Serbia

Tuesday October 29 2013

www.ft.com/reports | @ftreports

Belgrade's new leaders set sights on EU status

Serbia has plenty of pressing domestic concerns as it starts out on the long road to joining the 28-member bloc, writes *Neil Buckley*

Time to tighten belts: cafe society finds its place in central Belgrade, though austerity is the watchword Getty

Since Yugoslavia started to unravel more than two decades ago, Serbia has spent much of the time in a turbulent search for its identity and direction. Finally, it seems to have achieved a consensus – that the eventual destination is European Union membership.

A groundbreaking agreement to normalise relations with the former province of Kosovo in April, brokered by EU foreign policy chief Catherine Ashton, unlocked the way for Serbia to begin EU membership talks by next January. That is only the beginning of a road that could take years to traverse – membership is unlikely before the next decade. But it is a hugely important beginning.

The government is shifting attention to longstanding economic problems, with ambitious but painful austerity measures and structural reforms announced this month.

"The time has come to employ people and to provide for them a better life, social care, healthcare," says Tomislav Nikolic, the one-time nationalist who was elected president 18 months ago. "EU membership isn't the only way to provide this, but it is the best and most secure way."

The progress was scarcely foreseeable last year when Mr Nikolic beat the ostensibly more pro-western president Boris Tadic, and the government led by Mr Tadic's Democratic party was defeated and replaced by one led by ex-nationalists.

Mr Nikolic, and the deputy prime minister, Aleksandar Vucic, had both been associates of the ultranationalist Vojislav Seselj, now on trial in The Hague for alleged war crimes. The prime minister, Ivica Dacic, was once a spokesman for the nationalist Yugoslav president Slobodan Milosevic.

All claimed to have reinvented themselves as pro-Europeans. Indeed, Mr Nikolic led his colleagues out of Mr Seselj's Radical party in 2008, and formed the Progressive party, professing EU integration as its goal.

The government's subsequent actions have helped convince the EU that it is serious. Particularly on Kosovo, it has achieved things Mr Tadic seemed unable or unwilling to do.

"There's a kind of poetic justice that people . . . connected to forces which contributed a lot to the situation that Serbia is in, and especially the nationalists, now have to do part of the fixing of the damage," says Sonja Licht, president of the Belgrade Fund for Political Excellence. "It is difficult to imagine that things could have gone so far and so quickly with those who were not part of the story."

> 'In opposition, you can say whatever you want. When you . . . lead a country, you have to be responsible'

Ms Licht draws parallels with neighbouring Croatia's Ivo Sanader, who succeeded the 1990s strongman president Franjo Tudjman as head of the nationalist HDZ party and steered it towards mainstream European Christian democracy. That paved the way for Croatia to become the EU's 28th member state last July.

Mr Vucic says his switch to a pro-EU stance was "pragmatic, realistic and rational".

"In opposition, you can say whatever you want," he told the FT. "When you . . . lead a country, you have to be responsible, to take care of people's lives, of the country's future. And we can't do that without . . . the support of the EU."

For his part, Mr Dacic – who led the talks with Kosovo's prime minister and one-time rebel commander Hashim Thaci – says he wants Serbia and its people no longer to be viewed abroad as "lepers".

"Our objective is to become the 29th EU state," he says. "We see this as an opportunity for Serbia, figuratively speaking, to come to Europe, in all walks of life."

Normalising relations with Kosovo was politically risky. But securing agreement to start EU talks has proven popular – though, paradoxically, the popularity seems to have rubbed off more on Mr Vucic than on the premier.

A poll last month found Mr Vucic to

Continued on Page 2

Inside »

Vucic holds reins
The deputy premier has emerged as the real power in the government
Page 2

Austerity shows coalition resolve
Tax rises and wage cuts are aimed at reducing debt
Page 2

Bad loan worries
A mixed picture for banks in a crowded market dominated by foreign groups
Page 3

Cars drive hopes for industry
Can Fiat plant point the way to revival for manufacturing?
Page 3

Seeds of growth
Opinions differ over whether thinking big or small is best for agribusiness
Page 4

CHOOSE EUROPE. CHOOSE SERBIA.

CHOOSE COMTRADE.

A company steeped in tradition from a country with a bright future.

With more than 1,600 software engineers, ComTrade is the brain-power behind some of the biggest names in the IT industry.
Software engineering, R&D, IT consulting, solutions and services is what we're good at – and we have 20 year track record to prove it.
We simplify technology and help reduce business complexity with our technology solutions. To learn how, visit us at **www.comtrade.com.**

ComTrade

Interested in investing in Serbia? **Join us at Serbia Investment Day**
Tuesday October 29, 2013 - The Andaz Liverpool Street, 40 Liverpool Street, London, UK
www.regonline.co.uk/Serbia2013

Vucic emerges as real power in coalition

Politics

The deputy premier will not be drawn on the prospect for fresh elections, writes *Neil Buckley*

Serbia last held general elections barely 18 months ago. But the hottest topic of political debate is whether new elections may be held next spring.

Riding a wave of popularity, the leader of the largest party in the governing coalition, deputy premier Aleksandar Vucic, has not confirmed he is considering an early ballot. Equally, he has carefully not ruled it out.

"I can't guarantee that we won't have elections, but I would rather see more of our efforts put into development of the country," Mr Vucic told the FT in an interview. "I'm not very willing to go for elections, but if there [are] more claims from the opposition side that we don't have legitimacy, we will say, 'OK, let's check it out'."

Election speculation was heightened by last month's dismissal of Belgrade's powerful mayor, Dragan Djilas, triggering a municipal ballot set for the spring. National polls could be held at the same time.

If, as expected, the EU agrees to begin membership talks with Serbia early next year, Mr Vucic is seen as keen to seize the political momentum. Recent opinion polling suggests he and his Progressive party might win a big enough victory to be able to rule without its coalition partner, prime minister Ivica Dacic's Socialist party.

It could give the Progressives a strengthened mandate to push through the difficult economic reforms that the government launched this month.

The Progressives finished surprise winners of last year's parliamentary election with 24 per cent, ahead of Boris Tadic's pro-western Democratic party on 22 per cent, and Mr Dacic's Socialists on 15. The Progressives' then leader, Tomislav Nikolic, won the simultaneous presidential election, beating Mr Tadic.

Aleksandar Vucic: popular

The Progressives went into coalition with the Socialists, with Mr Dacic able to set his price: the prime minister's job. The Democrats' ratings have since fallen sharply.

Mr Dacic has had a high profile as Serbia's negotiator in talks to normalise relations with the breakaway former province of Kosovo, which reached a landmark agreement in April.

Mr Vucic has emerged domestically as the real power in the government. After Mr Nikolic became president and had to renounce formal party ties, Mr Vucic succeeded him as Progressive leader.

As well as becoming first deputy premier, he also took responsibility for overseeing Serbia's intelligence agencies.

The latter position gave him the platform for his most popular – if controversial – initiative, namely a clampdown on corruption that went as far as the arrest last December of Serbia's richest man, the retail tycoon Miroslav Miskovic.

Critics and targets of the clampdown say it has been used selectively for populist purposes and to weaken political opponents. Supporters of Mr Miskovic claim the charges against him are flimsy and nonsensical.

Mr Djilas, who took over national leadership of the Democrats from Mr Tadic last year, and his colleagues also say their party has been disproportionately targeted.

"In 12 months, 65 people from the [Democratic Party] have been arrested, we don't have one from the Socialist party," he says, noting that the Socialists also participated in the previous government coalition.

Mr Vucic denies that the anti-corruption campaign has been politically motivated.

"It's not my fault if [the Democratic party] were in power for 12 years and they were involved in almost every criminal case in the country," he says.

Mr Djilas suggested that his dismissal as Belgrade mayor was one of many signals that Serbia was "sliding into dictatorship and single-party rule".

Socialists and Progressives in the city assembly voted to replace Mr Djilas in Belgrade after the former – which had been part of the city's governing coalition together with the Democrats – turned against him, accusing Mr Djilas of driving the capital into debt.

Mr Vucic denies there was anything undemocratic about the move. "This is democracy, the Socialists changed their minds," he says.

Despite such domestic concerns, the international community has largely given the government the benefit of the doubt. This is in part because it has delivered where the previous Democratic government, despite its pro-European orientation, could not – on improving ties with Kosovo.

"I can't recall a Serbian government that has had such open and strong support from the west," says Bosko Jaksic, a columnist with Serbia's Politika newspaper.

Though the Kosovo step seemed domestically risky, the fact it has secured the likely start of EU membership negotiations in January has proved to be the other main boost to Mr Vucic and the Progressives' popularity.

One hurdle on the road to the talks remains: Kosovo's November 3 municipal polls. A good turnout by the Kosovo Serb community is needed to ensure the April agreement's implementation can continue.

Door to Brussels is the only path to prosperity

Commentary
TONY BARBER

On taking office as president of Serbia in May 2012, Tomislav Nikolic sketched a verbal picture to parliament of his nation as "a house with two doors". One door would be open to the west: that is to say, the EU. The other would be open to the east: that is to say, Russia and, his listeners surmised, potential friends and benefactors such as China and Gulf Arab states.

It was a seductive but illusory picture. Since the fall of eastern European communism in 1989-91, many a politician in that precarious geopolitical space that divides the EU from Russia has toyed with adopting a stance of equidistance and even-handedness between east and west. Some, too, have dreamt of commercial investments and financial support from China and the Gulf as a way to lessen their nations' dependence on western economies and the International Monetary Fund.

For certain countries, above all former Soviet republics such as Armenia and Belarus, it might be difficult or unwise to loosen the bonds that still tie them to Moscow. For other states, including Serbia, it might seem too tiresome to espouse western economic norms and too galling to submit to the IMF's financial strictures.

However, Serbia and its Balkan neighbours, reborn as independent nations amid the violence of the post-communist era, are discovering that the path to prosperity, peace and political stability lies only through the door marked "EU entry".

In Serbia's case, a helping hand from Russia, China and the United Arab Emirates is proving useful to modernise infrastructure, retool industry and stabilise the public finances. But for the long-term political and economic transformation of Serbia, there will be no realistic alternative to the EU. Here lie the markets and the modernity that will free Serbs from the chains of a troubled past.

Over the past two decades, it has taken the collapse of the Yugoslav roof over Serbia's head, several disastrous wars, a ruinous dictatorship and much painful domestic upheaval for Serbian politicians to conclude that the nation's destiny is European. Even now, as Mr Nikolic's remarks indicated, the temptation lingers to play off the EU against Russia and other interested parties.

But Ivica Dacic, Serbia's prime minister, made clear in September that he aspires to a more sensible, if still ambitious goal: "A Serbia in Europe; and Europe – its values, its regulations and its systems – in each Serbian village."

In the eyes of Mr Dacic and like-minded politicians and businessmen, the prize of EU membership is so desirable that it is worth making concessions over Kosovo, the ethnic Albanian-majority province that declared independence from Serbia in 2008. Many Europeans underestimate the significance of this step. In centuries-old epic Serbian poetry, and in modern nationalist mythmaking, Kosovo is an inalienable part of Serbia.

But the invitation to EU accession negotiations, expected to start next year, would never have arrived without the deal in April between Mr Dacic and Hashim Thaci, Kosovo's prime minister and a former rebel commander with whom the Serbs were at war in 1998-99.

Even if they proceed smoothly, Serbia's entry talks are unlikely to result in EU membership until 2020 or even later. The despotic 12-year rule of Slobodan Milosevic, the communist turned warmongering nationalist deposed in 2000, left an enduring legacy of official corruption, violence in public life, weak state institutions, ethnic antagonisms and economic disorder.

Yet a strong motivation behind Serbia's bid to join the EU family is that Croatia and Slovenia have already done so, while Montenegro began its accession talks last year. For more than 12 months it has dawned on proud and thoughtful Serbs that, although Serbia was the most populous and powerful of Yugoslavia's six republics, it now trails three of them in the league table of European integration.

Meanwhile, the other two ex-Yugoslav republics are hardly role models. Like Serbia, Macedonia is an official candidate for EU membership, but its bombastic nationalism earns it little sympathy in EU capitals. In Bosnia-Herzegovina, almost 20 years after the civil war, the rivalries of Bosniak (Bosnian Muslim), Serb and Croat politicians are the despair of EU leaders.

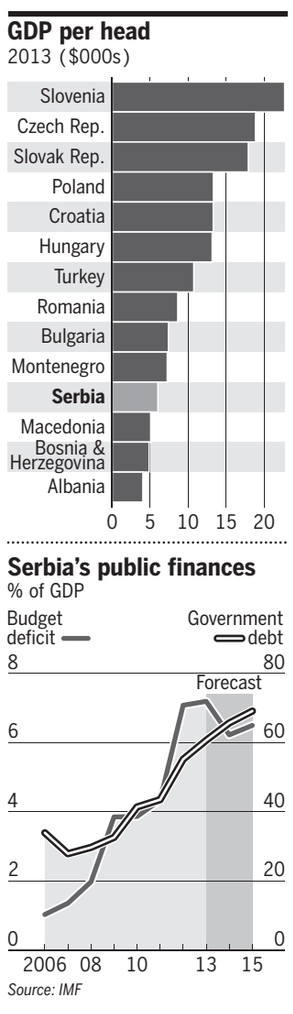
> EU governments should bear in mind that Serbia's inclusion in the bloc will benefit them

Once Serbia's membership talks start, the EU's 28 member states should not seek excuses to drag them out. For sure, the EU will have every right to set the bar high, as it did for Croatia, and insist that Serbia stamp out corruption, crack down on organised crime, strengthen the independence of the judiciary and protect the rights of minorities.

But EU governments should bear in mind that Serbia's inclusion in the bloc will be good for them, too. It will buttress the security of a region notorious, since the assassination of the Austrian archduke Franz Ferdinand in June 1914, for sucking the rest of Europe into its conflicts. Next year is the 100th anniversary of the outbreak of the first world war. It ought to remind us that a Serbia inside the European embrace is much better than a Serbia outside.

Austerity plan shows resolve to push through serious reforms

Economy Investors and analysts worry that tax rises and wage cuts may fail to resolve deep-seated problems, reports *Neil Buckley*



Aleksandar Vucic, Serbia's deputy prime minister, caused jitters on the financial markets when he warned in a television interview this month that the country was "on the verge of bankruptcy".

As Tim Ash, emerging markets analyst at Standard Bank, noted: "Serbia isn't imminently close to bankruptcy. They have enough cash and financing capacity to get them though to the year end," he said. "From a market perspective, this was not perhaps the best language to use."

Mr Vucic's words aimed to prepare Serbs for deep and unpopular austerity measures, including tax rises and public-sector wage cuts, announced the day after his interview. His underlying point, that Serbia could eventually face default unless it curbs the deficit to stabilise the country's rapidly increasing debt, was well-founded.

Analysts and investors have broadly welcomed the measures as a sign that the centre right-socialist coalition is finally trying to push through serious structural reforms. They are less convinced that the country can succeed.

Serbia's economic problems are daunting. Unemployment, at more than 25 per cent, is among the highest in Europe. After a 3.5 per cent economic contraction during the 2009 global recession, Serbia saw weak growth return in 2010 and 2011, but output declining 1.7 per cent again last year.

Even more worrying are the debt dynamics. Public debt has mushroomed from 33 per cent of GDP in 2008 to more than 60 per cent at the end of last year. The budget deficit was 7.5 per cent last year, and the International Monetary Fund this year warned it could hit 8.3 per cent in 2013 without additional cost-cutting measures – which the government has started to make.

Hundreds of sometimes moribund state-owned companies eat up billions of dinars in subsidies. More broadly, the IMF has warned that Serbia's post-communist economic transition is running a decade behind that of some central and eastern European neighbours.

The government is trying to signal its intention of tackling the problems. A summer reshuffle saw Mladjan Dinkic ousted as finance and economy minister, and his job split in two.

Mr Vucic brought in two non-party technocrats, apparently in the hope that they would be better able to steer through politically unpopular measures. Lazar Krstic, a 29-year-old Yale graduate and former McKinsey consultant, took the finance portfolio, with Sasa Radulovic, an economist and businessman, becoming economy minister.

"There is one overarching goal, and that is stabilising the public debt," says Mr Krstic. "In four or five years, it has doubled. It has got to the level where, for a country like Serbia, an emerging market, we basically need to invert the trajectory, to make it sustainable."

The austerity package Mr Krstic unveiled this month aims to reduce the budget deficit to 2-3 per cent and stabilise public debt at 75 per cent of GDP by 2016-17. The measures amount to fiscal consolidation of about 4.5 to 5 percentage points of GDP by 2017, or savings of more than €1.5bn.

Public workers earning more than 60,000 dinars (€525) a month will see a tax increase cut their take-home pay. This will affect about 200,000 out of the country's roughly 500,000 public employees. A lower-rate value added tax on food and staples of 8 per cent will be raised to 10 per cent.

> 'Political parties have their hands on some 65 per cent of GDP and they don't have any intention to change that'

The government plans to complete the privatisation of 179 state-owned businesses to cut the burden on the public purse, reduce state subsidies and clamp down on the grey economy.

The size of that grey economy, estimated at 30 per cent of GDP, is one reason budget revenues have undershot targets, contributing to the ballooning deficit. Another is the low number of Serbs in productive jobs and paying taxes.

On the economic front, Mr Radulovic is clear about his task. "My key job is growth," he says, "and that growth can also be described with one word, which is 'jobs'. Serbia needs jobs."

His programme includes reforming the labour code to make it easier to hire and fire, speeding up business permits, and dealing with non-performing loans at banks, which he says are often higher than officially acknowledged, to unlock more financing.

Mr Radulovic is making state-owned companies complete "ID cards" with comprehensive, unvarnished information about their financial affairs, with the aim of bringing in buyers, or strategic or minority investors. Financial data on state firms have often been untrustworthy, he notes, so there are penalties for any companies falsifying their ID cards.

With many Serbs still living less well now than under Yugoslavia's relatively liberal form of communism, however, opposition to the changes is likely to be intense, with protests possible. It remains unclear whether the economy and finance ministers' technocrat status will make it easier, or more difficult, for them to push through the reforms.

Danica Popovic, macroeconomics professor at the faculty of economics at Belgrade university, warns that the plans fail to tackle the root causes of Serbia's problems, which lie in its political economy. Key jobs throughout the public bureaucracy and state-owned companies are awarded to party members on the basis of loyalty, she says, not competence.

Every time governments change, so do the holders of those jobs, as parties reward their supporters. The result, she says, is inefficiency and corruption.

"Political parties rule the economy. They have their hands on some 65 per cent of GDP and they don't have any intention to change that," says Ms Popovic.

Without rules banning public-sector managers from being party members, she adds, the government's planned reforms – however ambitious – could still fall flat.

Belgrade's new leaders set sights on EU membership

Continued from Page 1

be by far Serbia's most popular politician, with 66 per cent saying he should be prime minister, against 16 per cent for Mr Dacic. That has stoked speculation that the deputy premier might seek new elections next spring, potentially cementing his Progressive party's hold on power.

Mr Vucic also benefited politically from leading a popular clampdown on endemic corruption, that has seen dozens of political and business figures arrested – including, last December, Serbia's richest man, the business tycoon Miroslav Miskovic.

Opponents allege many of the arrests have been politically motivated. Mr Miskovic's camp say charges against him are groundless.

Critics say the municipal intrigue that led to the dismissal last month of Belgrade's mayor, Dragan Djilas – who succeeded Mr Tadic as head of the opposition Democrats – was another sign that Mr Vucic is trying to create a monopoly on power.

Mr Vucic denies such suggestions, but observers say such risks exist.

"The latent danger [is] that [Mr Vucic] can start thinking of himself as the real saviour, and that can end up as a sort of dictatorship," says Bosko Jaksic, a columnist on Serbia's Politika newspaper. "There is not an imminent danger, but there are warning signs."

Mr Vucic's popularity could help the government in coming months as the focus moves to economic reforms. Unemployment, at 25 per cent, is among Europe's highest. The budget deficit hit 7.5 per cent of gross domestic product last year and government debt has doubled since 2008 to more than 60 per cent of output.

The economy went back into recession last year, after two years of weak growth. The Economist Intelligence Unit forecasts a return to 2 per cent growth this year, accelerating to an average of 3.6 per cent annually in 2014-18.

In a government reshuffle completed last month, Mr Vucic brought in non-party technocrats as finance and economy ministers to design a programme to stabilise the debt and boost growth.

He also hired Dominique Strauss-Kahn, the former International Monetary Fund chief, and Arjil, the Paris-based investment boutique for which Mr Strauss-Kahn is working, to advise on the economy.

The economic programme involves not just tax rises and wage cuts for many public employees, but also reforms of regulation and the labour market, and efforts to curb the black market – estimated at 30 per cent of GDP. Aiming to improve the business environment and boost foreign investment, the government hope to attract more schemes like Fiat's large investment in auto assembly at Kragujevac, south of Belgrade.

The government has renewed talks with the IMF, which last year suspended a €1bn standby programme under the previous government. Wladimir Mollof, chairman of Arjil, says an IMF facility is not essential but Serbia would like "a stamp of approval".

> 3.6%
> **EIU forecast for average annual growth, 2014-18**

Mr Vucic has courted funding from other sources, including United Arab Emirates. Etihad, the UAE airline, agreed in August to buy 49 per cent of Serbia's lossmaking JAT Airways, and Mr Vucic said this month he expected Serbia to receive a $1bn loan from UAE before the year end, and loans totalling $2bn-$3bn by the end of 2014.

Yet maintaining support through economic reforms and tortuous EU negotiations – neighbouring Croatia's talks took nearly six years – will be challenging. Other hurdles could arise in the future, especially if EU members insist that Serbia must formally recognise Kosovo's independence as the price of membership.

For now, Mr Nikolic says no one has made that demand. He notes several existing EU members do not recognise Kosovo and, therefore, Serbia should not be barred from membership for taking that position.

He takes the trouble to underline, however, that Serbia will stick to it. "Serbia has a clear stance on this. I don't see anyone could win elections by saying that he or she would recognise the independence of Kosovo."

Bad loans and currency risk cast shadow over sharp rise in profits

Banking

Kester Eddy finds a mixed performance in a crowded market led by foreign groups

Ask Veroljub Dugalic, general secretary of the Association of Serbian Banks, why 98 per cent of retail savings are in foreign currencies (chiefly euros) – rather than in local dinar – and he looks around for a minute before handing over an orange-pink Yugoslav banknote.

"See the eleven zeros? When was the last time you had 500bn in your hand? This was worth 10 Deutschmarks in 1993," he says, "but only in the morning. In the afternoon it was already worth less!"

Serbs remember those inflation-ridden days with dread. At the time they switched to saving in D-Marks – its successor today is the euro.

"Serbia, practically, has been a dual-currency country for decades," Mr Dugalic says. "Big transactions are calculated in euros. If you said you'd bought a car for 2.3m dinars, nobody would understand you."

Since three-quarters of all loans in the country are likewise denominated in foreign-currencies, the resultant exchange rate risk is a contributory factor to the biggest worry for the Serbian banking industry – non-performing loans (NPLs), which account for just over 20 per cent of the entire loan portfolio, according to the National Bank of Serbia (NBS).

"The exchange rate is considered the most important determinant of NPLs," the National Bank wrote in its 2012 report.

Other factors have their roles. "The Serbian banking sector is really a tricky one," says Gunter Deuber, head of central and eastern Europe research at Raiffeisen Bank International. "Views are rather divided. A lot of external observers are still rather critical."

Bank lending continued to expand in 2010 and 2011, only slowing in 2012, he says, despite the rise in NPLs.

The market is highly competitive. Despite the failure of two smaller banks in the past two years, 31 banks battle for clients in a country of just 7.2m people.

"The market share of the top five banks is low, around 48 per cent," Mr Deuber notes.

"In the Czech Republic or Slovakia the top five have 60-80 per cent."

As in much of central and southeast Europe, foreign banks, including Italian, Austrian, Greek and French lenders, are strongly represented in Serbia with 75 per cent of the €25bn total assets. Despite the anaemic economy in 2012, banking as a whole made pre-tax profits at 11.7bn dinars (€104m) – a ninefold jump on 2011.

On FT.com
Opportunity knocks

- Making small loans – often to the poor or the unemployed – has paid dividends for Serbia's Opportunity Bank. **www.ft.com/serbia-2013**

This represents a return on equity of just 2 per cent – although the central bank, in its 2012 report, stripped out the two defunct banks, boosting the sector's return on equity to a more respectable 4.7 per cent.

The global number obscures polarisation in the industry. The five most successful banks made pre-tax profits of 30bn dinars, led by Italian-owned Banca Intesa, with 10.3bn dinars. Against this, the five worst performers had losses totalling 22.7bn dinars.

As Mr Deuber tactfully puts it: "The performance is very mixed. There are some smaller, locally owned players, sometimes, perhaps, underpricing risks here and there, and diluting competition."

The national bank is blunter, saying the sector's "key risks" include "corporate governance in some financial institutions, with special emphasis on those in state ownership".

Not that all domestically owned banks are unsuccessful. Komercijalna Banka, still 43 per cent state-owned, made 4.6bn dinars last year.

Ivica Smolic, chief executive of Komercijalna, says nine-month results for 2013 show a 19.5 per cent improvement on 2012.

Yet, bad loans hang over the banking industry, particularly from the corporate segment, which accounts for almost 60 per cent of total outstanding NPLs.

Jorgovanka Tabakovic, governor of the National Bank of Serbia, is quick to point out that the sector is stable and boasts, for example, a capital adequacy ratio of 20.3 per cent, quite comfortably above international norms.

She emphasises that legislative changes introduced last year to tackle the NPL issue – including incentives to the banks to invest more in chasing bad debtors – should take effect in the near future.

Bad loans, however, remain the industry's "key challenge", Ms Tabakovic says.

Help may be at hand. Agriculture, hit by bad weather in 2012, looks set to rebound this year and the new Fiat auto factory at Kragujevac is helping the country's export drive.

"In July, we had total exports of €1bn – a record for Serbia," says Slavko Caric, chief executive of Erste Bank Serbia.

The foreign exchange earnings will bolster the dinar, which in turn will dampen inflationary pressure, he argues.

The central bank is also introducing measures to encourage more "dinarisation" of the economy to reduce the currency risks.

That may be hard to achieve. As Mr Dugalic puts it, Serbs convert their monthly salaries to euros in their heads.

"You can keep the 500bn dinar note," he says, "you can feel very rich now."

Technical talent pool draws in global investors

Information technology

Conditions remain tough for homegrown companies, reports *Andrew MacDowall*

Innovative information technology centres that develop systems used worldwide, with chillout zones for their young, multilingual employees, seem a strange legacy of decades of communism. But Serbia's growing IT sector, which includes outsourcing as well as development, rests to no small extent on the country's strong tradition of technical, scientific and mathematical education.

"Non-ideological" subjects were embraced under communism as what was then Yugoslavia looked to close the gap with the west. Young Serbs grow up with an educational system that was moulded in those years, and also in a society changed by greater freedom and access to the internet.

Some years ago, executives at Microsoft realised that a disproportionate number of the company's software experts in the US came from eastern Europe, and resolved to set up operations in the region to capitalise on its talent pool.

In 2005, the global technology giant founded the Microsoft Development Center Serbia (MDCS), only its fourth such centre in the world at that time. Set among the grey communist-era blocks of New Belgrade, the MDCS has grown into an international base for innovation and a bright spot for investment in Serbia.

> 'Individuals in Serbia have a strong competitive mindset and strong fluency in English'

"Serbia has a long history of excellence in maths and computer sciences, which has created a strong pool of engineering talent, especially during the past 10 years," says Don Grantham, Microsoft president for central and eastern Europe.

"We have also found that individuals in the country have a strong competitive mindset and strong English-language fluency, and that contributes to our interest."

Microsoft is a leading light in Serbia's growing IT industry, which generated $200m in exports in 2011, according to the central bank – both from international investors and a significant number of dynamic homegrown enterprises.

"Most major IT companies have already invested or are in the process of expanding their investment in a variety of vertical [markets]," says Jitu Virwani, chairman of Embassy Group, an Indian company that has established an IT park in Indjija, near Belgrade.

"There have also been instances of international IT companies buying into Serbian firms. These companies are involved with various industry processes, including outsourcing and writing programme codes, testing and developing software and website design, and are catering to markets in Germany, the US, the Netherlands and others."

Examples include ComTrade, a software services company with 300 clients in 16 countries; Execom, a software engineering outfit that works with companies such as Chess, a Dutch electronics designer and developer; and Schneider Electric DMS, which develops power grid management systems.

Partnerships are mutually beneficial, says Biserka Ilic, general manager of Belgrade-based Informatika, which works with clients such as Siemens. The German technology company and other multinationals can subcontract to low-cost but efficient partners, while Serbian businesses can participate in contracts that they would be too small to win on their own.

Serbia is a favoured location for technical support centres, with international players such as US-based NCR, Sitel and Euronet all present.

As well as its skills base – technical schools account for around a third of the 43,500 students who graduate each year – Serbia benefits from its geographical location, multilingual workers (particularly in English and Russian), relatively low costs and government incentives, including grants and tariff-free imports of equipment.

The country is in the same timezone as most of Europe, and has minimal time differences from much of the former Soviet Union, as well as the UK. Servicing a wide range of affluent and growing markets is relatively straightforward.

Gross monthly salaries for programmers range from €1,000 to €2,000, depending on experience, according to the Serbia Investment and Export Promotion Agency. Prime office rents are lower than in most countries in eastern Europe.

"Serbia has improved its economic climate remarkably in recent years and is one of the largest and fastest growing markets in the region, especially in the IT sector," says Embassy Group's Mr Virwani. "We believe Serbia will be the future hub for ICT in the region."

Not all are as bullish. Despite a number of homegrown success stories, including her own company, Informatika's Ms Ilic says local companies in particular face serious challenges, including an uncertain legal environment for designing and executing IT projects, corruption and the "brain drain" that effects Serbia's whole economy.

However, Ms Ilic says Serbia is still some way ahead of its neighbours, and has the potential to challenge the best in the world. With some traditional industries such as steel unlikely to undergo a significant revival, and service sectors such as tourism still emerging, IT has an important role to play in Serbia's future.

Kragujevac on a roll: automotive production has attracted the largest share of foreign investment, not least because wages are considerably below EU levels AP

Cars drive hopes for industrial revival

Manufacturing Low costs prove attractive but red tape remains a hurdle, writes *Andrew MacDowall*

Just 14 years ago, the sprawling Zastava car plant in Kragujevac was wrecked by Nato bombs and 150 people were injured. Now, it is again the pride of Serbia's manufacturing economy. The factory was reduced to a "junkyard of twisted metal", according to one report after the bombing.

Last year, contrary to expectations of its demise, what was a roofless ruin reopened, under the aegis of Fiat Automobili Srbija (FAS), following a €1bn investment that ranks as the largest in the history of Serbian industry.

The plant exports cars as far afield as the US, and is among Fiat's most modern factories anywhere in the world. Could it be a harbinger of a Serbian industrial renaissance?

With the ability to produce a new car every two minutes, the plant is expected to turn out 110,000-150,000 units this year, depending on demand, and the plant has full annual capacity of 186,000.

Fiat aims to export to around 100 countries. These include highly competitive markets such as Italy, the US and Germany.

The choice of a landlocked eastern European country with a fairly recent history of war, and still several years from EU membership, may seem an unusual one. But Fiat has a long relationship with Kragujevac, having formed a partnership with Zastava in the 1950s. For decades the plant produced rebadged Fiats. The Italian company saw a number of competitive advantages that it could exploit in order to establish a production centre that exported far and wide.

"We believe Serbia's greatest advantage is its location, which is excellent, on the crossroads between western and eastern Europe," says Antonio Cesare Ferrara, FAS chief executive. "The second greatest advantage is certainly its industrial culture, especially in the automobile industry."

Mr Ferrara cites strong support from the government throughout the project's development, and incentives such as tax breaks and cheap land. The state has a 33 per cent stake in FAS. Fiat has helped develop roads to Kragujevac as part of the deal.

FAS has fostered a cluster of suppliers in the vicinity of the plant, including Johnson Controls, the US parts company. It purchases many of the components it needs in Serbia.

The company has been able to take advantage of another key factor – the country's low labour costs. Starting salaries at FAS are about 30,000 dinars ($360) a month. Even skilled production workers at Kragujevac command wages considerably below EU levels.

"Serbia's competitive advantage rests in its fairly highly qualified and well-educated labour force," says Abbas Ameli-Renani, an emerging-markets strategist at RBS.

"Despite high public [sector] wages, labour costs are relatively low in Serbia and serve as an attraction for foreign investment."

Utilities are also quite cheap. According to the Serbia Investment and Export Promotion Agency (SIEPA), power costs are €0.05 per kW hour. SIEPA adds that gas and water are €0.42 and €0.20 per cu m, respectively.

Fiat's vote of confidence in Serbia undoubtedly makes the plant the standout industrial investment in the country, although it is not the only one.

The automotive industry has been particularly successful, attracting more foreign direct investment than any other manufacturing sector.

In September 2012, Germany's Bosch laid the foundation stone on its first plant in Serbia, just outside Belgrade, which will make windscreen wipers. Bosch plans to invest €70m by 2019, and employ about 630 people.

This month, the Finnish automotive electronics group PKC said it was establishing a new wiring systems plant in Smederevo. On the Danube some 30km east of Belgrade, the city is known both for its impressive fortress and a struggling renationalised steel plant that became a symbol of Serbia's industrial decline.

Many of the advantages the car manufacturers enjoy also apply to electronics. There is a dovetailing between the two industries, as PKC's project shows. Significant investments include those by Slovenian white goods manufacturer Gorenje. It has invested €50m in three factories since 2006, with the objective of exporting to the rest of Europe and Russia.

> 'The Serbian government tries its best to help, but sometimes procedures cannot be accelerated'

Siemens, the German technology giant, manufactures components for renewable power plants at Subotica, near the Hungarian border, and has been expanding its operations. So, too, has Panasonic, the Japanese electronics company, which manufactures energy-efficient parts for lighting fixtures.

The pharmaceutical industry benefits from Serbia's high skills base and access to the Russian market. Domestic demand topped €700m in 2011, 60 per cent of it met by local production. The market is dominated by Hemofarm, bought by Germany's Stada for €480m in 2006, and Galenika, a state-owned company that exports to Russia and aims to obtain EU licences as well. A long-running effort to privatise a 70 per cent stake in Galenika for €200m fell through in June. Serbia said no bidders were suitably strong, though suitors were put off by Galenika's €170m debt and bloated workforce.

Other manufacturing segments include wood and furniture, chemicals, clothing and packaging, though between them have attracted only half the foreign investment of automotives since 2000, says SIEPA.

Aside from the small domestic market, other factors frustrate foreign investors, even the biggest overseas companies that are in Serbia.

"From the Fiat perspective our biggest problem is the same all foreign investors have: bureaucracy and very long waiting periods when it comes to issuing permits and administrative procedures that can sometimes slow the business," says Mr Ferrara.

"We must say the Serbian government tries its best to help, but sometimes the procedures cannot be accelerated."

Mr Ferrara also cites patchy infrastructure, including roads and railways, and outdated energy utilities.

On top of this, political uncertainty has held back investments in the wake of the Yugoslav wars. RBS's Mr Ameli-Renani says Serbia is still "ideologically transitory" but political risk is reducing as a widespread political consensus in favour of EU accession now exists.

Greater impetus behind cutting red tape and overhauling infrastructure, encouraged by the prospect of EU accession and higher foreign investment, would allow Serbia to capitalise more on the competitive advantages that led to Fiat's investment.

On FT.com »

Interview
The FT meets Tomislav Nikolic, Serbia president
Edited transcript of discussion with Neil Buckley

Slide show
Huge potential for tourism after years of neglect
Regatta to make a splash, writes Tatjana Mitevska

Contributors »

Neil Buckley
Eastern Europe editor

Tony Barber
Europe editor

Andrew MacDowall
FT contributor, Belgrade

Kester Eddy
FT contributor, Budapest

Tatjana Mitevska
FT Researcher

Andrew Baxter
Commissioning editor

Andy Mears
Picture editor

Steven Bird
Designer

Chris Campbell
Graphics

For advertising details, contact: **Jim Swarbrick**, tel +44 (0)207 775 6220, email jim.swarbrick@ft.com, or your usual Financial Times representative.

All FT Reports are available on FT.com at ft.com/reports Follow us on Twitter at **@ftreports**

All editorial content in this supplement is produced by the FT.

Our advertisers have no influence over or prior sight of the articles or online material.

KPMG
cutting through complexity

As ambitious as your business plans!

Serbia is rapidly transforming itself into a regional business hub, opening new opportunities for your business.

Find out how we can support your business in Serbia with our 18 year-long experience on the local market.

kpmg.com/rs

© 2013 KPMG d.o.o. Beograd, a Serbian limited liability company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.

Farmers look for seeds of growth

Agribusiness Opinions differ over whether thinking big or small is best, writes *Kester Eddy*

Under a churning, twilight October sky, operations at the Pecinci sugar refinery, on the plains about 30 miles west of Belgrade, are in full swing. Outside the factory gate a dozen lorries, heavy on their springs, wait to unload.

On the input side, this plant, owned by the Belgrade-based MK Group, gobbles some 350 tonnes of beet per hour at peak production. At the other end of the line, a trio of engineers is monitoring new equipment that dries the fibrous residue pulp, largely denuded of its precious sucrose.

The new drier – a steel container 10.5m in diameter at its maximum girth – is where steam at a pressure of 16 atmospheres dries the beet residue, before it is pressed into cattle fodder pellets. "The new drier saves up to 65 tonnes of heavy oil that used to heat the old rotary system," says Zeljko Cvorkov, one of the engineers.

Investment projects such as this have made Pecinci and two sister sugar refineries among the most efficient in Europe, says Miodrag Kostic, president of MK, a conglomerate he has built up in the wake of the collapse of the former Yugoslav socially-owned system in the 1990s.

"When we took over in 2003, we produced 40,000 tonnes of sugar annually, with 560 permanent workers," he says. "Now we produce 90,000-100,000 tonnes with 124 workers. When we've finished the upgrade, this refinery will produce 130,000 tonnes per year."

Known locally as "the sugar king", Mr Kostic bought the three refineries for €1 apiece in a privatisation auction.

While many Serbs were outraged by the sale, claiming he used political connections, he says critics forget that the refineries were run down, saddled with €30m in debt, and needed €150m in investment to achieve today's results.

Mr Kostic claims to have been no supporter of the former Yugoslav system, yet is a firm believer in the integrated agri-businesses built up under former President Josip Broz Tito. These combined arable, livestock and often food processing units for efficiency purposes. "It's still the best," Mr Kostic says, arguing that the economies of scale justify the large investments needed to raise the productivity of Serbia's 4.2m ha of arable land.

Core business: farmers can make a good living from apple orchards Reuters

Yet, just 30 miles to the north, Zoran Keserovic, professor of fruit science at Novi Sad university, says the future as far as fruit production is concerned is the "family farm". The country has excellent soil, good weather and water, he notes. "A farmer with three hectares of apples can produce €100,000 per year."

Indeed, even under current conditions, Serbia produces huge quantities of fruit, including plums, apples, quince and raspberries. Much of it goes for export to neighbouring countries, western Europe and Russia.

Serbian agriculture in general, and small farmers in particular, are "far from delivering their potential", says Prof Keserovic.

Many small farmers, who – especially in central and southern Serbia – work plots of between two and 10 ha, are largely unaware of modern technology, lack capital and suffer from poor surrounding infrastructure.

Most have difficulty meeting the conditions to get bank credit, or cannot fulfil the repayment conditions.

Charged with rejuvenating the sector, Dragan Glamocic, minister for agriculture, wrestles daily with the many conflicting demands.

"About 95 per cent of agricultural land is in the form of small and medium-sized farms," he says. "Incomes vary but are generally much lower than they could be, but this means we can achieve a 50 per cent, [or even] a 100 per cent improvement by applying the right methods."

The government plans educational programmes and financial support for family farms in the form of cash grants and interest relief on bank loans. The minister admits that many farmers will still struggle to meet conditions.

"They may already have debts from the past, and/or have disputes regarding land title, so can't provide the necessary collateral," Mr Glamocic laments.

Serbia is keen to encourage foreign capital.

Foreign investment into agriculture, and especially food and drink production, in the past decade "has hit more than $1bn", Mr Glamocic says; "foreign investors clearly recognise the comparative advantages of Serbia."

Among the better-known investor names are PepsiCo, the US soft-drinks company, NordZucker, the German sugar refiner, and Rauch, the Austrian fruit juice producer.

A blossoming relationship with the United Arab Emirates is on track to providing $400m in low-cost credit for agricultural development, and further investment into Serbian farming.

Mr Glamocic, who has a farming background, acknowledges that years of mismanagement, the break-up of Yugoslavia and subsequent rupture of traditional markets and economic relationships, and war and sanctions have caused incalculable damage to Serbia's agricultural development.

While seeking to support the country's many small farmers, he accepts Mr Kostic's arguments that ultimately Serbia must seek to re-establish a more integrated chain of production than presently exists, with arable farming providing fodder to domestic livestock farms, which in turn process the meat for both local kitchens and export.

"Some years ago a former minister bragged about corn [maize] as our number one agricultural export. This was a disgrace. We should grow corn for fodder and add value [to our agricultural economy]," says Mr Glamocic.

Renewables growth aims to outstrip EU

Energy

Market reforms and security strategy cause controversy, reports *Andrew MacDowall*

Energy security, greater use of renewables and market liberalisation are the three priorities of Serbia's energy strategy over the next decade.

In June, the government adopted an action plan that foresees meeting 27 per cent of gross final energy consumption from renewable sources by 2020. This is up from 21.2 per cent at present and well above the EU's 2020 target of 20 per cent.

To this end, the country is aiming for €2bn of investment, mostly from the private sector, to install 1.1GW of new renewable capacity over the next seven years, much of it in hydroelectric plants.

The country guarantees favourable feed-in tariffs for renewables plants for 12 years, after which power-purchase guarantees are locked in at market rates. The ministry of energy, development and environmental protection is also trying to improve the business environment for energy investors.

"In addition to financial incentives, the ministry is very committed to reducing administrative barriers for the construction of facilities," it says. "Currently, one of the most important goals of the ministry is to simplify authorisation procedures, especially for the investments in renewable energy resources, which will increase investor interest."

In February, however, Serbia followed a regional trend and reduced feed-in tariffs for renewables. With 1.5GW of existing installed capacity due to be closed by 2018 and ambitions to boost exports, Serbia will require new coal plants, which will be built "in an environmentally friendly manner", the ministry says.

The ministry has promised greater energy market liberalisation but will not give details. Serbia is due to open its mid-voltage market next year.

Another plank of energy liberalisation is the proposed restructuring, announced in April, of Srbijagas, the state natural gas monopoly. Zorana Mihajlovic, energy minister, says changes will include reshuffling the company's debt, which is almost €1.2bn after years of selling gas below market rates.

The second phase will involve a restructuring that may be a precursor to privatisation. This proposal is politically charged and has been opposed by Dusan Bajatovic, the company's chief executive.

Ms Mihajlovic has said the reforms would support the South Stream gas pipeline project, which is designed to bring Russian gas to central Europe via the Balkans, including Serbia. South Stream is controversial as it is seen as increasing the region's dependence on Russia's Gazprom, but the project could help boost Serbia's supply of affordable gas.

"Serbia's relationship with Gazprom ultimately buffers the Serbian gas market from free market forces – both good and bad," says Benjamin Gage, associate director of IHS Energy Insight, the industry analysts. "As long as Serbia accepts the security of supply consequences of relying on a single exporter, it ensures certain benefits concerning the price of its gas."

'Serbia's relationship with Gazprom buffers the Serbian gas market from free market forces'

But it will be some time before any benefits of South Stream are felt. IHS does not expect the pipeline to be completed until 2018 at the earliest.

Gazprom has bold plans to expand in the region through its Serbian subsidiary NIS, in which it has a 56 per cent stake. Last year, NIS announced a programme of investments of €500m every year until 2015 and €1bn annually thereafter.

Analysts question whether the company will be able to meet its investment targets – and whether the seemingly large sums will really be a game-changer for Serbia.

"Beyond Serbia's borders, NIS's [exploration and production, or E&P] efforts could offer revenue benefits to offset the cost of Serbia's energy imports," says Mr Gage. "However, given the company's small balance sheet and lack of upstream experience, it is unlikely that it will participate in any world-class E&P plays that could truly transform its situation."

High-tech niches signpost the way to urban rejuvenation

City profile
Novi Sad

Vibrant culture will not sustain economy, says *Kester Eddy*

The approach to Novi Sad from Belgrade is – to say the least – an uninviting experience: local planners, in their wisdom, sanctioned a huge waste dump near the motorway exit.

The road to Serbia's second city then passes a motley collection of homes, offices and decaying industrial units. Next, after drivers have negotiated the potholes and horse-drawn carts, cars reach the first set of traffic lights and are surrounded by Roma children begging.

"The economic resources and enterprises [of the city] have been devastated in previous decades," says Milos Vucevic, a lawyer turned mayor of Novi Sad, the capital of Vojvodina, Serbia's semi-autonomous and historically distinct northern province. "Rejuvenating the municipal utilities and these economic [assets] is the municipality's primary aim."

Across the imposing town square is evidence of the promised renewal: workmen are busy welding replacement pipes for the district heating system.

In truth, the city centre is a total contrast to the ominous images glimpsed on the outskirts. Novi Sad has a population of 340,000, a significant minority of whom seem to spend many hours sipping, supping and genteelly socialising in the bars and restaurants along the main pedestrian drag, surrounded by designer outlets selling international and local labels.

If on an autumn evening it seems busy, it is positively buzzing in July, when the city hosts the five-day Exit music festival, says Aleksandar Samardzija, who accommodates tourists on a farm 8km outside town.

On the tourism trail: Aleksandar Samardzija Kester Eddy

"I am always fully booked for Exit, almost the whole city is," he says. "Some of the performers sleep here, like Atoms for Peace, the star [US] band, this year. They like the rural calm."

While Exit, which attracts typical daily crowds of 40,000, has spread the name of Novi Sad far beyond Serbia's borders, the city needs more than an annual festival to survive and prosper.

Information technology is one industry that has seen substantial growth in the past decade. Dejan Curcic started his own company, building website software, as a student in 1997, just after the first commercial internet service became available in the city.

In 2007, by when it had taken on eight employees, the company merged with HintTech, a Dutch international web engineering services provider that was seeking an overseas partner.

Voted the best employer among small and medium-sized businesses in Serbia in 2010, the local operation has since expanded to 45 staff, who are housed in a relaxed, modern office in a Novi Sad suburb.

Mr Curcic says the basis for local success in IT was established by far-sighted academics in the mid-1990s. "The university professors from then should really take the credit for identifying technologies, such as Java and XML, which were pretty new at the time, and teaching students about them," he says.

An even more successful business is Schneider Electric DMS, which has developed advanced software for the management of electrical power systems.

30,000 people, or one in five of Novi Sad's potential workforce, are unemployed

Originating from a collaboration between the university of Novi Sad and the local electricity distributor in the mid-1990s, the Novi Sad operation was taken over by Schneider Electric of France in 2011. It employs 720 people and has ambitious expansion plans.

Its Advanced Distribution Management System (ADMS), which enables utilities to shave peak loads, is installed at more than 50 utility companies worldwide.

"This is a world leader. It can save billions for utilities," says Dragan Popovic, chief executive of Schneider Electric DMS.

But the abandoned factories on the road from Belgrade are no illusion: tens of thousands of people in what was Yugoslavia's most industrialised city were left jobless when the system created to protect them fell apart with the break-up of Yugoslavia.

Many are still among Novi Sad's 30,000 registered unemployed – one in five of the potential workforce. Olivera Simovic, manager of the Novi Sad economic development office, says very few will be able to retrain as IT whizz-kids.

But she adds: "There is a huge number of middle-level, [blue-collar] workers from closed industries who are very skilled. We have an education centre to retrain them at no cost to new investors."

Some have found work at one of the new foreign-owned companies, including Viscofan, the Spanish packaging and casings company, which set up production to serve the local meat industry.

Compared with many Serbian municipalities, Novi Sad is blessed with a rich and varied cultural heritage, excellent educational facilities and good transport connections.

Mayor Vucevic observes that the city hosts the headquarters of numerous domestic companies, many linked to the rich agricultural land to the north, along with NIS, the Serbian oil and gas company, majority owned by Russia's Gazprom.

It is "children's week" in Novi Sad, and after meeting a group of 100 young people, Mr Vucevic says: "It was particularly interesting how they define the job of mayor: in their words, it is my job to make residents happy."

ITpark Indjija
Embassy Techzones

EMBASSY GROUP

Fast track to a global work place

Your Gateway to South East Europe

- The only LEED® GOLD Certified Class A office space on the market
- Convenience of premises and scalability (hot desking, flexi, virtual offices)
- 1,200 sqm Multi-Tier Telco neutral Data Center
- Ideal location for Business Continuity, Disaster Recovery and Business Process Outsourcing
- 20 MW of power from two grids (up to 100 MW)
- Lowest costs of co-location in Europe
- International level Facilities Management and adherence to Global Security Standards

Embassy Techzones d.o.o
Serbia, 11000 Beograd, Omladinskih brigada 90b,
Ph: +381 11 353 35 63
office@embassytechzones.rs
www.embassytechzones.rs