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www.eurobank.gr/research
research@eurobank.gr

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FOCUS NOTES: SERBIA

Written By:

Ioannis Gkionis:
Research Economist
Coordinator of Macro Research

New fiscal consolidation package deemed to be insufficient response towards fiscal crisis

- The government package of anti-crisis measures aims at cutting down the fiscal deficit to 3.5% of GDP in 2013 down from a projected 6.7% in 2012
- The government response towards the fiscal deficit crisis is deemed as insufficient by the Fiscal Council and the IMF mission
- The government will seek to use a combination of financing options to finance this year's budget including the Eurobonds market, domestic markets and a loan from Russia to finance this year's budget
- The post election domestic economy landscape is deteriorating: the recession deepens, the current account deficit is widening, inflation trends significantly higher on food prices whilr the Dinar has recovered only modestly from historic lows

The government cabinet introduced a package of anti-crisis measures and adopted a revised budget with new fiscal targets for 2012 and 2013

On September 10th, the new coalition government adopted a revised budget and introduced a new fiscal consolidation package under the title of "anti-crisis" economic measures. The majority of measures will be put in effect in October 1st. The rest of the measures will be implemented after the adoption of next year's budget which will be drafted in late October and debated in the second half of November in the parliament. The package touches upon the areas of taxation, public spending and business environment improvement. The main parameters of the budget revision are:

- Hike in the main VAT rate effective from October 1st. The main rate will be hiked by 2pps from 18% to 20%, but the lower rate charged on food products will be maintained at 8%.
- Increase in excise taxes for cigarettes and diesel fuels
- Increases in the corporate tax rates: Capital gains tax on dividend and interest income will go up from 10% to 15%. Corporate profit tax will go up from 10% to 12%, a measure to be implemented in 2013.
- Instead of public sector layoffs, the indexation of public wages and pensions will be limited below the levels required by the fiscal rules while public wages will be capped at 162,000 Dinars
- 130 para-fiscal levies and duties are abolished in order to reduce red tape and streamline the tax system

The implementation of this package could yield savings of RSD 26 billion in the last quarter of this year and RSD 120 billion (approximately € 1bn) in 2013, according to government calculations. Those measures aim to contain the general government deficit to 6.7% of GDP against a projected 7.2% of GDP in 2012, above the original full-year target of 4.25%. The target in 2013 has been set at 4% of GDP by the Minister of Finance Mr. Mladan Dinkic but soon thereafter revised to 3.5% of GDP after the initial reactions of the IMF mission and the report of the Fiscal Council in Serbia.

The government program is an inconclusive first step towards the right direction and certainly not sufficient enough to bring fiscal deficit back in check

In our view, the government program is a first yet inconclusive step towards fiscal consolidation. On the one hand, there are measures in the right direction to raise taxes and collect more revenue, streamline the tax system, increase government efficiency and reduce red tape. However, revenue raising measures would be hard to yield impressive results in a recessionary economic environment unless revenue collection improves substantially. The official macroeconomic assumption of the budget has been revised downwards to -0.5% compared to a prior forecast of +1.5% in 2012.

Furthermore, the government has introduced changes in the VAT law so that small and medium sized companies will now pay VAT after bill collection instead at the time of invoicing. VAT refund for agricultural producers will be raised from 5% to 8%, while penalties for the state services are envisaged if it is late with VAT refunds to businesses. Overall, the proposed changes will increase the liquidity of the small and medium sized enterprises but not necessarily boost VAT revenue. Finally, the hikes in tax rates will make business environment less attractive and certainly not boost competitiveness.

To make things worse, the effort to consolidate public spending is missing. In fact, new initiatives will increase total expenditures. The wage bill, the largest portion of public expenditures, will not be cut or at least frozen in nominal terms. In fact, pensions and wages will be assigned a 2% rise in October and a 2% rise in April. As a result, the indexation of pensions and wages may cost less than originally envisaged in the budget according to the existing fiscal rules. The government plan foresees that the wage and pension indexation will resume in October 2013. Instead, savings from the public sector wage and pension indexation will be partially offset by the special provision for low income pensioners (519,000 pensioners). Pensioners receiving less than RSD 15,000 a month will get "the 13th pension," of RSD 16,000, in four installments, with the first installment expected to be paid in late September and the second in late 2012. A total of RSD 4.2 bn will be set aside for this purpose by the end of the year. On top, the budget revision bill envisages increasing spending on social protection by a total of RSD 7 billion.

The new consolidation package is not likely to soothe financial markets concerns and revive the IMF precautionary agreement

The reaction of Fiscal Council and the IMF mission to the new consolidation package is not positive. The opinion of the Fiscal council, an independent body elected by the parliament whose task is to advise the government over fiscal policy issues is more critical. The Fiscal Council assessed that the first step of fiscal consolidation of the new government was in the wrong direction and that rebalancing the budget increased the fiscal deficit instead of lowering it.

According to the Fiscal Council, the fiscal deficit is projected to end at RSD 222bn or 6.7% of GDP in 2012 instead of RSD 216bn or 6.5% of GDP without taking the corrective measures in the revised budget. Accordingly, the public debt to GDP ratio could reach 60% 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. In August, the Fiscal Council had warned over a looming fiscal crisis if no adequate measures were taken.

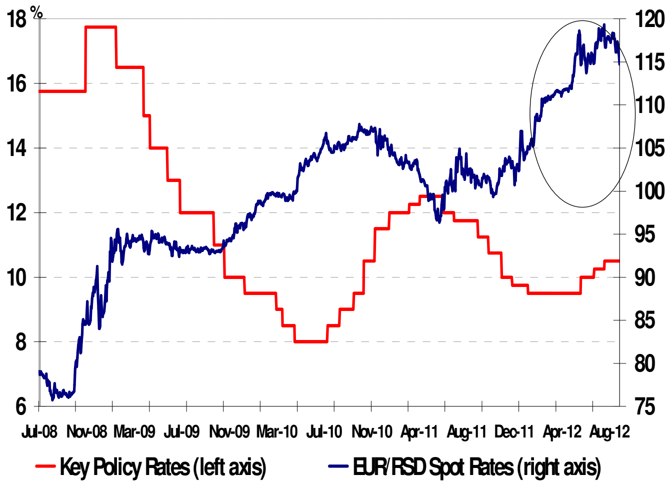
The reaction of the IMF mission who visited Belgrade between is also skeptical. The conclusion of the IMF mission underlines that tangible fiscal consolidation is needed and calls for additional fiscal restraint. The savings of the rebalancing are more than offset by higher expenditure including new spending initiatives. On a more alarming note, the achievement of the fiscal target in 2013 requires significant additional measures.

All in all, eyes are turned to the refinancing needs and financing options of the budget. The total financing needs of the budget including the refinancing needs from maturing debt, amount to RSD 562.6bn (EUR 4.8bn) in 2012 with €1.5 bn need to be secured until the year end. Those funds will come from the combination of three sources: tapping the domestic market, the re-opening of the Eurobond issue (USD 750mn) and the utilization of the rest of the loan from Russia (USD 300mn loan aimed to finance the railways expansion will be used for budgetary purposes). Although the situation is still manageable, it will be harder to get access to funding in 2013 given the difficulties posed by the Euroarea sovereign debt crisis, the riskier sovereign profile of Serbia and the size of government financing needs (approximately €4bn). For that reason, the government has already asked already for direct budget support through a new regular IMF 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.

Effectively, the IMF put the precautionary agreement on freeze since last February. IMF challenged the outgoing government commitments on the precautionary agreement framework. Given the expansionary nature of the revised budget, it is more likely for IMF to ask for further spending cuts before a new regular agreement is approved. In addition, there is one more unresolved issue which may complicate the relations of the new government with the IMF. The amendments to the Central Bank law limit the independence of monetary authorities according to the IMF and EU officials. Those amendments resulted in the resignation of the previous Central Bank governor Mr. Dejan Soskic and his Vice Governor Mr. Bojan Markovic.

The reaction of the FX market to the new package is relatively muted. Dinar has recovered modestly from its historic lows in line with its regional peers helped by the latest ECB decisions. However, it is going to take a committed effort towards fiscal consolidation and an improvement in the macroeconomic environment before a change in the depreciation trend takes place. Dinar depreciated as much as 118.92/€ on July 25th, only to strengthen a bit to 115.4/€ (-12.7% year to date, -9.1% year on year). (Figure 1)

Figure 1
Dinar recovered only modestly vs. € in mid September helped by increased risk appetite



Source: Ecowin, EFG Research

Meanwhile, the post election domestic economy landscape is deteriorating. The high frequency indicators indicate that recession is deepening. All of them (industrial production, retail trade, and exports) are in recessionary territory. For that reason, we have revised our forecast downwards to -1.5% in 2012 against flat growth in our previous issue of New Europe Economics & Strategy. In addition, the current account deficit is projected to widen to double digit levels (10.6% of GDP in 2012 vs. 8.9% of GDP in 2011). After bottoming out, inflation trended higher at 7.9% yoy in August and is projected to exceed 10% by year end on higher food prices and the feeding pass-through effect from Dinar depreciation.

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Eurobank 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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