Euler Hermes Economic Research

Country Report

Serbia

Improving short-term economic outlook

General Information

GDP	USD37.5 billion (World ranking 86, World Bank 2012)
Population	7.22 million (World ranking 99, World Bank 2012)
Form of state	Republic
Head of government	Prime minister Aleksandar VUCIC
Next elections	2017, presidential

Strengths

- Foreign exchange reserves appear currently adequate (but are vulnerable to domestic and external shocks)
- Acceptable business environment

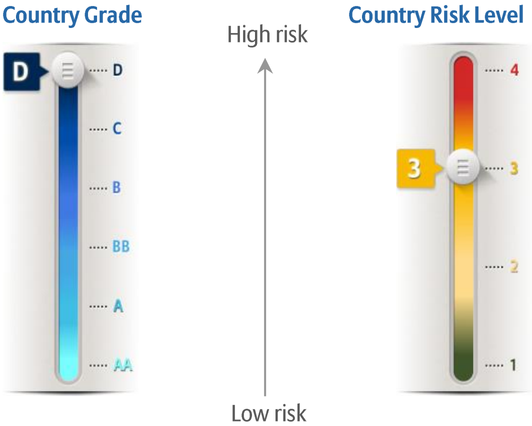
Weaknesses

- High systemic political risks: government instability, weak policymaking, unresolved Kosovo conflict
- Poor economic policy track record
- Deteriorating public finances
- Exchange rate risk (exchange rate volatility poses refinancing risk for Serbian businesses and raises payment default risk for exporters to Serbia)
- Ongoing large current account deficits
- High external debt burden

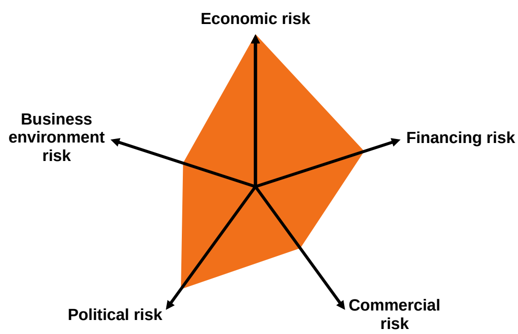
Country Rating

D3

Country Grade **Country Risk Level**

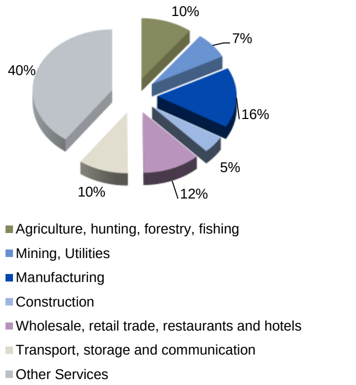


Risk Dimensions



Economic Structure

GDP breakdown (% of total, 2011)



Sources: UnctadStat, Euler Hermes

Trade structure (% of total, 2011)

By destination/origin

Exports		Rank		Imports
Germany	11%	1	13%	Germany
Italy	11%	2	10%	Italy
Bosnia and Herzegovina	10%	3	8%	Hungary
Montenegro	8%	4	6%	Romania
Romania	7%	5	5%	Slovenia

By product

Exports		Rank		Imports
Iron and steel	8%	1	12%	Petroleum, petroleum products and related materials
Non-ferrous metals	8%	2	6%	Gas, natural and manufactured
Electrical machinery, apparatus and appliances	6%	3	6%	Road vehicles
Cereals and cereal preparations	6%	4	4%	Other industrial machinery and parts
Vegetables and fruits	6%	5	4%	Electrical machinery, apparatus and appliances

Economic Forecast

	2010	2011	2012	2013	2014f	2015f
GDP growth (% change)	1.0	1.6	-1.5	2.5	1.0	1.5
Inflation (%, end-year)	10.3	7.0	12.2	2.2	3.0	3.0
Fiscal balance (% of GDP)	-3.9	-4.3	-7.2	-5.7	-6.5	-6.0
Public debt (% of GDP)	46.5	49.5	62.4	65.8	69.0	72.0
Current account (% of GDP)	-6.8	-9.1	-10.7	-5.0	-4.7	-4.5
External debt (% of GDP)	85.0	76.7	86.9	80.8	80.0	79.0

Sources: IHS Global Insight, national sources, Euler Hermes

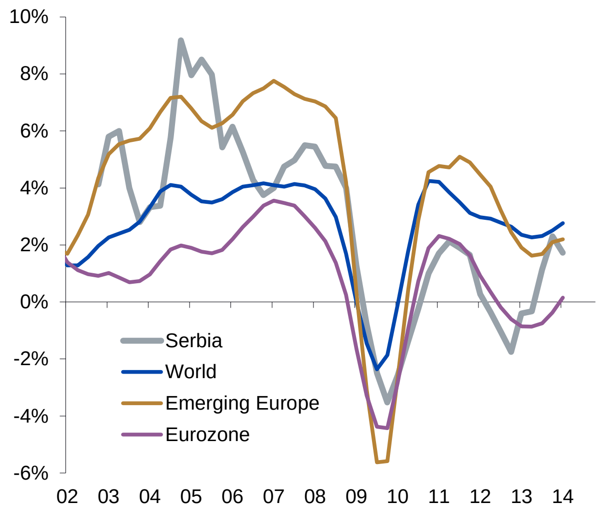
Economic Growth

GDP growth to ease after surprising rebound in 2013

Following the double-dip recession in 2009 (-3.5%) and 2012 (-1.5%) with two years of modest growth in between, real GDP growth of +2.5% in 2013 surprised on the upside. The recovery was driven by a good harvest (after a poor one in 2012) and strong automobile production thanks to output at the Fiat car plant that came on line in mid-2012. The latter also boosted real export expansion to +16.6% in 2013 which was the exclusive growth driver on the demand side. Imports increased by just +2% so that net exports contributed +5.5pps to growth. In contrast, domestic demand remained very weak. Household and public consumption declined by -1.5% and -1.7%, respectively. After strong growth in 2012, fixed investment dropped by -7.7% in 2013 as government investment was cut back, bank lending shifted to contraction and foreign direct investment remained well below potential.

Given very high unemployment (around 22%) and ongoing fiscal consolidation, domestic demand is unlikely to recover substantially in 2014 while external demand will lose momentum as the one-off effects of strong output increases in agriculture and automobiles will not be repeated, so that growth is likely to slow down in 2014. This is supported by the flash estimate of +0.4% y/y GDP growth in Q1 (no breakdown available as yet). EH forecasts annual growth of about +1% in 2014 and +1.5% in 2015.

GDP growth (% y/y, 4 qtrs cumulated)



Sources: IHS Global Insight, national sources, Euler Hermes

Exchange rate risk remains on the cards

The RSD/EUR exchange rate has shown considerable vulnerability and high volatility over the past decade and in particular since the onset of the 2008-2009 global financial crisis. The RSD fell by -8.7% during the recession year 2012, followed by -0.8% in 2013 and by -0.9% in the first five months of 2014. Prevailing weak macroeconomic fundamentals, doubts about the economic policy direction including fiscal consolidation and protracted uncertainty on global financial markets potentially will continue to put occasional downward pressure on the RSD. Any domestic or global bad news could lead to another relatively sharp drop of the exchange rate.

Inflation forecast to remain modest until 2015

Exchange rate volatility strongly feeds through to consumer price inflation which has shown similar volatility over the past decade. Inflation moderated from 7% at end-2011 to 2.7% y/y in April 2012, before accelerating again to 12.2% at end-2012 as a result of currency depreciation, increased food prices due to a poor harvest, tax rises and increasing administrative prices. As these negative impacts have waned over the course of 2013, inflation has steadily fallen to 2.2% at end-2013 and, after a short increase in early 2014, stood at 2.1% y/y in April. EH forecasts average inflation of close to 3% in 2014-2015.

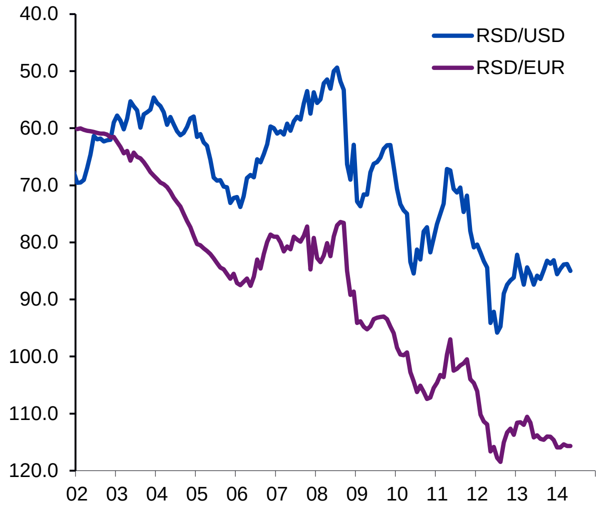
Monetary policy appears ineffective

The primary objective of the National Bank of Serbia (NBS, the central bank) is defined as "to achieve and maintain price stability". Therefore the NBS has defined an inflation target of 4% with a tolerance band of ±1.5 percentage points for the period 2012-2016. However, in practice monetary policy has been more reactive than proactive and failed to achieve price stability for most of the time. This is also reflected in very frequent interest rate changes (54 changes since 2007).

Public finances continue to deteriorate

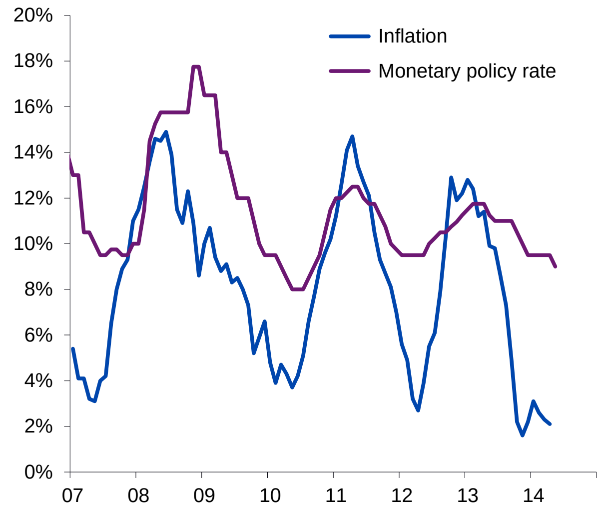
The fiscal deficit steadily deteriorated in recent years and reached an unsustainably large 7.2% or so of GDP in 2012. Although revenues underperformed, expenditure cuts helped to reduce the deficit to a still large 5.7% of GDP in 2013. In 2014, higher interest payments, new public investment and subsidies and social costs are likely to boost the fiscal deficit again to about 6.5% of GDP, followed by a forecast 6% in 2015. Public debt has rapidly increased from a low of 33% of GDP in 2008 and will probably exceed 70% of GDP in 2015.

Exchange rate



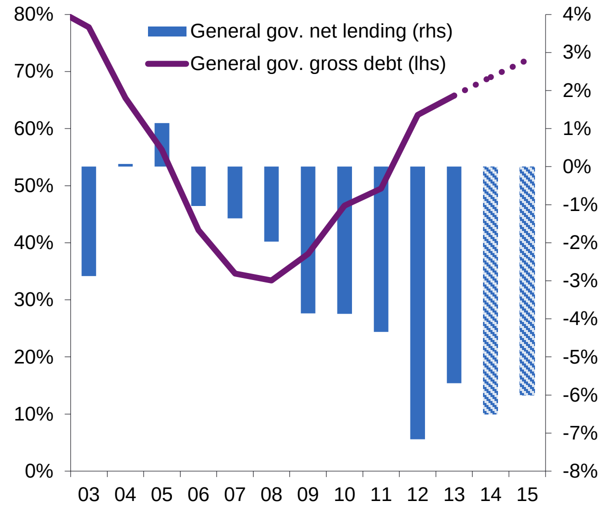
Sources: National Bank of Serbia, Euler Hermes

Inflation rate (% y/y) and monetary policy interest rate (%)



Sources: National sources, Euler Hermes

Public finances (% of GDP)



Sources: IMF, Euler Hermes

External Sector

The current account deficit narrows but remains elevated

After many years of unsustainably high current account shortfalls (10.7% of GDP in 2012), the deficit narrowed to a still relatively large 5% of GDP in 2013, thanks to the strong export performance. However, the room for further improvement is limited in 2014-2015, so that EH expects annual current account deficits of about 4.5% of GDP. The coverage of the deficit through net foreign direct investment inflows increased from just 8% in 2012 to 44% in 2013, but this was still well below an adequate level of 75%. The remainder of the deficit had to be financed through new external borrowing.

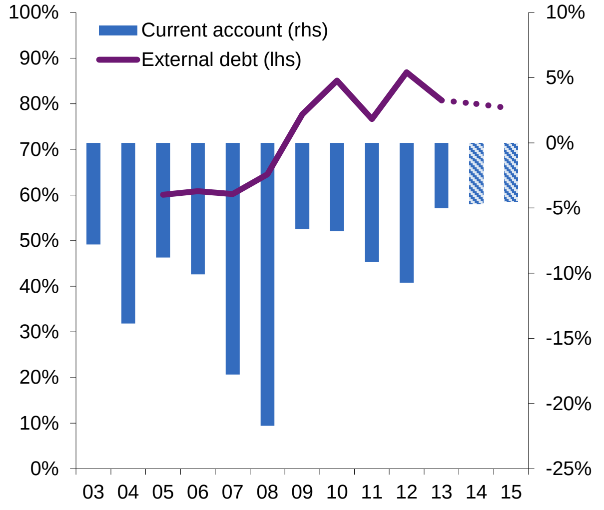
External debt burden is very high

Gross external debt has been relatively stable since 2011 and stood at EUR25.5 billion in March 2014, equivalent to about 80% of GDP (77% in 2011) or 180% of annual export earnings. The annual debt service on medium- and long-term debt is forecast at a relatively high 30% of export earnings in 2014.

Foreign exchange reserves appear adequate but could erode quickly

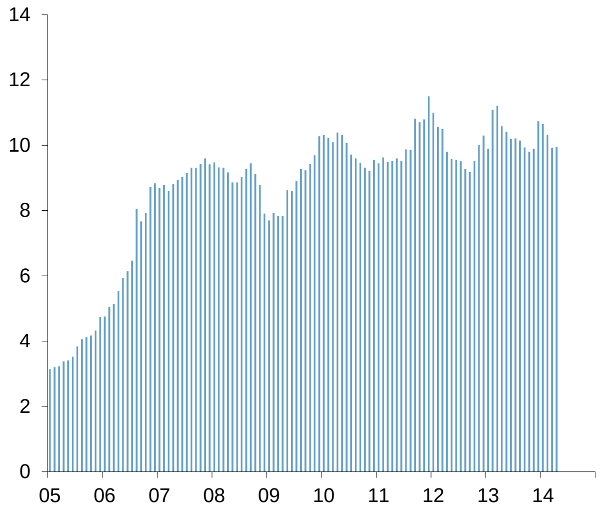
Foreign exchange (FX) reserves have broadly moved sidewards since 2010, with recurrent strong bouts of volatility. For example, reserves dropped by 20% from a peak of EUR11.5bn at end-2011 to EUR9.2bn in September 2012; then by 13% from March to October 2013; and by 8% from end-2013 to March 2014. The current level of FX reserves (EUR10bn in April 2014) is still comfortable with regard to import cover (about seven months). However, the high volatility suggests that there is a significant risk that reserves could erode rapidly should market confidence diminish once again and the central bank launch an attempt to support the RSD.

Current account balance and external debt (% of GDP)



Sources: IMF, National Bank of Serbia, Euler Hermes

Foreign exchange reserves (EUR billion)



Sources: National Bank of Serbia, Euler Hermes

Last review: 2014-06-10
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