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Serbia: reforms on hold

The first half of this year has been quite good in economic, though not in political terms. Both these developments have led to low interest in and thus low expectations of a speed-up in reforms. There is some chance that a more ambitious programme of reforms will be introduced after the planned presidential and local elections at the end of this year.

GDP has been reported by the central bank to have grown by 7% in the first quarter. One contributing factor has been fast growing exports. The government is also counting on fast growth of investments, 21.5% in real terms for the whole year, though so far the data on the development are not available. Retail trade has increased by almost 31% in the first four months of this year over the same period last year. Also, wages have gone up by just over 24% in real terms in the same period. Thus, consumption has clearly contributed the most to the GDP growth so far.

Industrial production has continued to grow more slowly than the GDP. Within it, manufacturing is actually doing better, as it posted an 8.6% growth in the first four months. Indirect evidence suggests, however, that services have continued to contribute more to GDP growth. Data on agricultural production come as a rule much later, but the early indications are that it may do worse than last year due to rather unfavourable weather conditions. Construction posted an over 9% growth in the first quarter. There are some suggestions that most of it is happening in the big cities only, i.e., in the three largest cities: Belgrade, Nis and Novi Sad. This would be in line with what has been observed in most other transition countries.

Because of the prolonged political crisis after the parliamentary elections, held in late January, foreign investments, which are still mainly linked to privatizations, have not repeated the stellar performance of the last year. Net foreign direct investments have been put by the government at USD 873 million, which is about EUR 650 million, but some of that money is for the deals done last year. Serbia is supposed to pay a bit less than EUR 500 billion for the acquisition of the Telecom in the Republika Srpska in Bosnia and Herzegovina, so that the net result for the year as a whole may turn out to be rather modest.

In mid-May the government was finally formed. The coalition included the Democratic Party (around 22% of the votes) – which was in opposition in the past three years but is headed by the President of the Republic, Boris Tadić –, the Democratic Party of Serbia (together with the Peoples Party around 17% of the votes) headed by the previous and the current Prime Minister, Vojislav Koštunica, and the small party G17 Plus (around 7% of the votes) headed by the former minister of finance and now minister of economy, Mladjen

Dinkić. The single largest party is the Radical Party (close to 30% of the votes), which is considered to be too nationalist and also openly against EU integration, and was left out of the government; it will have to remain in opposition.

This distribution of votes made it difficult for the coalition to be formed. The incumbent prime minister, Mr. Koštunica, threatened to go into coalition with the Radical Party if he was not re-elected. In the end, his request was accepted and he retained the post of prime minister. This, however, does not address the root causes of the political instability in Serbia. Basically, the government is committed to fight off the independence of Kosovo, which it considers a province of Serbia and which has been under UN protection since the end of the NATO intervention in 1999. At the same time, it is essential for Serbia's stability to continue to strengthen its ties with the EU, which in turn supports independence of Kosovo and is indeed poised to take over most of the UN and NATO responsibilities there. In addition, the progress in EU integration depends on the cooperation with the Hague Tribunal, which means that the Serbian government will have to come up with the most wanted indictees, Radovan Karadžić and Ratko Mladić. On any of these issues, the government can collapse.

After the formation of the new government, the EU resumed the negotiations for the Stabilization and Association Agreement that had been discontinued last year because of Serbia's lack of cooperation with the Hague Tribunal. The Serbian government on its part arrested two out of the five remaining indictees. At the same time the process of Kosovo independence has stalled in the UN Security Council giving the Serbian government the much needed time to try and strengthen its political position. It has chosen a two-pronged strategy as far as anyone can tell. On the one hand, it is trying to speed up the process of EU integration.

On the other hand, it has decided to shelve further reforms for the time being. This is clear from the budget that was adopted at the end of June. This is the budget for 2007 to be sure; again because of the political crisis, the budget was not adopted at the end of last year and could not be adopted earlier this year since there was no government. As a consequence, the budget essentially legalizes the fiscal inertia created during the long period of temporary financing. Therefore no reforms are envisaged in this budget. Worse than that, no corrections of the strong pre-election expansion of expenditures is contemplated. According to the central bank, the fiscal deficit was 7.4% of the GDP in the last quarter of 2006. Most of the increase in spending went to wages and salaries, which has not been reversed. Thus, the budget counts with more than 20% real growth of wages with only 5% growth in productivity in 2007.

The prospects for consolidation and reforms later this year or next year depend very much on the outcome of the presidential and local elections that should take place at the end of

the year. Presidential elections might not even be held, though they were planned. If the nationalist opposition does well in the local elections, which is almost certain, the prospects for reforms will be bleak. At the moment, business sentiment does not reveal any expectations of political or economic shocks. The stock exchange has become somewhat risk averse, but that is in line with similar developments in the stock markets throughout the region.

Given the growing confidence of the business community, short-term and medium-term prospects are favourable, political risks and instability notwithstanding. Further than that, much will depend on the way that growing imbalances especially on the external account are handled.

Table RS

Serbia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., mid-year ²⁾	7500	7481	7463	7450	7440	.	.	.	.
Gross domestic product, RSD mn, nom.	1020117	1171564	1431313	1750000	2139800	.	499000	2427000	2701000
annual change in % (real)	4.2	2.5	8.4	6.2	5.7	7.0	8.7	5	5
GDP/capita (EUR at exchange rate)	2242	2408	2643	2833	3424	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5380	5530	6150	6670	7210	.	.	.	.
Gross industrial production ³⁾									
annual change in % (real)	1.8	-3.0	7.1	0.8	4.7	5.7	4.8	5	5
Gross agricultural production									
annual change in % (real)	-2.1	-11.4	26.0	-3.4		.	.	.	.
Construction output total									
annual change in % (real) ⁴⁾	-7.4	10.8	3.5	2.0	9.3	.	.	.	.
Consumption of households, RSD mn, nom.	819739	885658	998540	1221531	1475003	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
Gross fixed capital form., RSD mn, nom.	120502	188875	253333	301962	383907	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
LFS - employed persons, th. Oct ⁵⁾	3000.2	2918.6	2930.8	2733.4	2630.7	.	.	.	.
annual change in %	-3.4	-2.7	0.4	-6.7	-3.8	.	.	.	.
Reg. employees in industry, th pers., avg.	648.1	605.3	562.2	536.1	493.3	508.7	470 ¹⁾	.	.
annual change in %	-8.0	-6.6	-7.1	-4.7	-8.0	-5.7	-8.4 ¹⁾	.	.
LFS - unemployed, th pers., Oct ⁵⁾	459.6	500.3	665.4	719.9	693.0	.	.	.	.
LFS - unemployment rate in %, Oct ⁵⁾	13.3	14.6	18.5	20.8	20.9	.	.	22	23
Reg. unemployment rate in %, end of period ⁶⁾	30.5	31.9	26.4	27.1	27.9	.	.	29	30
Average gross monthly wages, RSD	13260	16612	20555	25514	31745	28202	35047.7	.	.
annual change in % (real, net)	29.9	13.6	10.1	6.4	11.4	10.9	18.6	.	.
Consumer prices, % p.a.	16.6	9.9	11.4	16.2	11.6	14.8	4.8	8	6
Producer prices in industry, % p.a.	8.8	4.6	9.1	14.2	13.3	14.3	5.5	8	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	.	.	-2	-2
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⁾	-1323.4	-1256.9	-2308.0	-1790.2	-2906.1	-680.5	-1149.0	-3700	-3700
Current account in % of GDP	-7.9	-7.0	-11.7	-8.5	-11.4	.	-18.5	-12.5	-11.5
Gross reserves of NB, excl. gold, EUR mn	2076.8	2728.2	3008.0	4753.7	8841.3	5142.0	8598.4	.	.
Gross external debt, EUR mn	10768	10858	10355	13064	14885	12616	14858	.	.
Gross external debt in % of GDP	64.0	60.3	52.5	61.9	58.5	.	.	.	.
FDI inflow, EUR mn ⁷⁾	504.1	1208.3	777.1	1265.3	3504.3	161.0	665.4	.	.
FDI outflow, EUR mn ⁷⁾	.	.	.	17.9	16.8	-7.5	2.9	.	.
Exports of goods, BOP, EUR mn ⁷⁾	2347.6	2937.9	3283.8	3998.9	5155.7	1041.1	1381.3	6450	7750
annual growth rate in %	15.5	25.1	11.8	21.8	28.9	.	32.7	25	20
Imports of goods, BOP, EUR mn ⁷⁾	5773.5	6497.1	8487.9	8255.3	10107.8	2142.3	2793.6	12600	15700
annual growth rate in %	25.3	12.5	30.6	-2.7	22.4	.	30.4	25	25
Exports of services, BOP, EUR mn ⁷⁾	794.9	919.7	1188.2	1316.3	1674.8	306.5	441.7	2340	2930
annual growth rate in %	16.0	15.7	29.2	10.8	27.2	.	44.1	40	25
Imports of services, BOP, EUR mn ⁷⁾	657.0	740.9	1047.4	1321.2	1724.1	338.2	451.6	2240	2690
annual growth rate in %	59.1	12.8	41.4	26.1	30.5	.	33.5	30	20
Average exchange rate RSD/USD	64.40	57.58	58.38	66.71	66.82	72.61	60.86	.	.
Average exchange rate RSD/EUR (ECU)	60.68	65.05	72.57	82.91	84.06	87.18	80.19	82	84
Purchasing power parity RSD/USD, wiiw	21.80	24.00	26.30	29.50	32.90	.	.	.	.
Purchasing power parity RSD/EUR, wiiw	25.30	28.30	31.20	35.20	39.90	.	.	.	.

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. - 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.

Source: wiiw Database incorporating national statistics; wiiw forecasts.