010 under the influence of increases of energy prices and excise taxes. It is expected that the average inflation rate will rise to 2.7% in 2011.

The anticipated economic growth in Slovenia could slow down if growth in its main trading partners decelerates. According to simulations of IMAD, a decrease of economic growth of Slovenia's main trading partners by 2.2 percentage points would result in a GDP growth rate in Slovenia of 0.5% in 2011, instead of a forecasted 2.4%. Such a development of Slovenia's trading partners would cause a stagnation of exports, while investment would grow by only 1.2%.

Romania is one of the few EU countries that remained in recession during 2010, with an anticipated negative GDP growth rate of 1.8%. This development is due to weak domestic demand as a result of the implementation of austerity measures aimed at fiscal consolidation (such as a 5 percentage points increase in the VAT rate, reduction of salaries and dismissing of surplus workforce in the public sector), lower remittances from abroad and stricter financing conditions for private households and businesses. While domestic demand remained weak, industry benefited from the recovery in the main trading partner countries. As a result, exports increased by 15.0%, while imports rose by around 12.0%. This development led to a positive contribution of net exports to growth. The stand-by arrangement agreed with the IMF at the beginning of the crisis was completed. The National Bank of

Romania will not draw the last installment of EUR 1 billion from the IMF as the international reserves are already at a very comfortable level. Romania will reach a precautionary stand-by arrangement with the IMF and the EU worth EUR 5 billion (EUR 3.6 billion from the IMF and EUR 1.4 billion from the EU). The World Bank will be also part of this agreement and will lend EUR 400 million to Romania.

Following the decline in 2010, GDP may rise by 1.5% in 2011 and by 3.5% in 2012, driven by an expected recovery of domestic demand. An improved absorption of EU funds could significantly benefit infrastructure investment.

The average annual unemployment rate is estimated at 7.4% in 2010, after 6.9% in 2009. For 2011 and 2012, a slight reduction to 7.2% and 7.1%, respectively, is expected. As a result of the increase in the VAT rate, inflation rate rose to 7.9% in December 2010, up from 4.7% a year earlier. The annual average inflation rate amounted to 6.1% in 2010, after 5.6% in 2009.

Croatia was heavily hit by the crisis. After a sharp decline of economic activity by 5.8% in 2009, with a contraction of investment of almost 25.0%, GDP growth remained negative in 2010 (-1.8 %). A significant decline of domestic demand was partly mitigated by the growth of net exports, as imports declined more than exports. The Croatian Government announced large infrastructure projects, but no financial resources have been allocated for them so far.

For 2011 and 2012, a positive growth of the Croatian economy by 1.8% and 2.0%, respectively, is anticipated. This growth will be mainly driven by private consumption and investment. There are first signs of a recovery of domestic demand. Private consumption has been given a positive impetus from the progressive abolition of the so-called "crisis tax", which was introduced in 2009, and lending activity is slowly increasing. It is expected that imports will grow more than exports in the forecast period so that net exports will turn negative. The accession of Croatia to the EU should be accompanied by an increase of investor trust, hence larger inflows of foreign direct investment can be expected.

The labour market reacted slowly to the recession until 2010, when the unemployment rate reached 11.0%. It is expected that employment will grow slowly in 2011 and 2012, and hence the unemployment rate may decline to 10.0% in 2012.

Russia

The devastating drought and forest fires in the summer of 2010 led to a slowdown of economic growth in Russia in the course of the year and an increase in the inflation rate in the third quarter. Domestic and external demand registered a dynamic development. Fixed capital formation rose moderately, mainly due to the expansion of energy sector investment, which contributed to growth together with exports. A growth rate of 4.0% is thus estimated for 2010.

The recovery in international demand for raw materials and high oil prices will support the development of the Russian economy in the coming years. The volume of Russian exports is expected to grow slower, as the expansion of oil production will slowdown. A stronger dynamic can be expected for the growth of natural gas exports. A self-sustained, consumption-led recovery should gradually take hold as the adjustment of bank balance sheets appears to have been implemented, and banks are cautiously expanding lending.

Consumption of private households will be supported by gradually rising real wages and lower unemployment. Russia continues to be vulnerable to the volatility in capital flows and global risk appetite. For instance, the euro crisis in May 2010 led to a rise of volatility in the Russian stock markets and downward pressure on the rouble.

The fiscal challenges in Russia will be to ensure that the large fiscal stimulus (about 9 percent of GDP) is unwound as the global economy gathers strength. Given the composition of government spending, reversing the fiscal stimulus will be difficult without undertaking significant public sector reforms that allow savings in socially sensitive areas such as health care, social protection, and pensions.

The more flexible exchange rate regime, alongside cuts in policy interest rates, has helped to deter speculative capital inflows. Over the medium term Russia is facing challenges such as to improve the investment climate and diversify the pattern of growth, by reducing its dependence on oil revenues. Additionally Russia has to reform its public administration and civil service and implement a judicial reform.

It can be expected that the inflation acceleration will continue in 2011, which will make policy rate hikes necessary, while unemployment will be on a downward path. Increased investment and a further recovery in consumer spending should allow a GDP growth of 4.5% both in 2011 and 2012.

Table 1: International Environment (% change over previous year)

	2009	**2010**	**2011**	**2012**
Percentage change over the previous year				
World trade	-11.1	12.1	5.5	7.0
GDP, real				
Germany	-4.7	3.6	2.2	2.2
Italy	-5.0	1.1	1.1	1.3
USA	-2.6	2.8	2.1	2.7
Euro area	-4.1	1.8	1.6	1.9
NMS-12	-3.1	1.9	2.6	3.6
EU-27	-4.2	1.7	1.7	2.0
Absolute values				
RSD/EUR exchange rate	95.9	103.5	105.3	105.3
RSD/USD exchange rate	66.7	79.3	79.3	79.3
Oil price (US dollar / barrel Brent)	61.3	79.4	85.0	90.0

Source: Eurostat, IMF, OECD, CPB, IHS.

CURRENT ECONOMIC SITUATION IN SERBIA AND OUTLOOK

2

Overview

Due to strong exports and the adoption of timely and appropriate measures in agreement with the IMF, the Serbian economy picked up in 2010, after recording a decline in 2009.

Private consumption, as the key driver of GDP growth in the pre-crisis period, slumped, due to disruptions in the credit supply and capital flows from abroad in the wake of the global financial crisis. In each quarter of the year 2010 seasonally adjusted GDP recorded positive growth over the same quarter of the previous year, hence the economy has overcome the recession. According to the IMF, from 2013 onwards GDP growth should return to its pre-crisis level and record annual growth rates of about 5.5%.

After recording monthly positive growth rates during January to September 2010, industrial production showed a downward trend in the last months of 2010. However, it increased by 3.2% in the period January to November 2010 compared to the same period of the previous year.

As a result of the rather weak domestic demand there were no significant inflationary pressures in 2009. Consumer prices rose by 5.9%. At the beginning of 2010, the National Bank of Serbia (NBS) adopted the target inflation rate in the range of 6.0%+/-2%. But Serbia once again ended the year outside the NBS target range, with a CPI inflation of 10.3 %, in December. It seems that most of the depreciation pass-through effect has already been incorporated in the consumer prices. The CPI figures for the end of 2010 / beginning of 2011 mirror the effects of the depreciation of the national currency (dinar – RSD) at the end of the year. In annual terms, the RSD lost 9.1%, which improved the international price competitiveness of Serbian goods on the world market and thus helped exports. But, on the other hand, the devaluation created significant inflationary pressure.

In 2010 the budget deficit rose by around 20.0% compared to the previous year, amounting to RSD 107.7 bn. Nevertheless, at about 3.5% the budget gap as a share of GDP came significantly under the threshold of 4.8%, as agreed with the IMF for 2010.

For the forecast period a more balanced growth pattern can be expected. The weaker dinar should continue to support competitiveness and hence exports, but on the other hand it creates inflationary pressures. Rising exports will support manufacturing. As in addition banks will be less reluctant to provide credit, investment activity should pick up. Private consumption will be supported by the – albeit only gradual – improvement on the labour market and by higher real wages, in particular in 2012. In 2012 real wages will be supported by the abating inflation. Taken together, while in 2010 growth was almost exclusively driven by external demand, in 2011 and 2012 domestic demand should become the second growth pillar of the Serbian economy.

The agreement with the IMF and the application for EU membership have been important decisions for the Serbian economy. The agreement with the IMF will expire in April 2011. The seventh and last review will take place in early 2011. At the sixth review the government adopted the following targets: a budget deficit of 4.1% of GDP in 2011, a raise of pensions and public sector wages by 2.0% in January followed by two more increases in 2011, freezing subsidies at 2010 levels, and boosting the transfers to local authorities by 25.0% in 2011 from the levels envisaged in the 2010 budget. Also, new fiscal rules have been adopted, which provide for a continuous reduction of the budget deficit over the coming years to reach 1.0% of GDP in 2015.

Serbia has sent its application for EU membership to the EU Council. This made a unanimous decision on October 25, 2010 to forward Serbia's membership application to the European Commission for an opinion, which is considered an important step in the EU entry talks. The European Commission is expected to give its opinion on Serbia's membership bid in the second half of 2011. In November 2010 the EU Commission published the 2010 progress report on the country's efforts to join the Union. Although the Commission praises Serbia's efforts in bringing the country closer to the EU, a number of challenges are still remaining.

Economic activity – GDP

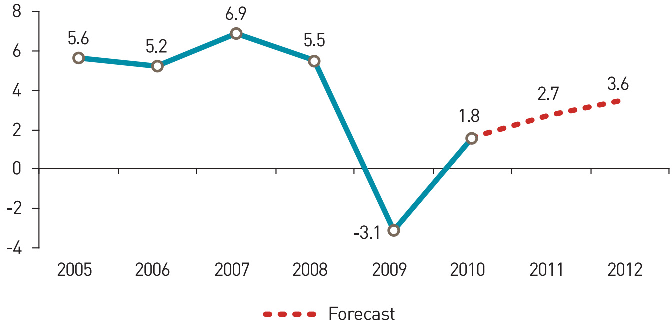
Following a GDP drop of 3.1% in 2009, positive GDP growth rates were recorded in all quarters of the year 2010, compared to the same quarters of the previous year. A modest growth of economic activity of 0.3% in the first quarter was followed by significant higher growth rates in the second and third quarters (2.0% and 2.7%, respectively). For the fourth quarter, GDP growth has been estimated at 1.7%, and for the whole year 2010, at 1.8%. The main driver of growth in 2010 was external demand. In addition, the depreciation of the national currency, RSD, has helped the rise of exports.

From the production perspective, the highest growth rate of gross value added in the third quarter 2010 was registered in the following sectors: Transport, storage, and communications (7.4%), financial intermediation (8.7%), and manufacturing (5.0%). The largest decline was registered in the construction sector (-9.2%) and in the production of electricity, gas, and water (-4.4%). After a significant decline in 2009, the sector wholesale and retail trade started recording growth from the second quarter of 2010 onwards, so that the average annual growth rate amounted to 2.0%. The growth in this sector points to the beginning of the recovery of domestic demand.

In 2010, industrial production grew by 3.0% compared to the previous year; manufacturing rose by 3.9%. Within manufacturing, the strongest growth was registered by the manufacture of basic metals (21.0%), the manufacture of electrical machinery and apparatus (16.4%), mining and quarrying with 13.8%, and the manufacture and distribution of electricity, gas, and water with 4.3%. The manufacture of electrical machinery and apparatus registered also the highest growth in exports in 2010.

Based on the already registered positive trends in the Serbian economy and assuming that, despite the recent slowdown in external demand and in Serbia's main trade partners, Germany and Italy, exports will continue to be a driver of economic growth in the forecast period it is expected that the economy of Serbia will grow by 2.7% in 2011 and by 3.6% in 2012 respectively. In the forecast period, exports will be more and more supported by investment and private consumption as growth drivers.

Figure 7: Real GDP growth rate (%)



Industrial production will continue its robust growth in the forthcoming period. The Government plans to allocate around 1.0% of GDP in 2011 for assistance to the development of industrial production.

According to the data for the first three quarters of 2010, unit labour costs (in EUR) have stabilised at a level that is significantly lower than the level recorded before the beginning of the crisis (due to the depreciation of the dinar and a strong reaction of the labour market to the recession). This increases the competitiveness of the domestic economy and may lead to further increases of exports.

Foreign trade

According to the Statistical Office of the Republic of Serbia, in 2010 overall foreign trade (exports + imports) amounted to EUR 20,015.3 million, which represents an increase of 14.6% compared to the previous year. Exports of goods and services in EUR grew by 24.0% in 2010 compared to 2009, while imports rose by 9.7% during that same period. The significant growth of exports in 2010 was the result of the sizable increase of exports of products made of ferrous and non-ferrous metals, as well as of agricultural products. Export growth was driven by the rise of foreign demand and dinar depreciation. The trade deficit amounted to EUR 5,228.5 million, which implies a reduction of 5.7% compared to 2009.

In 2010, the highest share in exports belonged to the SITC sections[2] iron and steel (EUR 720.3 million with a growth of 56.6% compared to the previous year), non-ferrous metals (EUR 525.4 million with an increase of 66.8%), electrical machinery and apparatus (EUR 446.5 million with a rise of 53.1%), cereals and cereal preparations (EUR 435.0 million with a rise of 27.6%), and vegetables and fruits (EUR 398.0 million with an increase of 23.4%). These five sections represent 34.2% of total exports. The main foreign trade partners for Serbian exports were Italy, Bosnia and Herzegovina, and Germany.

The most important SITC import sections were petroleum and petroleum derivatives (EUR 1,137.2 million, with a growth rate of 28.5% compared to the previous year), natural gas (EUR 707.1 million, with a growth rate of 26.8%), non-ferrous metals (EUR 504.3 million, with a growth rate of

2 Sections according to Standard International Trade Classification (SITC).

75.7%), electrical machinery and apparatus (EUR 483.6 million with a growth rate of 14.1%), and iron and steel (EUR 443.5 million, with a growth of 24.4%). The share of these commodity groups in total

imports amounted to 25.9% in 2010. The main foreign trade partners on the import side were the Russian Federation, Germany, and Italy.

Foreign Direct Investment (FDI)

According to the data of the Ministry of Finances, in 2010 the volume of net Foreign Direct Investment flows amounted to EUR 762 million and was thus lower by 45.6% compared to 2009 (EUR 1.4 billion). Having in mind the need for FDI of the Serbian economy, the Government plans to implement a number of measures aiming at improving the business climate and attracting foreign investors. Some of the activities include the completion of the "Guillotine of regulations" project, the adoption of new legislation in the economic field, the clarification of the issue of property rights over land and the restitution of property that has been taken away from the citizens and institutions after World War II, as well as measures against corruption. Considering the above-mentioned measures, it is expected that from 2011 to 2013 the average annual FDI inflow volume will amount to EUR 1.6 billion.

Fiscal policy

In 2010, the budget deficit of the Republic of Serbia amounted to RSD 107.7 billion. This implies a deficit to GDP ratio of about 3.5%. Revenues made up RSD 662.0 billion, and expenditures amounted to RSD 769.7 billion. In 2010 compared to 2009, budget revenues grew by 6.0% in nominal terms and declined by 0.4% in real terms. The growth of revenues is attributed to the increase of tax revenues, primarily the increase of revenues from the value added tax (VAT), amounting to RSD 22.4 billion (an increase of 7.55% in nominal terms), and the growth of revenues from excise taxes, amounting to RSD 15.8 billion (an increase of 13.16% in nominal terms).

Budget expenditures grew by 7.9% in nominal terms and by 1.3% in real terms and amounted to RSD 56.49 billion. The two largest items on the expenditures side, i.e. the costs of employees and the transfers to mandatory social insurance organisations, recorded a slight nominal growth in 2010, by 2.9% and by 1.5%, respectively. In real terms they registered a decline by 3.35% and by 4.7%, respectively. This development is explained by the measures to freeze pensions and salaries in the public sector, implemented since December 2008, as a way of mitigating the negative consequences of the world economic crisis. The expenditures for social protection from the budget rose by 18.5% in nominal terms and by 11.3% in real terms. This growth is attributed mainly to the payment of a lump-sum assistance amounting to RSD 5,000.00 to the employees in the public sector, who receive a monthly salary of less than RSD 50.000,00, and to pensioners whose pension is lower than RSD 30,000.00.

Based on the provisions of the Law on the Budget System, in October 2010 general and special fiscal rules for the public sector were introduced, aiming at providing long-term sustainability of fiscal policy. The general fiscal rules envisage that the target fiscal deficit is to be reduced from 4.7% of GDP in 2010 to 1,0% of GDP in 2015. It was also stated that public debt must not exceed 45.0% of GDP and that the fiscal deficit of a local government can be created to finance public investment. At the same time, it should not exceed 10.0% of its revenues in the respective year. Special fiscal rules regulate the trends in salaries and pensions as well as the method of indexing pensions and salaries in the public sector. The aim was to reduce the costs of pensions to 10.0% of GDP and the costs of salaries in the public sector to 8.0% of GDP. The Law on the Budget System provides for the establishment of the Fiscal Council as an independent supervision body that will issue an opinion on the degree of harmonisation of fiscal policy with the principles and rules of fiscal responsibility.

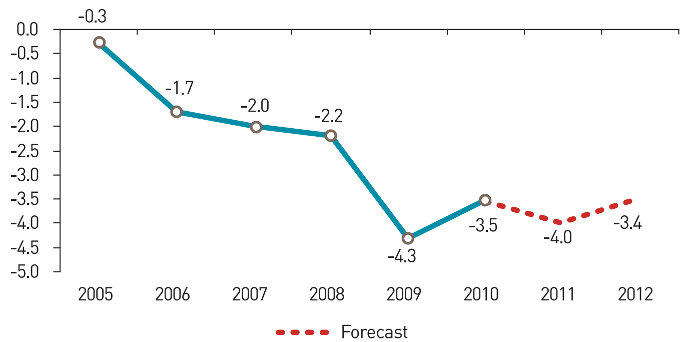
According to the Ministry of Finance, the public debt of the Republic of Serbia amounted to EUR 12.2 billion, by the end of 2010. Compared to the end of 2009, public debt rose by 23.6%. The ratio between public debt and GDP amounted to 41.5% by the end of 2010, which was by 8.6 percentage points more compared to the end of 2009. The growth of public debt can partly be explained by the inclusion into the official data of the loan granted by the IMF by the end of 2009 and partly by the fact that the obligations towards certain countries and financial institutions, which used to have the status of non-regulated obligations, were also included into public debt. The largest share in total public debt, amounting to EUR 10.46 billion (85.9%), refers to direct obligations, while EUR 1.71 billion (14.1%) refer to indirect obligations of the state. The position Public borrowing from abroad (63.9%) accounted for the largest share.

In the coming months, risks to public finances are in particular posed by the development of GDP. According to the analyses of the Ministry of Finances, a reduction in GDP growth of 1 percentage point in 2011 would lead to a lower growth of revenues by 0.35 percentage points, amounting to about RSD 18 billion. A further risk refers to the trends in the foreign exchange rate. These have an impact on both revenues and expenditures, due to the servicing of public debt obligations and to the share of public debt in GDP. Another risk refers to the possibility of activating guarantees based on the repayment of loans of public companies and overtaking of non-guaranteed debts and defaults of public companies – the total amount of guaranteed obligations is EUR 1.4 billion. Finally, the dynamics of interest rates on domestic and international markets determines the amount which has to be paid as interest for servicing public debt obligations. Due to the connection between the reference interest rate of the National Bank of Serbia and the average weighted yield on public bonds, the announced restrictions of monetary authorities and a possible depreciation of the exchange rate could significantly increase the amounts of interest payments on state bonds.

The utilisation of funds obtained from the privatisation of large public companies (Telekom Srbija) should also be considered. There are two possible ways to use these funds – for the repayment of a part of the existing debt, with high interest rates and financing of large infrastructure projects, or for the financing of increased current expenditures (e.g. salaries in the public sector) during the pre-election and election campaigns.

Having the above-mentioned risks in mind, a small increase of the budget deficit is expected in 2011. This should be followed by a constant decline in accordance with the Law on the Budget System and the fiscal rules that have been introduced.

Figure 8: Budget balance (% of GDP)



Employment and salaries

Although the economy of the Republic of Serbia recovered in 2010, this has not been reflected in an improvement on the labour market. Negative employment trends continued, even though they attenuated. According to the data from the most recent Labour Force Survey (total employment = formal + informal) from October 2010, the number of employed people of the working age (15-64 years of age) declined by around 181,000, i.e. by 7.4% in the period from October 2009 to October 2010, while during that period the number of unemployed increased by around 49,000 persons, i.e. by 9.5%. The reason for the large difference between the decline of employment and the increase of unemployment is to be seen in resorting to inactivity. This, in addition to the loss of motivation for actively seeking a job, increases the poverty risk.

Following the usual pattern, the labour market follows the development of GDP with a time lag. However, during the economic crisis the decline of employment was by far more pronounced than the decline of GDP, when overall economic activity dropped cumulatively by 4.7%, while employment decreased by 12.5%[3]. This accentuated decline in employment is attributed, in addition to the economic crisis, to an accelerated process of restructuring and privatisation of companies. Such a strong adjustment of the labour market also points to problems that have partly been inherited from the past and that are to a certain degree attributed to an insufficiently developed private sector in Serbia. One important characteristic of the labour market in Serbia is its duality in the sense of a differentiated behaviour of the private and the public sector: the private sector adapted to the reduced economic activity through dismissing employees, while in the public sector the adjustment occurred largely through a freezing of salaries.

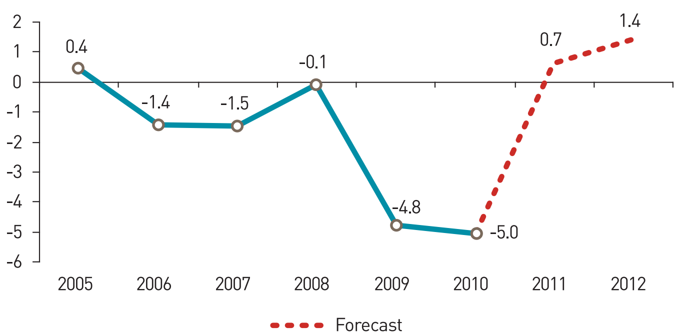
The data on formal employment from the RAD Survey of the Statistical Office of the Republic of Serbia confirm the trends registered by the Labour Force Survey. In the period from September 2009 to September 2010, formal employment decreased by 93,000 persons, i.e. by around 5.0% (from 1,868,000 in September 2009 to 1,775,000 in September 2010). The largest decrease in employment by around 58,000 persons (12.0%) was recorded among entrepreneurs and persons employed by them, while among legal entities the registered decrease in employment was around 35,000 persons

3 Quarterly Monitor of Economic Trends and Policies in Serbia, issue 21, April - June 2010, Foundation for the Advancement of Economics – FREN, Belgrade

(2.5%). The number of formally employed persons continued to decrease till the end of 2010. In December it amounted to about 1,771,000 persons, 1,344,000 of whom were employed in companies, institutions, co-operatives and organisations. There were 427,000 entrepreneurs and persons employed by them. The largest decrease in the average number of employed persons in 2010 compared to 2009 was registered in the manufacturing sector – around 27,000 persons (8.5% within the sector), followed by construction – around 7,000 persons (9.3% within the sector), wholesale and retail trade – around 6,000 persons (3.2% within the sector), and transport and hotels and restaurants – around 2,000 persons per sector (2.2% and 7.6% within the sector, respectively). Positive employment growth was registered only in the real estate sector – around 4,000 persons (4.3% within the sector).

Taking into account the previous trends on the labour market as well as the existing problems - namely discrepancies between supply and demand, high long-term unemployment, low labour force mobility, as well as an insufficiently developed private sector - a slight increase in the number of employed persons by 0.7% is expected for 2011, followed by an increase by 1.4% in 2012.

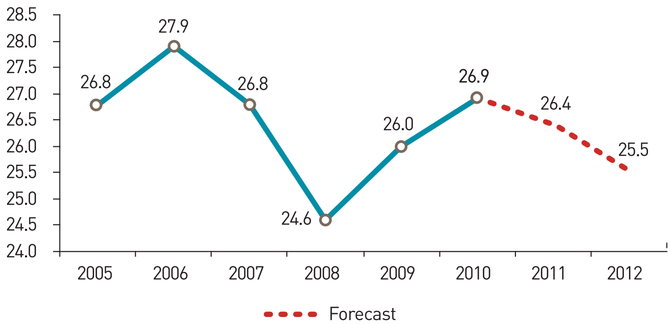
Figure 9: Employment growth (in %)



According to the data of the National Employment Service, the average registered number of unemployed persons in 2010 was 744,222. Compared to 2009, this implies a decline by 2,383 persons or 0.3%, when 746,605 unemployed persons had been registered. The average administrative unemployment rate was 26.9% in 2010, which was by 0.9 percentage points higher than in 2009.

In accordance with the expected economic growth and the projected stabilisation on the labour market, it is anticipated that the administrative unemployment rate will decrease to 26.4% in 2011. For 2012 the forecast implies a slightly more pronounced improvement to 25.5%.

Figure 10: Administrative unemployment rate (in %)



The average salary in 2010 amounted to 34,159 RSD (332 EUR[4]). Compared to the average wage in 2009, this implies a nominal growth rate of 7.6%, while in real terms growth reached 1.2%[5]. In the forecast period, it is expected that both nominal and real gross salaries will continue to grow. In nominal terms, the salaries in 2011 and 2012 will grow by 8.6% and 9.8%, respectively, while in real terms wages are expected to stagnate in 2011 (0.1%) and to grow by 2.5% in 2012.

Figure 11: Nominal wage growth (in %)

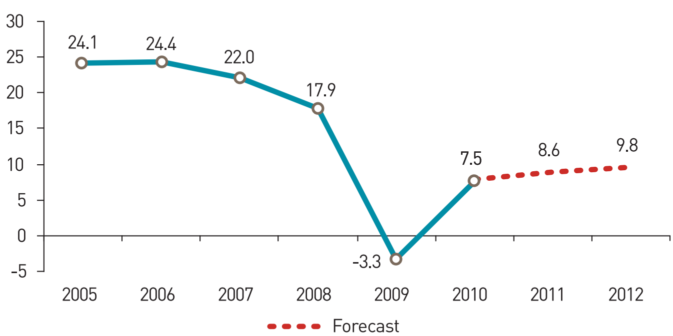
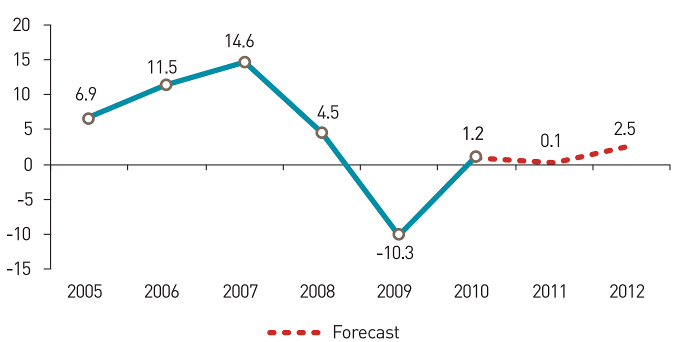


Figure 12: Real wage growth (in %)



4 The value in euro was calculated with the average exchange rate of the National Bank of Serbia for 2010, which was 1EUR=106,6 RSD

5 The real growth rate was calculated using the Harmonised Index of Consumer Prices (HICP).

The highest growth of average net salaries in 2010 was registered in the manufacturing sector (14.4 %) and in the sector mining and quarrying (13.8%). The first place according to the amount of salaries in 2010 is occupied by the sector financial intermediation with RSD 73,382 (EUR 688), followed by mining and quarrying with RSD 49,652 (EUR 466) and the sector electricity, gas and water supply with RSD 46,352 (EUR 435). The lowest salaries were registered in the sector hotels and restaurants with RSD 18,910 (EUR 177).

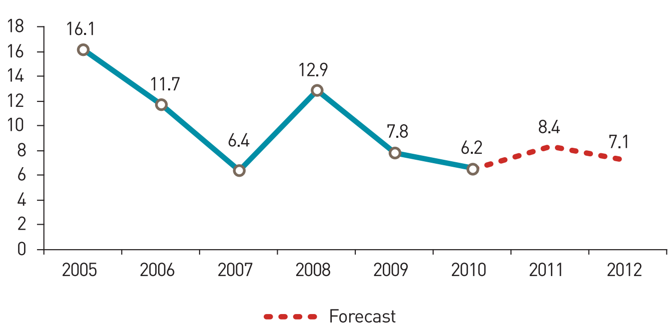
Inflation

Rather weak domestic and foreign demand in the second half of 2009 brought about an untraditional break in inflationary pressures, hence in 2009 the annual average inflation rate reached 7.8%, down from 12.9% in 2008 and close to the midpoint of the targeted range of 8.0% +/-2.0% for 2009.

Several factors contributed to the rather low inflation rate in 2009. A rather large increase in commodity prices at the beginning of the crisis was not passed onto end-consumers, and regulated prices of electricity and heat had been controlled by the Government. Due to the necessity to reduce the budget deficit - not least to the Agreement with the IMF - regulated prices can be expected to be raised in the coming months. Furthermore, prices in the unregulated segment will barely be resistant to dinar depreciation any longer. Also, Serbia is quite dependent on imports of agricultural products, which exhibit increasing price trends on the world markets.

As a result of these more unfavourable factors as compared to the previous year, throughout 2010 the inflation rate rose from 4.8% in January to 10.3% in December. This implied that inflation moved above the NBS targeted range for year-end 2010 (6.0% +/-2.0%). Due to the low start into the year, the annual average in 2010 amounted to 5.9%[6]. According to the NBS, the key factor contributing to the rising inflationary pressure in the last few months was the bad agricultural season, accompanied to a much lesser extent by depreciation pass-through effects and some recovery in the aggregate demand. Food & non-alcoholic beverages (10.7% y-o-y increase in 2010) have a 37.8% weight in the CPI basket. Prices of transport services (11.0% weight in the basket) increased by 9.5%, furniture & household equipment and routine maintenance (4.9% weight) increased by 9.4%, prices of health care (4.25% weight) increased by 8.5%, and prices of recreation and culture (5.2% weight in the basket) rose by 7.6%.

Figure 13: Inflation rate (in %)



6 Annual average inflation rate is calculated as growth rate of average indices (2005=100)

Taking into account the continued depreciation pressure of the dinar as well as the ongoing increases of international prices for oil and agricultural raw materials, the targeted inflation of 4.5% +/-1.5% for 2011 will be difficult to achieve. In our forecast, we expect inflation to reach 8.4% in 2011. In 2012 inflationary pressures might abate, and the CPI should rise by 7.1%.

The Banking sector

Growth of the bank placement based on the domestic sources continued throughout 2010. Foreign currency savings recorded a significant growth of an additional EUR 1.1 billion. Credits in foreign currency increased by an additional EUR 0.4 billion.

Growth of credit to the private sector was especially pronounced in autumn. It is expected that in 2011 the customers of banks will be mainly financed at market conditions, while the subsidisation of credit costs will become less important. In 2011, the program of subsidised loans will be continued to a lesser extent, in line with the recovery of domestic demand.

In November 2010 the share of indexed and foreign currency loans in total loans amounted 70 %; this means that in 2010 the share of indexed and foreign currency loans in total loans has been reduced by more than five percentage points. With the intention to reduce the risks associated with foreign currency loans (increase of the loan value in dinar when the domestic currency depreciates), the NBS aims at achieving a larger share of loans in RSD in total loans.

In November 2010 gross non-performing loans amounted to 17.4% (net 10.4%) of total loans. In 2010, the growth rate of the share of problem loans in total loans was much slower than in 2009: 1.7 pp in the first 11 months 2010, compared to 6.2 pp in the same period of 2009.

It is expected that the ongoing financial restructuring of companies will contribute to improve the debt collection and hence reduce the liquidity problems of the economy.

Exchange rate

Restrained FDI flows together with increased international competition to attract new investment, prompted Serbian companies to increase their international price competitiveness, besides others, by using weakened dinar. However, considering the high level of the economy's euroisation, it is a dangerous strategy to speculate on a weak dinar in an economy burdened by structural problems such as prevalent monopolies and a large state share in the economy.

Furthermore, the NBS drained RSD liquidity by frequent and large interventions on the foreign exchange (FX) market, which eventually resulted in the repo stock hitting its minimum level of EUR 354 million in November 2010 (slightly recovering to EUR 443 million in December).

In addition, improving the international competitiveness by currency depreciation does not seem to be necessary, since the Government stimulus for FDI will have positive effects, as can be seen by the announcements of several foreign companies to invest in Serbia (e.g. Fiat, Gorenje, Benneton, Grammer, Swarovski, CM Manzoni). As a result, it is expected that in 2011 the FDI flows to Serbia will show an upward trend and amount to EUR 1.76 billion including the Telekom privatisation.

Taking all factors influencing the exchange rate together, a slightly stronger dinar can be expected in the forecast period. However, given the uncertainties associated with exchange rate projections, for this forecast we follow the convention which is also applied by several organisations such as the European Central Bank (ECB) or the European Commission in their forecasts to assume that the exchange rate prevailing at the time of preparing the forecast remains constant over the projection horizon. This implies an exchange rate of 105.3 RSD/EUR both in 2011 and 2012.

Table 2: Summary of the Forecast for Serbia

	2010[1)]	**2011**	**2012**
GDP per capita, current prices [dinar]	416,495	457,653	503,161
Real GDP growth rate [%]	1.8	2.7	3.6
Monthly gross wage per employee [dinar]	47,450	51,552	56,582
Monthly gross wage, growth rate [%]	7.5	8.6	9.8
Real gross wage, growth rate [%]	1.2	0.1	2.5
Labour productivity, growth rate [%]	6.6	2.0	2.2
Employment, growth rate [%]	-5.0	0.7	1.4
Registered unemployment rate [%] [2)]	26.9	26.4	25.5
Inflation rate, consumer prices [%]	6.2	8.4	7.1
Budget balance [% of GDP]	-3.5	-4.0	-3.4

[1)] 2010 partly estimated.

[2)] Unemployed persons as percentage of unemployed persons plus total employment (formally employed according to employment survey RAD plus employed in agriculture according to Republic Institute for Health Insurance)

Source: Statistical Office of the Republic of Serbia; IHS / CESS.

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