# Serbian economy grows steadily, but further reforms and capital inflows needed

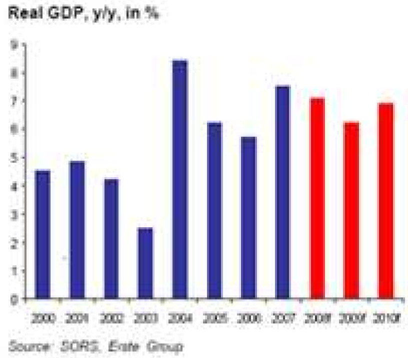
**06.10.2008**

- Political risks diminished - Serbia's EU prospects stable
- GDP growth to remain strong at around 7%, growth to remain driven by domestic demand
- Current account deficit to widen, given pressures on merchandise account
- Inflation pressures expected to moderate towards year-end
- NBS expected to remain on hold in 2008

The political developments in the last six months have again been extensive. The parliamentary elections organized in May were concluded, after intense negotiations, with the pro-European forces managing to assemble a DS-led coalition and a new government headed by DS candidate Mirko Cvetkovic. Such a resolution alleviated a significant proportion of the political risks to macroeconomic stability and was in line with our expectations (as stated in previous reports). Additionally, Serbia got a boost in its EU prospects by cooperating with the ICTY in The Hague to arrest alleged war criminal Radovan Karadzic. Provided that this step will be followed by additional efforts to prove full cooperation with the ICTY, high chances are that the EU will open negotiations. Overall, we conclude that the degree of political risk is significantly lower than six months ago and that Serbia is on a stable EU track. Given the recent political developments, it may also be the right time to pursue structural reforms to a greater extent and improve institutional capacities. This would enhance the business climate and attract much-needed investments.

**Steady GDP growth at around 7% - economy performs strongly**

After the 4Q07 slowdown, 1Q08 brought a recovery of economic activity, as GDP growth accelerated to a robust 8.2% y/y, thus beating our expectations. In 2Q, GDP performance should be supported by agricultural production, while construction activity is also expected to maintain a supportive tone. On the other hand, short-term indicators imply a lower contribution from industrial production, mainly as a result of lower non-manufacturing activity. “Overall, we see the FY08 GDP growth rate at slightly above 7%, pointing to a stable and strong performance of the economy in terms of GDP growth. In the mid run, we see stable economic performance prospects”, comments Alen Kovac, the macro analyst of Erste Group.



Source: SORS, Erste Group

Despite a one-off improvement due to a methodology change that has increased the current transfers balance, the current account deficit remains high at 13.2% of GDP for 2007; 2008 should bring an additional widening of the external imbalances. Import and export dynamics accelerated in 2Q, with imports maintaining the stronger pace, outpacing exports by 27.7% vs. 24.5% y/y (in EUR terms). Since there is still no clear signal from the merchandise account that would support a significant trend reversal in the coming years, we see the deficit standing at 17% of GDP in 2008.

On the financing side, FDI financing trends remain favourable, although the structure of FDIs is less favourable, as the financial sector is dominant and there is no significant effect on production and export capacities. Finally, given the high level of FX reserves, foreign debt repayment risk remains low and Serbia has quite strong capacities to neutralize potential external shocks (ensuring steady capital inflows remains a priority).

**Maintaining a prudent fiscal policy is essential**

In a more stable political framework, further reforms should pave the way for much-needed capital inflows – the recent FIAT example should show the direction to go in. On the other hand, the fiscal performance calls for some caution, as - according to the 2008 budget - a rebalance and increase of the fiscal spending deficit to around 2% could be expected. While the size of the fiscal deficit is not worrying, the direction of fiscal policy calls for some caution; with external imbalances and ongoing inflationary pressures, calls for prudent fiscal policy are getting louder. The achievement of the announced goals for the coming years will require a greater deal of fiscal discipline, which has yet to be proven.

**Inflation expected to tone down towards the year-end**

With strong pressures from global oil and market developments, inflation peaked in 2Q08; 3Q finally offered some trend reversal, as supply-side pressures eased to some extent. “Towards the year-end, we see inflation on a mild downward trajectory; for 4Q, we expect inflation to return to the single-digit region", Kovac further points out.  On average, the inflation rate is expected to stand close to 11% in 2008, but if pressure from the supply side does not reemerge in 2009, Erste Group analysts are optimistic that inflation could approach the NBS' 2009 targeted inflation band of 2.5-5.5%.

**No excessive exchange rate deviations expected**

After the turbulent developments on the FX market in 1H08, 3Q brought some stabilization. Political uncertainties have been assuaged by the new democratic bloc-led government, supporting exchange rate strengthening. The NBS further supported the dinar exchange rate. "With political risks considerably diminished, we see lower volatility on the FX market although towards the year-end there might still be some room for mild depreciation", Erste Group analyst comments. Overall, exchange rate stability should not come into question, while the central bank should maintain its orientation towards preserving exchange rate stability, in order to control both inflation pressures and expectations.

**NBS to remain on hold**

Since our last report, the NBS' monetary stance has tightened further. However, since the last key-interest rate in May, the NBS has remained on hold, assessing that the hiking cycle should suffice at the moment, accompanied by favourable exchange rate developments and dinar strengthening (by more than 5%, on average). We expect the NBS to remain on hold at least until it is assured of positive inflation developments, which means a relatively low likelihood that we will see the beginning of a cutting process already this year. The NBS remains keen to moderate credit growth and monetary trends, in order to tackle both external imbalances and inflationary pressures.

ERSTE GROUP

# Country Report Serbia

October 6, 2008

## Macroeconomy

Political risks diminished - Serbia's EU prospects stable

GDP growth to remain strong at around 7%, growth to remain driven by domestic demand

Inflation pressures expected to moderate towards year-end

NBS expected to remain on hold in 2008

# Country Report

http://global.treasury.erstebank.com

## Summary

- **Political risks diminished - Serbia's EU prospects stable**

- **GDP growth to remain strong at around 7%, growth to remain driven by domestic demand**

- **Current account deficit to widen, given pressures on merchandise account**

- **Indebtedness indicators to remain stable, international liquidity indicator looks comfortable**

- **Inflation pressures expected to moderate towards year-end**

- **No excessive exchange rate deviations expected**

- **NBS expected to remain on hold in 2008**

- **Prudential monetary measures to remain tight**

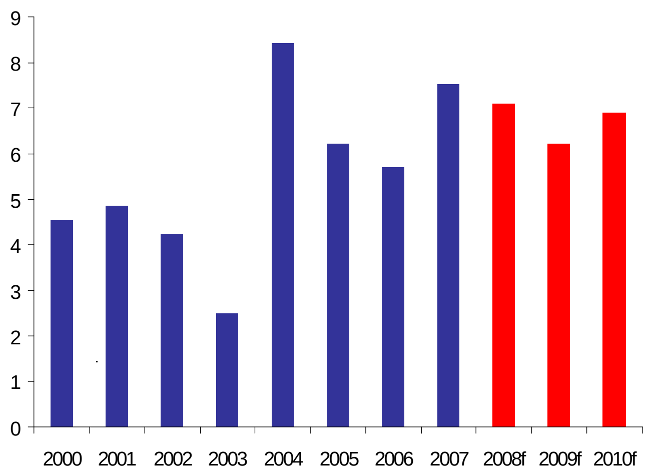
- **Some fiscal loosening underway in 2H08**

### Forecasts

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007F | *2008F* | *2009F* |
|---|---|---|---|---|---|---|---|---|---|
| Real GDP (% y-o-y) | 4.8 | 4.2 | 2.5 | 8.4 | 6.2 | 5.7 | 7.5 | *7.1* | *6.2* |
| Industrial production (avg.% y-o-y) | 0.1 | 1.8 | -3.0 | 7.1 | 0.7 | 4.7 | 5.4 | *4.5* | *6.0* |
| Unemloyment rate (%) - ILO methodology | 12.23 | 13.28 | 14.63 | 18.50 | 20.8 | 20.9 | 18.1 | *14.0* | *13.0* |
| RPI (average % y-o-y) | 91.8 | 19.5 | 11.7 | 10.1 | 16.5 | 12.8 | 6.5 | *11.0* | *7.2* |
| Consolidated government balance (% of GDP) | n/a | n/a | n/a | 0.5 | 0.7 | -1.5 | -1.9 | *-2* | *-1* |
| Current account balance (% of GDP) | 2.4 | -4.1 | -7.5 | -13.3 | -8.4 | -9.8 | -13.2 | *-17.2* | *-18.0* |
| Net FDI (% of GDP) | 1.4 | 3.0 | 6.6 | 3.9 | 5.9 | 14.4 | 5.5 | *8.0* | *8.6* |
| Gross external debt (% of GDP) | 96.2 | 64.0 | 60.3 | 52.5 | 62.0 | 61.4 | 60.8 | *58.9* | *59.1* |
| Gross external debt (% of exports) | 461.4 | 345.5 | 312.6 | 249.4 | 245.1 | 217.5 | 206.7 | *195.7* | *186.1* |
| Exchange rate (EUR/RSD) annual average | 59.78 | 60.68 | 65.05 | 72.57 | 82.92 | 84.16 | 79.98 | *79.50* | *78.00* |

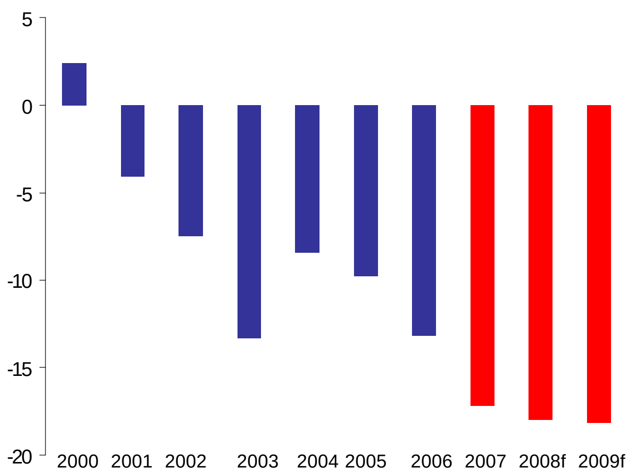
*Source: NBS, SORS, MFIN,EB*

### Real GDP, y/y, in %




*Source: SORS, Erste Group*

### Current account balance (in % of GDP)




*Source: SORS, NBS, Erste Group*

## Politics

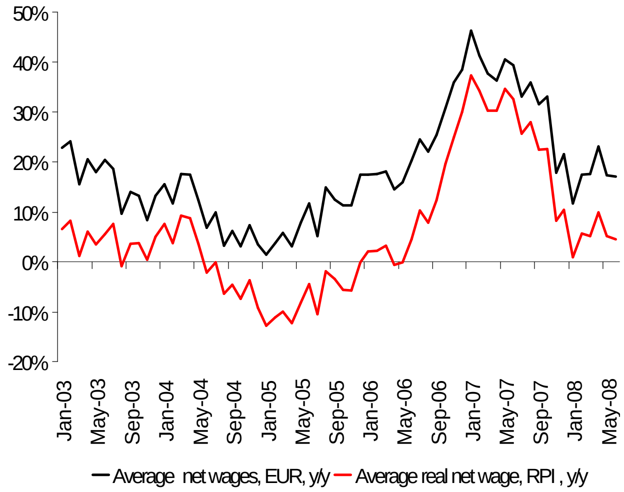
The political developments in the last six months have again been extensive. To start, May brought early parliamentary elections after the DS-DSS-led government broke up earlier this year. The elections, which were held together with the local elections, reversed the trend, as the coalition around President Tadic's DS party enjoyed increased support and accounted for the most votes (38.4%). The radical SRS came in second (29.5%), while former PM Kostunica's DSS party finished third (11.6%). Post-election negotiations were again difficult, as both the democratic bloc around DS and SRS&DSS needed support from former President Milosevic's SPS party to constitute a new government. Finally, in the aftermath of intense negotiations, SPS agreed to a DS-led coalition and the pro-European forces managed to assemble a new government headed by DS candidate Mirko Cvetkovic. Such a resolution alleviated a significant proportion of the political risks to macroeconomic stability and was in line with our expectations (as stated in previous reports).

Meanwhile, the Kosovo issue remains open, as Serbia is struggling to get support from the International Court of Justice and block Kosovo's claim to independence. While this legal battle could be lengthy, we currently do not assign a significant risk to overall macro stability from this issue. Coming to the EU front, in July, Serbia made a big step in proving full cooperation with the ICTY court in The Hague by arresting fugitive war criminal Radovan Karadzic. While full cooperation criteria have not been fulfilled yet (as another alleged war criminal, Ratko Mladic, has to be arrested), this recent event gave a strong boost to Serbia's EU prospects. Due to the lack of full cooperation, the Stabilization and Association Agreement activation is still blocked by the EU. On the other hand, the SAA triggered some political changes upon its parliamentary approval. SRS split up over that issue, given the lack of a common view between Mr. Nikolic and Mr. Seselj and other party members, as Mr. Nikolic opted to support the SAA and consequently had to step down (he was expelled from the party). The split of SRS into two or perhaps even more factions should dilute the radicals' strength and take a number of MPs from SRS, making the democratic bloc's position stronger. Overall, we conclude that the degree of political risk is significantly lower than six months ago and that Serbia is on a stable EU track. Some additional efforts to prove full cooperation with the ICTY are still needed, but signing of the SAA and subsequent opening of EU negotiations could occur quite soon. Given the recent political developments, it may also be the right time to pursue needed reforms to a greater extent.

## Labor market, reforms and fiscal policy

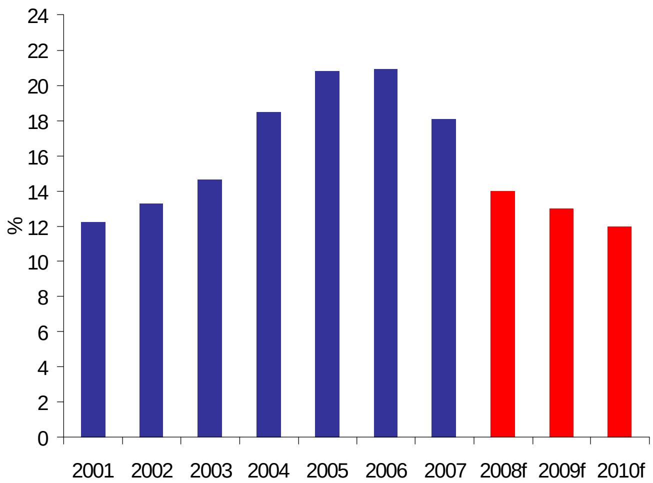
The latest Labor Force Survey figures brought some positive surprises, as the unemployment rate declined from 18.1% to 13.3% (i.e. from 18.8% to 14.0%, if we take into account the population aged 15-64). Such a strong decline of the unemployment rate can be attributed to the changing methodology (making it internationally comparable) and - to some extent - to the fact that, from 2008, the LFS Survey is being conducted semi-annual, so intra-year patterns could have affected the results somewhat. The activity rate slightly increased from 51% to 51.5%. In line with the declining unemployment rate, the employment rate increased from 41.8% to 44.7%. However, when talking about trends, we should take these figures with a grain of salt, as the unemployment rate decline was most likely a one-off influenced by methodology changes. Some positive trends are visible in the official statistics (biannual survey), as the total employment level increased by 5ths (for the first time since 2005) from September 2007 to March 2008. Another interesting development is that, for the first time since 2004, employment in legal entities recorded an increase (4ths). On the other hand, the job-creation process related to natural persons slowed down to some extent, but remained positive, recording an increase of 1ths. Overall, we expect a continuation of the mildly positive trends on the labor market and, in the mid run, the downward unemployment rate trend, driven by the strong economic performance, stabilization of wage dynamics and attraction of foreign investments. Wage growth in nominal terms remained robust but steady, slowing down only marginally to slightly below 20% y/y. However, in real terms, the trend deteriorated due to inflationary pressures, as real wages approached the neutral zone. So far, inflation pressures have not translated into rising pressures on nominal wages. Nevertheless, in nominal terms, growth remains strong and the wage catch-up process (at least in nominal terms) is still ongoing.

**Wages**




*Source: SORS, NBS*

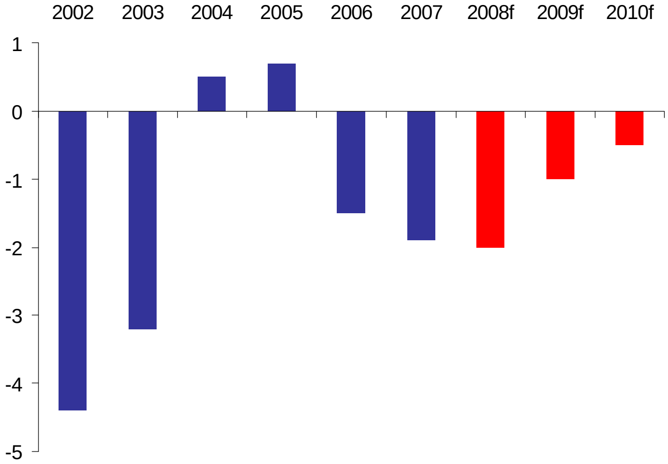
**Unemloyment rate (%) - ILO methodology**




*Source: SORS*

Given the beginning of the political cycle, it may be highly appropriate timing to tackle structural reforms further and improve institutional capacities and the institutional framework to enhance the business climate and attract much-needed capital inflows. The recent FIAT example should show the direction to go in, as, in the mid run, such large-scale FDIs would definitely have positive impacts on the employment level, production potential and exports. Also, the transfer of valuable knowledge and technology and the potential to form an automotive cluster provides an opportunity for additional investments and better economic prospects. Another proof of the strong incentives set out to attract scarce greenfield FDIs came in the form of covering 25% of a total greenfield investment if it surpasses EUR 200mn and employs at least 1,000 people. The fiscal performance calls for some caution, as - according to the 2008 budget - a rebalance and increase of the fiscal spending deficit to around 2% could be expected. While the size of the fiscal deficit is not worrying, the direction of fiscal policy calls for some caution; with external imbalances and ongoing inflationary pressures, calls for prudent fiscal policy are getting louder. While rationales can be found for capital spending such as on Koridor X and strategic deals like the partnership with FIAT, moves like the pension increase are more of a populist nature. The achievement of the announced goals for the coming years will require a greater deal of fiscal discipline, which has yet to be proven. Given the current turbulent global environment, some kind of an agreement with the IMF would be useful to boost fiscal creditworthiness and improve financing conditions.

**Consolidated government balance (% of GDP)**

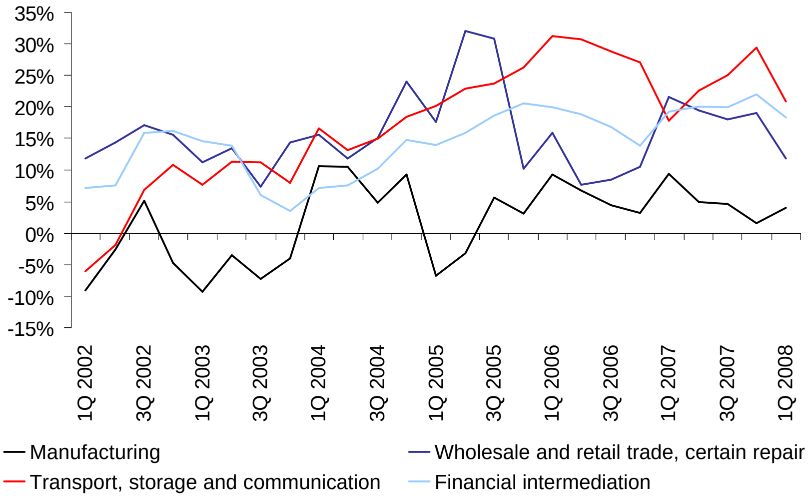



*Source: NSB, Erste Group*

## GDP, balance of payments and foreign debt

We will start with a quick recap of the 2007 GDP performance. Given the economic activity slowdown in 4Q07, FY07 GDP growth came in at 7.5% y/y, accelerating by a robust 1.8pp with respect to 2006. GDP growth moderated to 6.9% y/y in 4Q07, but, in structural terms, no dramatic changes occurred. The negative agricultural growth contribution was confirmed, while the industrial production contribution also slowed down. The service sector (with wholesale and retail trade, financial intermediation and communications and telecommunications in the first row) supported the growth and maintained robust growth rates. Construction activity also maintained its sluggish trend. After the 4Q07 slowdown, 1Q08 brought a recovery of economic activity, as GDP growth accelerated to a robust 8.2% y/y, thus beating our expectations. The agricultural production contribution - after falling into negative territory in 2007 - has stabilized at close to zero. Industrial production, on the other hand, supported growth robustly, as solid manufacturing activity (+3.9% y/y) was accompanied by strong quarrying and mining (9.5% y/y) and electricity, gas and water supply (10.9% y/y) activity. Construction activity also showed some signs of a revival, accelerating to 4.3% y/y. After a robust 4Q07, service sector trends slightly reversed. Wholesale and retail activity was affected the most, slowing down to 11.8% y/y (vs. 18.9% in 4Q07), while telecommunications and transportation also slowed down, recording 20.4% y/y (vs. 29.4% in 4Q07). Financial intermediation has been only marginally affected, slowing a notch to 18.3% y/y. For 2Q, we expect GDP growth to moderate to around 7% y/y. The GDP performance should be supported by agricultural production, while construction activity is also expected to maintain a supportive tone. On the other hand, short-term indicators imply a lower contribution from industrial production, mainly as a result of lower non-manufacturing activity. The service sector is expected to remain supportive, while some further moderation of the wholesale and retail trade contribution can be expected. As far as 2H08 is concerned, we do not anticipate a significant slowdown of economic activity, although several factors are likely to prove burdensome. High inflation pressures should continue to negatively affect purchasing power, which, given the moderating credit activity and deteriorating real wages, could have a negative effect on domestic demand. The strongest offsetting potential comes from the expectedly robust agricultural sector performance, which is expected to recover from the poor 2007, given the stable weather conditions. Industrial production and construction trends should remain on the positive side. Domestic demand could also get some support from the likely fiscal loosening in 2H08. Although the growth combo is domestic demand-driven, some downward risks come from the deterioration of global and regional economic prospects and the negative effect on the level of external demand. Overall, we see the FY08 GDP growth rate at slightly above 7%, pointing to a stable and strong performance of the economy in terms of GDP growth. In the mid run, we see stable economic performance prospects. However, we also anticipate some risks in 2009 from the global slowdown, always volatile agricultural output and existing risks related to domestic demand. Nevertheless, we do not see a significant slowdown as likely and we expect GDP growth of around 6%.

**GDP structure**

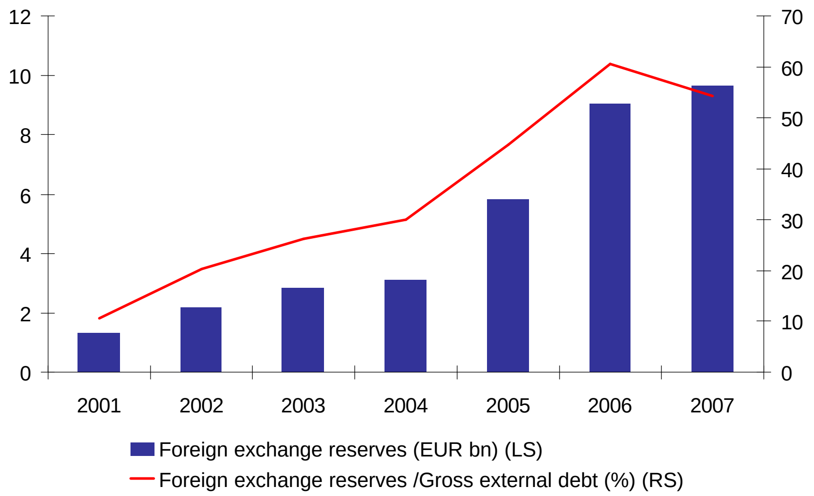



*Source: SORS, NBS*

Coming to the balance of payments performance, the picture looks quite different. Despite a one-off improvement due to a methodology change that has increased the current transfers balance, the current account deficit remains high at 13.2% of GDP for 2007; 2008 should bring an additional widening of the external imbalances. Once again, the merchandise account is in the spotlight. Import and export dynamics accelerated in 2Q, with imports maintaining the stronger pace, outpacing exports by 27.7% vs. 24.5% y/y (in EUR terms). Given the below 50% export/import coverage ratio, the deficit on the merchandise account widened by 31% y/y in 2Q. Overall, Serbia is paying for its strong domestic demand (both consumer and investment), while high oil and food prices have fuelled nominal-term imports. The conclusion remains roughly the same, as Serbia should strive to improve its export performance, while policies aimed at sustaining demand pressure should be strengthened to ease the pressure on the import side. In line with present trends (evident pressures on the import side and a challenge to maintain export growth dynamics, given the deterioration of the regional economic outlook), we see a further widening of the trade balance deficit, which is expected to approach 25% of GDP. The services account still has an overall marginal effect on the current account. On the other hand, the income account continued to deteriorate, as the deficit increased by approx. 20% y/y in 2Q. The rising income account deficit came as little surprise, given the higher cost of debt servicing and increasing dividend outflows. This category should continue to put create pressure in the coming year as well. Current transfers remain the only strong offsetting category, which is expected to continue to steadily ease the C/A pressure, as capacities to compensate for the rising imbalances are rather limited. Therefore, we see the C/A deficit standing at 17% of GDP in 2008, which is a significant deterioration from last year. There is still no clear signal from the merchandise account that would support a significant trend reversal in the coming years.

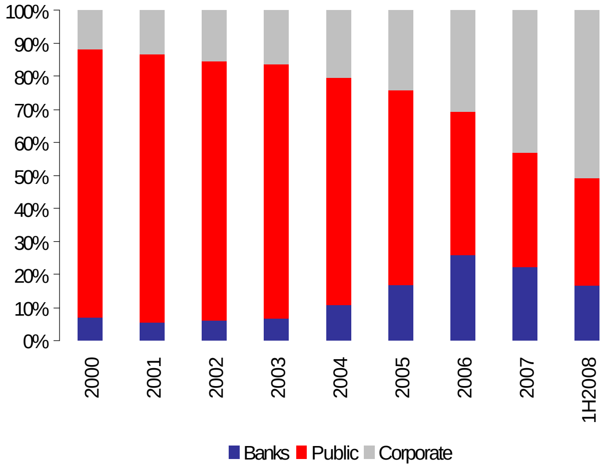
On the financing side, FDI financing trends remain favorable, although the structure of FDIs is less favorable, as the financial sector is dominant and there is no significant effect on production and export capacities. FDI inflows in 2006/2007 covered slightly less than 50% of the current account deficit. We see FDI inflows as likely to remain relatively stable, despite some risks arising from higher global risk aversion. Still, pressures on financing through foreign debt creation should remain, given the level of external imbalances. Also, the monetary policy framework continues to influence foreign debt trends, as the corporate sector (due to the tight monetary stance) is going for direct foreign financing. Hence, a look at the foreign debt structure shows that banks account for a declining proportion of total foreign debt (16.7%), while corporate sector borrowing activity remains robust (as the corporate sector accounts for over 50% of total debt). While foreign debt is expected to increase at a double-digit pace, indebtedness indicators are not expected to deteriorate, as foreign debt to GDP is expected to remain stable at around 60% of GDP (given the strong expected growth of nominal GDP), while foreign debt to total exports is expected to maintain its mild downward trend from the previous years. International liquidity indicators look quite comfortable, as short-term debt accounts for a small proportion of total debt (approx. 7%), while FX reserves cover almost 50% of total debt and short-term debt accounts for only 14% of total FX reserves. Hence, given the high level of FX reserves, foreign debt repayment risk remains low and Serbia has quite strong capacities to neutralize potential external shocks (ensuring steady capital inflows remains a priority). Also, the accumulation of FX reserves is unlikely to follow foreign debt growth. Hence, some deterioration of liquidity indicators can be expected.

**International solvency**



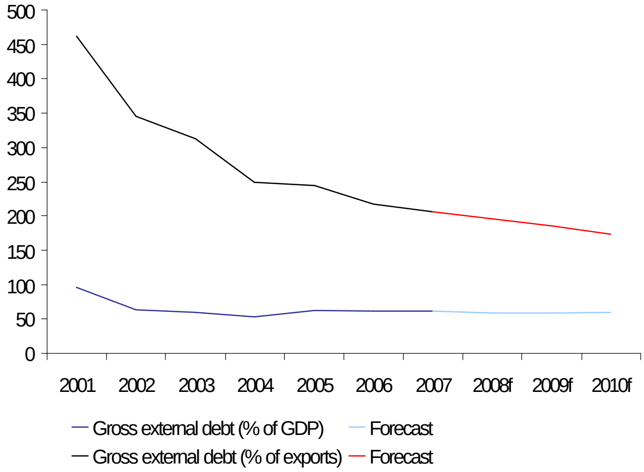

*Source: NBS, Erste Group*

**Foreign debt structure**




*Source: NBS*

**Foreign debt/GDP/Exports**

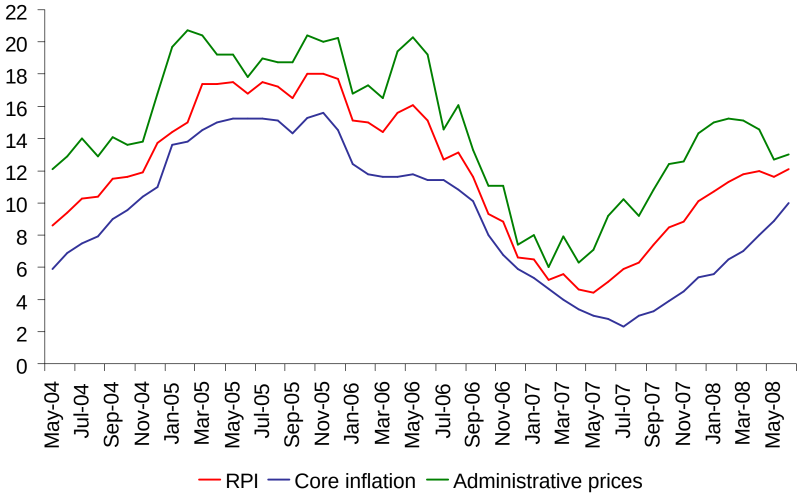



*Source: NSB, EB*

## Inflation and exchange rate

In our last country report a half-year ago, we characterized the official NBS targeted inflation range as challenging, as supply-side inflation pressures were surging. 1H08 brought similar trends, as food and oil prices escalated further, reaching all-time highs. Hence, what looked to be a challenging task six months ago is now clearly out of reach, as it is certain that the targeted inflation band will not be met. First of all, it should be mentioned that inflation is not an isolated Serbian problem, but rather a global phenomenon that tops policy-makers' agendas. Thus, NBS credibility should not be endangered, especially as its monetary policy has remained prudent. Moving back to indices, looking at both the RPI and CPI figures, food prices contributed substantially to inflationary pressures; in 2Q08, these components recorded approx. 30% y/y growth rates. With strong pressures from global oil and market developments, inflation peaked in 2Q08, as RPI recorded 12.1% y/y (the highest figure since mid-2006) and CPI hit 15.9% y/y (the highest level since the end of 2005). Inflation pressures were also boosted by rising inflation expectations. Also, the 1Q exchange rate depreciation could have had a latent effect on the inflation pressures in 2Q. 3Q finally offered some trend reversal, as supply-side pressures eased to some extent. July brought a decline of oil prices on global markets, which should translate into lower pressures from this side. Nevertheless, oil prices remain under considerable risk. Thus, a revival of these pressures cannot be ruled out. Due to the seasonal pattern and favorable weather conditions, food prices are also helping to moderate the pressure, while exchange rate strengthening has worked in the same direction. Hence, RPI and CPI decelerated to 10.5% and 11.6% y/y, respectively. Towards the year-end, we see inflation on a mild downward trajectory; for 4Q, we expect inflation to return to the single-digit region. Our forecast remains sensitive to external supply-side shocks. Stable exchange rate movements are expected to have a positive effect on price stability, while inflation expectations could remain elevated for some time. Some upward risks come from the expected fiscal loosening, while the electricity price hike in August should add to the pressures. Wage dynamics remain steady in nominal terms, hence not additionally burdening the inflation outlook at the moment. On average, the inflation rate is expected to stand close to 11% in 2008, but if pressure from the supply side does not reemerge in 2009, we are optimistic that inflation could approach the NBS' 2009 targeted inflation band of 2.5-5.5%.

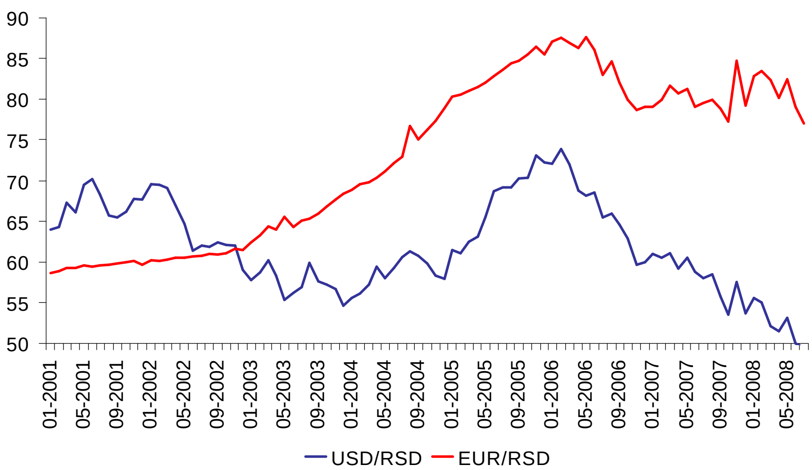
**Inflation**




*Source: NBS*

After the turbulent developments on the FX market in 1H08, 3Q brought some stabilization. Political uncertainties have been assuaged by the new democratic bloc-led government, supporting exchange rate strengthening. Other factors also supported the exchange rate. First of all, the NBS hiked the 2W reference REPO rate by an additional 125bps to 15.75%, aiming to attract interest rate-sensitive FX capital inflows. Also, by modifying the mandatory reserve calculation and increasing the proportion of reserves that have to be deposited in dinars, the NBS further supported the dinar exchange rate. Along with the continuation of robust capital intakes by the banking sector, the dinar appreciated from above the 80 RSD/EUR level, stabilizing in the 76-77 range during the recent period. With political risks considerably lower, we see lower volatility on the FX market. Towards the year-end, we still see some room for mild depreciation, but no significant deviation from the present levels. The external imbalance and high financing needs imply potential pressures on the depreciation side. Financing should be sufficient, but we do not anticipate excess FX inflows either. In the mid run, we leave our assumptions unchanged, as we expect pressures on the appreciation side to prevail. However, with rising external imbalances, we also do not expect excessive pressures to mount. Overall, exchange rate stability should not come into question, while the central bank should maintain its orientation towards preserving exchange rate stability, in order to control both inflation pressures and expectations.

**Monthly exchange rate**

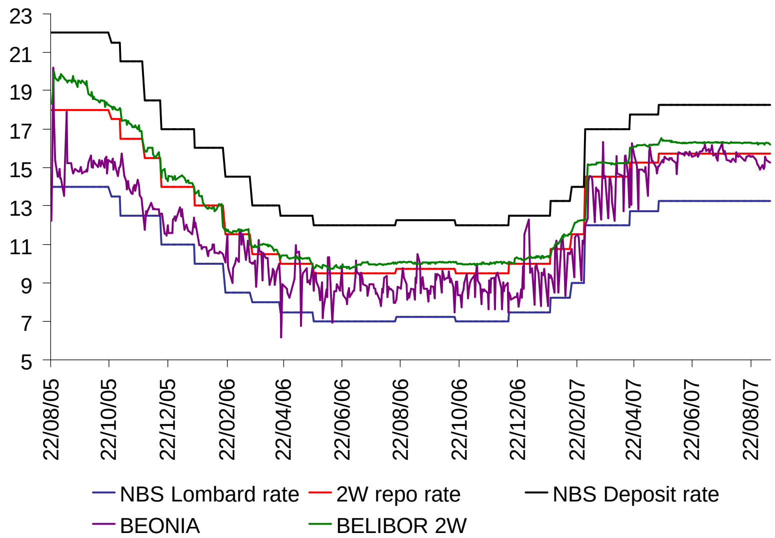



*Source: SORS, NBS*

## Monetary policy and banking sector

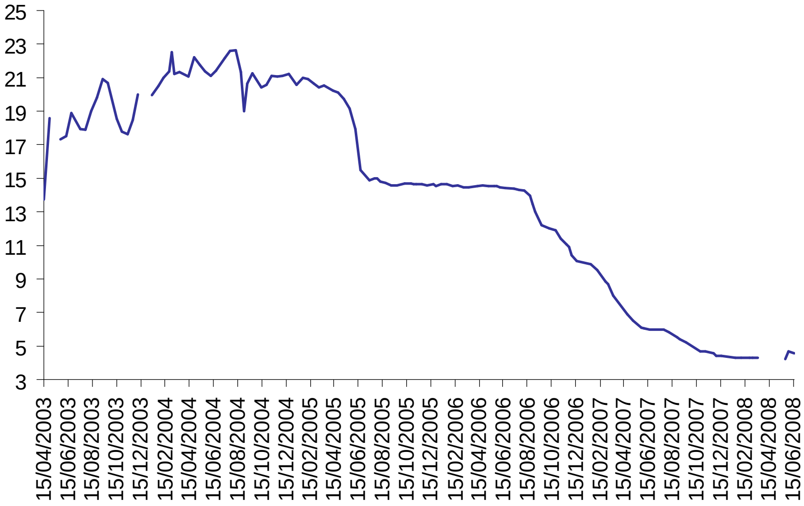
Since our last report, the NBS' monetary stance has tightened further, albeit to a much lesser extent than in 1Q08. At the very end of April, the NBS - due to ongoing currency depreciation pressures and increased volatility - again hiked, increasing the 2W REPO rate by 75bps to 15.25%. May brought another 50bps hike to 15.75%, adding up to a robust 625bps hiking cycle in less than six months. The NBS thus showed no reluctance to tighten the monetary stance in a rising inflationary environment accompanied by volatile exchange rate developments. Since May, the NBS has remained on hold, assessing that the hiking cycle should suffice at the moment, accompanied by favorable exchange rate developments and dinar strengthening (by more than 5%, on average). We expect the NBS to remain on hold at least until it is assured of positive inflation developments, which means a relatively low likelihood that we will see the beginning of a cutting process already this year. We also see relatively low risks of further hikes, given the favorable short-term inflation outlook. For 2009, we see some room for rate cuts if inflation trends remain relatively favorable, although we expect the NBS to act cautiously. Apart from changing the mandatory reserve calculation (increasing demand for RSD) and some minor regulation changes, the prudential measures remained unchanged. Overall, the prudential measures remain tight, given the high reserve requirement on foreign-based financing, thus making this financing channel unattractive, given the elevated global interest rates and increasing risk premium. The NBS remains keen to moderate credit growth and monetary trends, in order to tackle both external imbalances and inflationary pressures.

**MM rates**




*Source: Reuters, NBS*

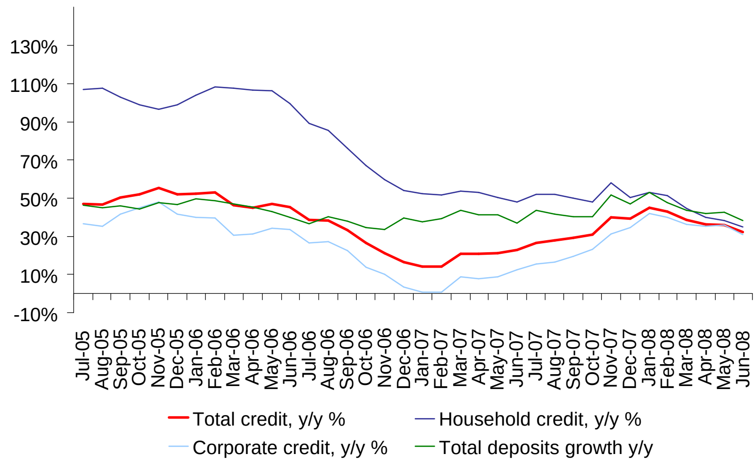
**91-day T-bill rate**




*Source: Ministry of Finance*

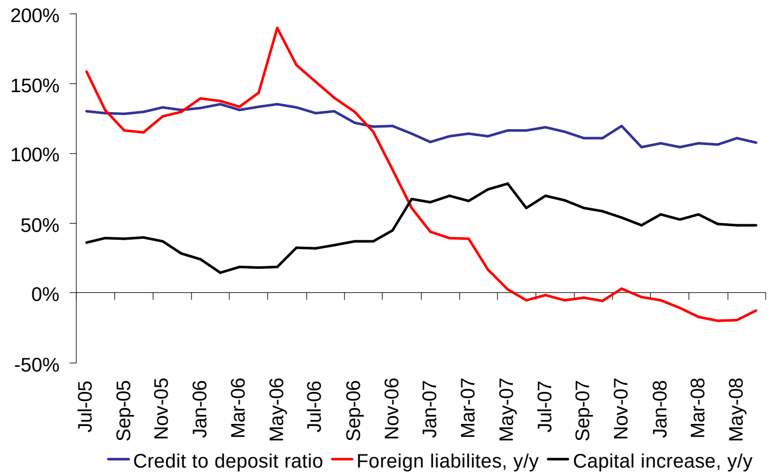
Looking at the monetary trends, credit activity (with respect to the end of 2007, 39.2% y/y, and 1Q08, 38.6% y/y) has lost momentum, moderating to 33.2% y/y. However, the picture is somewhat distorted by the exchange rate strengthening. Hence, the real slowdown is less pronounced. In terms of the segments, household credit slowed significantly, bringing the annual growth rate from above 50% in 4Q07 to approx. 35% at the end of 2Q08. Corporate credit slowed down to a lesser extent, as its annual growth rate is only a notch lower than at the end of 2007. Hence, the NBS' credit growth-moderating measures are gradually affecting credit activity, especially in the household segment (as the NBS is looking to shift banking sector preferences away from the household segment). Coming to the liabilities side, deposit activity also slowed down to some extent (again influenced by exchange rate strengthening). Household deposits moderated to 35% y/y, after hovering in the 45-60% y/y band in 4Q07.Corporate sector deposits also moderated, but remained solid at 37.5% at end-2Q08. Banks' orientation towards domestic deposit financing remains prudent, given the expensive foreign financing. Therefore, banks continued to lower their stock of foreign liabilities, reducing the importance of this component in the financing structure. The stronger orientation toward domestic sources is also visible in the decline of the credit to deposit ratio, which stabilized in the acceptable 105-110% range. We do not anticipate significant changes to the prudential measures, as the NBS wants to further moderate credit activity, or at least keep it under control. Thus, overall monetary trends should remain relatively robust, but still slowing down to some extent compared to the activity seen in previous years. Banking sector capitalization is high, as the capital adequacy ratio stands at 28.9%, on average. Financial results are showing strong improvements and increased capacity to offset potential deterioration of asset quality, which speaks in favor of positive developments in terms of financial system stability.

**Credit and deposits**




*Source: NBS*

**Banking sector indices**




*Source: NBS*

*Alen Kovac, Erste Bank Croatia, akovac2@erstebank.com*

# Country Report

## Summary table

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007F | *2008F* |
|---|---|---|---|---|---|---|---|---|
| Area (square km, w ithout Kosovo) | 88,361 | 88,361 | 88,361 | 88,361 | 88,361 | 88,361 | 88,361 | *88,361* |
| Population (mn, w ithout Kosovo) | 7.5 | 7.5 | 7.6 | 7.5 | 7.4 | 7.4 | 7.4 | *7.4* |
| **Macroeconomy** | | | | | | | | |
| Real GDP (% y-o-y) | 4.8 | 4.2 | 2.5 | 8.4 | 6.2 | 5.7 | 7.5 | *7.1* |
| Industrial production (avg.% y-o-y) | 0.1 | 1.8 | -3.0 | 7.1 | 0.7 | 4.7 | 5.4 | *4.5* |
| Unemloyment rate (%) - ILO methodology | 12.23 | 13.28 | 14.63 | 18.50 | 20.8 | 20.9 | 18.1 | *14.0* |
| GDP Constant Prices 2002 (RSD bn) | 979 | 1,020 | 1,046 | 1,134 | 1,204 | 1,273 | 1,368 | *1,466* |
| GDP Current Prices (RSD bn) | 784 | 1,020 | 1,172 | 1,431 | 1,747 | 2,042 | 2,339 | *2,780* |
| GDP Current Prices (EUR bn) | 13.1 | 16.8 | 18.0 | 19.7 | 21.1 | 24.3 | 29.2 | *35.0* |
| GDP Current Prices (USD bn) | 11.8 | 15.8 | 20.4 | 24.5 | 26.2 | 30.4 | 40.0 | *52.4* |
| GDP per capita (USD) | 1,567 | 2,110 | 2,678 | 3,285 | 3,520 | 4,103 | 5,401 | *7,077* |
| GDP per capita (EUR) | 1,748 | 2,242 | 2,370 | 2,643 | 2,833 | 3,273 | 3,946 | *4,718* |
| **Prices** | | | | | | | | |
| RPI (average % y-o-y) | 91.8 | 19.5 | 11.7 | 10.1 | 16.5 | 12.8 | 6.5 | *11.0* |
| RPI (end-year % y-o-y) | 40.7 | 14.8 | 7.8 | 13.7 | 17.7 | 6.6 | 10.1 | *9.0* |
| PPI (average % y-o-y) | 29.0 | 6.2 | 4.6 | 12.0 | 15.4 | 14.0 | | |
| Core Inflation (% y-o-y) | 20.5 | 4.4 | 6.1 | 11.0 | 14.5 | 5.9 | | |
| Wage rates (% y-o-y, nominal) | 129.6 | 51.7 | 25.3 | 23.7 | 24.1 | 24.4 | 28.0 | *18.0* |
| **Fiscal balance (% of GDP)** | | | | | | | | *-1.7* |
| Consolidated government balance | | | | 0.5 | 0.7 | -1.5 | -1.9 | *-2* |
| Total public debt | 102.3 | 69.5 | 64.3 | 53.3 | 50.3 | 36.2 | 29.4 | *26.3* |
| **External balance** | | | | | | | | |
| Exports (EUR bn) | 2.0 | 2.3 | 2.6 | 3.0 | 4.0 | 5.2 | 6.5 | *7.9* |
| Imports (EUR bn) | 4.6 | 5.7 | 6.4 | 8.3 | 8.3 | 10.1 | 12.9 | *16.4* |
| Trade balance (EUR bn) | -2.6 | -3.4 | -3.8 | -5.3 | -4.3 | -5.0 | -6.4 | *-8.4* |
| Trade balance (% of GDP) | -19.8 | -20.2 | -21.0 | -27.0 | -20.3 | -20.5 | -22.0 | *-24.1* |
| Current account balance (EUR bn) | 0.3 | -0.7 | -1.3 | -2.6 | -1.8 | -2.4 | -3.9 | *-6.0* |
| Current account balance (% of GDP) | 2.4 | -4.1 | -7.5 | -13.3 | -8.4 | -9.8 | -13.2 | *-17.2* |
| Net FDI (EUR bn) | 0.2 | 0.5 | 1.2 | 0.8 | 1.3 | 3.5 | 1.6 | *2.8* |
| Net FDI (% of GDP) | 1.4 | 3.0 | 6.6 | 3.9 | 5.9 | 14.4 | 5.5 | *8.0* |
| Export volume (% y-o-y) | 14.4 | 13.9 | 10.6 | 15.9 | 34.4 | 28.8 | 25.0 | *23.0* |
| Import volume (% y-o-y) | 32.3 | 23.6 | 11.0 | 30.7 | -0.3 | 22.3 | 27.4 | *27.0* |
| Foreign exchange reserves (EUR bn) | 1.3 | 2.2 | 2.8 | 3.1 | 5.8 | 9.0 | 9.6 | *9.6* |
| **Debt & international liqudity indicators** | | | | | | | | |
| Gross external debt (EUR bn) | 12.6 | 10.8 | 10.9 | 10.4 | 13.1 | 14.9 | 17.8 | *20.6* |
| Gross external debt (% of GDP) | 96.2 | 64.0 | 60.3 | 52.5 | 62.0 | 61.4 | 60.8 | *58.9* |
| Gross external debt (% of exports) | 461.4 | 345.5 | 312.6 | 249.4 | 245.1 | 217.5 | 206.7 | *195.7* |
| Foreign exchange reserves /Gross external debt (%) | 10.5 | 20.3 | 26.2 | 30.1 | 44.7 | 60.6 | 54.2 | *46.8* |
| **Interest and exchange rates** | | | | | | | | |
| 2-w eeks Repo Rate | | | | | | 14.0 | 10.00 | *15.75* |
| 3-month interest rate (T-bill avg %) | N/A | N/A | 18.4 | 21.2 | 16.9 | 13.4 | 6.36 | |
| Broad money supply M3 (% y-o-y) | 202.0 | 52.5 | 27.9 | 31.9 | 42.1 | 38.3 | 42.5 | |
| Exchange rate (USD/RSD) year-end | 67.67 | 58.98 | 54.64 | 57.94 | 72.22 | 59.98 | 53.73 | *53.79* |
| Exchange rate (USD/RSD) annual average | 66.68 | 64.46 | 57.56 | 58.39 | 66.70 | 67.10 | 58.44 | *53.00* |
| Exchange rate (EUR/RSD) year-end | 59.71 | 61.52 | 68.31 | 78.89 | 85.50 | 79.00 | 79.24 | *78.00* |
| Exchange rate (EUR/RSD) annual average | 59.78 | 60.68 | 65.05 | 72.57 | 82.92 | 84.16 | 79.98 | *79.50* |

*Source: NBS, SORS, MFIN, Erste Group*

# Country Report

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