

Belgrade, 30 November 2011

**Why foreign analysts and investors view Serbian macro prospects so differently from domestic public<sup>1</sup>**

Ladies and Gentlemen,

Recent turbulences in world financial markets have led to a rise in risk premia in many countries. In case of Serbia, these pressures were moderate relative to regional peers, but one cannot be too cautious and should be prepared to act swiftly in order to minimize negative impacts of current turbulences.

Improving or maintaining Serbia's sovereign credit rating in these turbulent times is a challenge of a great importance. This is because it ensures sustainable sources of financing at a lower cost, not only for the Government, but also for all other market participants – businesses, households, and banks, alike.

The Government and the central bank can best contribute to improving credit rating by pursuing policies that ensure long-term macroeconomic stability, such as: maintaining public debt at sustainable level, ensuring price stability in the medium term, and providing stable and resilient financial system. Any attempt to „stimulate“ the economy in an unsustainable way would jeopardize these goals, leading to a rise in the country's risk premium and eventually hurting the very economy it was meant to help.

Over the past years foreign market participants and credit rating agencies recognized an improvement in Serbia's macro prospects. Serbian press, however, has been even more deeply than usual flooded with doom-and-gloom commentaries of Serbian economic performance during the crisis and especially its macro prospects for the future:

*“We are facing inconsistency and incoherency of domestic economic policy daily observed by investors”* (Djordje Djukic, *Biznis i finansije*, June 2011),

*“Knocking on the IMF doors is a proof of a complete defeat of the domestic economic policy”* (Zarko Ristic, *Pravda*, September 2011),

*“Domestic economy is currently in a position of Titanic – sending SOS signals”* (Saša Dogović, *Nacionalni Građanski*, September 2009),

*“Economic collapse looms large”* (Branislav Grujic, *Novosti*, August 2011).

But at the same time, Serbia saw its credit rating upgraded, becoming one of the few countries in the region with the credit rating above the pre-crisis level. In November 2010, Fitch changed Serbia's credit outlook to stable from negative, in March 2011 S&P upgraded Serbia to BB from BB-, and in November 2011 Fitch confirmed credit rating for Serbia, despite downgrades in many regional peers. The financial analysts worldwide started becoming more positive about Serbian medium-term macroeconomic and currency prospects, and foreign investors started investing increasingly in Serbia through FDI or portfolio investments:

*“Progress has been made regarding monetary policy effectiveness. The NBS has performed well and enhanced its credibility since the 2008-2009 crisis.”* (Fitch, November 2011).

---

<sup>1</sup> I should like to thank Mirko Djukic for comments and suggestions.

“We believe the completion of the current IMF arrangement and the government’s intention to conclude discussions surrounding a new precautionary IMF agreement by around mid-year should further boost investment sentiment.” (Barclays Capital, April 2011)

„Serbia has set itself apart from other emerging-market economies in creating conditions to attract foreign investment that will fuel growth.” (Nomura Global Research, December 2010).

“The least vulnerable countries are Czech Republic, Poland and Serbia, and Turkey and Russia outside the CEE area. All enjoying high profitability of their banking sectors, low dependence of parent banks’ funding and larger domestic banking ownership“ (Standard Bank, August 2011),

What caused such a dichotomy of opinions between foreign investors and domestic public?

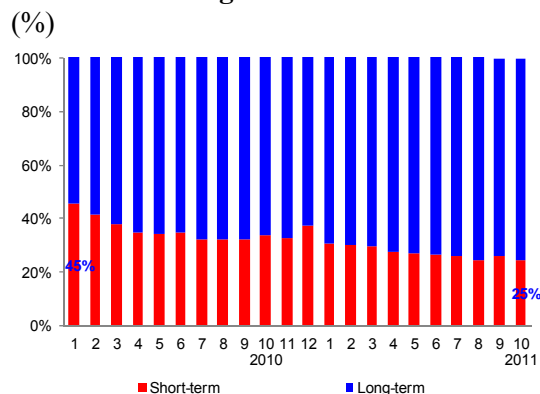
Among the key reasons for improved Serbian macro prospects in international analyses one would find the following:

First, the external debt structure was changing patterns over the past year. Banks’ external funding sources increased in maturity. While the long-run debt made up 56% of banks’ total external debt in January 2010, it grew to 75% by October 2011. Also, corporates’ external debt kept shifting from cross-borders towards domestic banking sector borrowing, yielding several important consequences. Domestic debt is under the strong prudential supervision of the National Bank of Serbia. Furthermore, domestic real credit growth of 15.2% in 2010 and 9.0 % p.a. in October 2011 indicates the growth potential of the Serbian banking sector. Finally, while the cross-border debt is exclusively in foreign currency, domestic debt is partly, and increasingly so, in dinars, reducing the level of FX exposure in the country.

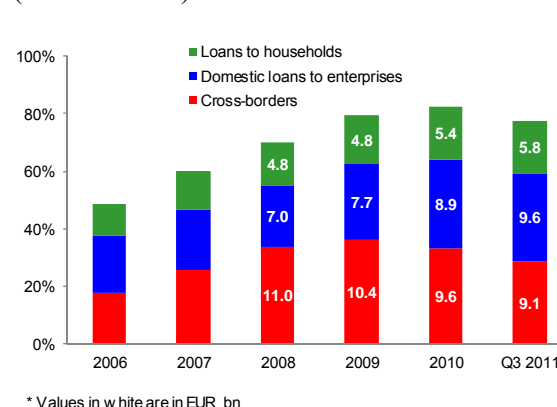
Second, the dinar financial market is steadily developing, and the NBS’s strategy of dinarisation is yielding some visible results. The yield curve has been extended from 12 months in early 2010 to 36 months by March 2011. The longer maturities opened up the bond market to non-resident investors, since they are legally allowed to trade with long-term government securities only. The hedging market is also gaining pace, and the bank credit market is becoming increasingly dinarised. In October 2011, 30% of total loans to corporates and households was in dinars, whereas in February 2010 it was only 24%. This implies that around 40% of new loans in the past year were in dinars.

Third, fiscal deficits in the past three years hovered around 4.5% of GDP, less than in many other European countries. In October 2010 the Law on Fiscal Responsibility was adopted, introducing the fiscal rule and establishing the Fiscal Council. In an effort to restrain public spending, public sector wages and pensions remained nominally frozen throughout 2009 and 2010. Public debt currently stands at around 45% of GDP, which is below ratios for most Eurozone countries.

**Chart1: Maturity Structure of Banks’ External Funding Sources**

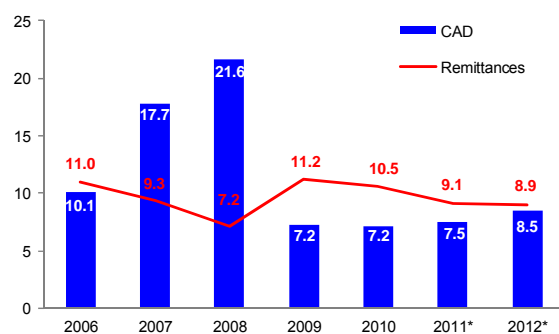


**Chart 2: Private Sector Debt in GDP (share in GDP)**



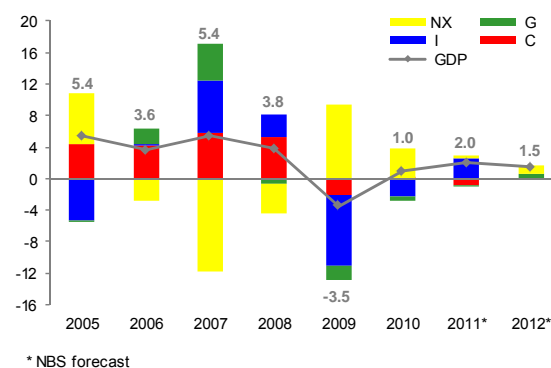
\* Values in white are in EUR bn

**Chart 3: Current Account Deficit and Remittances**  
(% share in GDP)



\* NBS forecast

**Chart 4: Contributions to Real GDP Growth**  
(y-o-y rates, pp)



\* NBS forecast

Finally, and perhaps most importantly, external imbalance, the largest pre-crisis macroeconomic problem, has been steadily adjusting since early 2009. In 2008, the current account deficit to GDP ratio reached the height of 21.6%, indicating large and unsustainable external imbalance. Since then, it corrected sharply to 7.2% in 2009 and 2010, and is estimated to be around 7.5% in 2011.

For the current account deficit to improve to such an extent, it was necessary to increase net exports and investments and to cut real consumption. Indeed, in 2009 and 2010 net exports contributed to growth by 9.3 percentage points and 3.7 percentage points, respectively. In the first half of 2011, fixed investments led GDP growth, contributing with 1.2 percentage points. At the same time, real consumption kept falling by 3.4% in 2009, 0.2% in 2010, and 2.7% in the first half of 2011, according to NBS estimates.

Although this adjustment was necessary in order to achieve sustainability of economic growth in Serbia, it, nevertheless, was extremely painful for Serbian consumers, especially since summer 2010, when food prices shot up substantially following a poor agricultural season worldwide.

And here lies the key reason for the difference of views between foreign investors and the Serbian public. While foreign investors focused on improved macroeconomic sustainability brought about by shrinking consumption, the Serbian public was feeling strongly the pinch of the necessary adjustments following the unsustainable consumption spree in the years before the crisis.

So, what should we do now? There are three choices in front of us:

One could stop the adjustment process and engage in another consumption spree. This is clearly tempting for many of a short-term approach, as the policy of reckless spending too often stroke a cord with a part of the Serbian electorate in the past twenty or so years. But there is also a catch: following the recent crisis, any policy leading to further imbalances becomes much discriminated by international financiers, who are unlikely to keep financing such a spending as generously as before the crisis.

Alternatively, one could try to give the electorate a bit of a break from further sharp adjustments in the pre-election period. But, loosening the consumers belt for a year, will not do them much favours in the medium term, and might also trigger a swift negative reaction from international investors at the time when they are particularly sensitive to non-prudent public spending.

Finally, and in my opinion most desirably, one could continue with necessary painful adjustments, while at the same time providing more assistance to the poorest and most

vulnerable households among us. Although politically risky, this would be the most responsible policy for the upcoming Serbian generations.

And at this point I should like to reiterate the National bank of Serbia's message over the past few years: it is better to have low but sustainable growth than high and unsustainable one.

The National Bank of Serbia will continue with an effort to stabilize inflation at lower level and maintain sound financial system, which, I firmly believe, is the best way to help the economy in the current circumstances.

A further challenge in front of us is to reduce credit risks related to FX exposure, as well as to exposure to interest rate fluctuations. For that reason, we will foster the development of transparent and simple hedging instruments, such as FX forwards and swaps, as well as interest rate swaps. At the same time, following an adverse financial stability effect internationally of some of the complex financial derivatives, such as CDSs, CDOs or NDFs, we would like to discourage the development of such instruments in Serbia at this stage of financial literacy in the country.

Ladies and Gentlemen, I should like to assure you that the National Bank of Serbia monitors international developments very carefully, both in the real and financial sectors, and stands ready to do everything and act in order to maintain macroeconomic and financial stability in Serbia.

**Table1: Changes of credit ratings and outlooks during the crisis – Serbia and neighbouring countries**

Changes of credit ratings and outlooks in times of crisis – Serbia and neighbouring countries										
Country	Standard & Poor's					Fitch				
	Credit rating (long-term)	Type of change	Date of credit rating change (long-term)	Outlook	Date of outlook change	Credit rating (long-term)	Type of change	Date of credit rating change (long-term)	Outlook	Date of outlook change
Serbia	BB-			negative stable	31.8.2008* 01.12.2009	BB-			stable negative	31.8.2008* 23.12.2008
	BB	upgraded	16.03.2011						stable	11.11.2010
Croatia	BBB			stable negative	31.8.2008* 27.10.2008	BBB-			stable negative	31.8.2008* 21.5.2009
	BBB-	downgraded	21.12.2010							
Slovenia	AA			stable negative	31.8.2008* 23.12.2010	AA			stable negative	31.8.2008* 28.9.2011
	AA-	downgraded	20.10.2011			AA-	downgraded	28.9.2011		
Macedonia	BBB-			positive negative	31.8.2008* 01.12.2008	BB+			positive stable	31.8.2008* 4.11.2008
	BB	downgraded	01.05.2009	stable	21.09.2009				negative stable	21.5.2009 27.10.2010
Bosnia and Herzegovina	B+	new rating	22.12.2008	stable negative	22.12.2008 28.07.2011					
	B	downgraded	30.11.2011.							
Montenegro	BBB+			negative	31.8.2008.*					
	BB	downgraded	31.03.2010							
Hungary	BBB+			negative	31.8.2008*	BBB+			stable	31.8.2008*
	BBB	downgraded	17.11.2008			BBB	downgraded	10.11.2008	negative stable	17.10.2008 10.11.2008
	BBB-	downgraded	30.03.2009	stable negative	02.10.2009 23.07.2010	BBB-	downgraded	23.12.2010	negative stable negative	2.3.2009 6.6.2011 11.11.2011
Romania	BBB-			negative stable	31.8.2008* 09.03.2010	BBB			negative stable	31.08.2008* 02.02.2010
	BB+	downgraded	10.11.2008			BB+	downgraded	10.11.2008		
Bulgaria	BBB-			stable negative	31.8.2008* 30.10.2008	BBB			negative stable	31.8.2008* 10.11.2008
	BBB	downgraded	30.10.2008	stable	01.12.2009	BBB-	downgraded	10.11.2008	negative positive	30.4.2009 24.5.2011
Greece	A			stable	31.8.2008*	A			positive stable	31.8.2008* 20.10.2008
	A-	downgraded	14.01.2009						negative	12.5.2009
	BBB+	downgraded	16.12.2009	negative	16.03.2010	A-	downgraded	22.10.2009		
	BB+	downgraded	27.04.2010			BBB+	downgraded	8.12.2009		
	BB-	downgraded	29.03.2011			BBB-	downgraded	9.4.2010		
	B	downgraded	09.05.2011			BB+	downgraded	14.1.2011		
CCC	downgraded	13.06.2011			B+	downgraded	20.5.2011			
CC	downgraded	27.07.2011			CCC	downgraded	13.7.2011			
Albania	B+	new rating	19.04.2010	stable	19.04.2010					

\*rating as of 31.8.2008.