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Serbia and Montenegro: entering transitional recession?

In the third year of transition, industrial production in Serbia is declining (the fall was close to 4% in the first five months of 2003 over the same period last year). Similar developments were recorded in 2002, but then a temporary recovery had started in the second quarter. The current decline, starting in December 2002, persisted throughout the first half of this year. In Montenegro, however, industrial production grew by nearly 12% – though the high growth took place mostly in the first quarter of this year. Overall, industrial production declined by very close to 3% in Serbia and Montenegro in the first five months of 2003.

GDP development is not known, but it is officially not expected to grow by more than 3% for the country as a whole this year. This may look optimistic for Serbia at this moment. In addition to the decline of industrial production, agriculture is expected to suffer from the drought. Finally, the trade deficit is widening. In Montenegro, the unknown factor is tourism. Currently, there are conflicting reports about the start of the tourist season.

Why do these developments resemble a transitional recession? Mostly because of the squeeze of demand. In Serbia, in the period 2001-2002, public expenditures grew significantly and money supply too. The former was the consequence of increased foreign inflows, both of grants and from privatization. As for the latter – growth of money supply – it came with exchange rate and price stability. Thus, base money almost doubled in 2001 and again in 2002. Broad money grew somewhat less in 2001, but much more in 2002, mostly because of the fast growth of foreign currency deposits in the aftermath of euro conversion. These trends were stopped or reversed at the turn of 2002/2003. In the first quarter, money supply shrank. In addition, there was some flight from dinars into foreign currencies, mainly euros. The central bank tried to defend the exchange rate by increasing the reserve requirement for banks, but then had to reverse its decision to avert adverse development. As a consequence, for the first time since the end of 2000, the dinar depreciated perceptibly, by about 5%, in the first half of 2003.

Public revenues also suffered in the first quarter, not only because of a decline in economic activity, but because of the closing-down of the Payments Bureau. Banks were slow in taking over the handling of payments and the budget under-performed. Even without that, public expenditures have to be held in check, partly because of the growth of the foreign debt service. The fiscal situation was improving in the second quarter, however.

The other sign of transitional recession is the effect of privatization. This and the next year should see a significant speed-up of privatization. This means that many enterprises are either preparing for privatization or are undergoing post-privatization restructuring. In both cases, production is, at least temporarily, suffering. It is difficult to assess now what will be the net effect of privatization on growth in the coming two years. This assessment is difficult also because the inflow of FDI has all but stopped. Unless the trend is reversed in the second half of the year, the budget will run into problems and the pressure on the exchange rate will increase.

The growing demand in the past two years did not translate into growth of production, but supported sizeable growth of imports. Exports have grown too, but so has the trade deficit. The growth of the latter continued in the first quarter of 2003. The current account deficit is also growing because of lower transfers. As a consequence, the deficit had to be partly financed from foreign currency reserves. The situation is delicate because the level of reserves is not particularly high. The reserves of the central bank probably cover between four and five months of imports, but the exchange rate market is quite sensitive to even slight negative changes. Also, while the central bank's reserves have recovered, those of the commercial banks have not. Clearly, the IMF will continue to support the central bank – a three-year Structural Adjustment Facility (SAF) programme is being implemented – but it seems reasonably clear that monetary policy has become quite vulnerable to adverse shocks.

Another indication of the problem is the low monetization of the economy. The central bank's reserves cover broad money, M2, more than 100%. In M3 there are only foreign currency deposits in addition to M2. M2 is about 10% of the GDP. M3 to GDP is less than 20%. From this, it can also be concluded that currency substitution in the banks is almost 50%. Of course, there is additional supply of money outside of the banking sector, which is also in foreign currencies. In addition to the halt in the inflow of foreign investments, there are some signs that private transfers are being withheld and there may be some capital flight out of the country.

The developments in Montenegro are somewhat different. Facing a decline in foreign financial support, the government has been going through fiscal consolidation last year and the effort will have to continue. Also, it is facing stubborn inflation, though the euro is the official currency in Montenegro. In 2002, inflation dipped just below 10%, but may accelerate this year because of the introduction of the VAT. Montenegro's trade deficit is also high, though higher incomes from tourism help. However, there are few foreign investments and tourism cannot probably grow very much without significant new investments.

Some of these negative developments are a consequence of the assassination of Prime Minister Zoran Djindjic in March 2002. It is probably more correct to say that this event has aggravated an already worsening trend. Political instability has become a major concern.

Clearly, it will persist until elections are held, which in Serbia may come as late as the end of 2004. In Montenegro, the elections in autumn 2002 have consolidated the power of the government, but stability has proved to be elusive because of the lack of reform.

The political situation in both states has been an obstacle to better cooperation in the Union that they have forged at the beginning of this year. Though the motivation for the creation of the Union has been more in the political problems which a break-up would entail, the explicit aim of the Union is to be a vehicle of EU integration. The EU has insisted on the harmonization of the foreign trade system of the two states as the minimal condition for the start of negotiations on a Stabilization and Association Agreement (SAA) with the EU. However, Serbia and Montenegro are becoming more and more reluctant to compromise. The most difficult issue is that of tariffs. Montenegro does not want to hike its low tariffs on imports, especially of food. By contrast, Serbia is increasingly worried about the growth of imports and the effect those have on its agricultural and food production. In Serbia, this has become an election issue while in Montenegro, any further rise in prices would be difficult to accept. Currently, both states are hoping that the EU will compromise and will start the process of Stabilization and Association without insisting on the harmonization of tariffs. Of course, the problem will re-surface once negotiations on the SAA start.

The growth prospects for this year are modest. Serbia is hoping that the inflow of FDI will surge in the second half of the year and will pave the way for a recovery in the next year. It is also expecting to wind down privatization of all but large state companies, mostly in utilities, and that the newly privatized sector will start to work more efficiently and contribute to an acceleration of growth. Still, the officially projected growth rates of 3% and 5% for this and the next year seem somewhat optimistic at this point. In Montenegro, similar growth rates seem also optimistic because fiscal consolidation will have to continue and a significant surge in investments is hard to envisage.

Table YU

Serbia & Montenegro: Selected Economic Indicators *)

	1998	1999	2000	2001	2002 [1]	2002	2003	2003	2004
						1st quarter		forecast	
Population, th pers., mid-year	10616.9	8372.7	8342.5	8326.4	8304.7	.	.	.	.
Gross domestic product, USD mn, nom. [2]	15487	10090	8670	11545	15686	.	.	19500	20900
annual change in % (real) [3]	2.5	-21.9	6.4	5.1	3.0	.	.	2	4
GDP/capita (USD at exchange rate) [2]	1459	1205	1039	1307	1889	.	.	.	.
Gross industrial production [4]									
annual change in % (real)	3.6	-23.1	11.2	0.0	2.0	-4.1	-3.1	1	3
Gross agricultural production									
annual change in % (real)	-3.2	-1.0	-12.9	17.2	-2.1	.	.	.	.
Goods transport, mn t-kms	45601	30026	32878	17456	5480	.	.	.	.
annual change in %	19.5	.	9.5	-46.9	-68.6	.	.	.	.
Gross fixed investment, YUM mn, nom.	17893.2	24867.8	59315.5	65845.8	.	.	.	.	.
annual change in % (real)	-2.2	-26.3	13.3	.	.	.	.	.	.
Construction output, value of work done									
annual change in % (real)	-0.8	-9.9	.	.	.	.	.	.	.
Dwellings completed, units	13096	13123	12732	12156	12776	.	.	.	.
annual change in %	-11.3	.	-3.0	-4.5	5.1	.	.	.	.
Employment total, th pers., average [5]	2504	2298	2238	2243	2201	2214	.	.	.
annual change in %	-0.1	.	-2.6	0.2	-1.9	-0.4	.	.	.
Employees in industry, th pers., average	884.4	804.5	764.7	739.0	684.0	711.3	.	.	.
annual change in %	2.4	.	-5.0	-3.4	-7.4	-5.3	.	.	.
Reg. unemployed, th pers, end of period	849.4	774.3	812.4	860.5	980.8	881.0	.	.	.
Reg. unemployment rate in %, end of period [6]	25.4	25.5	26.7	27.9	31.2	28.5	.	30	30
LFS - unemployment rate in %, average	13.7	13.7	12.6	12.9	13.8	.	.	15	15
Average net monthly wages, YUM	1063	1309	2588	5545	9113	7779	.	.	.
annual change in % (real, net)	2.0	-15.0	6.5	13.3	24.6	40.2	.	.	.
Retail trade turnover, YUM mn	48748	57697	119522	250312	325855	32112	.	.	.
annual change in % (real, calc.)	3.9	-13.5	11.6	10.8	11.7	17.1	.	.	.
Consumer prices, % p.a.	29.9	44.9	85.6	89.0	16.5	29.1	11.6	15	10
Producer prices in industry, % p.a.	25.5	43.4	106.5	85.1	8.7	14.4	4.8	10	10
General government budget, YUM mn									
Revenues	61360	79321	138749	320475	507008	108641	.	.	.
Expenditures	70739	.	.	.	.	.	.	.	.
Deficit (-) / surplus (+)	-9379	.	.	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP	-6.1	.	.	.	.	.	.	.	.
Money supply, YUM mn, end of period									
M1, Money	10807.3	16332.0	26954.0	52686.0	88839.0	61745.0	82426	.	.
Broad money [7]	62352.0	75393.7	65522.0	107825.0	186966.0	134481.0	184561	.	.
Discount rate, % p.a., end of period	33.7	26.3	26.3	16.4	9.5	12.4	9.0	.	.
Current account, USD mn [8]	-1180	-1341	-339	-624	-1731	.	-614 [9]	-2000	-2000
Current account in % of GDP	-7.6	-13.3	-3.9	-5.4	-11.0	.	.	-10.3	-9.6
Forex reserves of NBY, USD mn	300	297	524	1169	2280	1477	2113	.	.
Gross external debt, USD mn	11500	12500	11418	11740	11839	.	12921 V	.	.
Exports total, fob, EUR mn [10]	2517.7	1391.1	1808.2	2097.0	2399.0	524.2	366.0 I-II	2500	2600
annual growth rate in %	6.7	-44.0	30.0	16.0	14.4	9.4	.	4	4
Imports total, cif, EUR mn [10]	4283.5	3080.8	3892.1	5390.7	6647.5	1511.3	904.0 I-II	6600	6600
annual growth rate in %	0.9	-26.4	26.3	38.5	23.3	9.1	.	-1	0
Average exchange rate YUM/USD	9.34	11.01	16.69	66.84	64.19	69.37	58.88	60	64
Average exchange rate YUM/EUR (ECU)	10.46	11.74	15.30	59.44	60.79	60.34	63.36	66	70

*) Note: From 1999 (GDP from 2000) excluding Kosovo and Metohia.

Notes: 1) Preliminary. - 2) Estimates based on World Bank method. From 1999 based on market exchange rate. - 3) Based on GMP in Dinar. - 4) Excluding private enterprises. - 5) Employees plus own account workers, excluding individual farmers. - 6) In % of unemployed plus employment. - 7) From 2000: at official exchange rate, excluding Montenegro, government deposits, household frozen foreign currency saving deposits. - 8) From 2000 including official grants. - 9) Serbia only. - 10) Converted from the national currency to EUR at the official exchange rate.

Source: **wiiw** Database incorporating national statistics; **wiiw** forecasts.