

Waiting for economic recovery

In the third quarter of 2012, the value of realized GDP in RS was less than in the same period previous year. Negative data of industrial production in December 2012 suggest that the last quarter will end in the negative territory. This new wave of economic slowdown reflected on the decline of various indicators of economic activity, such as construction, retail and exports. For the first time after 2009 the total foreign trade turnover of RS decreased, while pensioners outnumbered workers. The increase of unemployment and weakening of domestic demand brought the pacification of inflation movements.

Last year in recession

Real growth rates of GDP in RS (%y/y)



Source: Institute of statistics of RS

Electricity production

The production of electricity in July decreased by 24.1%, and by 26.3% in August.

For the third consecutive quarter the domestic economy was in decline. In the first quarter of 2012 the GDP of RS decreased by 0.9%, by 0.6% in the second and by 0.9% in the third. The increased downfall of domestic economic activity during the third quarter mostly came from the energy sector's strong contraction of 14.2%, together with decreased production of electricity during summer months. On the other hand, with the growth of 7.5%, financial sector once again proved its resilience in relation to unfavorable movements in real economy sector.

Last year was marked by global economic slowdown. The growth of world economy slowed from 3.9% in 2011 to 3.2% in 2012. In the same period, the euro zone registered decline of 0.4%, while at EU level it was 0.2%. Similar developments were present in neighboring countries as well: according to preliminary statistic predictions for 2012, Serbian and Croatian economies realized identical decline of 1.9% in the third quarter.

Expected economic growth

According to the IMF predictions for 2013, world economy will grow by the rate of 3.5%, EU by 0.2%, B&H and Croatia by 1%, and Serbia by 2%.

The IMF issued very optimistic predictions, according to which the recovery of global, but also the domestic economy, will come as early as this year. However,

the anticipated recovery is threatened by still unclear development of debt crisis in the euro zone, “heated” by predictions of its economic decline of 0.2% in 2013.

Industrial recovery greatly depending on external factors

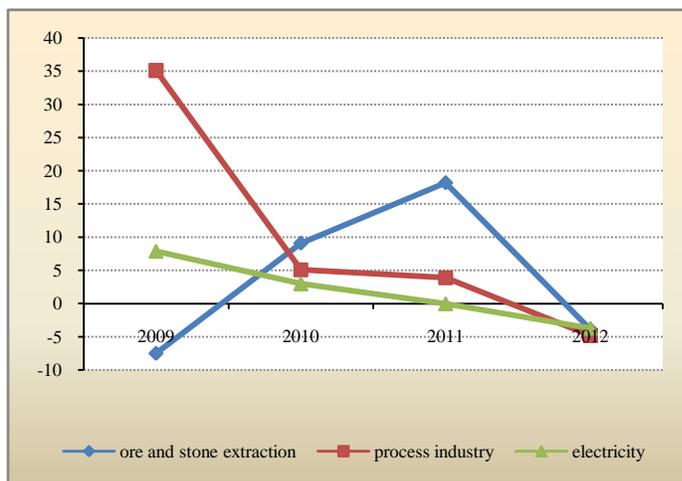
In 2012, physical volume of industrial production dropped by 4.2%. Ore and stone extraction sector declined by 3.9%, process industry by 4.8%, while the production of electricity decreased by 3.7%.

The decline of domestic demand on one hand and slowing down of industrial activity in broader regional and global context on the other determined most industrial results realized last year.

The decline of exportation sectors

In 2012 the production of textile in RS fell by 51%, clothes by 17.3%, and footwear and leather by 11.3%. Wood processing sector realized growth of 1.1% over the same period.

Growth of industrial sectors of RS (%)



Source: Institute of Statistics of RS

Therefore, the production of short-term products for broad consumption (primarily domestic) decreased by 3.3%, while the production of medium-lasting products (mostly intended for export) decreased by even 7.9%.

Serbia and Croatia, which besides the EU were the most important foreign trade partners of RS, also had negative industrial growth of 2.9% and 5.5% respectively. Industrial contraction in these two countries mostly came from the decline of export-oriented sectors of mining, textile and footwear industry and from the

stagnation of wood processing sector.

Current structure of industrial production in RS makes it highly sensitive to global trends, which is characteristic to other economies in the region as well. Due to such dependence, positive and negative tendencies in the region directly reflect on industrial results. To this, one has to add the generally low level of industrial production in RS and problems with which it deals in terms of international competitiveness.

Low participation of industry in the domestic economy

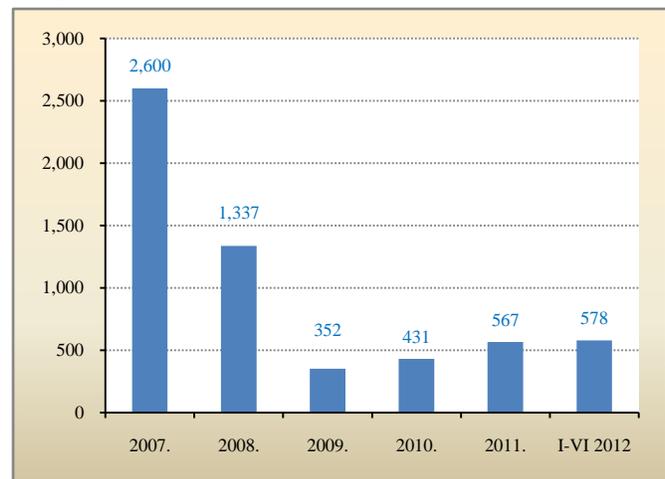
In the structure of GDP of RS in the third quarter of 2012 the share of process industry amounted was 11.5%, electro-energy sector 4.3%, while ore and stone extraction sector made contribution of 3.2%.

Unattractive business environment in relation to the region

In the first six months of 2012 Foreign Direct Investments (FDI) surpassed the value of investments in 2011 by 2%. According to the Central Bank of B&H, nett inflow of FDI in B&H was 578 million BAM. During the first six months, 240 million BAM was invested in the production of base metals, 186 million BAM in trade, 23 million BAM in financial mediation, 14 million BAM in food industry, 13 million BAM in chemical industry and 10 million BAM in other industrial sectors.

The growth of foreign investments in domestic conditions did not reflect actual improvement of the business environment and it mostly derived from the purchase of (remaining) attractive factories by foreign firms. According to the Ministry of Foreign Trade and Economic Relations of B&H, since the beginning of 2012 the biggest foreign investor has been “Birac Europe” a joint stock company from Lithuania, which invested more than 316 million BAM in the purchase of two companies from the metal processing sector.

Nett inflow of foreign direct investments in B&H (in millions of BAM)



Source: Central Bank of B&H

At the end of 2012, the unattractiveness of the domestic economy received another international confirmation. Out of 141 countries, B&H took 85th position on the list of countries with most favorable conditions for business issued by an American magazine “Forbes”. Out of neighboring countries, only Serbia had lower ranking than B&H and took 90th position. Previously, on its list of 144 most competitive countries, the World Economic Forum placed B&H on 88th place. Even though it made progress by 12 places over a year, the domestic economy is still one of the least competitive in the region. Better ranked were Slovenia (56th place), Montenegro (72nd place), Macedonia (80th place) and Croatia (81st place). During the same period, only Serbia and Albania were behind B&H taking 95th and 89th place. Inadequate access to funds, tax burden, ineffective public administration and widely spread corruption were marked as the most problematic factors for successful business operation in domestic terms.

Conditions for doing business

On Forbes list of countries most suitable for doing business Slovenia was ranked 23rd, Macedonia 37th, Montenegro 45th and Croatia 47th.

Slim chances for the recovery of the construction industry

The new wave of economic slowdown additionally increased the decline of construction activity in RS. Construction works performed during 2012 lost 7.9% of the value from 2011, while the number of employed workers fell by 2.5%.

Results in construction sector are determined by general economic trends and population's living standard, but also by the volume and dynamics of the realization of public works. Thus, as a direct consequence of population's worsened living standard and purchasing ability, in 2011, 34% less buildings were built than in 2008, and almost 60% less industrial objects. On the other hand, intensifying of works on transport infrastructure (+15%) mitigated the overall contraction of construction activity keeping the operations in the entity somewhat alive.

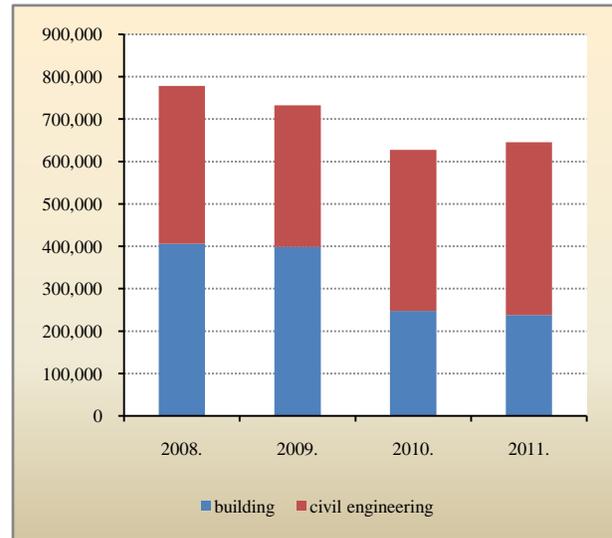
Unfavorable economic trends quickly transfer to construction sector. Since this statement does not apply for periods of economic recovery as well, domestic constructors will have to wait some time for a more significant increase of demand by private sector and population.

The U-turn of trends: Both exports and imports drop down

First time since 2009 domestic foreign trade turnover decreased. In 2012, affected by global economic slowdown, exportation from RS declined by 7.3%, while importation dropped by 2%. Thus, in 2012 exports covered only 52.9% of imports, whereas in 2011 the percentage was 55.9%.

Raw materials exports dropped by 6.1%, while exports of mineral fuels lost almost ¼ of its value. These were

The value of performed construction works (000 BAM)

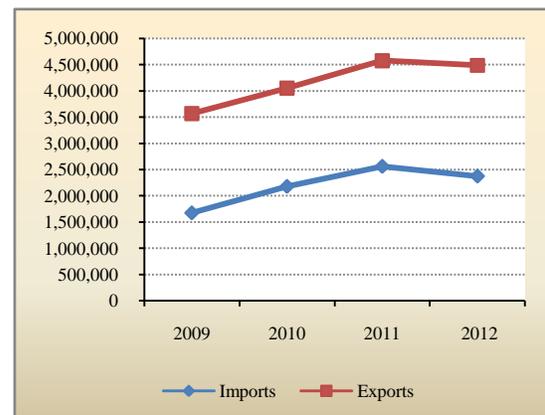


Source: Institute of Statistic of RS

Constructors take a blow

From 2008 to 2012 the value of performed construction works in RS on annual level decreased by 23.6%, with a remark that in 2011 there was growth of 2.8%.

Foreign trade activity of RS (000 BAM)



Source: Institute of Statistic of RS

the two most important groups of exportation products that made 38.5% of the total exports. On the other hand, imports of food, which is one of the biggest imported items, increased by 2%.

Exports activity of our most important foreign trade partners showed some resistance to unfavorable economic trends. Exports from Serbia grew by an inter-year rate of 4.7%, while in Croatia it was 1.4%. In both cases, food industry achieved good results (+9.2% in Serbia; +13.7% in Croatia), earning the most credit for the increase of the total exports.

Food exports

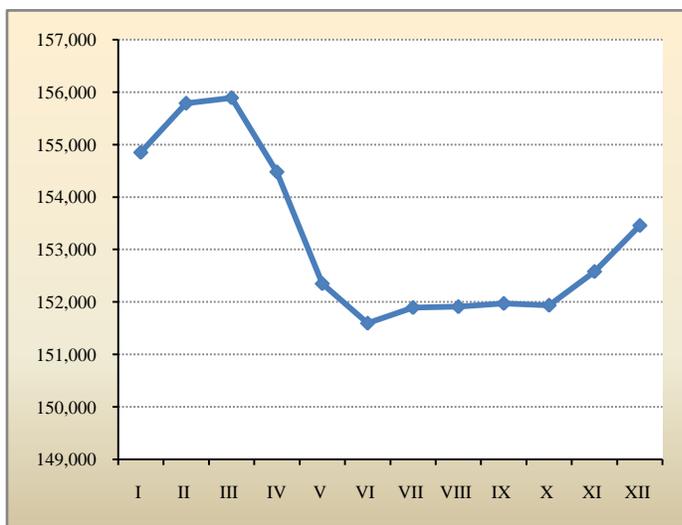
In 2012 food exportation from RS was 10.8% higher. In the total exports, food participated with 7.8%, which was less when compared to Serbia (18.6%) and Croatia (10%).

The increase of the world trade exchange of 5.9% in 2011 slowed to 2.8% in 2012. In the context of global recovery, the IMF expects that this exchange will increase by 3.8% in 2013 and by another 5.5% in 2014. Global increase of economic dynamics represents the key presumption for the recovery of domestic exports.

Employment in public sector stopped the growth of unemployment?

At the end of 2012 in RS there were 153.458 unemployed persons, which was almost the same as at the end of 2011. The autumn had “melted” very quickly the positive effects of opening of seasonal and temporary jobs over summer months, so the number of the unemployed increased by around 1% in the last quarter.

The number of unemployed persons in RS in 2012



Source: Institute of statistics of RS

The slowdown of economic activity additionally intensified the problem of unemployment globally. The

Employment in real economy sector of RS dropped by 1.2%, while public sector, despite all the measures taken by the Government on savings and rationalization of administration, received 475 new workers. Thereby, a partial compensation of the growth of unemployment in real sector was made, which resulted in the stagnation of the overall unemployment at the end of 2012.

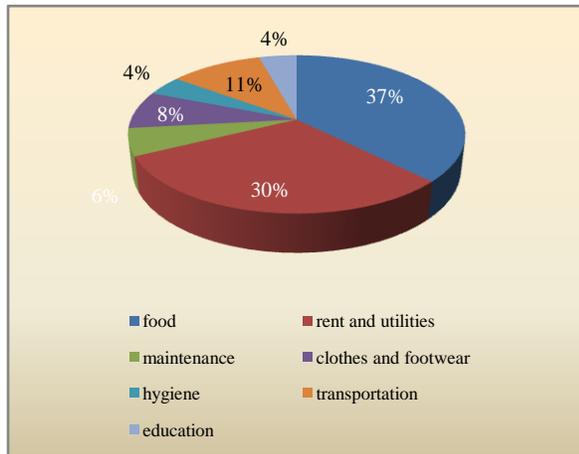
Unemployment

Unemployment rate in the EU reached 10.7% in 2012, and 11.7% in the euro zone. December unemployment rate in Croatia was 21.1%. Over the previous five years, unemployment rate in Serbia almost doubled, so in 2012 it was 25.5%.

number of unemployed persons in the world at the end of 2012 reached 197 million, which was four million more than at the end of 2011. International Labor Organization expects the continuation of this negative trend in 2013 and 2014, when the number of unemployed persons would increase by additional 5.1 and 3 million respectively.

Purchasing power of the employed weakens

Consumer basket in December 2012



Source: Alliance of Independent Trade Unions of RS

Welfare

During 2011 350.544 persons or ¼ of the total estimated number of population (1.429.668) of RS were receiving some of the forms of social aid.

Significant limitation for domestic consumption and, thereby, for overall economic activity comes from the population's purchasing power. In 2012, an average nett wage in RS amounted to 818 BAM, which was realistically less by 1%. Over the same timeframe,

living costs, measured by the consumer basket value, increased by 2.3%.

Over-pricing and over-dimensioning of the consumption-oriented sectors predominantly affect an average wage in RS. In the last year, an average nett wage in public sector (908 BAM) exceeded by ¼ an average wage in real economy sector (723 BAM).

Since January 1st, 2013 the Government's decision on decreasing wages of budget users by additional 10% has been in force. Besides the statistical effect on average income, this measure will result in the decrease of living standard, population's purchasing power and income from non-budgetary funds.

The number of pensioners exceeds the number of workers

"Finally", pensioners exceeded working population in numbers in RS (238.178 persons). During last year, the number of persons entitled to pension increased by 5.433 and at the end of 2012 it was 238.576.

With an average pension amounting to 311 BAM or 38% of an average nett wage, pensioners represent one of the most vulnerable social categories. It has to be added that, due to the effects of premature retiring of a great number of ensured persons and the high unemployment rate, there is a significant number of pensioners who support other family members as well, primarily their unemployed spouses, children and grandchildren.

In conditions of permanently increasing living costs, an average pension, which has remained unchanged for the last several years, does not cover even 1/5 of the consumer basket in RS. However, a new wave of crisis that has slowly been expanding to almost all economic and social segments will additionally worsen the position of pensioners. In such situation, maintaining the achieved standard will pose a great challenge, especially if one has in mind the expected growth of unemployment and possible decrease of exportation derived revenues of the Fund for Pension and Disabled Persons Insurance of RS.

The number of pensioners in RS in 2012



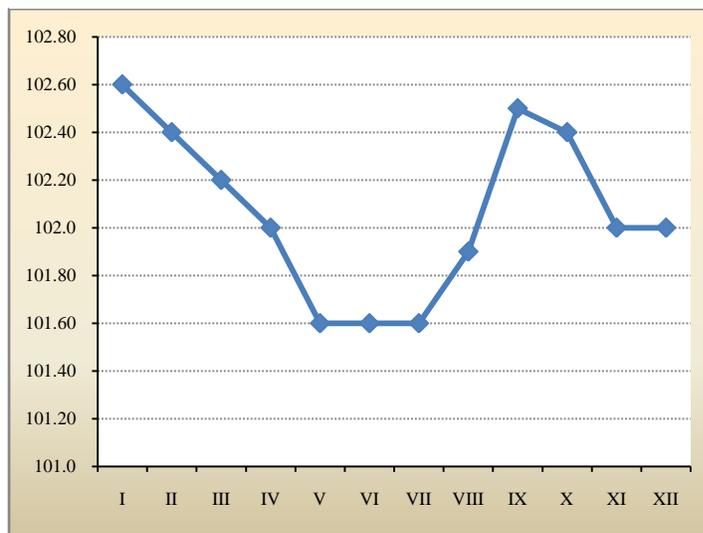
Source: Fund for Pension and Disabled Persons Insurance of RS

Average consumer basket

In 2012, an average value of consumer basket in RS amounted to 1.814 BAM. Over the same time, an average pension was not enough even to cover 1/2 of food expenses (680 BAM).

Moderate inflation

Consumption prices index in RS in 2012



Source: Institute of Statistics of RS

The end of the year brought pacification of overall inflation movements in RS. In such conditions, an average annual inflation rate in 2012 was 2.1%. Food products' price increased by 1.7%, tobacco by 14.1%, while clothes and footwear were cheaper by 3.9%. Transportation costs increased by 5.4%.

With the lack of more significant price shocks at energy markets, producers in RS increased average prices by 0.5%, greatly thanks to the growth of prices in ore and stone extraction sector (+3.3%). Production prices in industry's processing sector increased by only 0.1%.

Following growth of 2.1% in October, the stagnation of value in retail emerged in November, followed by its decline of 3.4% in December of 2012. Since during December people traditionally spend more money, this decline was the best confirmation that the new wave of crisis has weakened purchasing power and strengthened the RS citizen's determination towards saving.

According to the IMF estimations for 2013, inflation in B&H should reach its average annual level of 2.1%. Every further increase of prices, especially of products widely used, will represent an additional challenge for domestic consumption, which, thanks to the existing consumption-dependent model of domestic economy, will have the key role in the process of short-term economic recovery.

Oil price

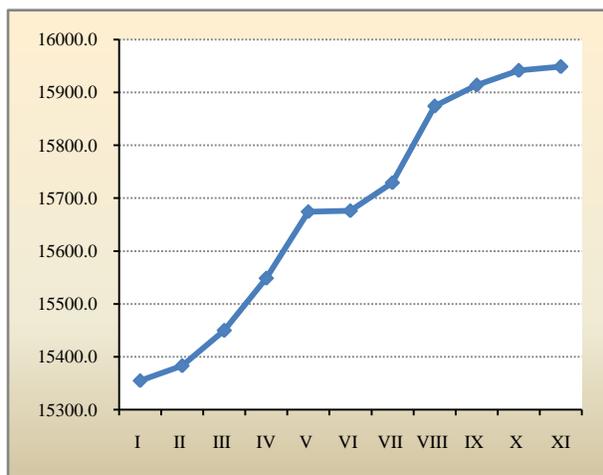
Oil prices grew by 1% in 2012 (in US dollars). According to estimations by the IMF, in 2013 they will decline by 5.9% and by additional 2.9% in 2014.

Financial sector still profitable, portfolio weakens

In the first six months of 2012 there was a mild increase in crediting activity in B&H. Increase of the amount of deposits signaled the return of trust in the stability of the banking system, but it also signaled citizens' greater orientation towards saving, amidst uncertain economic situation. The deterioration of credit portfolio still did not endanger domestic banks' profitability. In 2012 total turnover on the Banja Luka Stock Exchange lost almost 40% of the value in comparison with the previous year. Issuers from public sector maintained a complete domination at the primary market.

Continued growth of credit exposure

Status of all credits in B&H, 2012



Source: Direction for Economic Planning of B&H

Interest rate

On September 30th, 2012, an average nominal interest rate on credits by banks in RS amounted to 7.48%, which was 0.34% less than the 2011 average. In the Federation of B&H it was 6.88%.

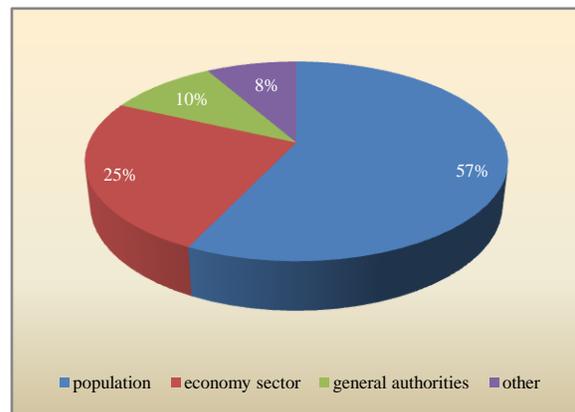
Domestic banks' credit growth continued in 2012 as well. Total amount of credits in the banking system of B&H, with the inter-year growth rate of 4.6%, reached 15.9 billion BAM at the end of November. The biggest contribution to this growth came from credits issued to the sector of population (+4.6%) and general authorities (even +55%). In the same period, the percentage of credits issued to economy sector was only the humble 1%.

Sector structure of newly granted credits represented the overall condition in the domestic economy in the best way. On one hand, it objectively reflected the level of investment activity in economy, which almost completely died out, and on the other, it reflected executive authorities' efforts to "patch up" budget holes through these new debts. Maintaining banks' crediting activity is a key presumption for the recovery of domestic consumption and overall economic growth, since consumption is largely financed straight from credit debts.

Deposits increase

In 2012 as well there was a positive trend of growth of total deposits in the banking system of B&H. On November 30th, 2012, in banks there was 13.2 billion BAM or 1.7% more funds deposited than at the same time previous year. True positive trend of growth of trust in the stability of domestic banks was reflected in the 8.7% high increase of deposits laid by population. On the other hand, total economic contraction and the chronic lack of liquidity resulted in the decrease of deposits from economy sector by 4.7%, while the strong decline of general authorities' deposits of 21.4% best reflected problems with public finance at all levels of executive authorities in B&H. Other deposits increased by 13.3%. The growth of total deposits positively influenced the liquidity and stability of the banking system in general and caused less dependability of domestic banks on the availability of capital at international financial markets and readiness of parent banks to perform their recapitalization.

Deposit structure, on November 30th, 2012



Source: Direction for Economic Planning of B&H

Deterioration of credit portfolio

Problems facing economy sector and population increasingly affect the quality of banks' credit portfolio. In the first three quarters of 2012, low quality credits (credits classified in risk categories of C, D, and E) grew by 14.5% in the banking system of RS and made 12.03% of total credits. Low quality credits to legal parties grew by the rate of 20%, and 7% in the case of natural persons. Over the same period, low quality credits by banks in the Federation of B&H grew by 10.49%, with 19% increase of low quality

credits to legal parties, while in the sector of population the percentage of such credits fell by 2%. The deterioration of credit quality indicators spoke in favor of difficult situation and the chaotic lack of liquidity in domestic economy. Anyway, further continuation of this unfavorable trend could jeopardize the stability of banks even beside the fact that they are still well capitalized.

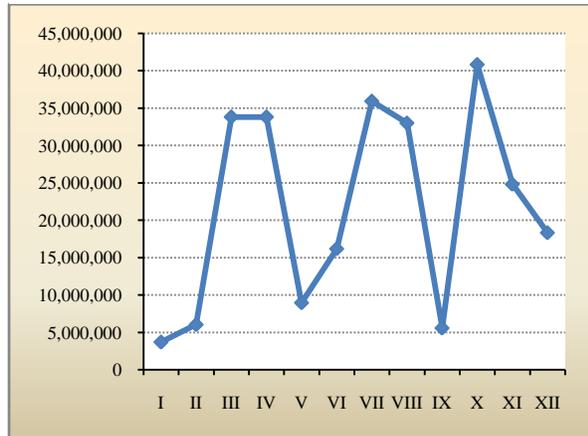
Even in conditions of the deterioration of debtors' credit position, which jeopardized their ability to settle their liabilities, domestic banks made profit. In the first nine months of 2012, banks earned nett income of 163.4 million BAM, out of which 52.4 million BAM fell to banks in RS, while 111 million BAM fell to banks in FB&H. After urges from the Banking Agency of RS, banks still have not directed the obtained nett income to the payment of dividends, but to the strengthening of their capital base.

Capital adequacy ratio

On September 30th, 2012, an average capital adequacy ratio in banks in RS was 16.1%, which was two percents less than at the end of previous year. In the same period, in the banking system of FB&H, this ratio remained equal to the level from the end of 2011, i.e. 17%.

Debt emissions maintain domestic capital market

Turnover on the Banja Luka Stock exchange in 2012



Source: The Banja Luka Stock Exchange

such way of saving. The liquidity fall did not result in greater decrease of the value of market capitalization (-0.2%).

The trend of growth of the primary segment of debtors' securities, where eminent of the RS Government and local governments dominated completely, is not a desirable direction for the development of domestic capital market. The

Total turnover on the Banja Luka Stock Exchange in

2012 was 260.9 million BAM, which was almost 40% less than in 2011. Major jump in trade was related to public offers of treasury bills (March, July, August and October), which made 36.4% of total last year's turnover. Humble stocks trade (primary and secondary) of only 56.3 million BAM was a reflection of the actual state of economy, i.e. the inexistence of quality market material that would ensure its owners a more significant dividend profit and/or capital income. One has to add to this the low accumulative power of economy and population, but also the undeveloped awareness of potentials of

Debt

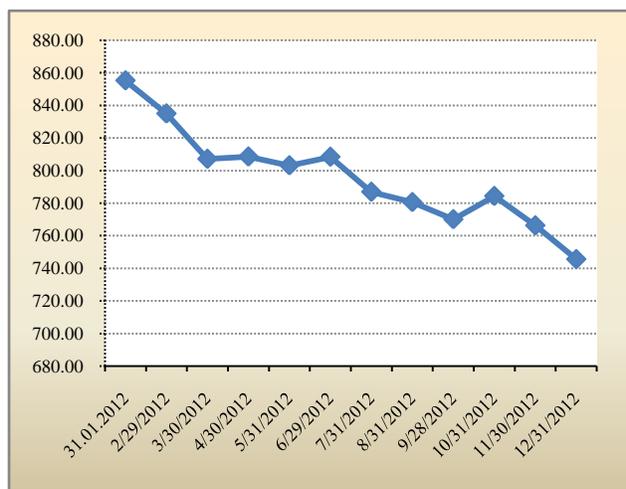
From 2011 to 2012 executive authorities in RS (republic and local), through capital market, indebted themselves by another 336.7 million BAM. In the same period, in the turnover structure realized on the Banja Luka Stock Exchange these emissions participated with 49%.

base of only few investors, mostly made of financial institutions, is not suitable for greater secondary trade that would surely make these securities more liquid. Executive authorities have created a certain habit of funding their own deficits through debt emissions. However, in the midterm period investors' interest could decrease due to the related lack of sales liquidity. The tendency to compensate the lack of liquidity with high incomes jeopardizes credit ability of public eminent in the long run.

Stock Market Index of RS – recovery uncertain

During 2012, the value of SMIRS (Stock Market Index of RS) moved in the interval from 745 to 835 points. Strong resistance to market growth was especially registered during the second half of the year. Then, SMIRS lost 7.8% value, plunging to its last year's minimum in December (745 points).

Stock Market Index of RS – SMIRS



Source: Banja Luka Stock Exchange

Overall economic trends do not leave enough space for optimism in terms of reaching sustainable growth of capital market that would support the recovery of SMIRS. On the contrary, the further deterioration of situation with negative reflection on overall market trends is far more likely.

Macroeconomic indicators for RS

Macroeconomic indicators	2008	2009	2010	2011	2012
Real economy sector					
Nominal GDP, in millions of BAM	8,489.3	8,223.0	8,307.0	8,669.0	8,710.0*
GDP, nominal growth rate in % (y/y)	15.5	-3.1	1.0	6.0*	0.5*
GDP, real growth rate in % (y/y)	6.2	-3.0	0.8	2.0*	-07.
Population, in millions (estimation)	1.43	1.43	1.43	1.43	1.42*
GDP, per capita, in BAM	5,906	5,730	5,797	6,167*	6,072*
Rate of growth of industrial production in % (y/y)	16.8	19.0	5.0	4.7	-4.2
Average number of the unemployed	135,102	139,536	145,343	150,344	153,225
Average number of the employed	259,205	258,634	244,453	238,956	238,178
Survey unemployment rate (SUR – ILO), in %	20.5	21.4	23.6	24.5	25.6

Average nett wage, in BAM	755	788	784	809	818
Average pensions, in BAM	309	335	321	320	312
Inflation, in %	7.2	-0.4	2.5	3.9	2.1
Financial sector, on September 30th, 2012					
Total nett credits	3,467.5	3,504.2	3,607.4	3,868.9	4,223.3
Total nett credits	32.0	1.0	3.0	7.0	9.7
Total deposits	4,702.5	4,160.8	3,778.0	4,009.2	4,814.5
Total deposits, growth rate in %, (y/y)	3.0	-12.0	-9.0	6.0	6.4
External sector					
Total goods exchange with abroad (in millions BAM)	6,064.1	5,240.0	6,230.9	7,146.1	6,861.9
Total goods exchange with abroad, growth rate in %, (y/y)	20.8	-13.6	18.9	14.7	-3.9
Exportation, in millions BAM	1,921.8	1,672.9	2,177.8	2,561.9	2,374.3
Exportation growth, in %	15.0	-13.0	30.2	17.6	-7.3
Importation, in millions BAM	4,142.3	3,567.1	4,053.1	4,584.2	4,487.5
Importation of goods, growth rate in % (y/y)	23.7	-13.9	13.6	13.1	-2.0
Importation of goods	46.4	46.9	53.7	55.9	52.9
Balance of goods exchange	-2,220.4	-1,894.2	-1,875.3	-2,022.3	-2,113.2

*Estimations. Source: Economic Policy of the Republic of Srpska for 2013