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Serbia: time to decide

Though the resolution of the Kosovo issue has been in the air since at least 2005, a decision has been postponed time and again. This influenced political stability in Serbia, which in turn put pressure on macroeconomic stability. This year, however, will be the one when the necessary political decisions will have to be taken. In mid-February, Kosovo declared independence. This has led to strained relations between Serbia and the European Union. The signing of the Stabilization and Association Agreement has been postponed and is awaiting the political decision in Serbia. That may have to be taken in early parliamentary elections, to be held perhaps in the second half of the year.

This political instability has influenced economic policy. The aim was to secure the stability of the government at the expense of macroeconomic stability. The same strategy was chosen for 2008. The fiscal policy was to be expansionary in order to secure increases in pensions, wages, and public investments. The central bank was supposed to keep inflation from getting completely out of control, but neither inflation nor external balances have been among the main priorities of the government.

The implicit strategy is to weather off the Kosovo separation and its aftermath and then to reconsider the economic policy mix and to speed up structural reforms. The expectation has been that a more ambitious stabilization programme and reform package will be adopted together with the budget for 2009. This strategy seems unrealistic now because early parliamentary elections are quite possible. If that proves to be the case, stabilization and reforms will be delayed for another year. That, however, seriously increases the risks of disorderly adjustment.

The key political instability is in the fact that the disenchanted opposition to EU integration, which includes some parties that are now in the government, commands the majority of the voters. Thus, early parliamentary elections can easily lead to the anti-EU coalition taking over the government. That would result in a major reassessment of the economic policy, but not in the direction currently being contemplated.

The key risk is that foreign investments will dry out and capital may even start to leave the country. Serbia has been running high current account deficits, last year of around EUR 5 billion, or around 16% of GDP. This year's deficit will have to be even higher if the projected growth rates of consumption and investment are to be realized. These foreign investments are increasingly debt creating, as the direct investment inflow has declined in 2007 and will probably not improve significantly in 2008. This is in part the consequence of the decision to sell the majority stake in the oil industry to Gazprom for only EUR 400 million. Other currently contracted or planned privatizations can hardly bring more than

EUR 1 billion. That implies borrowing needs of at least EUR 3.5 billion this year, which is more than 10% of GDP. If the risk continues to increase, that will require significant adjustment in the interest rate and in the exchange rate with the acceleration of inflation. That would also imply a significant reduction of consumption and investment or a significant increase in public expenditures.

Assuming that the government and the public will be aware of these negative consequences of worsened political instability, it can be expected that measures will be taken to reassure foreign investors and to keep control over macroeconomic balances with a view to preserving stability and insuring a favourable outcome in the early elections, if those were to be held. In that case, GDP should still grow by around 5% and inflation should not accelerate further. The fiscal and current account deficits should continue to increase, but should prove to be manageable. Thus, short-term prospects should be favourable, but adjustment and structural reforms will prove to be necessary in the medium run.

The medium-term prospects depend on these reforms being adopted and implemented. Assuming that is the case, Serbia should see strong and sustained growth especially if there is a speed-up in EU integration. All that development depends on the political decisions that will have to be taken this year under the strong negative influence of the secession of Kosovo. The baseline scenario is that Serbia will manage to make the right decisions, but the risks are now higher than at any time since 2003.

Table RS

Serbia: Selected economic indicators

	2002	2003	2004	2005	2006	2007 ¹⁾	2008	2009	2010
	Forecast								
Population, th pers., mid-year ²⁾	7,500	7,481	7,463	7,441	7,440	7,435	.	.	.
Gross domestic product, RSD bn, nom.	1,020	1,172	1,431	1,750	2,126	2,445	2,720	2,970	3,210
annual change in % (real)	4.2	2.5	8.4	6.2	5.7	7.5	5	5	5
GDP/capita (EUR at exchange rate)	2,242	2,408	2,643	2,834	3,399	4,106	.	.	.
GDP/capita (EUR at PPP - wiiw)	5,850	6,030	6,710	7,310	8,120	8,950	.	.	.
Gross industrial production ³⁾									
annual change in % (real)	1.8	-3.0	7.1	0.8	4.7	3.7	5	5	5
Gross agricultural production									
annual change in % (real)	-2.1	-11.4	26.0	-3.4	-2.6	.	.	.	.
Construction output total									
annual change in % (real) ⁴⁾	-7.4	10.8	3.5	2.0	7.7	.	.	.	.
Consumption of households, RSD bn, nom.	819.7	885.7	998.5	1,214.3	1,432.0	.	.	.	.
annual change in % (real) ²⁾	.	.	.	5.0	5.4	6	5	5	5
Gross fixed capital form., RSD bn, nom.	120.5	188.9	253.3	302.0	374.4	.	.	.	.
annual change in % (real) ²⁾	.	.	.	5.0	15.2	12	10	8	8
LFS - employed persons, th. Oct ⁵⁾	3,000	2,919	2,931	2,733	2,631	2,600	.	.	.
annual change in %	-3.4	-2.7	0.4	-6.7	-3.8	-1.2	.	.	.
Reg. employees in industry, th pers., avg.	648.1	605.3	562.2	536.1	493.3	450	.	.	.
annual change in %	-8.0	-6.6	-7.1	-4.7	-8.0	-8.8	.	.	.
LFS - unemployed, th pers., Oct ⁵⁾	459.6	500.3	665.4	719.9	693.0	700	.	.	.
LFS - unemployment rate in %, Oct ⁵⁾	13.3	14.6	18.5	20.8	20.9	21.2	23	23	23
Reg. unemployment rate in %, end of period ⁶⁾	30.5	31.9	26.4	27.1	27.9	32	30	.	.
Average gross monthly wages, RSD	13,260	16,612	20,555	25,514	31,745	38,744	.	.	.
annual change in % (real, net)	29.9	13.6	10.1	6.4	11.4	19.5	.	.	.
Consumer prices, % p.a.	16.6	9.9	11.4	16.2	11.7	7.0	6	4	3
Producer prices in industry, % p.a.	8.8	4.6	9.1	14.2	13.3	5.9	6	.	.
General governm. budget, nat.def., % GDP									
Revenues	39.9	40.3	41.2	.	.	.	.	.	.
Expenditures	43.2	44.2	42.6	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-3.3	-4.0	-1.4	1.4	-0.6	-0.5	-2	-1	-1
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	9.5	9.0	8.5	8.5	8.5	8.5	.	.	.
Current account, EUR mn ⁷⁾	-1,323	-1,257	-2,308	-1,790	-2,906	-4,800	-4,500	-4,500	-4,500
Current account in % of GDP	-7.9	-7.0	-11.7	-8.5	-11.5	-15.7	-13.6	-12.7	-12.0
Gross reserves of NB, excl. gold, EUR mn	2,077	2,728	3,008	4,754	8,841	9,616 ^x	.	.	.
Gross external debt, EUR mn	10,768	10,858	10,355	13,064	14,885	17,027	.	.	.
Gross external debt in % of GDP	64.9	63.3	57.1	63.8	55.3	.	.	.	.
FDI inflow, EUR mn ⁷⁾⁸⁾	504	1,208	777	1,265	3,504	1,500	1,500	.	.
FDI outflow, EUR mn ⁷⁾	.	.	.	18	17	600	20	.	.
Exports of goods, BOP, EUR mn ⁷⁾⁹⁾	2,348	2,938	3,284	3,999	5,156	6,440	8,000	9,600	11,500
annual growth rate in %	15.5	25.1	11.8	21.8	28.9	25	20	20	20
Imports of goods, BOP, EUR mn ⁷⁾⁹⁾	5,774	6,497	8,488	8,255	10,108	12,840	16,300	20,400	25,500
annual growth rate in %	25.3	12.5	30.6	-2.7	22.4	27	25	25	25
Exports of services, BOP, EUR mn ⁷⁾⁹⁾	795	920	1,188	1,316	1,675	2,110	2,600	3,300	4,000
annual growth rate in %	16.0	15.7	29.2	10.8	27.2	26.0	25	20	20
Imports of services, BOP, EUR mn ⁷⁾⁹⁾	657	741	1,047	1,321	1,724	2,210	2,800	3,400	4,100
annual growth rate in %	59.1	12.8	41.4	26.1	30.5	28	20	20	20
Average exchange rate RSD/USD	64.40	57.58	58.38	66.71	66.82	58.15	.	.	.
Average exchange rate RSD/EUR (ECU)	60.68	65.05	72.57	82.91	84.06	80.09	82	84	86
Purchasing power parity RSD/USD ¹⁰⁾	19.87	21.94	24.04	27.21	29.59	30.04	.	.	.
Purchasing power parity RSD/EUR ¹⁰⁾	23.25	25.97	28.58	32.17	35.19	36.74	.	.	.

Note: The new ISO code for the Serbian dinar is RSD. From 2004 the term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) wiiw estimate in 2005 and 2006. - 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, rate in per cent of labour force excluding farmers. - 7) Converted from USD with the average exchange rate. - 8) Until 2004 FDI net. - 9) From 2006 including trade with Montenegro. - 10) Benchmark results 2005 from Eurostat and wiiw estimates.

Source: wiiw Database incorporating national statistics; wiiw forecasts.