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FOCUS NOTES: SERBIA

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Further fiscal consolidation is an urgent priority in 2013

- **The consolidated general government deficit ended 6.6% of projected GDP in 2012 vs. 5% of GDP in 2011**
- **The achievement of the fiscal target in 2013 will be a challenging task**
- **Inflation climbed to 12.2% yoy in December, significantly above the NBS target range (4.5% +/-1.5%) in a very volatile year**
- **NBS hiked interest rates by 25bps to 11.75% bringing the cumulative hikes to 225bps since the beginning of the tightening cycle**

Inflationary pressures still on the rise: Consumer prices climbed to 12.2% in December, significantly above the NBS target range.

Inflation registered in December the highest year on year reading in a year. Consumer prices climbed to -0.9% mom/+12.2% yoy in last December vs. +0% mom/+11.9% yoy in November against only +0.6% mom/+2.7% yoy in April2012. The categories with the highest increase on a monthly basis were health (+1.3% mom) and household equipment (+1.1% mom). Food prices, the main driver behind inflation in the past months declined further by -1.5% mom in December vs. -0.7% mom in November, the second consecutive negative reading after last July 2012.

The December reading was the highest in 2012, a very volatile year as long as inflation is concerned. Average inflation declined to 7.3% in 2012 vs. 11.2% in 2011, only because inflation remained within the target band in 1H-2012. After bottoming out at 2.7% yoy in April 2012, inflation started accelerating in the 2H on a new supply side shock. The inflation rally was predominantly driven by supply-side factors related primarily to domestic unprocessed and processed food prices. The food prices shock was exacerbated by the high weight of food-37.8%- in the consumption basket. As a result, food inflation recorded its highest yearly reading in October (+3.1% mom /+17% yoy) up from only +1.3% mom/-2.5% yoy in March2012, only to step down to -1.5% mom/+15.4% yoy in December. Food inflation accounted for 70% of the cumulative rise in inflation between April and December. The implementation of a VAT hike in October (from 18% to 20%) coupled with higher oil prices worldwide contributed as well.

Inflation is seen as rising further on administered prices and peaking within 1H-2013. The hikes in administered prices, including the rise in electricity (by 12%) and natural gas prices (by 10%), will weigh negatively on inflation outlook in the period ahead. In contrast, the impact from higher food prices will start to fade away as the new agricultural season will kick in. All in, we continue see inflation rising up to 13.5% in the 1H-2013 and then trend lower primarily on base effects and low aggregate demand pressures.

To address the rising inflation risks, NBS hiked interest rates by a cumulative of 225bps from 9.5% to 11.75% between June2012-February 2013. On February 5th, NBS hiked by 25bps to 11.75% despite the expectations of the majority of analysts. The Central Bank highlighted the inflationary impact of regulatory prices hikes and their potential spillover effects on inflation expectations as one of the main reasons behind the decision to hike. Looking ahead the Central Bank has also brought up the impact of government's fiscal consolidation strategy and the stability of the domestic currency as important determinants of inflation outlook. Indeed, the domestic currency has recouped some of its earlier losses. Dinar traded at 111.16/€ on February 18th, against a an all time low at 119.3/€ on August 8th, 2012 (Figure 1).

Surge in pre-election spending and inadequate fiscal consolidation measures resulted in visible deterioration in public finances in 2012

The fiscal position of Serbia deteriorated visibly in 2012. Driven by high pre-election spending, the fiscal deficit soared to 7% of GDP in the 1H-2012. In order to address the mini fiscal crisis, the incoming government adopted in September 2012 a revised budget and introduced a new fiscal consolidation package. Those measures aimed to contain the full year budget deficit at RSD 203.6bn or 6.2% of projected GDP in 2012. Both the Fiscal Council and the IMF assessed that the measures identified would be insufficient to contain the deficit. Although the package provided for some immediate revenue raising measures, it provided for additional expenditures initiatives so that the overall result would be negative.

The government accomplished to finish the year with a slightly smaller budget deficit, outperforming the revised target. The budget deficit came at RSD 191.8bn or 5.9% of projected GDP in 2012 vs. RSD 132.5bn or 4.2% of GDP in 2011, expanding by 42% yoy. The outcome is considerably higher than the original deficit target of RSD 140bn agreed within the framework of the precautionary agreement with IMF last year.

Both revenues and expenditures underperformed those figures of the budget revision. Total revenues stood at 788.5bn, 5% below the planned level of RSD 829.6bn. The underperformance was largely driven by non tax revenues. On the positive side, VAT revenues expanded by 7.3% yoy driven by the VAT hike by 2pps (from 18 to 20%) performing relatively well in a recessionary environment. Total expenditures reached RSD 980.3bn, 5.2% below the planned level of RSD 1.033bn in the revised budget. The underperformance of expenditure was larger on a nominal basis (52bn vs. 41bn) and was explained by the underperformance of expenditure on wages and procurement and capital expenditures.

Overall, the full year budget performance sends an alarming message concerning the deterioration of the fiscal position of the country. The highly expansive policy followed from the previous cabinet led to an unsustainable widening of the fiscal deficit in 2008-2012. The consolidated government deficit widened from 2.6% of GDP in 2008 to 5% of GDP in 2011. Further on, the consolidated general government deficit ended at RSD 217.4bn in 2012 vs. RSD 158.4bn in 2011. As a percentage of projected GDP, the consolidated government deficit amounted to 6.6% of projected GDP in 2012. Accordingly, the public debt to GDP ratio reached 61.5% of GDP in 2012, significantly above the 45% threshold of the fiscal rule compared to 48.7% in 2011 and only 29.2% in 2008. Those metrics put Serbia among the most indebted countries in the region (Figure 2). For that reason, tangible fiscal consolidation and additional restraint particularly on the expenditures side is needed (total expenditures accounted for 49% of the projected GDP in 2012).

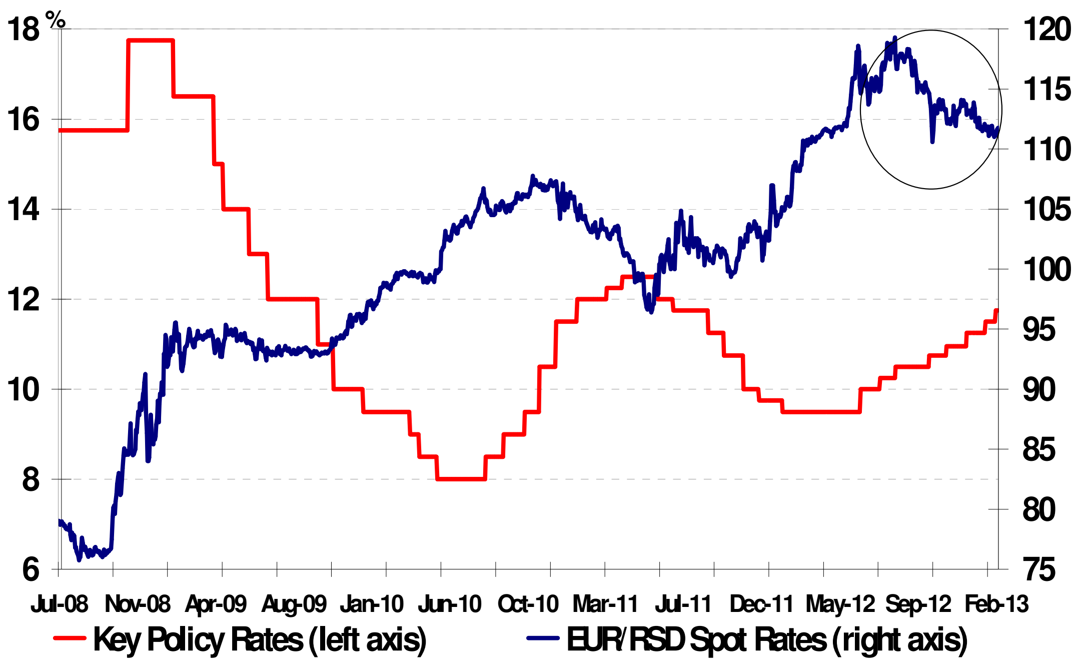
The implementation of the 2013 budget started on a good foot. The achievement of the full year fiscal target will be a challenging task.

Looking ahead, the government targets a significantly lower consolidated budget deficit at RSD132bn or 3.6% of GDP in 2013. The target for the republican budget, the bulk of the consolidated government, is ambitiously set at 121.9bn or 3.3% of GDP in 2013. The significant uncertainties and risks, both domestic and external, have rendered fiscal consolidation not only imperative but also a challenging task. First of all, the budget is built upon the macro-assumption of GDP growth at 2% in 2013 (EFG forecast 1.5%). At the moment, Serbia is still gripped in recession. Output contraction slowed to -1.5% yoy in Q4-2012 vs. -2.5% yoy in Q3-2012 according to the flash estimate, the full year estimate now stands at -2% in 2012. Even if headline GDP numbers turn out to be inline with the budget forecast, growth will be to a big extent driven by net exports while private and government consumption will have a negative contribution. Consequently the tax revenues content of growth may be not live up to budget forecasts. In contrast, higher inflation is going to give a boost on tax revenues, thus helping in fiscal consolidation.

Another source of concern lies within the assumption forecasts of individual items. The assessment report of the Fiscal Council identifies two areas of overruns. Firstly, the revenues from corporate income and non-tax revenues forecast have been overestimated. The targets for expenditures on procurement and subsidies will most likely be missed because of insufficient preparation. That said, Fiscal Council sees consolidated government deficit to overshoot at 4.3% of GDP in 2013 (assuming 1% GDP growth).

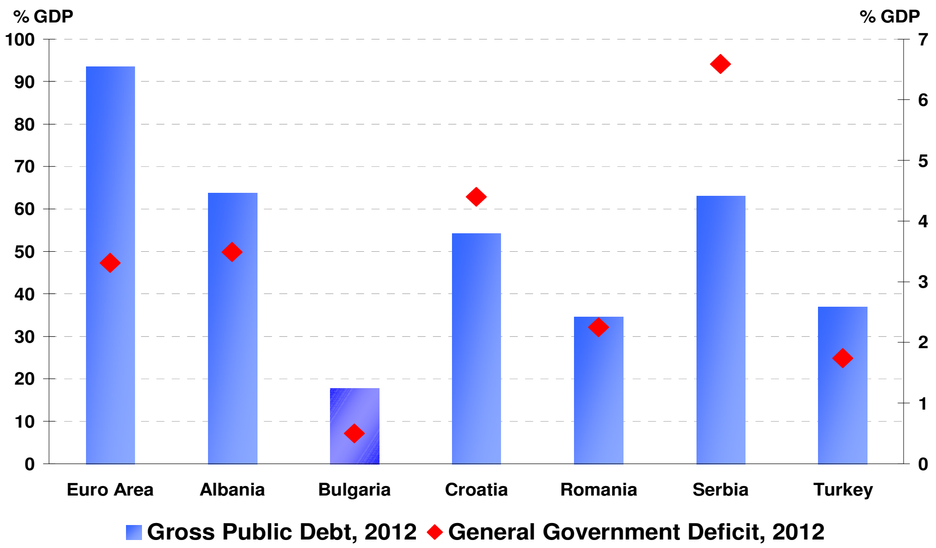
The reaction of the IMF mission who visited Belgrade in the past November is also skeptical. IMF conclusions viewed the announced 2013 budget deficit target as overly ambitious and underlined that the identified measures may not translate into the full needed adjustment in 2013. The latter implies that the achievement of the fiscal target in 2013 may require additional measures. Effectively, the IMF put the precautionary agreement on freeze since February 2012. At that time, IMF challenged the outgoing government commitments on the precautionary agreement framework. Given the expansionary nature of the revised budget, IMF has indirectly conditioned the approval of a new regular or precautionary agreement upon the fiscal consolidation success in 2013. As a result, negotiations with IMF on that issue will most probably resume some time in next spring, upon the review of the budget execution in the first months of 2013. For that reason, all eyes are turned to the budget execution. The implementation of the budget in 2013 started on a good foot. The non-consolidated government deficit came at RSD 7bn in January 2013, which is half than the one planned in the budget and 33% down from that recorded in January 2012.

Figure 1: NBS has hiked interest rates by a cumulative 225bps since June 2012



Source: NBS, Bloomberg, Eurobank Research

Figure 2: Serbia had the highest fiscal deficit in the region in 2012



Source: National Statistics, IMF World Economic Outlook, Eurobank Research

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