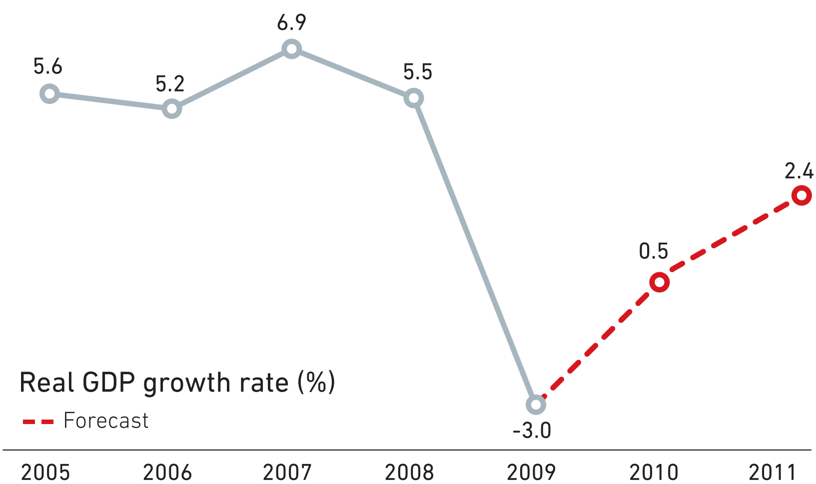
Austrian
Development Cooperation

Economic Forecast
for Serbia 2010 and 2011
Economy on the recovery path



VOJVODINA CESS

Centre for Strategic Economic Studies "Vojvodina-CESS"

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1 SUMMARY: ECONOMY ON THE RECOVERY PATH

After a sharp economic downturn in 2009, a slow recovery is expected for 2010, followed by a moderate acceleration of GDP growth in 2011. The forecasted GDP increase of 0.5 % in 2010 and 2.4 % in 2011 mirrors this development. As a result of the revived foreign demand, industrial production and exports are picking up in a few sectors.

Following a weak development during the first half of 2010, private consumption should get positive impulses during the next months from the government's decision to subsidise cash loans for businesses and individuals and provide assistance to public sector workers and pensioners. These measures should cushion the short-term impact of the implementation of the reforms agreed with the IMF regarding the pension system and the administration which are a condition for the disbursement of the next IMF tranche of EUR 380mn. Investment should also pickup, driven by a major infrastructure development program. Due to the beginning of the Ratification Process of Serbia's Stabilisation and Association Agreement, in the EU Member States a positive impulse on foreign investors' assessment of Serbia in the next months is to be expected.

As the recovery of production is rather subdued and since the labour market follows production with a certain time lag, unemployment will slightly increase to 28.7 % in 2010 and only marginally decrease to 28.5 % in 2011. In line with the National Bank of Serbia's target band, inflation should gradually decline from 7.8 % in 2009 to an annual average of 6.6 % this year and 5 % in 2011. In addition to low demand, the disinflation process will be supported by fiscal policy, since the envisaged measures are planned to rely on expenditure cuts rather than revenue hikes.

As a result of weak foreign demand, the foreign trade deficit narrowed sharply and - together with a relatively high surplus on current transfers and a low deficit on the income side - led to a drastic reduction of the current account deficit during last year. This and next year however, the increase of exports may trigger a growth of imports (mainly intermediate goods to be incorporated in the exported goods), while the remittances from abroad are expected to be lower. As a result, an increase in the current account deficit for this and next year are to be expected.

The budget gap is also increasing, following lower revenues as a result of weak domestic demand and rising unemployment. In line with the results of negotiations between the Serbian government and the International Monetary Fund (IMF), the general budget deficit has been raised to 4.8 % of GDP from 4 %, which has earlier been agreed for this year. Next year, the deficit ratio could decrease to 4 %.

The Serbian dinar (RSD) has been under depreciation pressures in the first half of the year, determining the National Bank of Serbia to intervene in the foreign exchange market in order to defend the currency. These depreciation pressures are going to persist in the rest of the year as companies try to reduce their foreign exchange exposure and FDI inflows remain low. We expect the key interest rate to remain stable at 8 % for the rest of the year, as authorities try to keep inflation low and to stimulate lending in local currency.

The forecast of the Serbian economy is based on the following assessment of the global economic perspectives. Since mid 2009, the world economy has overcome the recession and shows a high growth momentum. The sharp recovery is reflected in particular in the very strong expansion of world trade. However, there are considerable regional differences in growth. Particularly dynamic are the emerging market economies as China, India and Brazil. In the U.S., in the first quarter, GDP increased by 0.7 % compared to the previous quarter, after 1.4 % in the final quarter of last year. The economy of Japan is growing quite strongly, with 1.2 % over the previous quarter. On the other hand, the economic recovery in Europe is modest. In the first quarter, GDP in the Euro area rose by only 0.2 % over the previous quarter. Leading indicators for the second quarter indicate a further dynamic growth of the global economy.

The confidence crisis driven by the high public debt represents a burden for the economies of the Euro area. The volatility in financial markets has increased considerably, share values temporarily dropped and the Euro has lost value. Overall, we consider the European economy to be on a stable, though not particularly dynamic growth path for the rest of the forecast period.

According to our forecast, in 2010 and 2011 the industrialised countries are growing by 2.4 % and 2.2 %. The U.S. economy may expand by 3 % this year and by 2.4 % next year. The Euro area is expected to grow by 1.3 % in 2010, which should accelerate to 1.6 % in 2011. The German economy is growing by 1.9 % this year and 1.7 % next year. After recording a rise of 1.5 % this year, economic growth in Central and Eastern Europe is expected to amount to 2.8 % in 2011.

Risks to the forecast have increased in the recent months driven particularly by the financial sector. A broadening of the confidence crisis would endanger the economic recovery. Economic policy thus faces the task to initiate a timely consolidation process. In the long run expansionary economic policies are not financially viable. Possible loan defaults caused by the real economic crisis could negatively impact the banking sector and contribute to deteriorating financial conditions for households and businesses.

TABLE 1: FORECAST SUMMARY

	2009 [1)]	2010	2011
GDP per capita, current prices [dinar]	402,662	446,242	494,600
Real GDP growth rate [%]	-3.0	0.5	2.4
Monthly gross wage per employee [dinar]	44,182	46,749	48,832
Monthly gross wage, growth rate [%]	-3.3	5.8	4.5
Real gross wage, growth rate [%]	-10.2	-0.7	-0.6
Labour productivity, growth rate [%]	1.8	2.5	2.3
Employment, growth rate [%]	-4.8	-2.0	0.1
Registered unemployment rate [%]	28.3	28.7	28.5
Inflation rate, consumer prices [%]	7.8	6.6	5.0
Budget balance [% of GDP]	-4.1	-4.8	-4.0

[1)] 2009 partly estimated. 2010 and 2011: forecasts
Source: Statistical Office of the Republic of Serbia; IHS / CESS.

2 INTERNATIONAL ENVIRONMENT

2.1 GLOBAL ECONOMIC PERSPECTIVES

In the first half of 2010, the global economic recovery is proceeding as the financial and economic crises of the years 2008 and 2009 are gradually overcome. However, the pace of the expansion varies between the different regions of the world. In some emerging economies, particularly in Asia, the expansion is very dynamic and in some countries there is even the danger of overheating. In the industrialised countries, on the contrary, the recovery proceeds slowly and is mainly driven by external demand, by the policy stimuli and by the inventory rebuilding.

The relatively early and strong recovery of production and demand in the Asian emerging markets in the year 2009 induced noticeable effects in the developed countries, where external demand markedly contributed to growth. Although in the emerging markets production contracted in the autumn of 2008, in some cases quite strongly, the overall impact of the financial crisis on their medium-term growth pattern was quite limited, mostly due to their solid financial sectors and a generally favourable macroeconomic environment.

In this respect, a decoupling of the major emerging economies from the developments in the industrialised countries can be observed, where the aftermath of the financial crisis is still being felt. Since summer 2009, when financial markets in Europe and the United States witnessed a considerable relaxation, there has been seen only little improvement. In addition, financial markets worry now about public finances. Financial investors are currently seeing, although only for some countries, significant risks of insolvency. Sovereign debt is currently rising strongly almost everywhere. This brings fiscal consolidation in the developed and Eastern European countries to the foreground of economic policy in the medium term.

The aftermath of the financial crisis will continue to dampen the spending willingness of private households and companies for a longer time, especially there where the financial and real estate sectors were facing a structural crisis. But even in the countries which were particularly affected by the collapse of exports during the crisis, production should only recover slowly from the heavy losses.

Since the autumn of 2009 the global financial system has become more stable, however it is still weak. The high indebtedness of some countries in the Euro area represents an additional burden for the European financial markets.

In the developed economies economic activity is likely to remain at a low level in the current and next year. Under a growth scenario with a modest economic expansion the situation on the labour market will only gradually improve.

The forecast assumptions concerning the external environment are summarised in Table 2.

TABLE 2: INTERNATIONAL ENVIRONMENT

	2008	2009	2010	2011
Percentage change over the previous year				
World trade	2.1	-12.7	13.0	7.0
GDP, real				
Germany	1.3	-4.9	1.9	1.7
Italy	-1.3	-5.0	0.8	1.0
USA	0.4	-2.4	3.0	2.4
Hungary	0.6	-6.3	-0.5	3.0
Slovenia	3.5	-7.8	1.0	1.5
Romania	7.3	-7.1	0.0	2.5
Croatia	2.4	-5.8	0.0	2.2
Russia	5.6	-7.9	5.0	5.0
Euro area	0.6	-4.1	1.3	1.6
NMS-12*)	3.9	-3.1	1.5	2.8
EU-27	0.7	-4.2	1.3	1.7
Absolute values				
RSD/EUR Exchange rate	82	94	104	112
RSD/USD Exchange rate	56	67	82.5	92
Oil price (US dollar / barrel Brent)	97.5	61.7	80.0	85.0

2010 and 2011: forecasts and assumptions
*) Countries that joined the EU in 2004 and in 2007, respectively.
Sources: Eurostat, IMF, OECD, CPB, National statistical offices; calculations and assumptions by IHS and CESS.

2.2 FORECASTS FOR SELECTED COUNTRIES

In the **United States,** the economy will remain on an upward path during the forecast period; however, following the strong expansion in the second half of last year, economic growth will be comparatively slower. The **Euro area** is probably going to be an economic laggard in the current and next year. Some countries, where the desperate situation of public finances will force governments to implement sharp consolidation measures, will even remain in recession. On the other hand, in the emerging markets the expected economic expansion will be strong.

According to our forecast, world production will increase by 2.9 % in 2010 and by 2.7 % in 2011 after a reduction of 0.9 % in 2009. Following a decrease of 12.7 % in 2009, world trade is expected to expand at a rate of 13 % in 2010 and 7 % next year. The price environment is likely to remain calm this year, although the increase in inflation due to the rising oil prices may turn out to be somewhat higher in 2010 than in the past year.

In the **Euro area** overall economic output shrank by 4.1 % in 2009. The world-wide economic recovery should allow a GDP growth of 1.3 % in 2010 and 1.6 % in 2011. The global economic upward trend led to increases of raw material prices. Oil price rose in February to an average of 85.8 USD. It was thus higher by around 70 % than in the same period of the previous year. The prices of raw materials excluding energy rose by 26 % over the previous year. After recording an annual average of 61.7 USD in 2009, the oil price (Brent) is expected to rise to 80 USD per barrel in 2010 and 85 USD per barrel in 2011. The exchange rate between the dinar and the euro should stabilise at 104 RSD/EUR, after an annual average of 94 RSD/EUR in 2009. Regarding the exchange rate between the dinar and the US dollar, values of 82.5 RSD/USD in 2010 and 92 RSD/USD in 2011 are expected.

The global demand break-down left deep traces in the **European Union** in 2009. In the **EU-27** and in the **Euro area** the decline of economic production amounted to 4.2 % and 4.1 %, respectively. The German and the Italian economies were strongly hit by the slump in global demand, and consequently of world trade. In 2010, GDP in the EU-27 and in the Euro area may expand by 1.3 %, in 2011 growth may reach 1.7 % and 1.6 %, respectively.

Last year, investors were very cautious in undertaking private investments. Falling inflation and bad economic prospects were the main reasons for the European Central Bank to lower the key interest rate to 1 % in May 2009. Following that step, no further interest rate cuts took place till the end of the year. In 2009 the key interest rate thus recorded the lowest level since the introduction of the common currency in the year 1999. In 2010, the strongest growth driver for the economies of the **Euro area** will most likely be external demand from the countries outside the Monetary Union. From this the export-oriented economies such as Germany will benefit the most.

Consumer demand remains depressed because of the high unemployment and the slow growth of incomes. Due to the weak domestic demand we do not expect further interest rate cuts in the coming months. Inflationary pressures could however rise due to increasing prices of raw materials. There is no price pressure to be expected from domestic demand.

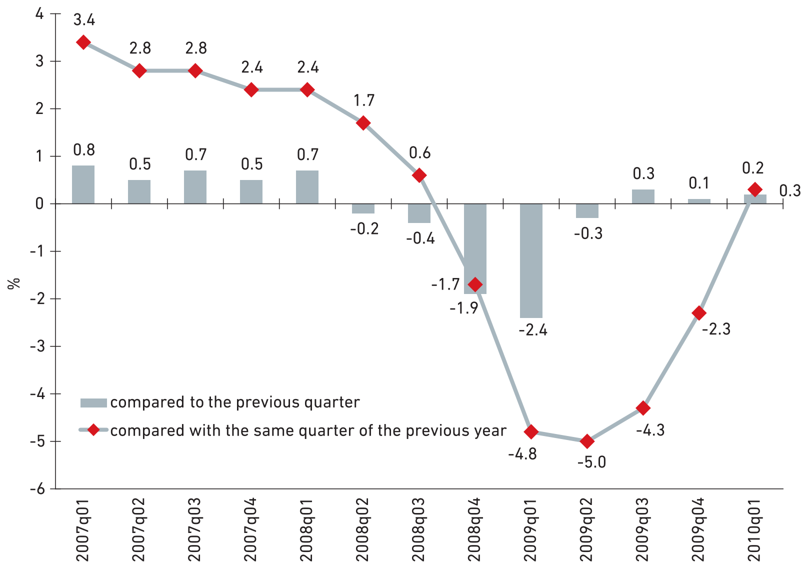
After strong growth in the third quarter, the upswing in the **Euro area** almost came to a temporary standstill in the fourth quarter. GDP rose by around 0.1 % over the previous quarter. From a year earlier, it has however shrunk by 2.1 %. Only export demand rose compared to the previous quarter.

In the **European Union** and in the **Euro area** confidence indicators improved steadily during the first quarter of 2010, which suggests a modest GDP growth. After the stagnation in the fourth quarter, the EUROFRAME-Growth-Indicator for the Euro area shows no acceleration in its upward trend. In particular, building activity recorded losses in some countries due to the cold winter. At the same time, the situation in industry relaxed, somewhat. According to the first release of GDP figures for the first quarter, seasonally adjusted real GDP grew by 0.2 % both in the Euro area and the entire EU. Leading indicators point to a stronger economic recovery in the second quarter.

The ifo indicator for the business climate in the Euro area rose in the first quarter of 2010 for the fourth consecutive time. Both the judgment on the current economic situation and the expectations for the next six months have brightened. Business climate has particularly improved in Germany, Italy, Austria, Belgium, and the Netherlands. On the other hand, it has deteriorated in France, Portugal, Slovenia, Greece, and Cyprus.

In March 2010 the unemployment rate was 10.0 % in the Euro area. The highest unemployment rate recorded Spain with 19.1 %. The lowest rate was registered in the Netherlands with 4.1 %. The inflation rate in the Euro area, measured by the increase in the Harmonised Index of Consumer Prices (HICP), was 1.5 % in April. The lowest inflation rates were observed in Ireland and the Netherlands with -2.5 % and 0.6 %, respectively. In comparison, prices in Austria rose by 1.8 %, while with 3.1 % and 4.7 %, respectively, Luxembourg and Greece recorded the highest inflation rates.

FIGURE 1: EUROPEAN UNION – REAL GDP GROWTH (% CHANGE)

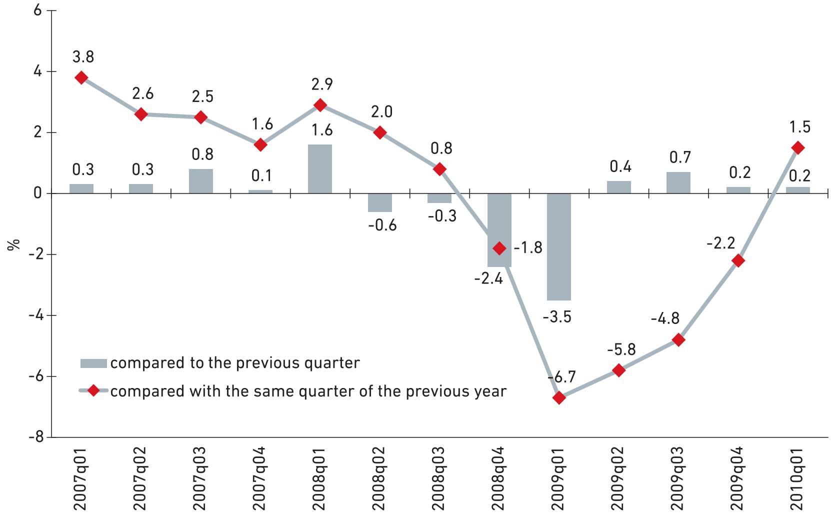


Source: Eurostat, IHS / CESS.

Germany was hit particularly hard by the economic and financial crisis. GDP shrunk by 4.9 % in 2009, mainly driven by the slump in exports due to the declining world trade, and by a sharp contraction of investment. After a sharp decline in the first quarter of 2009, the economic environment improved during the year. The impetus came from world trade and the economic stimulus packages in Germany and abroad.

Despite the strong euro, German exports increased steadily. Export goods, such as machinery, equipment, vehicles, and other capital goods were demanded particularly in Asia and the Arab world. Due to the dynamic growth in the second half of 2009, the German economy managed to regain already a quarter of the production slump. For 2010 and 2011, a moderate economic recovery is likely. Accordingly, GDP could rise by 1.9 % in 2010 and 1.7 % in 2011. The recovery is again likely to be driven by exports. Consumer spending could grow again, however slowly, due to the end of the stimulus package and the further deteriorating labour market conditions. The prices are expected to pick up by 0.9 % in 2010 and 1 % in 2011. Unemployment should fall slowly and reach 7.5 % in 2010 and 7.4 % in 2011, after recording 7.6 % in 2009.

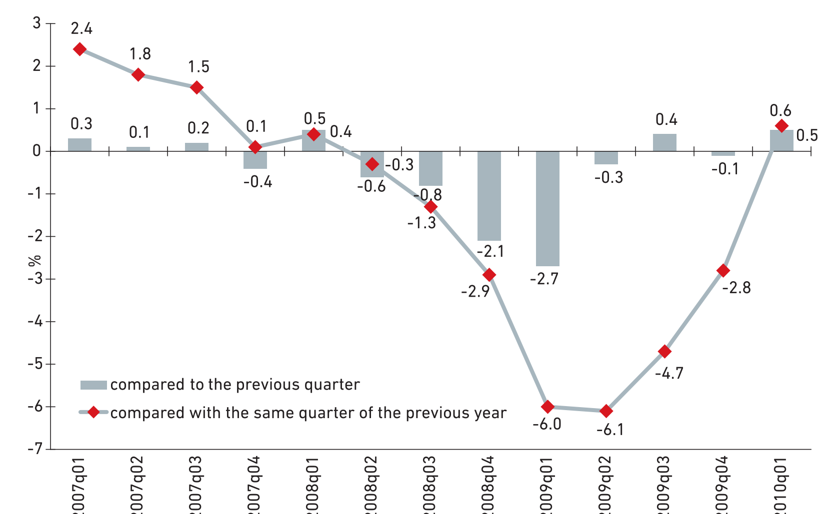
FIGURE 2: GERMANY REAL GDP GROWTH (% CHANGE)



Source: Eurostat, IHS / CESS.

Italy's GDP shrunk by 5 % in 2009. The export-oriented industries suffered the largest drop, and due to the low capacity utilisation also investment declined significantly. After the drastic decline in the first half of the year, the economy stabilised in the summer months. Exports recorded a slight revival, and the automotive and machinery industries benefited from public assistance programs and tax reliefs. In 2010, economic momentum will remain weak. A slight positive impact is expected to come from domestic demand. With the revival of the domestic and foreign demand, investment is expected to recover gradually. The prospects for the construction industry for the current year remain however bleak. Labour market conditions could brighten somewhat during the year. Private consumption is recovering slowly. As a result, the Italian economy could grow by 0.8 % in 2010 and 1 % in 2011. Inflation should be moderate with a CPI rise of 1.4 % in both years 2010 and 2011.

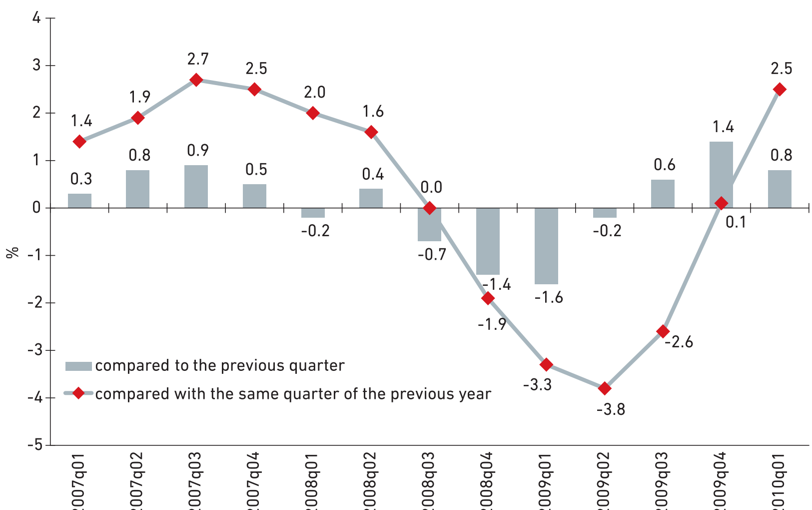
FIGURE 3: ITALY REAL GDP GROWTH (% CHANGE)



Source:
Eurostat, IHS / CESS.

The ***US*** economy shrunk by 2.4 % in 2009. Household demand, which accounts for 71 % of US GDP, fell for the second consecutive year. The decrease is due to high unemployment and negative wealth effects regarding both real estate and financial assets. The largest decline was, however, recorded for investment in equipment and construction. The comprehensive economic stimulus packages that the government has implemented drove the budget deficit significantly up. Since mid-2009 the US economy entered a growth path which continues in the current year. We expect for 2010 a GDP growth of 3 % and for 2011 a GDP rise of 2.4 %. Private consumption will grow only slightly due to the high unemployment and the high indebtedness of households. Because of the existing free production capacity, equipment investment is likely to grow only slowly. Exports, by contrast, will continue to show a strong momentum. However, rising raw material and energy prices and increasing demand may contribute to a pick-up of inflation. The Federal Reserve may raise interest rates in the forecast period, however, this is expected to happen only when the economic recovery has taken hold and the unemployment rate falls again.

FIGURE 4: USA REAL GDP GROWTH (% CHANGE)



Source: Eurostat, IHS / CESS.

The global economic crisis was felt in 2009 also in ***Latin America***. According to the IMF, aggregate GDP of the region contracted by 1.8 %. The decline was thus less dramatic than in the developed economies. Employment programs, tax cuts, and low borrowing costs contributed to the faster than expected recovery of the Brazilian economy. At the beginning of 2010, domestic demand is proving to be comparatively dynamic. The economic efficiency of current high capital inflows is mirrored by strong employment growth. The IMF expects that Brazil could achieve a GDP growth of 5.5 % in 2010, after a decline by 0.4 % in 2009. With the increasing domestic and foreign demand, the Mexican economy could grow by 4 % in 2010. Due to increasing international demand for commodities, exports of the entire region may rise again in 2010, and aggregated GDP is expected to grow by 4 %.

The ***Asian emerging economies*** have led the world economy out of the crisis. The economies of ***China*** and ***India*** were driven by domestic demand, supported by extensive fiscal stimulus programs. China and India thus achieved strong economic growth in 2009, with growth rates of 8.7 % and 5.6 %, respectively. In 2010 China's economy is expected to grow by 10.5 %, driven by rising investment and private household consumption. An additional impetus comes from foreign trade. The biggest challenge for Chinese economic policy is to avert a possible overheating. Currently, housing prices and credit demand are rising sharply. In India, according to the government the economy may grow by 8.2 % in 2010. In both countries, inflation pressure is rising, therefore a more restrictive monetary policy may be considered. The Asian "Tiger countries", whose economies have a very high degree of openness, have rapidly overcome the drastic economic downturn which they suffered at the beginning of 2009. All countries of the region registered positive economic growth in the fourth quarter of 2009. For 2010, the economic development is expected to remain robust. The IMF expects for the Asian emerging economies, including China and India, a GDP growth of 8.4 %, after 6.5 % in 2009.

2.3 CENTRAL AND EASTERN EUROPE

Last year the development of the economies of Central and Eastern European EU member and candidate countries was strongly influenced by the global financial and economic crisis. Following a GDP contraction of 3.1 % in 2009 in the 12 new EU Member States (NMS), it is to be expected that the economies of these countries will recover slowly in 2010 and 2011. Their GDP growth may thus reach 1.5 % and 2.8 %, respectively. The upswing in the Euro area is expected to support the recovery of the economies of the NMS, particularly in countries with a high degree of openness such as the Czech Republic, Slovakia, Hungary, and Slovenia. Net exports will be the key growth drivers in the forecast period. Private consumption and investment, which are often financed through loans, are likely to remain weak in 2010. In addition, the existing free production capacities will lead to the postponement of investment plans in many companies. As a result of the weak domestic demand, the high current account deficits have halved in 2009. Currently, the high budget deficits are posing new challenges in the NMS. Since the labour market responds to changes in production with a delay, a further rise in unemployment during the forecast period is to be expected.

In ***Hungary***, GDP contracted by 6.3 % in 2009. GDP fell in the fourth quarter over the third quarter by 0.4 % and compared with the same quarter of the previous year by 5.3 %. This decrease is due to a further deterioration in domestic demand, in particular a dramatic fall of private household consumption and fixed investments. After having declined in the previous quarters, exports recovered in the fourth quarter and increased by 3 %, while imports decreased by 2 %. The unemployment rate rose to 11 % in March 2010, by 1.4 percentage points higher than a year earlier. The rise in consumer prices accelerated to 5.7 % in April, after recording a 3.2 % growth a year earlier.

According to the IMF agreement, Hungary must implement substantial fiscal consolidation measures, particularly on the expenditure side. Although the budget deficit target for 2009 was increased to 3.9 % of GDP, Hungary has one of the lowest budget deficits in the region. However, it is to be expected that a renegotiation of the 2010 target (currently 3.8 % of GDP) will become necessary so as to take account of the adverse budgetary impacts of the weak domestic demand. Further fiscal consolidation measures are likely to dampen growth in the coming years. In 2010 a GDP decline of 0.5 % is to be expected, in 2011 GDP may rise by 3 %.

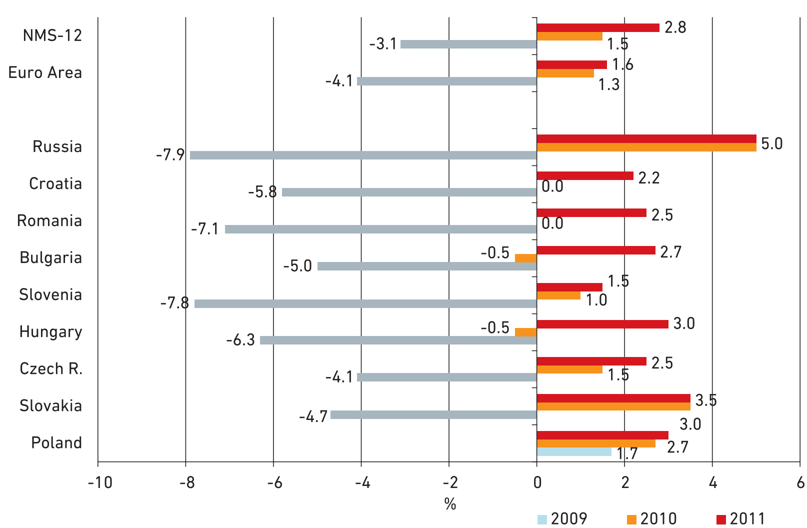
Slovenia's GDP contracted by 5.5 % in the fourth quarter and decreased by 7.8 % in the entire year 2009. Compared with the previous quarter, GDP grew in the fourth quarter by 0.1 %. The strong negative development during last year is primarily due to the sharp contraction of investment by 16.5 % as a result of the sluggish borrowing activity. The decline in exports and imports abated, compared to the previous quarters. Consumption declined by 1 %. The unemployment rate rose by 0.9 percentage points compared to the previous year and amounted to 6.2 % in March 2010. The budget deficit rose to 5.9 % of GDP in 2009 and is likely to remain at a high level (over 6 % of GDP) in the next few years. According to the Ministry of Finance a budget deficit below 3 % of GDP may be achieved no sooner than 2013. As a result of the improved international environment, a GDP growth rate of 1 % and 1.5 %, respectively, may be expected for 2010 and 2011.

In 2009 ***Romania's*** GDP contracted by 7.1 %. In the fourth quarter output decreased by 6.9 % compared to the same quarter of the previous year and by 1.5 % compared to the previous quarter. The decline was due to the recession in the Euro area and the tighter financial conditions for households and businesses. Private consumption fell in the fourth quarter by about 6 % compared to the previous year, and fixed investment contracted by about 30 %. While exports increased by about 3 % in the fourth quarter, imports shrank by about 11 %. The strong negative trend in imports in 2009 led to a 60 % reduction of the current account deficit. Unemployment rose to 7.6 % in December. The implementation of the fiscal consolidation measures agreed with the IMF, particularly on the expenditure side, could dampen growth in the forecast period. Therefore, the expected recovery may be slow, with GDP stagnating in 2010 and rising by 2.5 % in 2011.

In ***Croatia***, GDP fell by 4.4 % in the fourth quarter and shrank by 5.8 % in the year 2009. The sharp contraction was mainly a result of stagnant bank lending and the poor international environment. Due to declining imports in 2009, the high current account deficit fell by 40 % to 5.6 % of GDP. The unemployment rate rose to 9.3 % in January 2010. Due to the weak private consumption and business investment, GDP is expected to stagnate in 2010. In 2011 GDP growth could reach 2.2 %. Croatia could conclude the EU accession negotiations in 2010 and, according to the EU Commission, could join the EU in 2012. The prospect of accession should secure legal certainty for businesses and thus contribute to a revival of investment over the forecast period.

In 2009, the decline of ***Russia's*** GDP amounted to 7.9 %, according to preliminary estimates. This is mainly due to the contraction of global demand for commodities, which account for a large share of Russian exports, but also to the weak domestic demand. Fixed investment and private consumption contracted sharply. The unemployment rate rose to 9.2 % in January 2010. A continuation of the expansionary monetary and fiscal policies and a favourable development in the oil price should support economic growth during the forecast period. As a result, GDP could increase by 5 % both in 2010 and 2011.

FIGURE 5: GDP DYNAMICS (% CHANGE OVER PREVIOUS YEAR)



Source: European Commission, IHS / CESS.

3 CURRENT ECONOMIC SITUATION IN SERBIA

3.1 OVERVIEW

In the first months of 2010, industrial production showed an upward trend. The lower growth rate in February compared to the previous month was determined by manufacturing whose growth was lagging behind the growth rate recorded in January, partly due to the comparison base and partly because of a slower pace of increasing of basic metals production compared to January.

Domestic demand still remains weak, thus undermining a sustainable production growth. External trade of goods also kept an upward trend in February. In January-February 2010 the key driver of Serbian exports was iron and steel, followed by non-ferrous metals.

The National Bank of Serbia (NBS) has adopted the target rate of overall inflation (with a tolerance band), measured by the annual percentage change of the consumer price index. Inflation targets for the period 2010–2012 have been set by the National Bank of Serbia in cooperation with the Government based on the basis of current and expected macroeconomic developments and numerical guidelines for the increase in prices of products and services under the Government's direct or indirect regulation.

Though the weakening of the RSD had generated some inflationary pressures over the past several months, price stability should be maintained in the environment of low aggregate demand and a freeze of public sector wages and pensions.

Strengths

– IMF program represents a key policy anchor;
– FDI to benefit from the announcement of the sale of a 40 % share of the state- owned telecommunications company;
– No sign of meaningful inflationary pressures this year.

Weaknesses

– Domestic demand remains weak;
– Recovery in industrial production is centred on metal production;
– High foreign exchange leverage in domestic private sector.

3.2 FISCAL POLICY AND THE RELATIONS TO THE IMF

At the beginning of 2010, the main characteristic of the Serbian economy remained the weak domestic demand. The International Monetary Fund (IMF) program remains a key policy anchor for Serbia's sovereign rating, supporting the strengths of the Serbian economy. The resignation of Radovan Jelasic as Governor of the Central Bank should not affect monetary policy significantly, and the central bank might cut interest rates further.

A special role in alleviating the effects of the financial and real economy crisis is expected from the stand-by arrangement with the IMF, amounting to EUR 2.94 billion. One of the loan preconditions under the two-year lending facility approved in May 2009 was to limit the budget deficit to 3 % of GDP. However, the rapid deterioration of tax revenues resulted in a widening of the projected budget deficit to 4.75% of GDP in 2009 (i.e. to RSD 132.5 billion up from RSD 90 billion), which has been approved under the IMF revision. Up to now, Serbia has taken tranches of the IMF loan amounting to EUR 1.3 billion. Serbia is also expecting additional 580 million EUR from the World Bank in the next 12 months. From the total sum amounting to 580 million EUR, 400 million EUR will be allocated to the budget, 200 million EUR for the current, and 200 million EUR for the next year.

The Serbian Government has followed the IMF advices and has tried to achieve fiscal sustainability in the long run by accelerating structural reforms, especially in the fields of public administration, pension, health, and the education system. Freezing nominal public wages and pensions, together with reducing employment in the public sector was pointed out as a way to help reducing budgetary expenditures. The IMF suggested also a VAT rise as "the least distorting" measure to provide additional revenues.

The budget deficit at 4.75 % of GDP appears realistic and the government is committed to cut investment spending, if needed, in order to meet the budget deficit target. The main aim of the Serbian economic policy is to reduce the share of public sector wages from 11.5 % of GDP in 2010 to 8 % in 2015 and the share of pensions from 13 % of GDP to 10 % in 2015. Last year's and this year's nominal freezes of public wages and pensions should go a long way to help meet this goal.

3.3 GDP

After recording high GDP growth rates from 2003 to 2008, the worsening international financial market conditions are exposing the Serbian economy to increased risks, more difficult financing conditions and reduced FDI inflows.

In 2009 real GDP declined throughout all quarters (with respect to the same quarter of the previous year - yoy). Following a drop of 4.1 % in the first quarter, GDP contracted by about 4.2 % in the second quarter. In the third and especially in the fourth quarter, the decrease was smaller. In the third quarter GDP decreased by 2.3 % over the same period of the previous year, and in the fourth quarter the decline amounted to 1.6 %. In seasonally adjusted terms, real GDP fell by 2 % quarter over quarter (qoq) in the first quarter 2009. In the second quarter the decline diminished to 0.3 % qoq. After posting positive growth in the third quarter (0.5 % qoq), real GDP again decreased slightly by 0.1 % qoq in the final quarter 2009.

Growth in the transport sector (+7.2 % yoy), largely stemming from telecommunications, together with the financial sector (+5.1 % yoy) stabilised the economy in 2009. On the other hand, declines in construction (-17.1 % yoy), manufacturing (-15.3 % yoy), hotels and restaurants (-10.3 % yoy), and wholesale and retail trade (-8.7 % yoy) were the main drivers of the GDP contraction by 3 % in 2009.

3.4 INDUSTRIAL PRODUCTION

In the first two months of 2010, industrial production showed an upward trend. In February industrial production grew by 2.8 % compared with the same month of the previous year (January: +3.7 % yoy). The lower growth rate in February compared to the previous month was determined by manufacturing (+1.9 % yoy), whose growth was lagging behind the growth rate recorded in January (+8.1 % yoy), partly due to the comparison base and partly because of a slower pace of increasing of basic metals production compared to January. Mining and quarrying grew by 10.2 % yoy, followed by electricity (+3.0 % yoy). Seasonally adjusted production in February indicated that overall industrial output fell by 1.4 % compared to the previous month (January: +1.4 % mom), led by a 2.1 % mom manufacturing fall (January: -0.9 % mom). Domestic demand still remains weak, thus undermining a sustainable production growth.

3.5 EXTERNAL TRADE

External trade of goods kept an upward trend in February, mirrored in the seasonally adjusted monthly exports' growth of 5.7 % compared to the previous month (January: +0.7 % mom), while imports fell by 1.7 % mom (January: +6.2 % mom). This development resulted in exports of 473.6 million EUR and imports of 914.5 million EUR, resulting in a trade gap of 440.9 million EUR. In January-February trade volumes fell by 0.4 % yoy to 2.5 billion EUR, with exports increasing by 13.3 % yoy to 872 million EUR and imports falling by 5.3 % yoy to 1.7 billion EUR. The export-import ratio rose to 52.6 %, up from 44.0 % in 2009.

In January-February 2010 the key driver of Serbian exports was iron and steel (exports rose by 67.3 % yoy up to 109 million EUR), followed by non-ferrous metals (export growth by 67.4% year over year up to EUR 67.6 million). Exports of fruits and vegetables rose by 27.8 % (47.3 million EUR), while cereals exports grew by 13.7 % yoy. The key import products were: gas (168.4 million EUR, +13.6 % yoy), oil (147 million EUR, +26.7 % yoy), coloured metals (56 million EUR, +130 % yoy), and electric machines 58.1 million EUR, falling by 13.7 % yoy).

3.6 FOREIGN DIRECT INVESTMENT (FDI)

According to the Ministry of Finance, in 2007 and 2008, net inflow of direct investment in Serbia amounted to 1.8 billion EUR each year. In 2009, net FDI declined to 1.4 billion EUR. Although earlier this year was expected that the net inflow of FDI to Serbia will show signs of recovery to the level of the previous two years in 2010, and to more significant grow in the 2011, official data from the Ministry of Finance are not so optimistic.

3.7 WAGES AND EMPLOYMENT

In March 2010, the average monthly net wage amounted to 33,508 RSD (336 EUR[1]). This represents a rise of 3.6 % compared to February (32,336 RSD). The public sector saw wages rising by 3.6 % mom and by 3.1 % yoy, respectively, in nominal terms.

In March 2010, average wages over all sectors rose by 10.4 % compared to March of the previous year. The largest increase was observed in mining and quarrying (+28.2 %). Financial intermediation had the lead regarding the wage level with 69,727 RSD (699 EUR), followed by mining and quarrying 50,534 RSD (507 EUR) and electricity 47,403 RSD (475 EUR).

[1] The value of the euro exchange rate is determined according to the National Bank of Serbia, which for March totaled EUR 1 = 99.7 RSD

As a result of the difficult economic conditions, employment decreased and the unemployment rate rose during 2009. On an annual average, the total number of employees fell by 5.5 % compared to 2008. According to the Statistical Office of the Republic of Serbia, in January 2010 1,850,871 persons were employed in Serbia, of which 1,366,256 worked in enterprises, institutions, cooperatives, and organisations. 484,615 persons were employed in private entrepreneurs, self-employed persons and their employees. In January 2010, employment decreased by 6.7 % (yoy) or 132,268 persons.

According to the data of the National Employment Service (NES), the officially registered unemployment rate in January was 26.5 %. The registered unemployment rate increased by 0.6 percentage points compared to the previous month and by 2.2 percentage points compared to the same period of the previous year. By the end of February 2010 767,418 unemployed persons were registered at the NES. Unemployment increased thus by 2.1 % or 15,828 persons compared to the previous month. The share of the long-term unemployed in total unemployment is high in the Republic of Serbia, since at the end of February 63.8% persons belonged to those who have been unemployed longer than 12 months.

3.8 INFLATION

The National Bank of Serbia (NBS) has adopted the target rate of overall inflation (with a tolerance band), measured by the annual percentage change of the consumer price index. Inflation targets for the period 2010–2012 have been set by the National Bank of Serbia in cooperation with the Government based on the basis of current and expected macroeconomic developments and numerical guidelines for the increase in prices of products and services under the Government's direct or indirect regulation. The inflation target, with a tolerance band, is at the level of 6.0%±2% for the end of 2010. At the average level, the target inflation rate with the tolerance band amounts 6.9±2% for 2010, 5.2±1.5% for 2011 and 4.2±1.5% for 2012, respectively. The width of the tolerance band (±2 p.p. in 2010 and ±1.5 p.p. in 2011 and 2012) reflects the interest in the stabilisation of economic activity, as it provides scope for the flexibility of monetary policy in the period ahead without any detriment to its credibility. The tolerance band indicates a comfort zone providing for the fact that there may be many small transitory shocks causing short-term volatility of inflation, but not requiring a monetary policy response.

According to the National Bank Inflation Report (February 2010), growth in regulated prices in 2010 and 2011 will be within the planned ranges of 9±2% and 7±2%, respectively. In the first three quarters of 2010, inflation was expected to revolve around the lower bound of the target tolerance band, most probably undershooting it in the first half of the year. By the end of 2010 and throughout 2011, inflation is expected to revolve around the target. Though the weakening of the RSD had generated some inflationary pressures over the past several months, price stability should be maintained in the environment of low aggregate demand and a freeze of public sector wages and pensions.

Compared to the inflation projection published in the November 2009 Inflation Report, the inflation projection for the first three quarters is slightly lower, while the projection for the remaining period is somewhat higher. In March 2010 the consumer price index (CPI) increased by 4.7% year over year (1.2 % mom), up from 3.9 % in February (0.3 % mom). The inflation target of the National Bank of Serbia for March 2010 was 7.5 %, with a band of ±2%, thus inflation remained under the targeted range and it is likely to have remained below the range in the first half of the year. Compared to March 2009, the inflation rate fell from 9.4 % yoy and rose from 0.4 % mom. Electricity prices rose by 11.5 % and were the main inflation driver, but this will not change the overall picture for 2010. After rising in March, electricity prices are not expected to go up again in the rest of the year. Food prices, with the highest share in the CPI basket (37.8 %), went up by 0.5 % mom, mostly because fruit prices increased by 8.4 % mom. Core inflation amounted to 2.3 % yoy in March 2010 and 2.5 % in February 2010. In March 2009 core inflation amounted to 10.2 % yoy.

3.9 FISCAL POLICY AND EXTERNAL DEBT

After a substantial increase in February 2010 (RSD 15.3 billion), the budget gap declined in March to RSD 4.4 billion due to increases of revenues (+34.2% month over month) and expenditures (+6.6% month over month). The corporate income tax has driven revenues, almost doubling month over month (+EUR 2.8 billion month over month). VAT boosted by EUR 5.5 billion month over month (+28.5% month over month), as March had a few working days more than February (avg. VAT proceeds per day are app. RSD 1.5 billion). Revenues also gained strong support from excises which swell by RSD 3.4 billion month over month (+61.9% month over month), due to excises tax hikes as well as February's lower base. Interest payments recorded the strongest jump in expenditures (+EUR 1.9 billion), being more than doubled month over month. On an annual level, the budget deficit tripled year over year as the pace of expenses growth (+4.5% year over year) was not followed by revenues which even declined (-1.1% year over year) in March 2010.

3.10 EXTERNAL DEBT

External debt rose by 0.7% month over month (6.6% year over year) in February up to EUR 22.9 billion (72% to GDP). The rise was mainly driven by new short term debt by banks, raised by EUR 230.7 million.

3.11 MONETARY POLICY AND INFLATION

In 2010, the Monetary Board of the NBS lowered the key interest rate from 9.5% at the beginning of the year to 8.5% in March this year. March inflation data has occurred because electricity prices rose 11.5%, but this will not change the overall picture for 2010 in which we see a further moderation of inflationary pressures, while the target inflation has been at the level of 6.9% (±2).

After the resignation of the Mr. Radovan Jelasic, the newly elected governor of the National Bank of Serbia (NBS), Mr. Soskic, committed himself to maintain price stability and to preserve dinar's value.

3.12 BANKING INDUSTRY

In January 2010, borrowings from abroad declined (by 199 million EUR) for the first time since the beginning of the "Vienna initiative"[2]) implementation (April 2009). Financing was also turned down by a drop of corporate deposits in the amount of 286 million EUR, after it had bounced back in December (243 million EUR). Contrarily, private households increased their deposits (41 million EUR). In 2009, the average monthly increase had amounted to 107 million EUR. On the other hand, credit didn't suffer so much as it declined by 40 million EUR, whereas corporate local currency (LCY) credits dropped by 51 million EUR while retail credit fell by 12 million EUR.

[2] Meeting of representatives of the National Bank of Serbia and foreign banks operating in Serbia on the Serbian lending market, held in Vienna

A significant repayment of repo operations in February (-251 million EUR) enabled banks to lend more loans (94 mil, EUR, 75% of it to corporate) and also to increase their cash position (128 million EUR). As a result, total assets remained almost stable. After a fall in January, borrowings from abroad increased again (107 million EUR), which was offset by a decline of deposits, which was also mainly caused by corporate operations (-128 million EUR).

3.13 FOREIGN EXCHANGE RESERVES

The National Bank of Serbia's foreign exchange (FX) reserves fell by 130.6 million EUR in March 2010 to 10.4 billion EUR. Together with FX reserves of commercial banks of 1.5 billion, Serbia's total FX reserves came to 12 billion EUR at the end of the month. The strongest outflow of FX reserves referred to NBS interventions on the FX market, which amounted to 190 million EUR in March. This outflow was aimed to mitigate the excessive daily volatility of FX rate and to ensure the uninterrupted functioning of the market. External debt was repaid in the amount of 68.8 million EUR, and the new drawn loans accounted for the highest inflow of 57.8 million EUR, followed by bank's mandatory reserves of 38.5 million EUR.

3.14 FOREIGN EXCHANGE RATE

In March 2010, the RS dinar was relatively stable vis-a-vis the Euro, recording a slight depreciation of 0.1% compared to the previous month. However, going through the month there were a lot of challenges in EUR/RSD trading so the pair definitely broke the record heights above 99.80, but afterwards resumed a gradual stabilization. Late March saw a lot of pressures to the EUR/RSD exchange rate. Firstly, the key interest rate cut to 9% pressed the dinar and at the same day the NBS's Governor Resignation added additional pressure on the RSD, causing the RSD to break the level of 100 RSD/EUR. Soon after NBS's intervention in the foreign exchange market, the exchange rate lowered to 99.6. Dinar liquidity on the money market, drained by NBS's interventions and lucrative yields of Ministry of Finance T-bills, remained important factors influencing the behaviour of currency trading. However, demand remained strong so the NBS mitigated pressures by intervening in any instance where morning trading was below 7-10 million EUR, citing low turnover on the inter-bank market as the reason to sell 10-20 million EUR on occasions. After all, FX trading on the market resulted in 562 million EUR until March 2010.

4 FORECAST FOR 2010 AND 2011

After having been in a deep recession in 2009, a gradual recovery of the Serbian economy is expected for 2010. In 2011, the upswing should gain momentum. However, throughout 2010, the main characteristic of the Serbian economy will remain the weak domestic demand. It is expected that the currency stabilise for the value of 104 RSD/EUR after the last year when exchange rate was 94 RSD/EUR. We expect the key interest rate to remain at 8 % for the rest of the year, as authorities try to keep inflation low and to stimulate lending in local currency. The notoriously high foreign exchange leverage in the domestic private sector might pose a risk to the economic outlook.

Following a weak development during the first half of 2010, private consumption should get positive impulses during the next months from the government's decision to subsidise cash loans for businesses and individuals and provide assistance to public sector workers and pensioners. These measures should cushion the short-term impact of the implementation of the reforms agreed with the IMF regarding the pension system and the administration which are a condition for the disbursement of the next IMF tranche of EUR 380mn. Investment should also pickup, driven by a major infrastructure development program. Due to the beginning of the Ratification Process of Serbia's Stabilisation and Association Agreement, in the EU Member States a positive impulse on foreign investors' assessment of Serbia in the next months is to be expected.

As the recovery of production is rather subdued and since the labour market follows production with a certain time lag, unemployment will slightly increase to 28.7 % in 2010 and only marginally decrease to 28.5 % in 2011. In line with the National Bank of Serbia's target band, inflation should gradually decline from 7.8 % in 2009 to an annual average of 6.6 % this year and 5 % in 2011. In addition to low demand, the disinflation process will be supported by fiscal policy, since the envisaged measures are planned to rely on expenditure cuts rather than revenue hikes.

As a result of weak foreign demand, in 2009 the foreign trade deficit narrowed sharply and – in conjunction with a relatively high surplus on current transfers and a low deficit on the income side - led to a drastic reduction of the current account deficit. In 2010 and 2011 however, the recovering of exports may trigger a growth of imports (mainly intermediate goods to be incorporated in the exported goods), while the remittances from abroad are expected to be lower. As a result, an increase in the current account deficit for this and next year are to be expected.

The budget gap is also increasing, following lower revenues as a result of weak domestic demand and rising unemployment. In line with the results of negotiations between the Serbian government and the International Monetary Fund (IMF), the general budget deficit has been raised to 4.8 % of GDP from 4 % which had earlier been agreed for this year. Next year, the deficit ratio could decrease to 4 %.

TABLE 3: FORECAST OF THE SERBIAN ECONOMY FOR 2010 AND 2011

	2009[1)]	2010	2011
GDP per capita, current prices [dinar]	402,662	446,242	494,600
Real GDP growth rate [%]	-3.0	0.5	2.4
Monthly gross wage per employee [dinar]	44,182	46,749	48,832
Monthly gross wage, growth rate [%]	-3.3	5.8	4.5
Real gross wage, growth rate [%]	-10.2	-0.7	-0.6
Labour productivity, growth rate [%]	1.8	2.5	2.3
Employment, growth rate [%]	-4.8	-2.0	0.1
Registered unemployment rate [%]	28.3	28.7	28.5
Inflation rate, consumer prices [%]	7.8	6.6	5.0
Budget balance [% of GDP]	-4.1	-4.8	-4.0

1) 2009 partly estimated. 2010 and 2011: forecasts
Source: Statistical Office of the Republic of Serbia; IHS / CESS.

GDP

After recording negative GDP growth in 2009, it is expected that the improvement of international financial market conditions and in particular the improving international economic environment which is led by the developing Asian economies and the US will bring GDP growth in Serbia to the positive side in 2010 and 2011.

In 2009, real GDP declined by 3%. For 2010 and 2011, growth rates of 0.5% and 2.4%, respectively, are expected. Due to the financial crisis, from September 2008 until now (Summer 2010) the Serbian dinar devalued significantly against the euro. Though the devaluation supports Serbian exports, this gain in international price competitiveness is not sufficient to compensate for the fall in external demand.

FIGURE 6: REAL GDP GROWTH RATE (IN %)

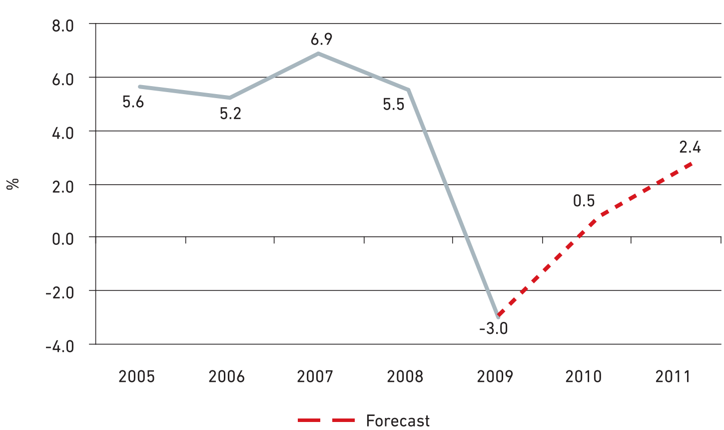
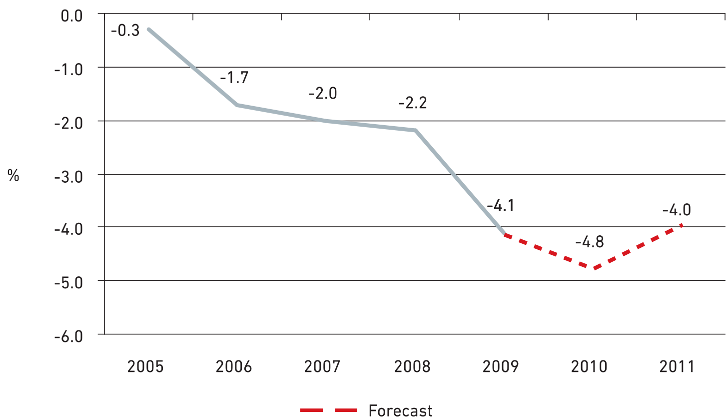


FIGURE 7: BUDGET BALANCE IN RELATION TO NOMINAL GDP (% OF GDP)



As the financial crisis is slowly waning, the conditions for financing investment projects are improving. Financial market conditions and the real economic situation are better than last year, so there is a good precondition for an increase of FDI to Serbia. It is expected that net FDI inflows to Serbia recover to the level of the two previous years already in 2010 and then will rise more significantly in 2011.

Real wages continue to grow at relatively high rates, while the reduction of employment is by far less pronounced than the fall in production. Hence, unit labour costs increase significantly, putting a further strain on investment, in addition to a substantial under-utilisation of production capacities. As a result of all these factors, fixed capital formation fell significantly in 2009.

FIGURE 8: GROWTH RATE OF NOMINAL WAGES (IN %)

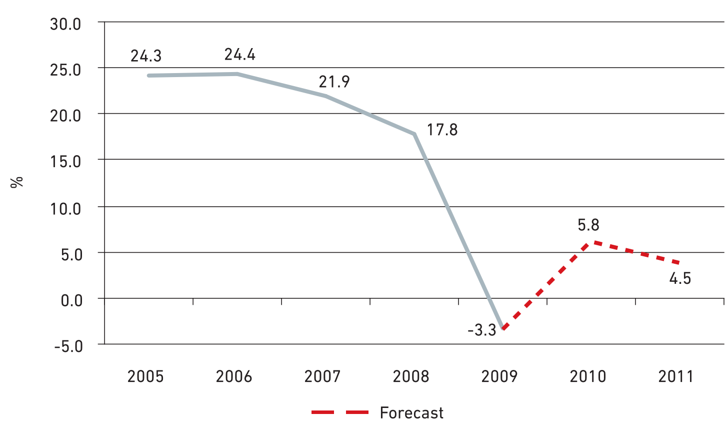
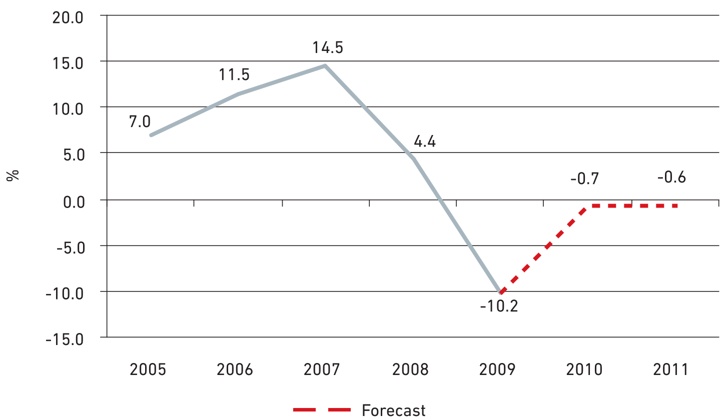


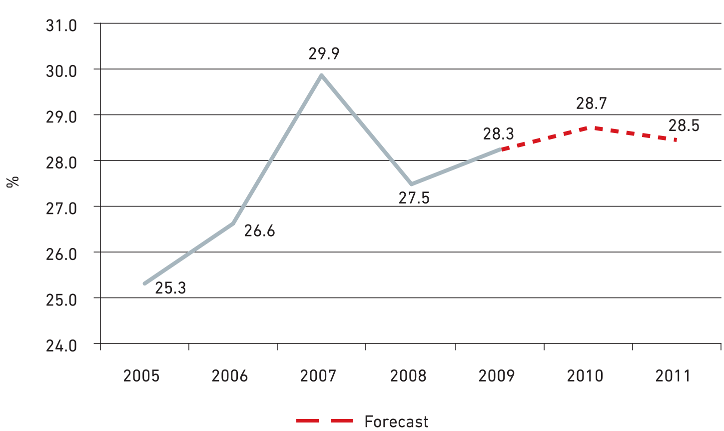
FIGURE 9: GROWTH RATE OF REAL WAGES (IN %)



LABOUR MARKET

As a result of the difficult economic conditions, employment decreased and the unemployment rate rose sharply during 2009. In line with the expected gradual recovery of the Serbian economy, employment will grow marginally. Unemployment will increase slightly in 2010 and decrease marginally in 2011.

FIGURE 10: UNEMPLOYMENT RATE (IN %)



While the Serbian economy is managing to find its way out of the crisis, the speed of the recovery is not sufficient to generate significantly more jobs. Since the companies kept their employees during the downturn, in the subsequent upturn there is no immediate need for hiring new staff. Therefore, employment will only rise marginally.

FIGURE 11: GROWTH RATE OF EMPLOYMENT (IN %)

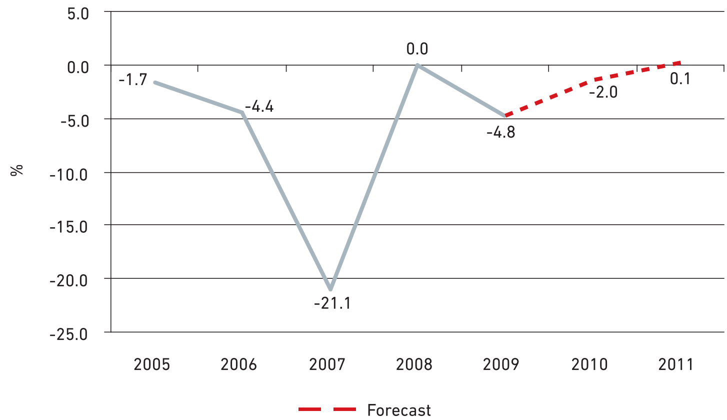
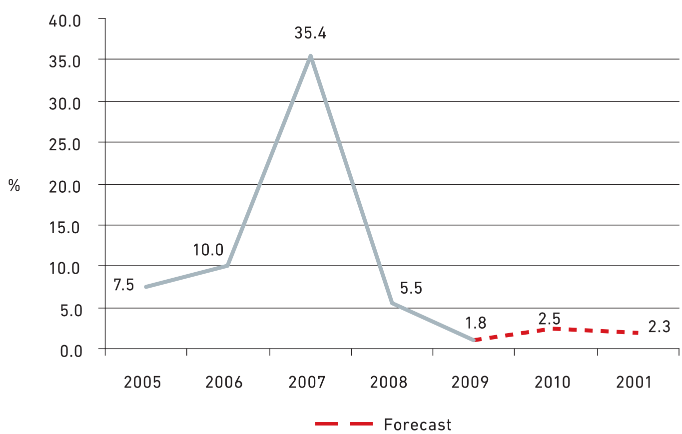


FIGURE 12: GROWTH RATE OF LABOUR PRODUCTIVITY (IN %)



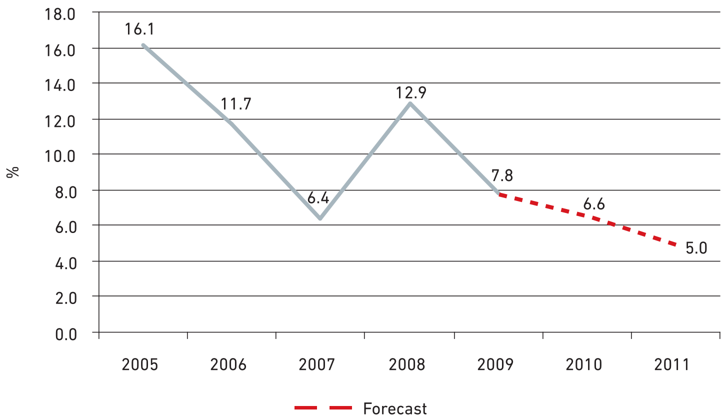
INFLATION

The Target inflation rate that has been adopted by National Bank of Serbia and the Government is 6.9±2% for 2010, 5.2±1.5% for 2011 and 4.2 ±1.5% for 2012, respectively. Inflation targets for the period 2010–2012 were set by the National Bank of Serbia in cooperation with the Government on the Basis of current and expected macroeconomic developments and numerical guidelines for the increase in prices of products and services under the Government's direct or indirect regulation.

Serbia has suffered some inflationary pressure due to the weakening of the RSD over the past several months. However, price stability should be maintained in the environment of low aggregate demand and a freeze on public sector wages and pensions.

Increases of electricity prices were the main inflation driver at the beginning of 2010. It is not expected that electricity prices will rise again in the rest of the year, so it will not be any inflationary pressure from that side. It is also not expected for food prices (which have the largest share in the CPI basket (37.8 %)) to go up, so there is no going to be any significant inflationary pressures this year.

FIGURE 13: INFLATION RATE (IN %)



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