New Europe Economic Dossier aims to provide a structural view on the evolution of the various countries in the region, highlighting the main achievements and the open challenges. Each issue is dedicated to a specific country and includes an analysis of the economic situation plus an interview to a leading figure for the future of the country. The dossier is edited by the New Europe Research Network of UniCredit.

by Márta Szegö

Serbia: political consensus is the key to economic progress

The political environment continues to represent a challenge for Serbia. The outcome of early elections, as well as widespread discord among political parties on necessary reform measures, together with still unresolved territorial issues, are indications of a protracted political deadlock. If it fails to quickly reach political consensus, Serbia risks further delays in its EU integration process and a slowdown in economic catching-up. Despite the political noise the economy is expected to show strong growth in the years ahead. Still it will not be in a position to exploit its full potential as structural reforms are slow and limited only to a few economic sectors. Thus, pushing ahead with corporate sector restructuring and stepping-up privatization efforts in order to increase the private sector's share in the economy, currently representing only a moderate 55-60% of GDP, will be essential to helping the economy realise its potential. Bolstered by a strong national currency, price stability will be maintained.

At the same time external imbalances are to remain pronounced, with sustained strong import demand countering the country's gradually increasing export potential. External financing needs will, however, to a great extent be met by strong foreign direct investment inflows. The creation of a business-friendly environment, ongoing EU integration and the overhaul of the legal, administrative and judicial system are necessary to secure sustained foreign direct investment inflow based on greenfield investments, once privatisation revenues dry up. Given strong capital inflows and ample foreign exchange reserves early debt repayments are expected to continue, further contributing to an improvement in Serbia's international debt position.

Political situation – In a referendum at the end of October 2006 Serbia adopted a new constitution, which states that Kosovo is an indivisible part of Serbia. The Kosovo issue, with the international community pressing for independence, dominated the electoral campaign in the run-up to early parliamentary elections on 21 January 2007, which became necessary after the G17+ withdrew from the government at the end of September leaving a minority government in parliament.

Against this background and a voter turnout of 60%, the nationalist Serbian Radical Party of Vojislav Seselj won the elections, garnering 28.6% of the votes. President Tadic's Democratic Party came in second with 22.7%, followed by Prime Minister Kostunica's Democratic Party of Serbia (16.6%) and Finance Minister Mladan Djinkic's G17+ (6.8%). Furthermore, the Socialist Party of Serbia (5.6%) and the Liberal Democratic Party (5.3%) made the 5% hurdle into the 250-seat parliament. Moreover, the new constitution, which calls for proper representation of ethnic minorities in parliament, propelled representatives of five minority parties into eight national assembly seats. With the pro-western democratic parties having a majority in parliament they are also expected to form the next government, but the coalition negotiations are likely to be a long and drawn-out process, especially in light of the pending decision on the future status of Kosovo. If a new government is not formed by 14 May, new elections will be called. If political consensus is not reached rapidly, not only is the timely implementation of structural reforms and thus sustainable economic development at risk, but also a smooth European integration, for which a prerequisite is also a closer cooperation with The Hague Tribunal. In December 2006 Serbia scored major foreign policy successes by joining the regional free trade agreement CEFTA and NATO's Partnership for Peace Programme. But membership in the former is negatively impacted by long-standing custom disputes with Croatia, in the latter by the still open Kosovo issue.

The proclamation of the new constitution also has direct consequences for economic policymaking, as it raises the question regarding the position of the Governor of the NBS, who according to the new constitution will be appointed by parliament in its first sitting after the formation of the next government, leaving markets in

MACROECONOMIC DATA AND FORECASTS

	2004	2005	2006e	2007f	2008f	2009f
Nominal GDP (EUR bn)	19,7	21,0	24,3	29,3	33,3	38,2
Nominal GDP (EUR bn)	2,643	2,827	3,281	3,963	4,517	5,1870
Real GDP (%, yoy)	8,4	6,2	5,7	6,0	6,3	6,5
Inflation (CPI) yoy, eop (%)	13,1	17,1	6,0	8,0	5,5	5,7
Inflation (CPI) yoy, avg (%)	11,4	16,2	11,7	6,2	6,4	5,9
Unemployment rate (%, avg)	18,5	20,8	22,2	21,0	19,8	19,3
Exchange rate/€, eop	78,9	85,5	79,0	78,0	77,5	75,5
Exchange rate/€, avg	72,6	83,2	84,4	78,6	77,9	76,5
2W repo rate, eop	16,3	19,2	14,0	10,0	8,0	7,0
2W repo rate, avg	14,5	16,1	19,5	11,1	9,2	7,6
Current account/GDP (%)	-11,6	-8,5	-12,0	-10,0	-9,7	-9,4
FDI/GDP (%)	3,9	5,9	14,4	6,7	6,3	5,9
Budget balance/GDP (%)	0,9	1,9	0,9	0,3	0,5	0,7
Public debt/GDP (%)	49,1	48,9	39,0	34,1	31,5	28,8
Total external debt/GDP (%)	57,5	59,2	64,2	62,6	62,9	63,1

f= forecast
Source: NBS, Statistical Office of the Republic of Serbia, UniCredit Group New Europe Res earch Network

doubt as to the future direction of monetary policy.

Economic slowdown continued in 2006, with some acceleration expected in 2007 – With real economic growth of 5.7% in 2006 the Serbian economy lost some further momentum in 2006, after recording a robust 8.4% and 6.2% in 2004 and 2005, respectively. Consequently, nominal GDP has reached slightly over EUR 24.3 bn, corresponding to a GDP per capita of some EUR 3,300. The main reason for the economy's slowdown was on the production side slower growth in the services sector (mainly in wholesale and retail trade), itself a result of the population's decreasing consumption propensity stemming from a more restrictive approach by the National Bank of Serbia (NBS) with regard to credit policy. On the other hand, the primary sector, which still generates some 15% of gross value added, showed signs of recovery as compared to a drought-induced decline in agricultural production in 2005. But also industrial production gained some momentum, especially in mining and manufacturing, on the back of progress made in corporate restructuring in privatized industries. The construction sector developed robustly, fuelled by brisk investment activity. On the demand side, domestic demand remained the main pillar of growth. Nonetheless, private consumption grew more slowly, as is indicated by moderate retail sales growth, given the monetary restrictions imposed by the NBS in the first half of 2006 with a view to curbing credit growth. In contrast, investments have picked up, given major successes achieved in privatization of

RESULTS OF EARLY PARLIAMENTARY ELECTIONS IN JANUARY 2007

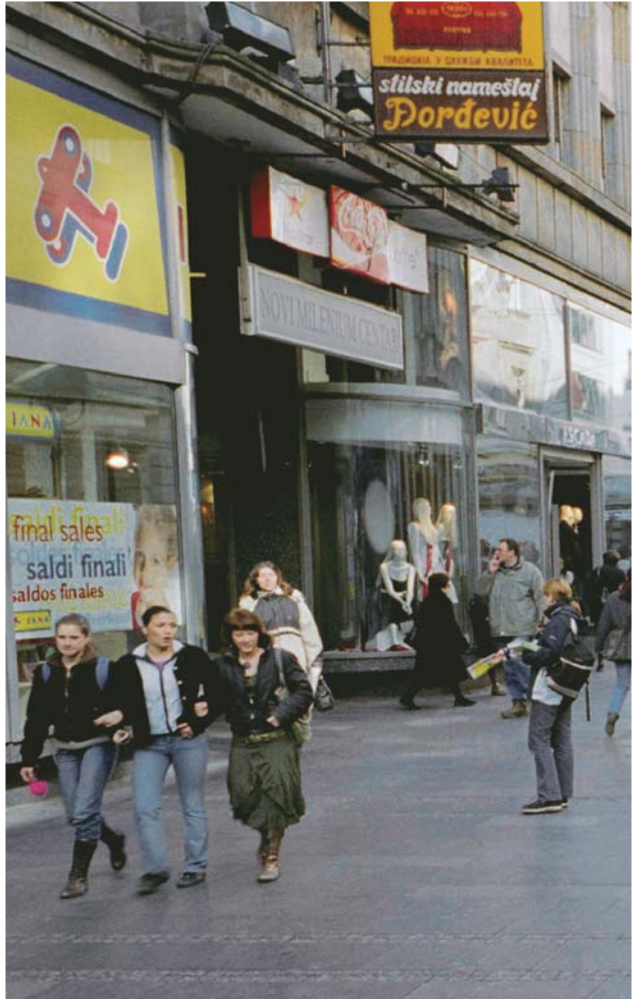
Political party	Elezction 21 january 2007		Change in number of seats as against previous election	Elections 28 December 2003	
	% of votes	Nr of seats		% of votes	Nr of seats
Serbian radical party	28,6	81	-1	27,6	82
democratic Party	22,7	64	27	12,6	37
democratic Party of Serbia-New Serbia	16,6	47	-6	17,7	53
G17 Plus	6,8	19	-15	11,5	34
Socialist Party of Serbia	5,6	16	-6	7,6	22
Liberal Democratic party et al.	5,3	15	15	0,0	0
Serbian Renewal Movement	3,3	0	-22	7,7	22
United Pensioners of Serbia Party & SDP	3,1	0	0	0,0	0
Power of Serbia Movement	1,8	0	0	0,0	0
Alliance of Vojvodina Hungarians	1,3	3	3	0,0	0
Coalition List for Sandzak	0,8	2	2	0,0	0
Roma Union of Serbia	0,4	1	1	0,0	0
Coalition of Albanians from the Presevo Valley	0,4	1	1	0,0	0
Roma Party	0,4	1	1	0,0	0
Other	2,8	0	0	15,4	0
	100,0	**250**		**100,0**	**250**

Source: Republic Electoral Commission, Statistical Office of the Republic of Serbia, UniCredit Group New Europe Research Network

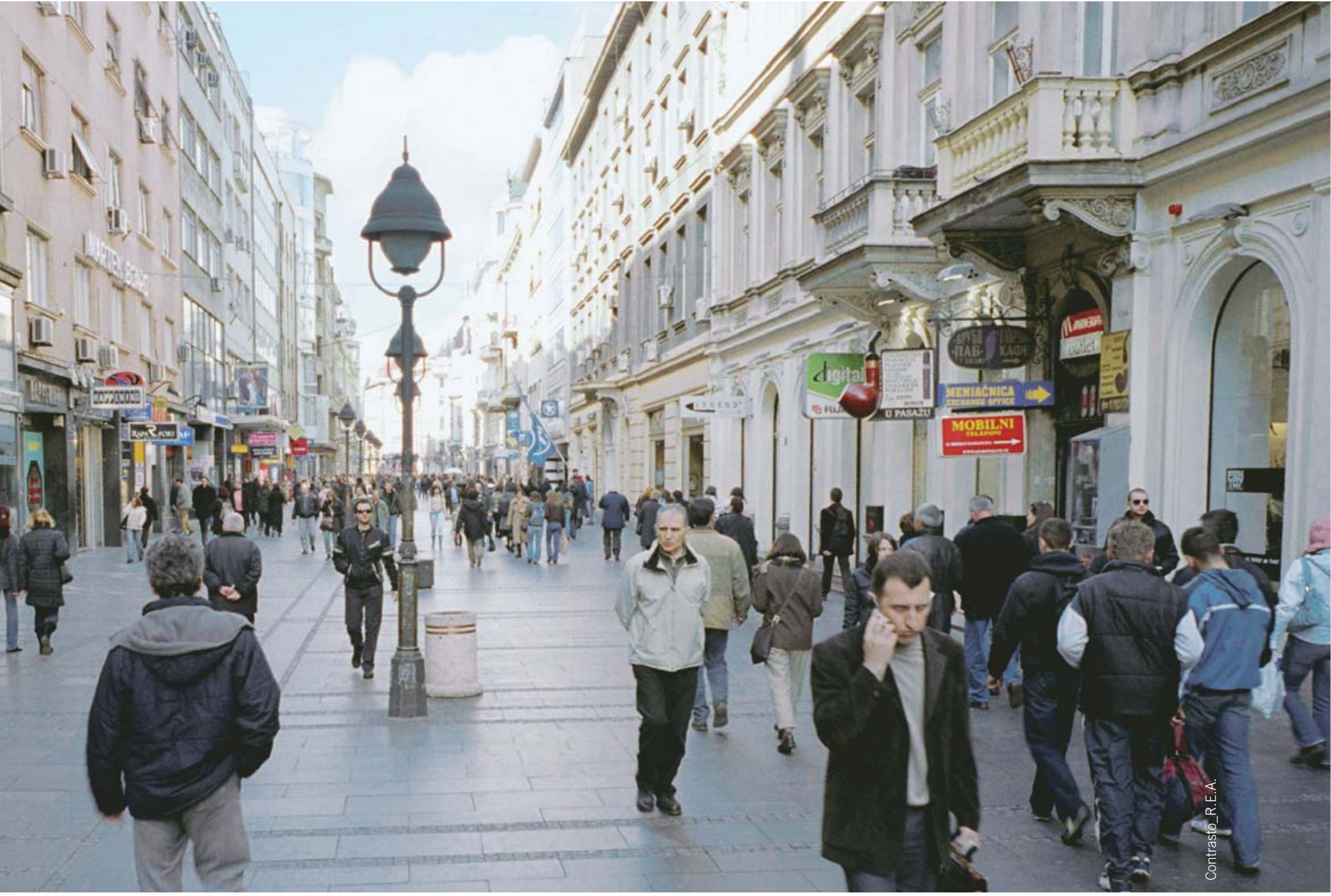
State-owned enterprises. Public consumption also accelerated toward year-end 2006 in the run-up to early elections. Although exports grew nearly twice as fast as imports, the foreign trade deficit widened given the higher base level of imports. In 2007 we see private consumption picking up on monetary easing and a continued generous public wage policy. Last year's huge privatisation deals indicate stepped-up investment activity, especially in the telecom and banking sectors. But the higher momentum of investments will also be underpinned by the National Investment Plan with an estimated investment volume of some EUR 1.7 bn, adopted by the government in the summer of 2006. The development of public consumption is, however, difficult to assess in light of the fact that no budget for 2007 was passed by the outgoing government ahead of parliamentary elections. Although exports are expected to grow robustly given gradually widening export capacities as a result of corporate restructuring, import propensity will rise on strengthening domestic demand and the anticipated further appreciation of the dinar, with the negative contribution of foreign trade to growth allowing only for a slight acceleration in growth to a real 6% in 2007, with some downside potential in case of a prolonged political paralysis.

Labour market rigidities prevail – High unemployment, currently at 33% (ILO: 21%) remains one of the key challenges for the Serbian economy. However, the year 2006 brought no improvement in labour market conditions.
The unemployment rate increased from 32.6% on average in 2005 to 33.2% in 2006, while employment decreased by an estimated 1.5% given ongoing restructuring in the corporate sector. Growth of real net wages accelerated significantly in the final months of 2006 against the background of the government's more generous wage policy ahead of early elections, putting the average growth rate at 11.4% in 2006 (2005: 6.4%). At the same time, labour productivity grew by 13.5% (2005: 9%), although in light of developments in employment most likely not on the back of efficiency gains but as a result of restructuring-induced labour shed¬ding. Strong wage growth is expected to continue also in 2007. with the government's wage policy as one of the main risk factors in the context of disinflation. The government recently approved a 12.2% increase in the minimum net wage to RSD 9,570 to be applied in the first half of 2007.

Favourable inflationary environment triggers monetary relaxation – Underpinned by a strong national currency and falling energy prices and despite an easing fiscal discipline, in the course of 2006 the NBS succeeded in bringing down inflation from 17.1% yoy as of year-end 2005 to 6% yoy a year later, with headline inflation averaging 11.7% for full-year 2006 (2005: 16.2%). Core inflation fell to 5.9% as of year-end 2006, well below the NBS's 7-9% target band. Given the favourable inflationary environment and the sustained strength of the Serbian dinar (since 25 October 2006 ISO-Code: RSD), in the final quarter of 2006 the NBS eased its



restrictive monetary stance on which it embarked in the second half of 2005 to dampen credit growth by considerably tightening minimum reserve requirements (in particular with regard to banks' foreign exchange liabilities) and introducing restrictive administrative measures. Starting from September 2006, the NBS has also formally adopted an inflation targeting monetary policy framework. Since then the NBS lowered the policy rate (2 week repo rate) in four steps by a total of 400 basis points from 18% to 14%. Above and beyond the rate cuts the NBS further adjusted monetary policy by reducing the minimum reserve requirements on dinar deposits in two steps by 8 percentage points to 10% and setting the minimum reserve requirement rate on foreign exchange deposits and external borrowings of banks at a standard 45 percent. At the same



time, however, the NBS decided for a stricter interpretation of loan-loss provisioning and prudential requirements on loan re-negotiations.

Inflationary pressure also remained moderate at the beginning of 2007, allowing the NBS to cut the policy rate by an additional 250 basis points to 11.5% in February. Given a favourable inflationary outlook for the whole of 2007 of 6.2% on average (official target: 6% core inflation with a +/- 2% variation band) and the current large interest rate differential to euro rates, further rate cuts are to be expected in the coming months with a view to preventing speculative capital inflows and thus a further significant strengthening of the RSD, which in turn could undermine Serbia's external competitiveness.

Huge capital inflows strengthen the RSD – Easing inflationary pressures were in particular the result of the strengthening of the Serbian currency, with the RSD appreciating by some 10% in nominal terms in the second half of 2006. This in turn can be attributed to robust FDI and long-term credit inflows. In fact, Serbia garnered significant privatisation revenues in 2006, including EUR 1.5 bn from the sale of the telecom operator Mobi 63, which was sold to Norway's Telenor in mid-2006. But the sale of a mobile telephone license to Telekom Austria for EUR 320 mn, the acquisition of Panonska banka by Italy's San Paolo IMI (EUR 122 mn) and privatisation receipts from the sale of Vojvodanska banka to Greece's NBG (EUR 385 mn) also underpin the record 2006 year in terms of FDI. Thus, total FDI inflows have reached EUR 3.5 bn in 2006 as a whole, the best result since the beginning of the transition process. The magnitude of FDI inflows in the next years will, however, largely depend on the pace of the formation of a new government, its longevity and finally its commitment toward structural reforms. Large-scale privatisations include a 37.5% stake in the national oil company NIS and the sale of Bor-based mining complex RTB. A novelty in FDI developments in 2007 will be a huge FDI outflow, as Serbia's State-owned Telekom Srbija in December 2006 acquired a 65% stake in Bosnia and Herzegovina's Serb entity's Telekom Srpska for EUR 646 mn.

FX reserves at record levels – Although in its fight against inflation the NBS is in favour of a hard RSD, it nevertheless intervened against the dinar on the foreign exchange market on numerous occasions in 2006 (reaching a total volume of some EUR 2 bn) in order to dampen the upward pressure on the national currency. Due to foreign exchange interventions and strong FDI inflows the country's foreign exchange reserves have grown by a total EUR 4 bn to EUR 9 bn in 2006. Hence, import cover rose from 6.2 months in 2005 to 9.1 months in 2006. In light of the higher reserves, after two transactions in June and September the NBS again made an early repayment of outstanding debt to the IMF (EUR 175.8 mn) and the World Bank (EUR 321.5 mn) in December, bringing total early repayments to the international lenders to EUR 880 mn in 2006. The remaining outstanding debt toward the IMF worth some EUR 180 mn has been repaid in March 2007. Despite these repayments and debt write-offs against Paris Club creditors Serbia's total external debt increased from EUR 13.1 bn or 59.2% of GDP in 2005 to EUR 14.9 bn or 64.2% of GDP in 2006 due to increasing indebtedness of the private sector, i.e. corporates and banks.

Persistent external imbalances – With FDI inflows and foreign exchange reserves at record levels, the financing of the current account deficit, which after a VAT introduction-related temporary narrowing in 2005, again reached double-digit figures in 2006, does not appear to be a problem. The widening of the

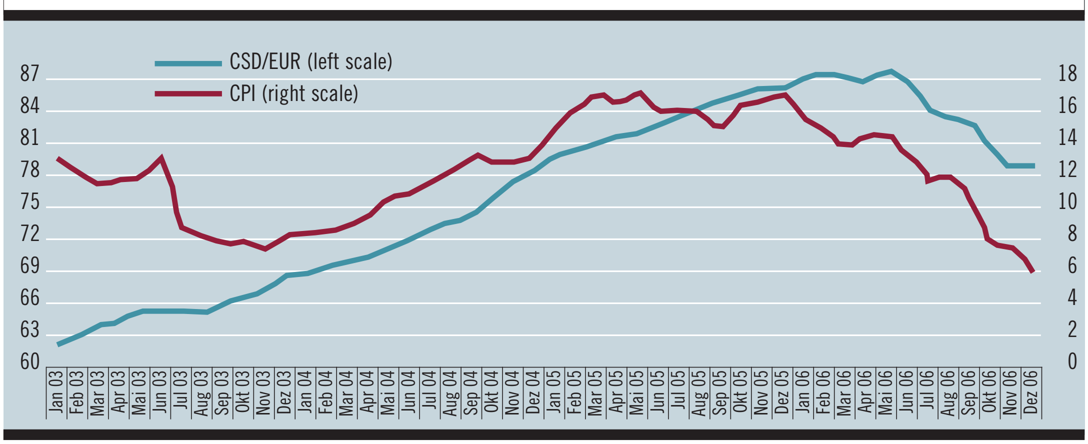
GDP AND CREDIT GROWTH

(2003-2006,%)

Fonte: NBS, UniCredit Group New Europe Research Network

INFLATIONARY AND EXCHANGE RATE DEVELOPMENTS IN SERBIA

(2003-2006)



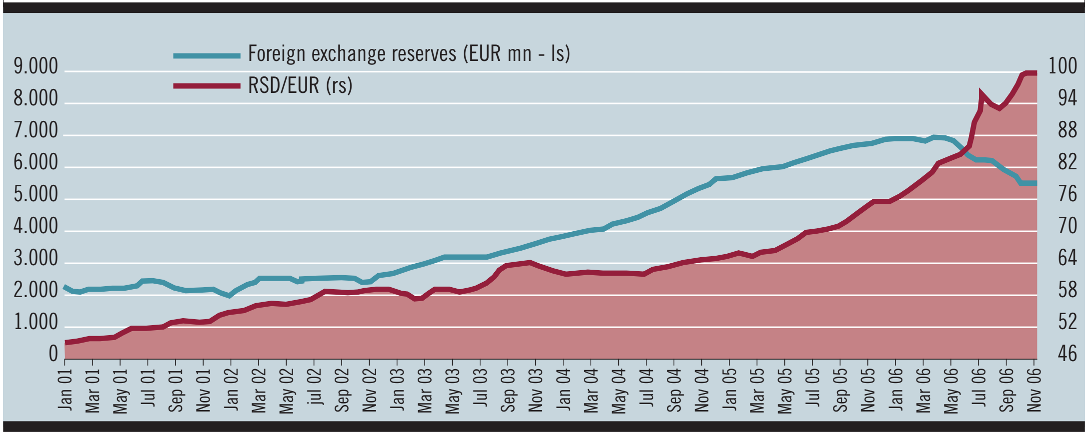
Source: NBS, UniCredit Group New Europe Research Network current account deficit from EUR 1.8 bn or 8.5% of GDP to EUR 2.9 bn or 12% of GDP can be mainly attributed to lower current transfers, and a widening trade deficit despite a 40% expansion in exports of goods and import growth of 20%, although the latter from a much higher base.

Serbia's main export partners in 2006 were with a 14.4% share in total exports Italy, followed by Bosnia and Herzegovina (11.6%) and Germany (9.9%). Serbian imports originated mainly from Russia (16.3%), Germany (9.5%) and Italy (8.3%). Against the background of an anticipated sustained robust private consumption in the years ahead, driven by both expansionary fiscal and monetary policies and the high FDI-related import propensity in regard to capital goods, the current account deficit is expected to narrow only marginally in 2007-2009, despite widening export capacities as a result of corporate restructuring and regional trade cohesion due to CEFTA membership. The current account deficit is seen moving between 9-10% of GDP in the next few years.

Easing fiscal discipline – Given external imbalances and inflationary pressures, a restrictive fiscal policy in Serbia is key to maintaining macroeconomic stability. Nonetheless, in a politically overheated environment ahead of early elections, the government opted for satisfying the electorate and thus to ease fiscal policy. An upward modification of expenditures (wage hikes in the budgetary sector, payments of bonuses, early repayment of debt to pensioners) led to a cut in the budgeted surplus from 2.3% of GDP to 0.7% of GDP back in October. Although the government's 2007 fiscal course is still unclear, given the fact that it has not adopted a budget for 2007 ahead of early elections, fiscal easing is expected to con-

FOREIGN EXCHANGE RESERVES

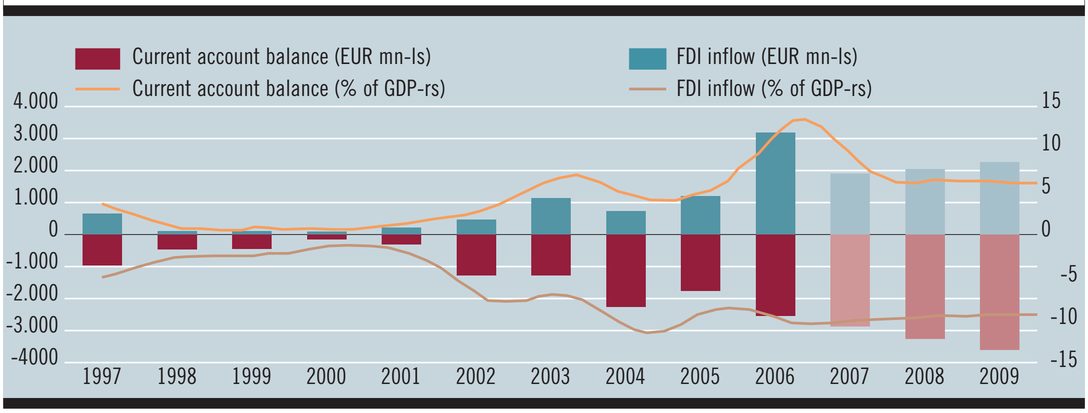
(2000-2006, EUR MN)



Source: NBS, UniCredit Group New Europe research

CURRENT ACCOUNT BALANCE AND FDI INFLOW

(1997-2009)



Source: NBS, UniCreditGroup New Europe Research Network tinue not only on the back of a lax public wage policy, but also due to higher public expenditures laid down in the National Investment Programme. The draft budget 2007 prepared in the autumn 2006, but not yet adopted by parliament, is based on GDP growth of 7% and inflation of up to 7.5% and calls for a target surplus of 0.5% of GDP. But the adoption of this draft will largely be determined by the outcome of coalition negotiations and the shape of the new government. Small budget surpluses and early debt repayments should, however, enable public debt to decrease in the years ahead.

Interview to Mr Hirschhofer, Representative of the International Monetary Fund in Serbia

Do sustained political tensions and delays in the EU integration process retard Serbia's economic caching-up?

Clearly, the heavy unresolved political questions have a negative impact on the risk premium of Serbia, thus negatively impacting investment and growth. But the problems to find a sustainable coalition also delays the implementation of important economic policy measures. For example, the financing of the budget after March 31st is still unresolved and the 2007 budget would need urgent revision to address external imbalances. And the speed of privatization and the use of the bankruptcy mechanism need to be accelerated. Furthermore, a clear commitment to support the Central Bank in its fight against inflation is needed.

High unemployment, currently at 33% (ILO: 21 %) remains one of the key challenges for Serbian economy. How could labor rigidities be decreased?

To reduce unemployment, the government has to implement strong structural policies in area of: privatization, bankruptcy and liberalization. Everyone is aware that this will imply additional unemployment, but if vigorously realized, this will created new and sustainable employment opportunities. Only a productive and international competitive economy will generate the needed employment opportunities.

Despite several privatization successes in 2006 inflow of FDI remains limited. Given political discord structural reforms are progressing only slowly and are limited to a few economic sectors (e.g. banking, Telecom). What are prerequisite for enhancing foreign investors' confidences?

To raise investor confidence, the government should adopt an economic program for the next four years with a clear commitment to deepen macroeconomic stability. Tight fiscal and monetary policies will need to reign in demand, while the above mentioned acceleration of privatization and bankruptcies, combined with opening all sector up to international competition will raise the productivity and wealth of Serbia.

Underpinned by a strong national currency the NBS succeeded in bringing down inflation significantly in the course of 2006. But is the strength of the RSD a concern for the country's international competitiveness?

Brining down inflation was a big success of the NBS, which now needs to be entrenched by the right fiscal and structural policies. I am not so concerned about the exchange rate's impact on competitiveness, because the main problem for Serbia's competitiveness is the slow progress of structural reforms. Too many people are still employed in loss-making enterprises whose products cannot compete on international markets in terms of quality. A fast depreciation of the dinar would eventually just feed into higher prices and wages, thus changing nothing on international competitiveness problems.

Are persistent external imbalances, i.e. a high current account deficit and rapidly increasing foreign debt, a cause for concern from the risk and financing point of view?

Yes, that is indeed our key message to the government. These imbalances need to addressed quickly to ensure sustainable growth and prosperity for Serbia.

What are greatest challenges Serbia faces in the short and medium term?

Structural reform of the real economy and strengthening the quality of budgetary spending.