

Serbia: Country Profile and Recent Economic Developments

This study provides an overview of economic developments in the Republic of Serbia since the end of the Milošević regime in the fall of 2000. Starting from a short review of the political context, the study reports on Serbia's relations with the EU and the IMF as well as the Paris and the London Clubs. Subsequently, the most important structural reform measures are presented. The article then turns to macroeconomic developments, focusing on GDP growth, the labor market, inflation, monetary policy, fiscal policy and the external sector. Based on this discussion, the paper concludes that after a lost decade Serbia has embarked on a fairly dynamic transition path and has achieved substantial progress in recent years. At the same time, however, the Serbian authorities are still facing a set of key challenges at the current juncture, such as high inflation and unemployment or the high current account deficit. Other major tasks include further advancing the privatization process and combating corruption. On the political front, further progress in the cooperation with the International Criminal Tribunal for the Former Yugoslavia (ICTY) in The Hague is needed, also with a view to promoting negotiations with the EU on a Stabilisation and Association Agreement. Given that Serbia's economic weight is comparatively large in the Western Balkans, a successful completion of the transformation process in Serbia is important also from a regional perspective.

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1 Political and Economic Framework, International Relations and Structural Reforms

1.1 Political Overview

The Federal Republic of Yugoslavia (FRY)⁴ was the last Southeastern European (SEE) country to start a comprehensive economic reform process in late 2000. After a decade of political and military conflict that peaked in the Kosovo war in 1999, the Milošević regime was overthrown on October 6, 2000. After democratic parliamentary elections, Vojislav Koštunica (now Serbian Prime Minister) became the new President of the FRY.

In February 2003, the parliament of the FRY ratified a constitutional charter, thus formally founding a new state union called Federation of Serbia and Montenegro. This constitutional charter established far-reaching competences for the two parts of the federation in the areas of monetary, fiscal, trade and customs policy. Furthermore, it instituted the possibility of a separation after a three-year period. In March 2003, the Serbian Prime Minister Zoran Djindjic was assassinated. The death of this pro-Western reformer slowed down the transformation process and led to early parliamentary elections.

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⁴ The Federal Republic of Yugoslavia existed until February 3, 2003, when it was transformed into the Federation of Serbia and Montenegro. When Montenegro declared its independence from the federation on June 3, 2006, two separate states emerged.

The new minority government – led by Koštunica and supported by the former party of Slobodan Milošević – continued the reform process. It improved the cooperation with the ICTY, which was rewarded by the opening of talks with the European Commission about a Stabilisation and Association Agreement (SAA) on October 7, 2005. However, the negotiations were temporarily suspended on May 3, 2006, after Serbia's government had let elapse the (extended) deadline to hand over the former Bosnian Serb military commander Ratko Mladić to the ICTY. Talks have not been resumed yet, despite the presentation of an action plan to capture Mladić by the Serbian government. The former political leader of Republika Srpska in Bosnia, Radovan Karadžić, has not yet been arrested, either (European Commission, 2006a).

Montenegro held a referendum about its independence from the Federation of Serbia and Montenegro on May 21, 2006, and voted for sovereignty. The result was internationally accepted. The Republic of Montenegro declared itself independent on June 3, 2006, and became a member of the United Nations on June 28, 2006. From an economic point of view, the independence of Montenegro has limited consequences, as Serbia and Montenegro had already been separate economic entities before the referendum.

Negotiations on the final status of Kosovo (still a Serbian province, but under UN control) started in Vienna in November 2005. So far, several rounds of talks have led to no result regarding Kosovo's final status. If the two parties fail to come up with an adequate compromise, the UN Security Council may take a final decision on the Kosovo issue.⁵

In October 2006, the Serbian parliament passed a new constitution which declares Kosovo a part of Serbia. This new constitution was accepted in a referendum in late October by a relatively narrow majority. The next parliamentary elections are due in the fall of 2007, but will presumably be held earlier.

1.2 International Economic Relations – A Driving Factor in the Reform Process

1.2.1 European Union

In a first step after the end of the Milošević regime, the FRY joined the EU-initiated Stability Pact for Southeastern Europe, which provides a long-term conflict prevention strategy based on security, democratic stability, and economic and social well-being.

In December 2000, the European Council decided to lift all sanctions against the FRY and to allow the country to benefit from Community Assistance for Reconstruction, Development and Stabilisation (CARDS). Since then, over EUR 2.5 billion have been allocated to Serbia⁶ (European Commission, 2006b). In April 2004, the European Commission published a feasibility report on the preparedness of Serbia and Montenegro to negotiate an SAA with the EU. This report was approved by the European Council in June 2004 and

⁵ Kosovo uses the euro as its legal tender, has its own separate monetary sector and collects official data on a euro basis. This study focuses only on the Republic of Serbia, excluding Kosovo.

⁶ Serbia includes the Republic of Serbia, the Republic of Montenegro and the Province of Kosovo.

serves as a benchmark for the further transformation process. It includes a detailed assessment of the political situation (democracy and rule of law, human rights and protection of minorities, regional and international cooperation/obligations), the economic situation (market economy and structural reforms, management of public finances) and the state of convergence with EU policies (internal market and trade, sector policies, cooperation in justice and home affairs). The negotiations, which started in October 2005, have been interrupted owing to Serbia's insufficient cooperation with the ICTY.

1.2.2 International Monetary Fund

In May 2001 the International Monetary Fund (IMF) implemented the first Stand-By Arrangement with the FRY since the early 1990s. When this arrangement expired one year later, an Extended Arrangement was launched in May 2002. The IMF completed the sixth and last review under this arrangement in February 2006 after a delay owing to insufficient progress of several reform projects such as the privatization of the state-owned oil and gas company NIS and the reform of the pension system. Serbia adopted legal regulations for the privatization of the oil industry and a new pension law in September 2005. The country received SDR 650 million from the IMF between 2002 and 2006.

Serbian officials are considering starting negotiations on a new Stand-By Arrangement with the IMF. If and when they will actually do so remains to be seen.

1.2.3 Paris Club and London Club

In 1984, the then Socialist Federal Republic of Yugoslavia started negotiations with the Paris Club, which granted its latest debt reduction agreement to the FYR in November 2001; it included a 66% relief of the country's long-term debts (with a payment period of more than 12 months) in two steps. The first debt tranche of 51 percentage points (around USD 2.2 billion) was cancelled in March 2002 upon the successful completion of the first Stand-By Arrangement with the IMF. The remaining debt portion of 15 percentage points (around USD 650 million) was relieved after the completion of the IMF agreement in February 2006.

In July 2004, the government of Serbia signed an agreement with the London Club that included a write-off of about 62% of the country's net present debt value and the exchange of the Republic of Serbia's remaining debt into bonds. This arrangement prompted Standard&Poor's to assign a credit rating of B+ to Serbia and Montenegro, which was upgraded to BB- in June 2005.⁷

1.3 Structural Reforms and Privatization Process

In its latest Transition Report, the European Bank for Reconstruction and Development (EBRD) diagnosed an overall slowdown in the privatization process in the SEE region (EBRD, 2005). Despite some setbacks, the Federation of Serbia and Montenegro was an exception as four out of the nine

⁷ Fitch Ratings assigned a BB+ rating to Serbia, while no rating is available from Moody's.

EBRD transition indicators were upgraded. The state union was able to make progress in the following areas: large-scale privatization, governance and enterprise restructuring, trade and foreign exchange liberalization and banking reform.

1.3.1 Structural Reforms – Fast Development but Slow Implementation

The country successfully implemented several structural reforms to reduce its high budget deficit. Despite some delays in their implementation, these measures have been a motor for the privatization process.

The tax reform was enacted in three steps. First, the overall tax system was simplified in 2001. This step resulted in the reduction of the average effective tax burden on wages and salaries (including social security contributions) by 7 percentage points from 38% to 31% in 2002. The second step, which was taken in 2002, aimed at making the tax system more supportive to investment and employment. It included the reduction of the corporate tax rate from 20% to 14% (January 2003) and then to 10% (August 2004). A 14% flat tax was introduced by the new personal income tax law (adopted in November 2002 and effective from January 2003). As a consequence, both tax rates are now among the lowest in Europe. These measures are likely to have helped contain the shadow economy and resulted in an improvement of tax compliance and tax collection (World Bank, 2006; Foundation for the Advancement of Economics, 2006).

The third corner stone of the tax reform was the introduction of a new value-added tax (VAT) regime with a regular VAT rate of 18% and a reduced rate of 8% for basic food, certain medical supplies, teaching material, etc. in January 2005 to replace the sales tax. At the same time, an import tax was introduced. The VAT implementation was a success: VAT revenues have increased significantly as a result of this reform step – a phenomenon which is again probably attributable to the fact that it has helped contain the shadow economy and the concomitant tax evasion (World Bank, 2006).

One main step to reduce fiscal expenditure was the start of the pension reform in 2005. The IMF had put increasing pressure on the Serbian authorities, as the deficit of the pension funds for employees, farmers and the self-employed had reached over 5% of GDP in 2004 (World Bank, 2006). The reform, based on the pension law of September 2005, included an increase of the retirement age and changes to the pension indexation formula. These measures aim at reducing the deficit of the pension funds from 2007 onward (IMF, 2006a). However, the deficit will be reduced only gradually. Finally, the adoption of a new health insurance law in November 2005 laid the basis for a rationalization of the health care system.

The process of harmonizing the foreign trade system with standards of the EU and the World Trade Organization (WTO), which started in 2003, is already well advanced. The law on customs tariffs (July 2005) and the foreign trade law (November 2005) have made the Serbian tariff system compatible with international regulations. Furthermore, the Federation concluded bilateral free trade agreements (FTAs) with all Western Balkan states, Bulgaria, Romania and Moldova. Under the auspices of the Stability Pact for South Eastern Europe, Serbia is expected to join the Central European Free Trade

Agreement (CEFTA) in the near future, alongside with the other SEE countries (Stability Pact for South Eastern Europe, 2006). Moreover, Serbia is the only SEE country that has been able to conclude an FTA with the Russian Federation. Serbia applied for WTO membership in December 2004, and the government expects accession to the WTO in 2008.

The country's legal tender, the dinar,⁸ became fully convertible for current account transactions in May 2002 (IMF Article VIII status), while capital transactions are only partly and gradually liberalized (for details see IMF, 2005c).

The agricultural sector still plays a crucial role in the Serbian economy. A reform of this highly indebted sector started in 2003. Since then, the country's budget expenditure for agricultural production has increased, while the funds directed to price support have decreased. The available funds have been used to raise the efficiency and competitiveness of the agricultural sector, to encourage sustainable rural development and to provide financial support to farmers. This development strategy aims to bring regulations in line with the EU's Common Agricultural Policy (CAP).⁹

In the sector of competition policy, the EBRD awarded the lowest possible grade of 1, which implies that no competition legislation and institutions exist (EBRD, 2005, p. 203). However, the government has recently taken action in this field, e.g. by introducing a competition law in end-2005 and establishing a competition agency in early-2006. The effect of these measures remains to be seen.

The government agreed on a national anti-corruption strategy, with technical assistance from the Organization for Security and Co-operation in Europe (OSCE) and the Stability Pact for South Eastern Europe in 2005 (World Bank, 2006). However, corruption is still a pressing problem in Serbia. More generally, the judiciary system is not yet functioning in a satisfactory manner, and thus contract enforcement remains a problem (EBRD, 2005, p. 10).

1.3.2 Privatization Process of State-Owned Enterprises

The privatization law, which was adopted in June 2001 and amended in May 2005, established the key principles of the privatization process in Serbia. It envisages three principal ways of privatization and reconstruction. Large enterprises shall be offered to strategic investors via tenders, while medium-size firms are to be sold via auctions. Finally, large loss-making companies should be reconstructed and subsequently sold via tenders and/or auctions. The sale of state-owned companies has proceeded: the private sector's share in GDP climbed from 40% in 2000 to 55% in 2005 (IMF, 2006a).

Based on the bankruptcy law, which was adopted in July 2004, unsellable companies have been declared bankrupt. The law on accounting and auditing December 2002 aimed at implementing the International Accounting Standards

⁸ The international currency code for the Serbian dinar is CSD; it is to be altered to RSD. From 1994 to 2003, the New dinar (YUM) was the currency of Serbia (except Kosovo). To improve the readability of this study, we will mostly refer to the Serbian currency as the dinar (CSD).

⁹ In this context, it is worth to note that agricultural land can be owned privately, whereas urban construction land cannot; this situation will change when the new constitution enters into force (World Bank, 2006).

(IAS). Banks and large enterprises have had to publish IAS-conform financial statements since 2004 and 2005, respectively.

A reconstruction program was developed for the eight largest, socially-owned enterprises in the electricity, petroleum, railway, postal, telecommunications, airline, airport and forestry sectors (IMF, 2005). This program includes cost rationalization in the form of e.g. spin-offs of non-core entities as well as reorganization measures. Furthermore, international economic advisors are being hired with the aim to ensure the smooth and transparent privatization of these companies.

By adopting a law on energy in August 2004, the legal prerequisites for an energy sector reform were put in place. They comprise the establishment of an independent energy regulator and the restructuring of the energy company Elektroprivreda Srbije (EPS). This restructuring entails selling off non-core activities and splitting the company into two parts, downsizing its core employment structure and fully servicing its debt to the Serbian government. Furthermore, it was decided that the company should not receive any state subsidies in 2004 and 2005 (IMF, 2004, p. 70).

Serbia's major oil company Naftna Industrija Srbije (NIS) is one of the largest state-owned enterprises that is scheduled to be sold in two steps. First, a minority stake is to be offered to a strategic investor in 2006, and after at least three years, a majority (and consequently managing) control will be sold in a second step. The Serbian state is planning to keep a minority share of 25%.

Mobi63 (formerly Mobtel) is the biggest mobile telecommunications provider in Serbia. In August 2006, the state-owned share of 70% was sold for EUR 1.5 billion to the Norwegian company Telenor, which outbid the Austrian Mobilkom and the Egyptian Orascom. This has been the largest privatization in Serbia so far. The remaining 30% share in Mobi63 is held by a consortium of Austrian investors.

Serbia's financial sector is mostly bank-dominated. While the country's capital market is still at an early stage of development, the privatization process of the financial sector is fairly advanced. The number of banks was reduced from over 80 in 2000 to 38 in mid-2006 mainly as a result of closing insolvent banks, including the country's four largest banks Beobanka, Beogradska banka, Investbanka and Jugobanka (IMF, 2002). Other banks have been privatized continuously. By mid-2006, 47% of Serbian banks were foreign-owned (NBS, 2005a). Financial stability has been improved by raising the supervision rights of the Narodna banka Srbije (NBS). The new banking law adopted in November 2005 aligns key areas of legislation with the Basel Core Principles for Effective Banking Supervision (IMF, 2006a, p. 72).¹⁰

The ambitious reform process in combination with financial sector stabilization and privatizations in several economic sectors have led to a significant increase in the inflow of foreign direct investment (FDI) in Serbia.

¹⁰ For more information on the financial sector in SEE, see the study on "Bank Intermediation in Southeastern Europe: Depth and Structure" in this issue of *Focus on European Economic Integration*. For an analysis of the transformation of the Serbian banking sector, see Zdrale (2006).

In the period from 2000 to November 2005, top investors in Serbia have been companies with headquarters in the Netherlands, Austria and Germany.

2 Economic Developments

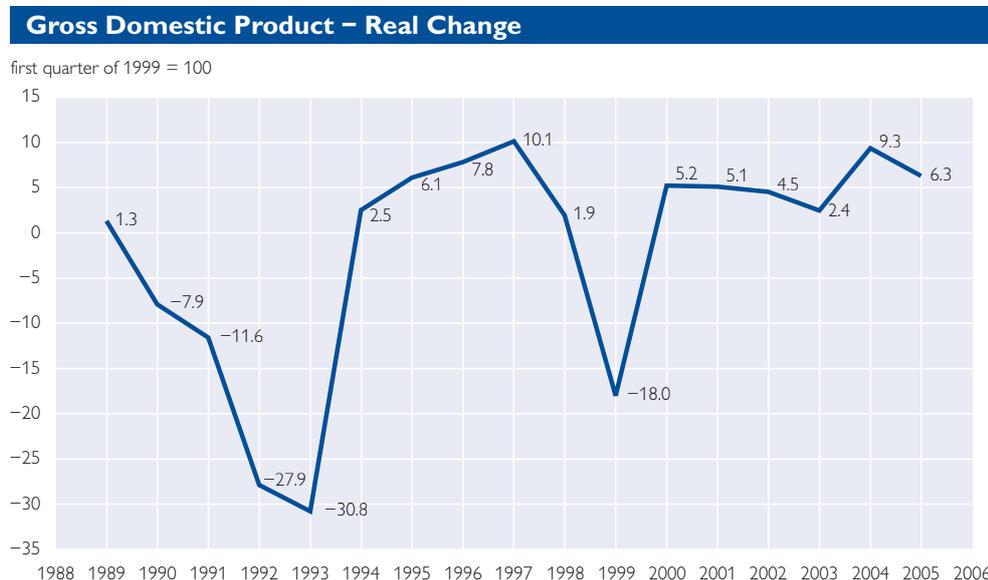
In the following, we intend to expound the economic developments in Serbia during the transition process, with a major focus on the most recent years. However, it should be borne in mind that our analysis is inevitably limited by data availability and reliability problems, which also pertain to some basic macroeconomic data series.

2.1 Economic Growth Robust Despite Recent Slowdown

In 2005, the Serbian economy grew strongly at 6.3%, and it continued at the same pace also in early 2006.

Chart 1 shows that Serbia's economic growth – after having regained momentum after the Kosovo war – nearly halved in 2003 (2.4%) in the wake of the aforementioned political changes. In 2004, the growth rate almost quadrupled to 9.3% and slowed down again somewhat in 2005, when GDP per capita at market exchange rates amounted to USD 2,880, while coming to USD 5,348 measured at PPP (IMF, 2006b). In both cases, this is about 30% of the level observed in the five new EU Member States (NMS-5: Czech Republic, Hungary, Poland, Slovenia and Slovakia).

Chart 1



Source: EBRD (1989–1999), Statistical Office of Serbia (2000–2004).

Note: Data from 1999 onward exclude Kosovo, data from 2000 onward exclude Kosovo and Montenegro.

Table 1 evidences that GDP growth in Serbia has been driven predominantly by robust domestic demand. In 2005, a strong real increase in private consumption (4.4%), which accounts for almost 100% of GDP in real terms, was the major contributing force. This strong performance was complemented by a considerable improvement in net exports. Although the level of exports

was still less than half that of imports, the gap has narrowed by more than 6 percentage points.

On the supply side, industrial production and the service sector jointly produce almost two-thirds of Serbian output, while agricultural production represents the third largest sector. As such, it was among the leading forces behind the strong economic performance recorded in 2004, which was mostly attributable to favorable weather conditions. In the following year, however, GDP growth decelerated, as the strong expansion in the service sector could only partially make up for the decline in agriculture, construction and also in industrial production (whose growth almost came to a halt after having gained momentum in 2004).

2.1.1 Expenditure Side Dominated by Domestic Demand

A closer look at the expenditure side (see table 1) shows that the share of private sector consumption in GDP has gradually trended upward between 2000 and 2004 at both current and constant prices, while it dropped marginally in 2005. The more pronounced increases in current prices in the first years of this decade might reflect the impact of early liberalization and reform efforts. In particular, the increase in 2002 and 2003 possibly mirrors the strong rise in real net wages in those years that resulted from the above-mentioned tax reform and strong disinflation at the time.¹¹ To put things in perspective, the share of private consumption in GDP is significantly higher in Serbia than in the NMS-5, where it amounts to about 55% of GDP.

Table 1

GDP Components (Expenditure Side)

Current prices in % of GDP

	2000	2001	2002	2003	2004	2005			
Private consumption	75.1	81.2	85.3	86.6	89.8	98.4	89.1	96.7	4.4
Public consumption	22.1	27.0	20.0	20.5	18.6	19.7	17.8	18.9	1.5
Domestic consumption	97.2	108.2	105.3	107.1	108.4	118.2	106.9	115.6	3.9
Gross fixed capital formation	13.8	9.2	13.1	14.1	19.3	13.9	17.1	12.7	-2.8
Stock changes	-6.4	5.3	2.1	0.7	3.3	3.9	1.1	1.4	-60.3
Gross capital formation	7.4	14.6	15.2	14.8	22.7	17.8	18.2	14.2	-15.3
Domestic demand	104.6	122.8	120.6	121.9	131.1	136.0	125.1	129.7	1.4
Exports	14.8	25.4	25.9	23.5	23.2	22.0	25.5	23.2	12.2
Imports	19.6	48.3	46.4	45.3	54.2	57.9	50.6	52.9	-2.9
Net exports	-4.8	-22.9	-20.6	-21.9	-31.1	-36.0	-25.1	-29.7	-12.1

Source: Statistical Office of Serbia, wiw.

Note: The second columns of 2004 and 2005 reflect constant (2002) prices, the third column of 2005 reflects year-on-year changes in % based on constant (2002) prices.

Despite an increase in public consumption by 1.5% in 2005 (measured at constant 2000 prices), its share in GDP has been declining steadily since 2002 at both current and constant prices. The Extended Arrangement with the IMF was approved in May 2002. Since then, the government has pursued a somewhat tighter fiscal policy than agreed with the IMF to compensate for the worse-than-expected private sector savings/investment balances.

¹¹ As will be elaborated in later sections, inflation fell from over 90% in 2001 to less than 10% in 2003.

Notwithstanding recovering FDI flows, gross fixed capital formation (GFCF) – measured at constant 2000 prices – contracted by almost 3% in 2005. Hence, after increasing somewhat in 2004, the share of GFCF in national output dropped again below the 2002 level. Nevertheless, important investment activities in the fields of transport, infrastructure and construction have been undertaken (NBS, 2005, p. 17). Furthermore, the government has adopted several measures to attract foreign investors, e.g. the corporate or income tax reforms described above. In addition, in early 2006 the authorities announced a plan to invest about EUR 1.3 billion from privatization proceeds in infrastructure projects, thus creating further incentives for investors. If we compare the Serbian GFCF-to-GDP ratio (at current prices) with that in the NMS-5, it turns out that at 17% of GDP in 2005, GFCF in Serbia is still lagging behind the NMS-5, where GFCF typically amounts to about 23% of GDP. Hence, raising the investment ratio will be essential if Serbia's GDP growth dynamics are to be sustained also in the longer run.

Although exports grew by more than 12% and imports declined by nearly 3% in real terms in 2005, the level of exports is still rather low at less than half the level of imports, which suggests a persistent need for restructuring in the economy.

As a result of the comprehensive price and foreign trade liberalization in late 2000, the share of exports in GDP at current prices roughly doubled to 25% within one year, while the share of imports jumped to almost 50% of GDP. Ever since, Serbia has not been able to substantially reduce the resulting large negative trade balance. This development is in part attributable to strong domestic demand for foreign consumer goods in combination with a lack of competitiveness of the traditional and some of the newly established domestic private companies.

The country's main import goods are petroleum products followed by road vehicles and industrial machinery (NBS, 2006b). The significant increase in FDI since 2003 is expected to boost the country's export performance in the future. So far, iron, steel and agricultural products have been the major export items. Concerning the regional structure of Serbia's trade, the bulk of exports in 2005 went to Bosnia and Herzegovina, Italy and Germany, while the most important import partner was the Russian Federation (owing to the high oil bill), followed by Italy. The European Union as a whole accounted for about one-half of total foreign trade in 2005 (NBS, 2006a).¹²

2.1.2 Production Side – Expanding Services versus Contracting Agriculture and Industry

Despite a slight decline in 2005, the agricultural sector is still the third largest sector, retaining its high relevance for Serbian output at 12.6% of GDP in 2005 (compared with 3% in the NMS-5). Agricultural output has been fairly volatile in recent years, largely due to changing weather conditions.

The contribution of the industrial sector to GDP declined sharply from about 27% in 2000 to 20% five years later. This drop is chiefly ascribable to a decline in the manufacturing sector, which accounts for more than three-

¹² For an analysis of trade integration in SEE, see Lamotte (2006).

Table 2

GDP Components (Production Side)														
Constant 2002 prices in % of GDP														
	2000	2001		2002		2003		2004		2005 P		Q1 2006 E		
Gross domestic product (GDP)		5.2		5.1		4.5		2.4		9.3		6.3		6.3
Agriculture	13.8	-12.4	15.4	17.4	14.3	-3.2	13.0	-7.0	14.1	19.0	12.6	-5.2	5.5	-4.6
Industry	26.9	12.9	24.8	-3.1	23.1	-2.5	21.7	-3.8	21.2	6.8	20.1	0.7	11.9	6.0
Construction	4.5	16.8	3.7	-14.3	3.3	-7.4	3.5	10.8	3.3	3.5	2.9	-7.0	1.3	5.4
Services	43.4	5.6	43.0	4.1	43.3	5.2	44.6	5.6	44.2	8.2	46.6	12.2	29.7	11.1
Taxes minus subsidies on products	11.4	8.3	13.1	20.8	16.1	27.9	17.2	9.5	17.2	9.3	17.8	10.1	9.9	0.0

Source: Statistical Office of Serbia.

Note: P stands for preliminary results, E for estimated results. The second column of each year reflects year-on-year changes in %.

quarters of industrial production. However, the country's overall industrial performance recovered slightly in annual average terms, given that (1) the electricity, gas and water supply sectors (which account for about 15% of industrial output) grew rather strongly throughout 2005 and (2) the manufacturing sector regained momentum in the last two quarters of 2005. In particular, manufacturing seems to have re-embarked on a strong growth path since the second half of 2005, as the effects of extensive privatization and structural reforms seem to start kicking in.

After the value of construction works had fallen from 4.5% to 3.3% of GDP between 2000 and 2002, the Serbian government implemented a new planning and construction law aimed at creating better conditions for higher and more efficient investment in this sector. The effect was mixed, though. On the one hand, the total amount of construction activities increased by over 10% in 2003. On the other hand, however, this performance could not be maintained and, after a considerable growth slowdown in the following year, the construction sector shrank by 7% in 2005.

The service sector made the biggest contribution to GDP in Serbia, amounting to nearly 47% of GDP in 2005. Between 2000 and 2005, this sector showed the most stable performance among the major supply-side components of GDP, growing at an average annual rate of almost 7% in real terms. Compared with 2004, service sector growth accelerated by 4 percentage points in 2005, recording a 12% annual rate. This strong performance has helped considerably to make up for the decline in the agricultural and construction sectors, and it is likely to increase even further in 2006. The main driving subsectors were financial services, wholesale and retail trade as well as transportation.

2.2 Labor Market Plagued by High Unemployment

Table 3 shows that in 2005, the number of registered unemployed persons increased by 50,000 to a total of nearly 1 million. The official unemployment rate thus climbed by 1 percentage point to 32.6% and remained at similar levels in 2006. The high unemployment is one of the key challenges for the Serbian authorities; only two other transition countries in Central and

Table 3

Labor Market Indicators						
	2000	2001	2002	2003	2004	2005
Registered data						
Employment (thousands)	2,097	2,102	2,059	2,034	2,039	2,048
Unemployment (thousands)	722	769	843	947	945	992
Unemployment rate (% of the registered labor force)	25.6	26.8	29.0	31.8	31.7	32.6
Labour Force Survey						
Employed (thousands)	3,094	3,106	3,000	2,919	2,931	2,733
Unemployed (thousands)	426	433	460	500	665	720
Unemployment rate (in %)	12.1	12.2	13.3	14.6	18.5	20.8
Monthly economy net wages (annual average, EUR)	41	90	150	169	179	204
Economy net wages, (year-on-year changes in % based on CSD)	89.5	125.8	71.0	24.9	22.6	23.8
Economy net wages deflated by CPI (year-on-year changes in %)	10.7	15.8	43.1	13.7	10.4	6.6
Monthly economy gross wages (average, EUR)	64.9	145.9	216.2	243.6	260.8	299.0
Economy gross wages (year-on-year changes in % based on CSD)	91.1	128.9	52.6	25.1	23.7	24.3
Total economy gross wages deflated by CPI (year-on-year changes in %)	11.6	17.4	27.7	13.9	11.4	7.0
Average effective tax rate (% of gross wages)	37.2	38.1	30.6	30.8	31.4	31.6

Source: Statistical Office of Serbia, Narodna banka Srbije.

Southeastern Europe – Bosnia and Herzegovina, and Macedonia – face higher unemployment levels.

After recording an average ratio of about 25% between 1997 and 2000, the unemployment rate has been steadily rising since the onset of economic reforms in late 2000. However, according to the Labour Force Survey (LFS), the unemployment rate is noticeably lower at around 20%, as many people who found informal employment do not define themselves as job seekers. The NBS estimated that in 2003, 600,000 to 800,000 persons in Serbia (8%–10% of the total population) worked without being registered. These numbers indicate that the shadow economy is still a big problem. At the same time, however, the registered unemployment rate declined only marginally in 2004 (the year of record GDP growth).¹³ The number of those who did not work at all, not even on the shadow market, was estimated at 500,000.

According to the NBS, it takes four years on average until an unemployed person finds a new job. This suggests that a considerable part of the high unemployment figures is of a structural nature (e.g. attributable to skill mismatches). Moreover, around 150,000 of those unemployed are aged 50+.

This development prompted the Serbian authorities to adopt a new law on employment and unemployment insurance in 2003, which focuses on a more active involvement of unemployed persons, particularly older ones. At the same time, the law raised the fines for those who employ unregistered workers.

Massive emigration of skilled workers – driven by both internal and external factors – is another problem for transition countries in general, and

¹³ The LFS-based rate even increased substantially in the same period as a result of harmonizing of the methodology with ILO standards.

those in Southeastern Europe in particular. Besides escaping low economic standards in their countries of origin, highly skilled professionals are also attracted by the new immigration policies of some OECD countries designed to respond to the demands of their domestic labor markets. In general, this brain drain entails serious losses for the source countries, especially when they are small and highly skilled labor is scarce, even if this effect is tempered by substantial remittances (for details see e.g. OECD, 2006).

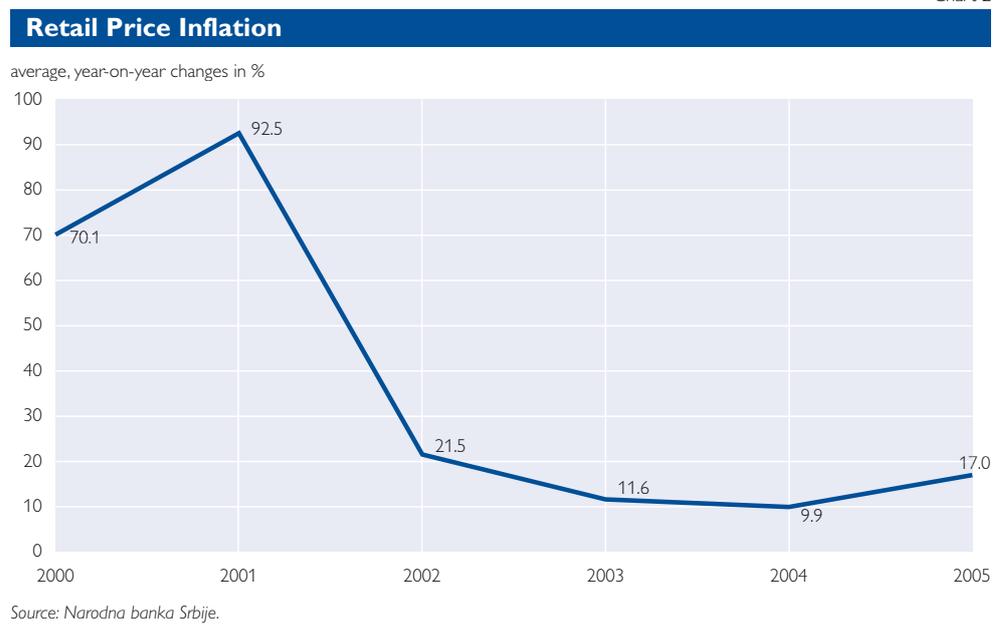
The strong economic growth in recent years in Serbia has been mirrored in rising real wages and, consequently, climbing average living standards. In particular in 2002, household incomes went up considerably. Within one year, average net wages soared by over 40% in real terms as a result of a substantial increase in gross wages combined with the aforementioned reduction of the average tax burden by 8 percentage points. This wage development was apparently attributable to a large extent to an increase in public sector wages. The growth rate of real net earnings has slowed down since then (to 6.6% in 2005). These numbers reflect, inter alia, the authorities' commitment to a stricter incomes policy aimed to contain demand and improve competitiveness in light of the excessive public sector wage increases earlier in the decade.

2.3 Inflation – Another Key Challenge

In 2005, the country's annual average inflation measured at retail prices accelerated to 17%. In the first half of 2006, it eased somewhat, ranging between 14% and 16%. However, year-on-year inflation dropped to 12.7% in July (see chart 2). The price level in Serbia amounted to about 41% of the EU-25 in 2005.

Retail price inflation surged from 40% in 1999 to above 90% in 2001 owing to (1) the economic crisis in 1999 in the wake of the Kosovo war, (2) comprehensive price liberalization and (3) the devaluation of the dinar in late

Chart 2



2000. However, average retail price inflation slowed down to single-digit levels in 2004 (9.4%) as a result of several factors: first, the NBS held the nominal exchange rate stable until end-2002 after the depreciation in late 2000; second, fiscal deficits were reduced and financed by debt issuance and privatization receipts instead of being monetized (as was the case earlier); and third, administered prices were introduced in the run-up to the elections at end-2003. The price index has surged since owing to a combination of adverse global and domestic factors. The former included rising energy prices and ensuing increases in administered energy prices and in the cost of energy production, while the latter included strong domestic demand fueled by rapid credit growth, exchange rate depreciation in combination with extensive exchange rate indexation of prices and, in addition, the one-off impact of VAT introduction in January 2005.

For 2006 the NBS expects the disinflationary trend to continue, while increased government spending¹⁴ and rising wages in the private sector are expected to pose key risks to price stability. In addition, severe floods followed by an extended period of droughts in the first half of 2006 are likely to have adversely affected agricultural production, which will be reflected in rising prices. By contrast, however, nominal exchange rate stability (in fact a real appreciation) vis-à-vis the euro as well as declining short-term inflation expectations and tight monetary policy are expected to help contain inflation pressures. However, it should be borne in mind that, in particular in the short run, the NBS can effectively control only the part of inflation that is market-determined, while the Serbian government has power over the part of inflation stemming from adjustments in administered prices and tariffs.

2.4 Monetary Sector

2.4.1 Narodna banka Srbije's Monetary and Exchange Rate Policy

According to the Law on the National Bank of Serbia, adopted in mid-2003, the primary objective of Narodna banka Srbije (NBS) is to achieve and maintain price stability. In addition to that, the central bank shall also strive for maintaining financial stability. After the new government had come to power in October 2000 and the dinar had devalued by 80% against the euro by December 2000, the authorities tightened fiscal and monetary policies. The NBS ensured a stable exchange rate against the euro until end-2002. Since then, the dinar has been devaluing steadily and gradually under a managed-float regime. The central bank drastically limited refinancing to banks and net lending to the government. Its net claims on the general government slumped and turned into net liabilities. In parallel to these restrictive measures, increasing net foreign assets became the NBS's third main goal. Rising net foreign assets have also been the exclusive source of monetary base creation in recent years.

¹⁴ Despite the downward trend of the share of government expenditures in GDP and a budget surplus in 2005 (see section 2.5).

2.4.2 Main Monetary Policy Instruments

Unlike many other central banks, the NBS has not used a short-term reference interest rate as its operating target, at least until recently. Instead, excess liquidity and reserve money (net foreign and domestic assets) have been employed as control variables. These variables are relatively easy to control, but rather distant from monetary and financial stability objectives. The NBS's intermediate target is a monetary aggregate target. In practice, the exchange rate also seems to play a role as a de facto intermediate target in Serbia.

Table 4

Balance Sheet of Narodna banka Srbije												
year-on-year changes in %												
	2000	2001	2002	2003	2004	2005						
Monetary base	254.3	254.3	43.0	43.0	22.1	22.1	14.1	14.1	28.3	28.3	67.0	67.0
Net foreign assets	-556.0	167.8	-23.3	-9.1	390.2	81.2	47.0	39.3	36.1	38.8	94.9	108.4
Domestic claims	315.2	706.0	8.6	22.5	-89.0	-177.3	-134.5	-24.1	6.7	-0.4	504.3	-22.8
of which: net claims on government	55.3	16.3	59.2	7.6	-20.2	-2.9	-226.1	-21.2	-4.3	0.4	282.8	-21.8
credit to banks	352.1	683.7	6.1	15.2	-95.3	-175.3	-23.2	-1.6	-16.3	-0.8	-32.0	-1.0
credit to other sectors	1,383.1	6.0	-16.4	-0.3	81.7	0.9	-84.7	-1.3	-18.9	0.0	49.0	0.1
Other assets	1,135.1	-481.9	-41.4	61.2	-144.2	87.5	-34.8	-7.6	58.7	7.4	3.7	0.6
Other liabilities	267.9	137.6	59.3	31.6	-51.8	-30.7	-28.1	-6.6	118.9	17.6	76.1	19.2
of which: NBS bills	29.7	0.8	30.5	0.3	114.0	1.0	43.5	0.7	-21.2	-0.4	38.1	0.4
deposits of banks undergoing liquidation	-59.9	-0.5	1,656.1	1.6	106.2	1.3	-16.9	-0.3	-70.8	-1.0	12.2	0.0
capital and reserves	205.2	27.2	28.9	3.3	-74.7	-7.7	27.5	0.6	468.2	11.1	43.4	4.6
other liabilities	317.9	1,10.2	64.6	26.4	-53.8	-25.3	-42.2	-7.5	87.4	7.9	33.9	4.5
Net other assets	660.3	-619.5	-14.7	29.6	-98.5	118.2	68.7	-1.0	457.0	-10.2	191.9	-18.6
Monetary base	254.3	254.3	43.0	43.0	22.1	22.1	14.1	14.1	28.3	28.3	67.0	67.0
Local currency-denominated	118.6	62.7	119.0	38.8	67.0	33.4	4.0	2.7	14.0	8.7	21.9	12.1
of which: currency in circulation	63.0	25.7	131.1	24.6	73.0	22.1	-1.7	-0.7	5.1	1.9	18.8	5.7
required reserves	205.7	15.2	116.0	7.4	42.9	4.1	41.4	4.7	29.2	4.1	24.3	3.4
excess reserves	503.8	20.7	99.6	7.0	73.3	7.2	-23.6	-3.3	0.4	0.0	33.8	2.5
other dinar deposits	179.4	1.1	-29.8	-0.1	14.5	0.0	906.6	2.0	136.7	2.7	15.4	0.6
Foreign currency-denominated	406.3	191.7	6.3	4.2	-22.6	-11.3	36.0	11.4	51.7	19.6	122.6	54.9
of which: OFIs foreign currency deposits	..	..	..	..	..	..	..	0.6	39.1	0.2	27.8	0.2
of which: banks' foreign currency deposits	406.3	191.7	6.3	4.2	-22.6	-11.3	34.0	10.8	51.9	19.4	123.9	54.7

Source: Narodna banka Srbije.

Note: The second column of each year reflects the contribution to changes in the monetary base in percentage points.

The reserve requirements are among the principal instruments the NBS utilizes. The central bank introduced a reserve requirement model which calculates the required reserves with respect to commercial banks' domestic and foreign currency liabilities in early 2004. As commercial banks have found ways to circumvent the reserve requirements, excess liquidity in the economy has been rising persistently. The NBS reacted by selling government bonds and newly issued NBS bonds and by adjusting reserve requirements in several steps in 2005 and early 2006. As a result, the reserve requirement now amounts to 60% on all deposits, loans and other funds received from abroad with a maturity of up to two years and to 40% on those with a repayment period of over two years, regardless of the currency in which they are denominated. The

reserve requirement ratio on foreign exchange deposits in Serbia is 40%, while it is 18% for domestic deposits denominated in dinar. The fact that the reserve requirement rate for foreign currency deposits exceeds that for dinar deposits should help develop the dinar market. Despite actions set by the NBS to rebuild trust in the local currency, foreign currency deposits (51%) continued to grow faster in 2005 than dinar-denominated deposits (38%), although the gap between growth rates has shrunk substantially compared with previous years (NBS, 2006c, p. 25).

The NBS conducts open market operations to fine-tune the liquidity of the banking system. In addition, they also serve as a tool for impinging on the structure and level of money market interest rates. In line with the IMF recommendation, the interest rate on two-week repo operations has been assigned the role of the reference rate to improve the signaling of the monetary policy stance to the public (IMF, 2006a). The weighted average interest rate recorded at auctions for repo transactions with a 14-day maturity was 20.13% in July 2006.

After being reduced steadily from 33% in the second half of the 1990s, the discount rate has amounted to 8.5% since January 2004. In recent years, it has thus remained negative in real terms. However, this probably has had no major refinancing impact, as refinancing to banks has been virtually stagnant since 2002.

Interest the NBS pays to banks on the average daily balance of the allocated dinar reserve requirement that does not exceed the amount of calculated dinar reserve requirements in the maintenance period was raised to 3% in September 2006, after having amounted to 2.975% for one and a half years.

2.4.3 Market Interest Rate

Nominal weighted deposit rates of commercial banks have decreased over the last years in parallel to the discount rate development. The NBS distinguishes between household and enterprise deposit rates. Corporate deposit rates are usually lower on long-term deposits, while households earn less on short-term deposits. The rates on six- to 12-month corporate deposits fell from 22.5% in 2000 to 17.1% in 2001, which marked the beginning of a steady decline. The rate reached 7.0% in 2005 and increased only gradually in 2006. However, it should be borne in mind that the real interest rate on deposits has been negative over the whole period under review.

2.4.4 Monetary Developments – Rapid Growth of Money Supply

The monetary base grew by 67% in 2005, which is a very brisk growth rate given the principal monetary policy objectives (see table 4). This growth was entirely attributable to increases in net foreign assets, as the NBS tried to absorb large foreign exchange inflows from banks' external borrowing, FDI, privatization proceeds and foreign exchange deposits of the private sector. The NBS' net foreign assets nearly doubled in 2005. By contrast, domestic claims – negative since 2003 – swelled sixfold, thus making a large negative contribution, as did net other assets. These figures suggest intense activity by the NBS as a buyer in the foreign exchange market and, in parallel, its

Table 5

Monetary Developments												
Year-on-year changes of broad money in percentage points												
	2000	2001	2002	2003	2004	2005						
Broad money	161.4	161.4	92.9	92.9	53.1	53.1	27.2	27.2	32.0	32.0	42.0	42.0
Net foreign assets	243.7	-301.0	17.2	-27.9	-192.4	189.8	31.8	18.7	-5.1	-3.1	43.0	19.1
Domestic claims	332.5	1,366.6	4.1	27.7	-66.3	-243.1	6.2	5.0	62.4	42.1	42.9	35.6
of which: claims on general government (net)	365.3	729.1	-4.6	-16.4	-100.6	-176.8	413.9	-2.9	-190.1	5.5	-543.7	-10.6
claims on the corporate sector	305.1	616.8	10.3	32.2	-39.2	-70.1	3.8	2.7	37.7	21.9	44.4	26.9
claims on households	221.3	20.6	103.6	11.9	31.2	3.8	50.8	5.2	119.9	14.7	94.6	19.3
Net other assets	482.1	-904.1	-22.3	93.2	-64.3	108.1	-5.7	2.2	23.8	-6.9	49.2	-13.4
Claims on the nonbank nongovernment sector	301.4	637.4	13.6	44.1	-34.7	-66.4	9.8	7.9	52.1	36.6	57.0	46.2

Source: Narodna banka Srbije.

Note: The second column of each year reflects the contribution to the year-on-year change of broad money in percentage points.

determined sterilization efforts which, however, have not been entirely successful.

The vast capital inflows to the Serbian economy were reflected also in the structure of the monetary base as banks' foreign currency deposits more than doubled in 2005, thus contributing substantially to monetary base growth. Bank's dinar-denominated excess reserves increased by one-third as banks returned some of the securities they had previously purchased from the central bank (NBS, 2006b).

A longer-term analysis reveals that the pace of monetary base growth has picked up again after a significant slowdown from 43% in 2001 to 14% in 2003. Net foreign assets have risen twentyfold since 2001 owing to intensified capital inflows. In parallel, domestic claims have fallen substantially over the same period. This decline was attributable to the 2002 banking sector reform on the one hand and to the dramatic cut in net claims on the government in 2003 (when central bank lending to the government was forbidden) on the other. Subsequently, the net government position with the NBS dropped fourfold in 2005. The reason was a rise in dinar and foreign exchange deposits coming mainly from privatization proceeds and the newly introduced VAT.

Robust monetary base growth was also reflected in the development of money supply: Broad money (M3) climbed by 42% in 2005 and thus substantially contributed to inflation acceleration (see table 5). However, in contrast to the monetary base, the creation of money supply stemmed from both net foreign and domestic assets that went up by about 43%. Driven by a steady rise of credits to the household and corporate sectors (over +57%), domestic assets were the major contributor to broad money growth.

Lending to the private sector has recently grown dynamically in a number of transition economies, promoted by macroeconomic stabilization, privatization and comprehensive reforms. In those countries that recorded fast and persistent private sector credit growth, current account deficits have moved above levels that are sustainable over a longer period of time. Related analyses conducted recently by the OeNB corroborate the case for keeping

macroeconomic vulnerabilities in check by containing domestic demand growth and current account deficits at sustainable levels over the medium term in the countries concerned (see Backé and Zumer, 2005, or Backé et al., 2006).¹⁵

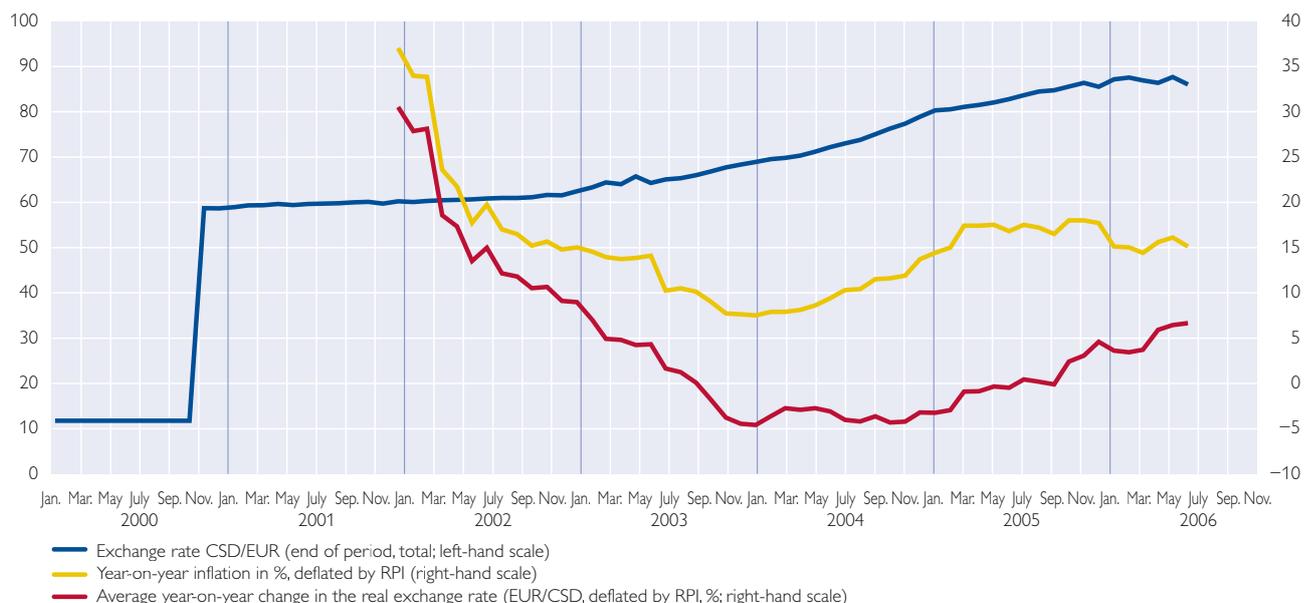
Money supply growth has mirrored the development of the monetary base also in the long term. Having slowed down between 2001 and 2003, it has gathered speed since. The year 2002 was a year of major structural changes. While loans to households grew only moderately, credit to the corporate sector declined by 40% and the (until then sizeable) credits to the government turned into liabilities. From 2003 on, the growth of loans to the private sector has been accelerating. The contribution of household credits to broad money growth thus rose from less than one-fifth in 2003 to almost one-half in 2005. Nevertheless, the overall credit-to-GDP ratio stood at about 40% at end-2005, not much below the average level in the NMS-5 (about 53%). These figures suggest that the measures taken by the NBS to contain rapid growth and in particular the increase in reserve requirements have only been partly successful so far.

2.4.5 Exchange Rate Developments – Nominal Depreciation Has Come To a Halt

In December 2000, right after the regime change, the National Bank of Yugoslavia (now NBS) devalued the dinar by more than 400% from YUM/EUR 11.7 to YUM/EUR 58.7 (see chart 3). Within the framework of an exchange rate-based stabilization program, this rate remained approximately stable until end-2002, which substantially helped curb inflation. From early

Chart 3

Exchange Rate of the Serbian Dinar and Retail Price Inflation



Source: Narodna banka Srbije.

¹⁵ For a more detailed analysis of credit expansion in SEE, see Kraft (2006).

2003 onward, the dinar constantly devalued until it stood at about CSD/EUR 87 in early 2006. Since then, the devaluation has come to a hold owing to increasing capital inflows – the dinar even appreciated a bit to CSD/EUR 83 in July. The NBS has reacted to the stronger appreciation pressures stemming from capital inflows by intensive foreign exchange interventions.

The real exchange rate appreciated until September 2003. The appreciation pace slowed down in parallel to the disinflation process. The dinar devalued in real terms over the next two years, but this tendency was reversed in the second half of 2005. This last turn has happened on the back of the aforementioned inflation acceleration on the one hand and a broad stabilization of the nominal exchange rate on the other.

2.5 Public Finance – Serbia’s Budget Deficit Has Turned Into a Surplus

Table 6 shows that the general government budget recorded an estimated surplus of 1.6% to 2.0% of GDP in 2005, after posting deficits for many years until 2004 (NBS, 2006b; European Commission, 2006a). This result is attributable to a substantial overhaul of public finances in Serbia on both the revenue and the expenditure sides in the first half of this decade. The basic and most essential act of the reform was the adoption of a law on the budget system in 2002, which governs public finances at all levels. However, it should be

Table 6

General Government Finances								
% of GDP	2001		2002		2003		2004	
	Revenue	39.1	..	44.3	47.1	43.1	15.9	45.0	24.9
Expenditure	40.7	..	48.0	53.0	47.3	17.5	46.5	17.6
Balance (ESA)	-1.6	..	-3.7	193.2	-4.2	37.1	-1.5	-57.0

Source: wiiw.
Note: The second column of each year reflects year-on-year changes in %. No data were available for 2005.

noted that the long-term fiscal prospects are not unambiguous. On the one hand, rationalization measures that address the army, the health and education systems, and public administration are acclaimed as steps that pave the way to permanent expenditure savings. On the other hand, the IMF (2006) expresses concerns about the government’s initiatives toward public-private partnerships in the construction of toll highways at an estimated total cost of close to 6% of GDP over three years. Moreover, the Vienna Institute for International Economic Studies (wiiw, 2006) suspects that the 2005 surplus was mainly ascribable to accelerating inflation. This allowed the government to step up its spending, but only at a rate below GDP growth, so that it still recorded a falling public-to-GDP ratio. According to the wiiw, if inflation is brought down too quickly in the short run, the fiscal balance will again fall into deficit, especially if the quasi-fiscal deficit is included.

2.5.1 Budget Revenues

As described above, the reform of the tax system, which began in 2001, has made the public revenue system simpler and more transparent. Although the

fiscal burden on taxpayers has been reduced, tax revenues have not declined.¹⁶ As a matter of fact, after surging to 44% in 2002, the ratio of public revenues to GDP oscillated around that level in the following years (see also NBS, 2006b).

The bulk of public revenues has been collected from the sales tax, which was replaced by the new VAT in January 2005. Social security contributions, personal income tax and excise tax follow as the next largest positions on the revenue side. Although the VAT reform did not affect this ranking of contributing items, the composition of public revenues has shifted significantly from direct to indirect taxes.

2.5.2 Budget Expenditures

Expenditures climbed by nearly 8 percentage points to 48% of GDP in 2002. This growth was substantially higher than that registered in revenues. Since 2002, however, the expenditure ratio has continuously declined to reach an estimated 41.1% in 2005 (NBS, 2006b). Substantial changes have been implemented also on the expenditure side, particularly for the two major expenditure items – wages of public sector employees and pensions. In addition to the above-mentioned overhauls of the pension and health care systems, a major reform of public administration and services was initiated in 2005. It provides for streamlining the pay bill and cutting the number of government employees (including the army and health care system) by 10%.

It is noteworthy that expenditures relative to GDP were reduced also in 2003, a year of relative economic slowdown. Moreover, in 2004, the economic upswing was accompanied by the implementation of a countercyclical fiscal policy.

2.5.3 Budget Deficit and Government Debt

In sum, the general budget deficit increased until 2003 owing to (1) a rise in spending that was higher than the growth in revenues in 2002 and (2) lower GDP growth in 2003. However, thanks to the combined effects of economic recovery and fiscal reforms, the deficit dropped to a mere 1.5% of GDP in 2004 and turned into a surplus in 2005.

In accordance with the positive development of the general government budget, general government debt was also cut substantially from over 85% of GDP in 2001 to an expected 52% in 2005 (European Commission, 2006a). The completion of the Extended Arrangement with the IMF in February 2006 paved the way for an additional 15% write-off of the debt to the Paris Club, so that the ratio of public debt to GDP declined to an estimated 44% at end-2006 according to Serbia's Ministry of Finance. Moreover, the government announced that privatization proceeds exceeding the minimum expected amount of EUR 1.3 billion in 2006 will be used to repay external debt.

¹⁶ The obvious reason is that the tax base has been enlarged and, apparently, the shadow economy and tax evasion have been contained.

2.6 Positive Signs in the External Sector

2.6.1 Current Account

Following the liberalization measures of 2000, the trade deficit expressed as a percentage of GDP more than tripled to 31% within one year. In the following years, it improved slightly in parallel to the slowdown of real exchange rate appreciation. In 2004, however, the Serbian trade balance worsened again and reached a record deficit of close to 34% of GDP. The deterioration was brought about in particular by the rising raw material prices, especially for oil and gas, and by an accelerated accumulation of imports in anticipation of the VAT introduction in January 2005. By contrast, goods exports expanded by 20% in 2005 owing to the kick-in of structural reforms and the good harvest of 2004. At the same time, the VAT introduction was the major factor curbing imports. Hence, the overall trade deficit declined by 10 percentage points to 23% of GDP as imports went down by 6%, although goods exports grew at no more than half the pace of 2004 (20% vs. 42%). Unfortunately, the latest data suggest that this positive trend might prove only temporary. In the first quarter of 2006, year-on-year import growth (44%) outpaced that of exports nearly by a factor of two (23%).

The traditional surplus of the services balance deteriorated and shrank from 2% of GDP in 2004 to merely 0.1% in 2005, as services imports expanded much more strongly than services exports. However, while the total volume of foreign trade stagnated for goods compared with 2004, it widened by 25% for services. The first quarter of 2006 might not have changed much on the services

Table 7

Balance of Payments												
% of GDP												
	2000	2001	2002	2003	2004	2005						
Goods exports	27.9	7.3	18.9	32.8	17.0	13.7	13.7	-13.9	18.8	42.7	20.0	19.9
Goods imports	59.5	16.6	45.5	49.9	44.7	23.5	40.3	-3.3	52.8	35.8	44.1	-5.8
Trade balance	-31.7	26.3	-26.7	65.0	-27.6	30.5	-26.6	3.2	-33.9	32.3	-24.1	-20.1
Services exports	8.1	11.3	7.1	72.2	5.7	0.1	5.5	4.9	7.2	34.3	7.0	9.4
Services imports	5.2	39.2	3.0	13.9	3.8	56.6	3.9	11.6	5.2	37.6	6.9	48.7
Services balance	2.9	-18.5	4.1	178.2	1.9	-41.9	1.6	-8.6	2.0	26.1	0.1	-95.8
Goods and services exports	36.0	8.2	26.0	41.6	22.7	10.0	19.2	-9.2	26.0	40.3	27.0	17.0
Goods and services imports	64.8	18.2	48.6	47.0	48.4	25.6	44.2	-2.1	58.0	36.0	51.0	-0.9
Goods and services balance	-28.8	33.6	-22.6	53.7	-25.7	43.6	-25.0	4.1	-32.0	32.7	-24.0	-15.5
Income balance (net)	0.0	-114.4	-0.2	2,628.0	-0.7	229.1	-0.8	35.9	-1.0	30.4	-1.3	43.8
Transfers (net)	18.2	75.9	11.7	25.8	10.6	14.7	12.6	27.3	16.5	35.7	14.8	1.0
Unclassified (net)	4.8	0.0	5.2	111.9	3.5	-16.5	2.6	-18.4	2.5	-0.7	1.4	-36.0
Current account	-5.8	-47.9	-5.9	100.7	-12.3	161.8	-10.6	-7.9	-14.0	37.2	-9.1	-26.9
Capital account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account balance	6.5	110.6	6.5	95.5	15.0	191.0	14.1	1.2	15.1	11.0	19.1	42.1
of which: FDI (net total including intercompany lending)	0.9	-48.5	1.6	240.6	3.3	171.2	7.4	138.7	4.6	-35.5	6.4	55.5
portfolio investment (net)	0.9	88.6	5.9	1,220.7	6.8	45.4	1.6	-74.5	1.4	-12.0	1.9	52.1
other investments (net)	4.7	434.7	-1.0	-140.9	4.8	-713.8	5.1	13.1	9.1	86.8	10.8	33.9
Change in reserves as a percentage of GDP	-4.1		-3.4		-7.9		-7.0		-3.3		-8.9	

Source: Narodna banka Srbije.

Note: The second column of each year reflects year-on-year changes in %. Changes in reserves: A minus sign indicates an increase in reserves.

trade balance from end-2005, as both exports and imports went up at nearly equal annualized rates (about 20%).

The bulk of the deficit on the goods and services balance is offset by receipts from current transfers, consisting largely of remittances of Serbs working abroad (over 15% of GDP in 2004 according to the IMF). Although the surplus of current transfers declined by 2 percentage points to 14.6% of GDP during 2005, the resulting current account deficit of 8.8% of GDP is the lowest since 2001, down by 6 percentage points from previous year's perilous level of 14%. The reason is that the overall goods and services deficit declined by 8 percentage points, driven by a substantial trade balance improvement. Hence, the long-term trend of persistently high (and mostly widening) current account deficits might have been reversed.

2.6.2 Financial Account

In 2005, the expansion rate of the financial account surplus nearly quadrupled at 42% against the previous year. The surplus thus amounted to almost 19% of GDP, which is three times higher than in 2001. Capital inflows were primarily attracted by higher interest rate margins, declining risk and strong demand for capital.

The reform process in combination with financial sector stabilization and privatizations in several economic sectors have led to a significant recovery of FDI inflows in Serbia. Foreign direct investment – starting from a low level in 2000 (net inflow of EUR 54 million) – more than tripled in 2001 and then more than doubled in each of the two following years. The share of FDI in GDP developed along the same trajectory, recording a transition period peak at 7.4% in 2003. After a substantial decline caused by a privatization slowdown in 2004, foreign investors rediscovered the Serbian market in 2005. Net FDI inflows thus came to EUR 1.2 billion and, at 6.4% of GDP, accounted for 72% of the current account deficit in 2005. This favorable development mirrors the ongoing transformation process and in particular privatization, to which most of the investments were related.

Foreign loans have been the second major part of financial inflows. Boosted by Serbia's reintegration into the international financial markets, their share in GDP has doubled since 2003 and stood at over 10% in 2005. As expounded in previous sections, the surge in external borrowing was primarily stimulated by buoyant growth of credit to the private sector which was partly financed by commercial banks' borrowing from abroad (to a large extent from their parent banks). The share of credit to the private sector in total external debt climbed by 10 percentage points to 41% in the course of 2005.

2.6.3 Official Reserves and Foreign Debt

Despite current account deficits, the official reserves of the NBS have continuously grown since 2000, given that the financial account surplus has constantly exceeded the current account deficit. In 2005, the NBS added a further EUR 1.6 billion to its stocks, as it intervened heavily in the foreign exchange market to counteract dinar appreciation pressures stemming from strong capital inflows. The foreign exchange reserves thus amounted to about 5.9 months' worth of imports. Reserves continued to grow also in early 2006,

amounting to about EUR 6.3 billion at the end of June (+ EUR 1.3 billion compared with end-2005).

After four years of continuous decline, Serbia's external debt rose by 8 percentage points in 2005, coming to 64% of GDP at year-end. As a consequence of debt relief (see section 1.2.3), the external debt structure broken down by creditors shifted from debts granted by the Paris and London Clubs toward international financial institutions (for more details, see NBS, 2006c).

3 Conclusions

In October 2000 the Milošević regime was overthrown. Under the new President and later Prime Minister Vojislav Koštunica, the Federal Republic of Yugoslavia (which was transformed into the Federation of Serbia and Montenegro and later into the independent state of Serbia) has embarked on a comprehensive transformation process toward a market-oriented economy.

Despite the difficult political situation, the Serbian authorities have been able to achieve considerable progress in macroeconomic stabilization owing to prudent fiscal and tight monetary policies: Prices, external trade and foreign exchange have been liberalized. Reintegration into the international financial system has been achieved. Fiscal transparency and modern budgetary planning have been introduced in the public finance sector. The reform steps have enhanced public confidence remarkably and provided a better environment for investment, as evidenced by recovering FDI inflows. Austria is among the top investors in Serbia.

However, challenges still lie ahead on both economic and political fronts. First of all, despite a clear progress in combating inflation, price increases fueled by rapid credit growth and external shocks have accelerated recently and remain a key challenge for policymakers. Similarly, the unemployment rate remains high at socially unacceptable levels, as does the current account deficit at nearly 9% of GDP, despite a significant cut in 2005.

The Federation of Serbia and Montenegro was given the perspective of eventual EU membership at the Thessaloniki Summit in June 2003. The European Union opened negotiations on a Stabilisation and Association Agreement (SAA) in October 2005. However, in its underlying assessment, the European Commission recommends a further rationalization of public administration in combination with curbing the shadow economy. The privatization of banks, nonbank financial institutions and large companies should be completed to support the country's competitiveness and its external sector. Finally, the Commission calls for a fight against organized crime, money laundering and corruption. At this stage, however, the country's insufficient cooperation with the ICTY is a major obstacle to further progress in Serbia's European integration process. Improving this cooperation is the key prerequisite for the European Commission to resume negotiations with Serbia on the SAA, which were interrupted in May 2006.

Overall, however, it has to be acknowledged that after a lost decade Serbia has embarked on a fairly dynamic transition path and has achieved substantial progress in recent years. Given that Serbia's economic weight is comparatively

large in the Western Balkans, a successful completion of the transformation process in Serbia is important also from a regional perspective.

Cutoff date for data: October 30, 2006.

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