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## **Serbia and Montenegro**

### **Serbia: problems with the budget**

In the first half of 2005, Serbia's record has been mixed. Growth is negative, at least of industry, while there are no indications how agriculture and services are performing. Inflation is higher than anticipated and will probably continue to run faster than planned. On the positive side, exports are higher by about 50% than a year before, while imports are lower by about 8% in the first four months. The target is for exports to grow by 25% and for imports to rise by less than 10% for the year as a whole. At the moment, that seems achievable. The aim is to decrease the trade and current account deficits, which have been designated as the main threats to macroeconomic stability by the IMF as well as by the government.

In order to get consumption under control, monetary policy has become even more restrictive than it was in the previous year. Reserve requirements are being raised from time to time and preference is given to loans in dinar rather than in euro or other foreign currencies. It is not yet clear whether this is having the desired effect of curtailing the growth of private spending.

More importantly, there is increased pressure from the IMF to reduce overall public spending significantly. The plan is for a budget surplus this year. This is to be achieved through a reduction of subsidies and of public expenditures on wages and salaries. Also, an added effort should be made to increase the collection of public revenues, particularly after the introduction of VAT at the beginning of 2005. In the first five months, the central budget was in surplus; data on the general government budget are not available.

The IMF has also demanded that the reform of the public sector is speeded up. A number of actions are planned but those will mostly signal intentions rather than bringing real action. There are huge problems with the restructuring of the energy sector and of utilities in general. Also, difficult decisions will have to be made with regard to the car plant Zastava in central Serbia, which has been a chronic problem and the major beneficiary of subsidies. There is no doubt that employment in the public sector will go down significantly, which will also contribute to lower consumption.

Overall employment has not been decreasing, though there have been announcements of some significant shedding of labour in the public sector later this year. Data on unemployment are not very reliable and the difference between registered unemployment and unemployment according to the LFS continues to be quite high. The situation on the

labour market is also difficult to assess: flexibility seems to be rather high, with employees moving out of the public employment tending to find jobs in the private sector rather quickly; wages continue to rise faster than productivity, which indicates that there are still significant structural problems in the labour market.

In the second half of the year the government intends to initiate the necessary legislation for a pension reform. The intention is for pensions to be cut, working years to be prolonged and private pension schemes to be introduced. The final outcome is hard to predict in details, but there is no doubt that the pension bill will go down. The amount will depend on political and social considerations, which may weigh heavily on the government because of the possibility of early elections being held some time at the beginning of next year.

Privatization should also be speeded up, in particular in the banking sector and in the oil and telecommunications sectors. A number of smaller banks are to be sold, but much more important will be the privatization of the oil company. The process should start this year, but it is unclear when it will be finished. The battle between the interested companies will be fierce and in all probability the competition will be rather less than fair. The experience from recent privatizations suggests that one or the other type of corruption plays a role in the sale of state assets.

Similarly, there is the continuing saga of the privatization of the mobile phone company Mobtel. Lately, the private part of the company was bought by a group of Austrian investors, though the share they actually bought is unclear. The division of shares between the previous private owner and the Serbian government is yet to be decided by an international court of arbitration.

Overall economic prospects for this year are not very good. GDP will probably grow by around 3%, though the risk is on the downside because of the uncertainty connected with the performance of agriculture, which may not be as good as expected. The squeeze on consumption will most likely have the expected effect on the decrease of the trade deficit, but will also contribute to a lower growth rate. Inflation will remain relatively high, while the success of intended reforms is quite uncertain. Much of those are undertaken in order to complete the current three-year programme with the IMF, now prolonged until the end of this year, because the remaining write-off of the inherited foreign debt, in an amount of close to USD 1 billion, is conditional on that. The continuation of the reforms after that is increasingly uncertain.

Table Serbia

Serbia: Selected Economic Indicators <sup>\*)</sup>

	2000	2001	2002	2003	2004 <sup>1)</sup>	2004 1st quarter	2005	2005 forecast	2006 forecast
Population, th pers., mid-year <sup>2)</sup>	7661.4	7736.3	7515.1	7532.6	7550	.	.	.	.
Gross domestic product, CSD mn, nom.	355168	708423	919231	1095402	1305700	.	.	1560000	1800000
annual change in % (real)	5.2	5.1	4.5	2.4	8.6	7.1	5.2	4	5
GDP/capita (EUR at exchange rate) <sup>3)</sup>	882	1541	2012	2228	2370	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4230	4500	4940	5140	5600	.	.	.	.
Gross industrial production <sup>4)</sup>									
annual change in % (real)	11.4	0.1	1.8	-3	7.1	9.5	-3.4	3	5
Gross agricultural production									
annual change in % (real)	-12.8	18.6	-3.4	-7.2	19.8	.	.	.	.
Construction, hours of work actually done									
annual change in %	.	-13.8	-7.4	10.9	5.2	.	-18.8	.	.
Gross fixed investment, CSD mn, nom.	50047	66765	122922	.	.	.	.	.	.
annual change in % (real)	13.3	-4.1	-0.8	.	.	.	.	.	.
LFS - employed persons, th, Oct. <sup>5)</sup>	3093.7	3105.6	3000.2	2918.6	2930.8	.	.	.	.
annual change in %	.	0.4	-3.4	-2.7	0.4	.	.	.	.
Reg. employees in industry, th pers., avg.	.	705.0	648.1	605.3	562.0	569.0	535.0	.	.
annual change in %	.	.	-8.1	-6.6	-7.1	-8.2	-6.0	.	.
LFS - unemployed, th pers., average <sup>5)</sup>	425.6	432.7	459.6	500.3	665.4	.	.	.	.
LFS - unemployment rate in %, average <sup>5)</sup>	12.1	12.2	13.3	14.6	18.5	.	.	20	20
Reg. unemployment rate in %, end of period <sup>6)</sup>	.	.	30.5	31.9	32.4	31.4	33.1	34	34
Average net monthly wages, CSD <sup>7)</sup>	2389	5375	9208	11500	14108	12567	15140	.	.
annual change in % (real, net)	5.5	16.5	29.9	14.0	11.1	5.0	16.5	.	.
Consumer prices, % p.a.	79.6	93.3	16.6	9.9	11.4	8.6	16.0	15	10
Producer prices in industry, % p.a.	102.6	87.7	8.8	4.6	9.1	5.7	13.5	15	10
Central governm. budget, nat.def., % GDP									
Revenues	.	.	.	.	25.5	.	.	.	.
Expenditures	.	.	.	.	27.3	.	.	.	.
Deficit (-) / surplus (+), % GDP	-0.9	-1.4	-4.5	-4.2	-1.7	.	.	.	.
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	26.3	16.4	9.5	9.0	8.5	8.5	8.5	.	.
Current account, EUR mn <sup>8)</sup>	-352	-398	-1514	-1546	-2349	-596	-264	-2500	-2500
Current account in % of GDP	-5.2	-3.3	-10.0	-9.2	-13.1	.	.	-14	-13
Gross reserves of NB, excl. gold, EUR mn	.	1138.6	2076.8	2728.2	3008.0	2613.0	3211.0	.	.
Gross external debt, EUR mn	11659	12609	10768	10858	10355	11111	10934 <sup>Apr</sup>	.	.
FDI net, EUR mn <sup>7)</sup>	55	186	502	1197	777	170	263	.	.
Exports of goods, BOP, EUR mn <sup>8)</sup>	1699	1935	2191	2513	3133	587	807	3600	3960
annual growth rate in %	.	13.9	13.2	14.7	24.7	13.0	37.6	15	10
Imports of goods, BOP, EUR mn <sup>8)</sup>	3632	4791	5928	6578	8799	1887	1475	9700	10700
annual growth rate in %	.	31.9	23.7	11.0	33.8	40.5	-21.8	10	10
Exports of services, BOP, EUR mn <sup>8)</sup>	495	832	886	886	1196	281	251	.	.
annual growth rate in %	.	68.1	6.5	0.0	35.0	51.1	-10.6	.	.
Imports of services, BOP, EUR mn <sup>8)</sup>	320	363	604	632	870	170	274	.	.
annual growth rate in %	.	13.4	66.4	4.6	37.7	47.9	60.8	.	.
Average exchange rate CSD/USD	16.69	66.84	64.19	57.44	58.69	56.31	69.40	.	.
Average exchange rate CSD/EUR (ECU)	15.30	59.44	60.79	65.26	73.00	61.68	80.82	85	90
Purchasing power parity CSD/USD, wiiw	9.67	17.87	21.92	24.64	26.88	.	.	.	.
Purchasing power parity CSD/EUR, wiiw	10.95	20.33	24.76	28.30	30.88	.	.	.	.

\*) Note: Excluding Kosovo and Metohia.

1) Preliminary. - 2) From 2002 according to census data. In 2004 wiiw estimate. - 3) In 2000 wiiw estimate with black market rate. - 4) From 2004 new methodology harmonized with EU standards. - 5) From 2004 fully adjusted to ILO definition. - 6) In % of unemployed plus employment (excluding individual farmers). - 7) From 2002 including various allowances. - 8) Converted from USD to EUR at the official cross exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

### **Montenegro: slow improvement**

The similarity with Serbia is that Montenegro is making the same effort at fiscal consolidation. It also aims to bring down the trade and current account deficits. In other respects, Montenegro is different. Inflation is slowing down, perhaps not as fast as planned because of the rising oil prices, and growth is accelerating, though still rather slowly. Also, privatization is in a different stage as it started much earlier than in Serbia and was based on vouchers rather than on sales. Finally, foreign investors are showing increased interest, especially for the tourist sector.

The latter also gives a different significance to the trade deficit. Investments in tourism should bring higher revenues and will contribute to the sustainability of the trade deficit. Tourism has a great potential and its growth will mainly depend on an upgrading of infrastructure. Significant growth cannot be expected this year, but the prospects are much better over the medium run.

The labour market does not indicate any major changes. Employment and unemployment rates have not changed very much in the recent past. Wages do not seem to be growing faster than productivity, though the data could be improved. There are indications that inequality is growing as are regional differences. These social developments may have important consequences.

The improved macroeconomic and business situation in Montenegro is the reason that the country is having less of a problem with the IMF than Serbia. The main vulnerability is the public sector, which is still rather unreformed. There are also worries about the soundness of the banking sector, in part because it is financing the state. Thus, the public sector is the main remaining threat to macroeconomic stability. Short-term expectations are for an acceleration of growth and a further deceleration of inflation.

### **Political risks**

This and the next years may prove crucial for Serbia and Montenegro because of the political decisions that will have to be taken, some of which are rather risky. The future of Kosovo will be discussed and there are indications that the positions of international mediating bodies may be opposed by Serbia. In spring of 2006, most likely in April, Montenegro will hold a referendum on independence. Whatever the outcome, the risks of destabilization will increase. Finally, the issue of cooperation with the Hague tribunal will have to be resolved by the end of 2005. Each of these decisions and even more all of them in conjunction have the potential to raise the political risks and also bring the existing governments down. If all of them are taken and stability is preserved, political risks will be reduced significantly. Chances for a good outcome are better than fifty per cent at the moment.

Table Montenegro

## Montenegro: Selected Economic Indicators

	2000	2001	2002	2003	2004 <sup>1)</sup>	2004 1st quarter	2005	2005 forecast	2006 forecast
Population, th pers., mid-year <sup>2)</sup>	608.9	612.9	615.9	620.1	625.0	.	.	.	.
Gross domestic product, EUR mn, nom. <sup>3)</sup>	1022.2	1244.8	1301.5	1433.0	1535.0	322	340	1660	1800
annual change in % (real)	.	-0.2	1.7	2.3	3.7	.	1.9	5	5
GDP/capita (EUR at exchange rate)	1679	2031	2113	2311	2456	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	4800	4840	5030	5140	5340	.	.	.	.
Gross industrial production <sup>4)</sup>	.	.	.	.	.	.	.	.	.
annual change in % (real)	4.3	-1.0	1.1	2.1	13.8	-1.7	3.9	5	5
Net agricultural production	.	.	.	.	.	.	.	.	.
annual change in % (real)	-5.0	6.9	5.9	.	.	.	.	.	.
Construction, hours of work actually done	.	.	.	.	.	.	.	.	.
annual change in %	.	.	.	.	.	.	.	.	.
Gross fixed investment, EUR mn, nom. <sup>5)</sup>	.	226	183	166	.	.	.	.	.
annual change in % (real)	.	.	.	.	.	.	.	.	.
Employment total, average reg <sup>6)</sup>	140.8	141.1	140.8	142.7	143.5	142.5 <sup>I-II</sup>	142.1 <sup>I-II</sup>	.	.
annual change in %	-3.3	0.2	-0.2	1.4	0.6	.	-0.2	.	.
Reg. employees in industry, th pers., avg <sup>7)</sup>	.	36.7	35.8	34.1	36.6	.	.	.	.
annual change in %	.	.	-2.3	-5.0	7.6	.	.	.	.
LFS - unemployed, th pers., average	.	.	.	.	.	.	.	.	.
LFS - unemployment rate in %, average <sup>8)</sup>	20.1	19.5	21.6	22.9	22.3	.	.	23	23
Reg. unemployment rate in %, end of period <sup>9)</sup>	.	.	.	32.9	29.3	33.3 <sup>Feb</sup>	29.3 <sup>Feb</sup>	.	.
Average gross monthly wages, EUR	.	.	251	271	303	284	297	.	.
annual change in % (real, net)	.	.	.	9.3	9.6	.	5.7	.	.
Retail prices, % p.a.	22.9	22.8	17.6	7.8	3.3	6	3.6	3	3
Producer prices in industry, % p.a.	.	.	14.6	4.5	5.7	7.3	3.1	3	3
Central governm. budget, nat.def., % GDP	.	.	.	.	.	.	.	.	.
Revenues	.	.	.	.	.	.	.	.	.
Expenditures	.	.	.	.	.	.	.	.	.
Deficit (-) / surplus (+), % GDP <sup>10)</sup>	6.0	3.1	2.7	3.0	2.1	.	.	.	.
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	.	.	.	.	.	.	.	.	.
Current account, EUR mn <sup>11)</sup>	.	-195.4	-163.5	-102.0	-143.0	-74.6	-34.5	-80	-90
Current account in % of GDP	.	-15.7	-12.6	-7.1	-9.3	-23.2	-10.1	-5	-5
Gross reserves of NB, excl. gold, EUR mn	.	.	.	.	.	.	.	.	.
Gross external debt, EUR mn	.	.	.	408	502	.	.	.	.
FDI net, EUR mn	.	10.6	89.2	38.7	50.0	9.3	161.2	.	.
Exports of goods, BOP, EUR mn <sup>11)</sup>	.	235	323	271	382	102	95	400	450
annual growth rate in %	.	.	37.2	-16.2	41.0	32.9	-6.5	5	13
Imports of goods, BOP, EUR mn <sup>11)</sup>	.	723	748	630	813	205	163	900	950
annual growth rate in %	.	.	3.5	-15.8	29.0	32.6	-20.6	11	6
Exports of services, BOP, EUR mn <sup>11)</sup>	.	150	172	191	241	17	21	.	.
annual growth rate in %	.	.	14.4	11.4	26.0	40.0	26.7	.	.
Imports of services, BOP, EUR mn <sup>11)</sup>	.	53	73	80	101	21	23	.	.
annual growth rate in %	.	.	35.9	9.8	27.1	44.8	5.2	.	.
Average exchange rate EUR/USD	0.92	0.90	0.94	1.13	1.24	1.07	1.31	.	.
Purchasing power parity EUR/USD, wiiw <sup>12)</sup>	0.31	0.37	0.37	0.39	0.40	.	.	.	.
Purchasing power parity EUR/EUR, wiiw <sup>12)</sup>	0.35	0.42	0.42	0.45	0.46	.	.	.	.

Notes: 1) Preliminary. - 2) From 2003 according to census 2003. Year 2004 wiiw estimate. - 3) Including non-observed economy. - 4) Excluding small private enterprises and arms industry. - 5) 2003 excluding private sector. - 6) Employees plus own account workers, excluding individual farmers. - 7) In 2004 new methodology. - 8) Estimate of the Institute for Strategic Studies and Prognoses (ISSP). - 9) In % of unemployed plus employment (excluding individual farmers). Quarterly data refer to new methodology (employees include private sector as well). - 10) Data given by ISSP. - 11) In 2001 converted from USD to EUR at the official cross exchange rate. - 12) Estimate based on a 45% price level (EU-25=100) in 2003 and extrapolation with GDP deflator.

Source: wiiw Database incorporating national statistics; wiiw forecasts.