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NEW EUROPE
ECONOMICS & STRATEGY

August 3, 2012

FOCUS NOTES: SERBIA

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New government cabinet confronted with significant challenges -NBS Governor resigned from his post

- The new coalition government will be confronted with significant fiscal challenges in the period ahead as the budget deficit is derailed and the precautionary IMF agreement is still broken
- Serbia is on the brink of a fiscal crisis if no adequate consolidation measures are taken: the general government deficit will most probably exceed 6% of GDP and public debt will reach 55% of GDP in 2012
- On August 3rd, NBS Governor Mr Dejan Soskic resigned from his post over legislation which in his opinion limits Central Bank independence
- The freezing of the precautionary IMF agreement, increased fiscal outlook risks, the uncertainty in the political landscape for three months and the negative market reaction to NBS Governor's resignation led Dinar to trade at historic lows

A new government cabinet finally in place after three months since elections

Three months after the inconclusive May 6th parliamentary elections, a new coalition government was sworn in and received vote of confidence in the parliament on July 27th. The new government will be comprised of four parties: the Serbian Progressive Party (SNS), the Socialist party (SPS), the United Regions of Serbia (URS) and the Social Democratic Party of Serbia (SDP). Mr. Ivica Dacic from the Socialist party (SPS) assumed the post of Prime Minister. In addition, there will be three deputy prime ministers, from each party which participates in the government. The government consists of 17 ministries and 4 offices (Kosovo & Metohia, Diaspora, Human Rights, Churches and Religious communities).

The Socialist Party (SPS), a partner in the previous government coalition, together with its electoral allies PUPS & JS gained 44 seats and had almost sealed an agreement with Democratic Party (DS)-67 seats- to participate in the new government. However, after the breaking down of the negotiations with DS, SPS turned to Serbian Progressive Party (SNS)-73 seats -whose leader Mr. Tomislav Nikolic won the presidential elections after a tight race. The United Regions of Serbia (URS) of the former Minister of Economy Mr. Mladan Dinkic (14 seats) together with the Social Democratic Party of Serbia (4 seats) of the former Minister of Labor and responsible for the co-operation with ICTY, Mr. Rasim Ljajic also joined the government coalition.

The new coalition government received parliamentary support from 142 members, 72 voted against and 26 abstained in the 250 seat parliament. The majority of the new government in parliament is solid and much broader than that of its predecessor government which is a good signal for its stability. At the same time, the participation of SNS in the government guarantees minimal disruption in the effort of the government in legislation making and implementation. The latter is so because the majority of the cabinet members appointed and the President who holds veto power will come from the same party.

The agreement which was signed between the participating parties earlier this month describes the core principles of the parties' co-operation. Fostering economic recovery, while preserving social justice, is the top priority of the new government. Restoring public finances health and tax reform is another. According to the speech of the Prime Minister in the first session of the parliament, the new cabinet will seek to upgrade the business environment of the country in order to attract more FDI.

European integration remains a top government priority. Maintaining the EU accession project on track is closely tied to the contentious issue of Kosovo independence. The government has vowed to respect the agreements of the previous government with Kosovo authorities but not recognize Kosovo independence. The rhetoric of Serbian Progressive party (SNS) is more conservative and stands for a tougher approach in the Kosovo dispute. The hard line stance of the government may push EU accession back. Relations with EU may be tested as EU officials have stated that negotiations for EU accession can only start upon progress in the Kosovo dispute issue.

Political risk declines after the formation of the coalition government. The new cabinet will be confronted with significant challenges in the post election landscape

The formation of the new government marked the end of the three month political deadlock. On the other hand, the new government coalition which was formed in late July will be confronted with significant challenges. First of all, the new cabinet will have to deal with a mini fiscal crisis in a recessionary domestic economic environment.

The consolidated government data in the first six months sends a particularly alarming signal for the full year fiscal outcome. The data of the consolidated government (central government plus social security institutions and local governments), bring the fiscal deficit up to RSD 111.2bn in 1H 2012 vs. a full year target of RSD 150 bn. The year-to-June 2012 central government budget deficit had already reached RSD 99bn or an equivalent 2.8% of projected GDP. Unless urgent corrective action is taken, the deficit could exceed RSD 200bn given the target overrun by RSD 35bn in 1H. That would be an equivalent of more than 6% of GDP in 2012 compared to a realization of 5% of GDP deficit in 2011. Accordingly, the public debt to GDP ratio has reached already €15.3 bn or 49.5% of GDP in June 2012. Provided that debt dynamics continue, public debt would reach 55% of GDP in 2012, significantly above the 45% threshold of the fiscal rule compared to 47.7% in 2011 and only 29.2% in 2008.

Thus, the new government may have to present a supplementary budget by September and introduce a credible fiscal consolidation package. Moreover, the macroeconomic assumptions upon the current budget are far from realistic anymore. The original budget was built upon the assumption of 1.5% growth in 2012. At the time of writing this report, the forecast of the Central Bank stands at 0.5%.

From that point of view, those fiscal consolidation measures may be incompatible with the pre-electoral promises and at odds with their constituencies. The government has proclaimed that the fiscal consolidation will not be achieved at the expense of freezing or cutting down on wages and pensions, which leaves a narrower set of policy choices. Given that expenditure on wages and pensions is a vast fraction of the total expenditures, the focus will be given to revenue raising measures (e.g. VAT rate increase to 22%). On the other hand, revenue raising measures would be hard to yield impressive results in a recessionary economic environment unless revenue collection improves substantially.

One of the toughest issues the new government will have to deal is the broken precautionary IMF agreement. Effectively, the IMF put the precautionary agreement on freeze since last February.

The dispute between the outgoing government and IMF was rooted in government spending in the budget of 2012. IMF challenged the government commitments on the precautionary agreement framework. According to the IMF calculations, the extra spending commitments on infrastructure projects and debt issuance guarantees could add at least an extra of 2% of GDP on the deficit of 2012. Bringing the fiscal deficit again within the targets agreed with the IMF (4.25% of GDP fiscal deficit target for 2012, 1% for debt guarantees), is a requirement to revive the precautionary agreement. Getting back the program on track is crucial because it provides a cushion for external financing needs and acts as an anchor of expectations for investors, thus reducing the risk premium of the country. The depletion of the NBS reserves (more than €1.3 bn in the 1H-2012 were spent to defend the Dinar) provides an additional argument in favor of the revival of the agreement.

In addition, the economy is in bad shape. Spillovers from the Euroarea sovereign crisis weigh negatively on capital and trade flows. High frequency indicators paint a very gloomy picture of the domestic economy in 1H-2012. All of them (industrial production, retail trade, and exports) are in recessionary territory. After showing a lackluster recovery from the recession in 2009, the economy appears to have entered a new round of technical recession. After four consecutive quarters of negative on quarter growth, second quarter GDP contraction narrowed to -0.6% yoy in Q2 compared to -1.3% in Q1. However, under the assumption of a mild recession in Euroarea, the full year growth estimate stands at 0-0.5% in 2012. Such minimal growth places Serbia close to stagnation and significantly below the region peers like Bulgaria or Romania. To make things worse, unemployment climbed at 25.5% as of April 2012. In addition, Serbia is suffering from high external imbalances: the current account deficit has deteriorated to 9.5% of GDP in 2011 vs. 7.4% in 2010. Accordingly, the gross external debt had reached 77.5% of GDP in 2011 down from 84.9% in 2010.

More worryingly, the current account dynamics have been deteriorating in the first months of 2012. The current account deficit has grown by 32.5% yoy in Jan-May 2012 while the quality of financing has become more problematic in the first months. Net FDI recorded €189mn net outflows in Jan-May 2012. Although the repurchase of Telekom Srbija from the government of Serbia impacts decisively on the outflows (accounts for €380mn), the prospects for attracting more FDI inflows in the rest of the year are limited given the deepening Euroarea sovereign crisis. On top of that, pressures on the balance of payments intensified. Deposit outflows from the banking sector and significantly lower portfolio investment pushed the BoP in deep red. The deficit in BoP reached €2bn in the first five months compared to a €259mn surplus at the same period last year.

On August 3rd, NBS Governor Mr Dejan Soskic resigned from his post over legislation which in his opinion limits Central Bank independence.

On August 3rd, NBS Governor Mr Dejan Soskic resigned from his post. In his resignation letter, the outgoing governor pointed out that the proposed by the government amendments to the Central Bank law are the main reason for his resignation. According to him, those amendments would limit NBS independence, could significantly endanger financial and macroeconomic stability in the country and slow EU integration process. The reaction from IMF and European Union officials is negative. Both IMF and European Union have expressed their concern over the proposed legislation and warned against on clamping down of the NBS authorities.

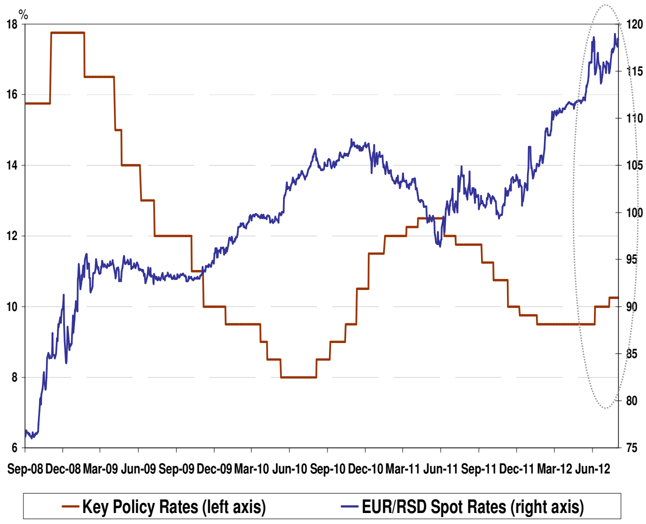
The resignation came after weeks of pressures from the incoming government politicians on him to resign. Incoming government officials have criticized the Central Bank work on monitoring the financial sector and safeguarding price stability. For that reason, the incoming government introduced a bill in the parliament to amend the Central Bank law. The bill intended to replace the governor and the vice governors with a supervisory body. According to the draft law, the supervisory body would not only take active role in monetary policy making but also have the authority to prevent any banks from "abusive international payment operations and money-laundering activities".

The last rate decision under the outgoing NBS governor took place on July 10th. At that time, the NBS increased the key policy rate by 25bps at 10.25% for the second time in a row. The move aimed at deterring further domestic currency weakness and was also necessitated by the inflation outlook risks. After inflation reached its trough in April at 3.2% yoy and edged higher at 5.5% in June on phasing out base effects from last year food inflation rally and Dinar depreciation pass-through. Inflation is expected to trend higher until year end at the upper end of the Central Bank band 4.5% +/- 1.5%), despite the weak growth outlook.

The freezing of the precautionary IMF agreement, increased fiscal outlook risks and the ongoing uncertainty in the political landscape for three months after the inconclusive May 6th elections have put pressure on the Dinar and Dinar denominated assets. To make things worse, the deepening Euroarea sovereign crisis puts additional strain on the region which is reflected across all currencies.

The use of strong FX interventions together with the mobilization of required reserves have not been efficient to discourage Dinar from reaching new historic lows. Dinar depreciated as much as 118.92/€ on July 25th, only to strengthen a bit to 117.6/€ on July 31st, and trade at 118.7/€ (-11.8% year to date, -14.3% year on year). The Central Bank has spent over €1.3 bn, or 10% of its total FX reserves (more than half of it during April-May) since the beginning of 2012 in order to support the domestic currency (Figure 1). In addition, 5Y-CDS had remained close to multi month high after it had climbed at 550bps on June 8th vs. an intra year low at 360bps on March 9th (Figure 2).

Figure 1
Dinar traded at historic low levels vs. € in early August



Source: Ecowin, EFG Research

Figure 2
Five year CDS trade close to multi month highs since early June 2011

Source: Bloomberg, EFG Research

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