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Erste Bank analysts: Serbian economy on growth path, but needs institutional framework reforms and further FDI

- **Tight race makes outcome of May 11 elections unpredictable**
- **GDP growth over 6% in 2008**
- **Controlling external imbalance to remain high on the agenda**
- **Restrictive monetary policy to continue**

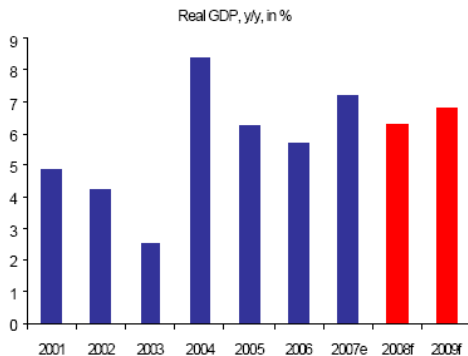
The outcome of the presidential elections at the beginning of 2008 clearly showed that the majority of people in Serbia would like to see the country on the road to the European Union. On February 17, Kosovo's temporary parliament formally declared independence for this southern Serbian province, which was supported by a majority of EU members and the US administration, but strongly opposed by the Serbian government, which remains determined to never recognize Kosovo as an independent state. In the aftermath the coalition broke up and new parliamentary elections were scheduled for May 11. The outcome is highly unpredictable - hence, political risk in Serbia remains high, with potential to influence economic developments strongly: *"We continue to stick with the scenario that Serbia will remain on the EU track and, in the mid run, continue its successful convergence story. In the short run, the political situation will influence economic performance only mildly. If the situation turns out differently, it would most likely mean a significant negative revision of the forecasts"*, comments Alen Kovac, the macro analyst of Erste Group.

High GDP growth: Even with 2H07 slow down, overall 2007 showed an excellent performance

Strong domestic demand remained the growth impetus, pushing the service sector up further. The transport and communications sector performed especially well, recording a 24.3% y/y increase, supported by wholesale and retail trade activity (+18.1% y/y) and financial intermediation (+20% y/y). *"We expect for the whole 2007 a GDP growth of 7.2% y/y and for 2008 the GDP growth rate at 6.3% y/y, still a reasonably high growth rate"*, predicts Alen Kovac.

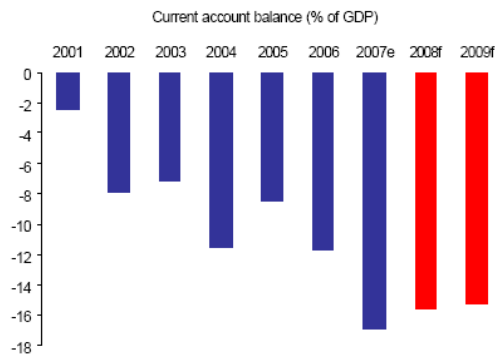
The current account deficit reached USD 6.9bn, increasing a robust 88% y/y and accounting for an estimated 16.9% of GDP (+5pp with respect to 2006). Stronger domestic demand, the solid exchange rate performance and higher energy prices negatively affected growth rates. Exports, on the other hand, were impacted by the lower level of competitiveness and appreciation of the real exchange rate as well as the negative affect by an administrative decision to ban exports of some agricultural products. FDI inflows were significantly lower than in 2006, accounting for 5.4% of GDP - only slightly above 30% of the total C/A deficit. *FDI inflows are expected at around USD 3bn for 2008, but this forecast is sensitive to political conditions. Finally, indebtedness indicators are expected to remain stable, largely due to strong GDP and export performance in nominal terms"*, states the Erste Group analyst further.

GDP forecast



Source: SORS, Erste Bank

C/A deficit



Source: NBS, Erste Bank

Controlling external imbalance crucial

Serbia still needs to undergo further reforms to improve its institutional framework and attract new FDI - especially greenfield export-oriented projects. In order to remain on the EU track and resolve open issues, the continuation of negotiations should be considered a top priority. Currently, significant dedication to pursuing reforms is not expected, as the technical government (until the elections) will not open any important issue. Also, the privatization process will be stalled, at least as far as big projects are concerned. Hence, with a fiscal deficit at 2% of estimated GDP, fiscal policy in 2008 should remain prudent, in order not to worsen the external balance and show a positive signal to international investors.

Inflation to remain elevated

The NBS inflation target for 2007 was successfully achieved, as core inflation remained comfortably within the 4-8% target band, standing at 5.4% y/y in December. *“On average, we expect the inflation rate at a higher level than in 2007 (around 9%); towards year-end, we see pressures moderating, bringing headline inflation close to the upper band of the NBS range (3-6%)”*, sums Kovac up.

Fundamentally, the dinar has room to appreciate

At the beginning of 2008, rising political risks related to the presidential election and Kosovo issue again confirmed how fragile the FX market is and how sensitive it is to political risks. Currently, the exchange rate is moving in the 83-84 range, under pressure from the government break-up and new parliamentary elections in May. “Still, political risks are currently high and could possibly influence the exchange rate stability if the outcome of the elections results in a deterioration of EU prospects. “Our forecast assumes that the pro-Europe option will prevail in the upcoming elections, thus removing the political risks to some extent and stimulating FX inflows and boosting appreciation pressures in 2H08.”

Erste Group, Press department

1010 Vienna, Graben 21, Fax: 0043-50100-19849

Hana Cygonková, Tel: 0043-50100-11675, e-mail: hana.cygonkova@erstebank.at

Ionut Stanimir, Tel: 0043-50100-11676, e-mail: ionut.stanimir@erstebank.at

You can also download this text from our homepage at <http://www.erstebank.com/Press>.

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