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## **Serbia: shocks and confusion**

Serbia has entered into a new phase of political instability. Its economic policy also lost coherence and direction. The economic consequences are still relatively mild, though there are three worrying signs. One is inflation that may get out of control. Another one is represented by the widening trade and current account deficits. Finally, economic activity seems to be slowing down. The government plans to sell the mobile telephone operator and a number of state-owned banks, so it should not face serious financial problems. It is also not expected to introduce any new reforms, because it will most probably have to face early election by the end of this year or early next year.

It was always well understood that this year will be a difficult one because a number of crucial, constitutional issues have to be resolved in and outside of Serbia that may shake its stability. The first shock has come with the result of the referendum on independence in Montenegro. Though the result had been expected, it has caught Serbia unprepared. There is a realization that Serbia needs to adopt its own constitution. It is, however, not clear whether this will prove to be politically feasible. The political parties will have to figure out whether that changes their electoral prospects and in which way. Thus, it may turn out that early elections will be needed for the constitution to be adopted, while the preferred sequence for the government is that the elections should follow the adoption of the constitution.

This dilemma may prove to be beside the point if it drags on, because the second shock will have to be absorbed soon, probably before this year's end. Kosovo will in all probability be granted independence by the international community. Though the Serbian public expects that outcome, it is quite unprepared for the new situation it will find itself in. The elections will have to be held in the wake of the decision on Kosovo, and it is hard to predict at this point in time what will be the results.

These political developments will take place in a context that is unfavourable for Serbia. At the beginning of May, the European Commission disrupted the negotiations on the Stabilization and Association Agreement with Serbia. The chances that those may be continued are slim: The government of Serbia would need to secure the transfer of Ratko Mladić, who is indicted for war crimes, to the Hague Tribunal. However, the government does not want to arrest him, while he does not want to surrender himself voluntarily. In the run-up to the crucial decisions on Kosovo and with early elections looming, it is unlikely that the government will gather the will to be more resolute than it has been in the past. Thus, the negotiations cannot be resumed and Serbia will not be able to enter into contractual

relations with the EU. This will be a serious blow to the government because the improved relations with the EU have been its own tangible success.

These political uncertainties have had effects on the macroeconomic stability. The increasing macroeconomic instability has in turn started to impact on economic activity. Inflation has been speeding up as soon as this government took office in early 2004, close to two and a half years ago. Last year inflation climbed to over 16% and this year it can hardly manage to stay below 15%. Inflation was a way to improve the fiscal balance in the last couple of years and may be relied on to improve the election results this year. This fiscal dominance has led to a tightening of monetary policy in the form of ever increasing reserve requirements on loans that banks take abroad. Currently, 60% are kept with the central bank without interest. The effects so far have not been very encouraging. Strong credit growth has continued together with the costs of borrowing. Though data are not available, it is to be expected that households are continuing to borrow as are large firms, but small firms and entrepreneurs may be driven out of the market. That may be one of the reasons why there is growing uncertainty about the growth prospects of the economy.

Unlike the previous year, imports are growing faster than exports and the trade deficit is widening. Other balances in the current account are not moving very much in the opposite direction, so a widening of the current account deficit should be expected too. It is not easy to forecast the development of external balances because the exchange rate policy of the central bank is not clear, though the latest aim seems to have been to keep the dinar exchange rate for the euro fixed with the real exchange rate appreciating. There is an obvious rationale for that policy in terms of providing an anchor to inflation, but the development of the trade deficit may make this policy unsustainable.

Growth is driven mostly by consumption, which however is slowing down. Investment is also flowing into construction, but the pace of growth of investment in manufacturing seems to be winding down too. The government has been floating ideas to boost public investments, but those have been discouraged by the central bank and by the IMF due to fears of runaway inflation. Still, GDP growth in the first quarter and probably in the second quarter as well could end up being around 3-4%, which would indicate a certain deceleration. In the second half of the year, growth should remain at about the same level, though there are indications that agricultural production will post a negative growth rate due to bad weather in the winter. Industrial production seems to be growing at a slower pace also and services are coming against the decline in demand due to slower growth of wages and salaries, in part because of the steep growth in unemployment.

Assuming that political decisions will have to be made in the next six to nine months, what political outcome can be expected to emerge? It is quite likely that the strongly nationalistic Radical Party, which is already the largest party in the Serbian parliament, will come out of

the early elections strengthened. Even if it does not participate in the new government, it will have quite an influence on the policy that will be pursued by whoever is in the government. That may lead to a prolonged stalemate in the process of EU integration. It is not very likely, as things stand now, that Serbia will be able to sign the Stabilization and Association Agreement with the EU by the end of this year as envisaged, and that will probably have to be put off for as long as the political configuration in Serbia is being changed.

In addition, the already widespread reliance on the state will increase. The process of privatization of the public sector will be all but stopped and foreign investments will be invited on a selected basis. Regional cooperation will in all probability deteriorate and much stress will be put on the cooperation with out-of-the-region and out-of-the-EU countries, in particular with Russia and China. Preference will be given to economic cooperation with the USA, who is already the largest investor in Serbia.

The effects of these policies are hard to assess at this moment in time because the details are still to be worked out. It is quite likely that growth may get some boost from increased public consumption, but inflation may prove to be a powerful constraint on that. In any case, the prospects are worse now than any time since the assassination of premier minister Zoran Djindjić in early 2003.

Table Serbia

## Serbia: Selected economic indicators

	2001	2002	2003	2004	2005 <sup>1)</sup>	2005 1st quarter	2006	2006 forecast	2007
Population th pers., mid-year <sup>2)</sup>	7736.4	7500.0	7480.6	7463.2	7450.0	.	.	.	.
Gross domestic product, CSD mn, nom.	708423	919231	1095402	1310300	1601000	.	.	1915000	2290000
annual change in % (real)	5.1	4.5	2.4	9.3	6.3	5.6	.	4	4
GDP/capita (EUR at exchange rate)	1540	2020	2251	2419	2583	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4560	5020	5170	5790	6300	.	.	.	.
Gross industrial production <sup>3)</sup>									
annual change in % (real)	0.1	1.8	-3.0	7.1	0.8	-3.4	5.7	4	4
Gross agricultural production									
annual change in % (real)	18.6	-3.4	-7.2	19.5	-5.3	.	.	.	.
Construction output total									
annual change in % (real) <sup>4)</sup>	-14.3	-7.4	10.8	3.5	-7.0	-20.5	.	.	.
Consumption of households, CSD mn, nom.	575195	784493	948591	1177080	1426621	.	.	.	.
annual change in % (real)	.	.	.	.	4.4	.	.	.	.
Gross fixed capital form., CSD mn, nom.	65498	120502	154544	253333	273852	.	.	.	.
annual change in % (real)	.	.	.	.	-2.8	.	.	.	.
LFS - employed persons, th. Oct <sup>5)</sup>	3105.6	3000.2	2918.6	2930.8	2900.0	.	.	.	.
annual change in %	0.4	-3.4	-2.7	0.4	-1.1	.	.	.	.
Reg. employees in industry, th pers., avg.	704.5	648.1	605.3	562.2	536.0	538.0 <sup>hii</sup>	510.5 <sup>hii</sup>	.	.
annual change in %	.	-8.0	-6.6	-7.1	-4.7	-4.9	-5.1	.	.
LFS - unemployed, th pers., average <sup>5)</sup>	432.7	459.6	500.3	665.4	.	.	.	.	.
LFS - unemployment rate in %, average <sup>5)</sup>	12.2	13.3	14.6	18.5	20.8	.	.	22	23
Reg. unemployment rate in %, end of period <sup>6)</sup>	.	30.5	31.9	26.4	26.9	.	.	34	34
Average gross monthly wages, CSD <sup>7)</sup>	8691	13260	16612	20555	25514	22166	28202	.	.
annual change in % (real, net)	16.5	29.9	13.6	10.1	6.4	5.0	10.9	.	.
Consumer prices, % p.a.	93.3	16.6	9.9	11.4	16.2	16.0	14.8	15	15
Producer prices in industry, % p.a.	87.7	8.8	4.6	9.1	14.5	13.5	14.3	15	15
General governm. budget, nat.def., % GDP									
Revenues	39.1	44.3	43.1	45.0	.	.	.	.	.
Expenditures	40.7	48.0	47.3	46.5	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-1.6	-3.7	-4.2	-1.5	.	.	.	.	.
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	16.4	9.5	9.0	8.5	8.5	8.5	8.5	.	.
Current account <sup>8)</sup>	-354	-1348	-1362	-2274	-1687	-331	-479	-2000	-2000
Current account in % of GDP	-3.0	-8.9	-8.1	-12.6	-8.8	.	.	-10	-10
Gross reserves of NB, excl. gold, EUR mn	1138.6	2076.8	2728.2	3008.0	4753.7	3211.0	5142.0	.	.
Gross external debt, EUR mn	12609	10768	10858	10355	13064	10761	12616	.	.
FDI net, EUR mn <sup>8)</sup>	184	504	1204	777	1196	262	179	.	.
Exports of goods, BOP, EUR mn <sup>8)</sup>	2032	2348	2598	2997	3754	761	955	4030	4430
annual growth rate in %	13.3	15.5	10.7	15.4	25.2	44.0	25.6	10	10
Imports of goods, BOP, EUR mn <sup>8)</sup>	4608	5774	6409	8341	8248	1479	2026	9400	10340
annual growth rate in %	31.0	25.3	11.0	30.1	-1.1	-14.7	37.0	10	10
Exports of services, BOP, EUR mn <sup>8)</sup>	685	795	906	1171	1306	248	300	.	.
annual growth rate in %	49.3	16.0	13.9	29.3	11.6	-10.1	21.0	.	.
Imports of services, BOP, EUR mn <sup>8)</sup>	413	657	720	1020	1293	273	329	.	.
annual growth rate in %	35.2	59.1	9.5	41.7	26.7	39.1	20.5	.	.
Average exchange rate CSD/USD	66.36	64.40	57.58	58.38	67.21	61.68	72.61	.	.
Average exchange rate CSD/EUR (ECU)	59.46	60.68	65.05	72.57	83.19	80.62	87.18	90	100
Purchasing power parity CSD/USD, wiiw	17.50	21.10	24.20	25.90	28.40	.	.	.	.
Purchasing power parity CSD/EUR, wiiw	20.10	24.40	28.30	30.30	34.10	.	.	.	.

Notes: 1) Preliminary. - 2) From 2002 according to census 2002. 2005: wiiw estimate. - 3) From 2004 according to NACE and new weighting system. - 4) Gross value added. - 5) From 2004 according to census 2002 and revisions based on ILO and Eurostat methodology. - 6) Until 2003 jobseekers divided by labour force excl. farmers. - 7) From 2002 including various allowances. - 8) Converted from USD.

Source: wiiw Database incorporating national statistics; wiiw forecasts.