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FOCUS NOTES: SERBIA

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New Government Cabinet- Old Challenges

- **The ruling party SNS won a landslide victory in the early parliamentary elections which enables it to accelerate fiscal consolidation efforts and implement difficult structural reforms**
- **The negative impact from floods is expected to put additional downward pressure on growth in 2014**
- **The fiscal target was slightly outperformed in 2013, yet fiscal consolidation challenges remain largely unattended**
- **In a broadly unexpected move, NBS cut interest rates by 50bps to 9% on May 8th**

The early parliamentary elections results give a clear pro-reform mandate to the ruling party

The early parliamentary elections held in mid-March 2014 didn't reveal any surprise. In line with the results of the polls, the coalition led by the ruling Serbian Progressive Party (SNS) collected 48.4% of the popular vote obtaining 156 seats in the new 250 member parliament. The coalition SPS-PUPS-JS led by the Socialist Party of Serbia won 14.1% and 44 seats, the coalition led by the New Democratic Party (NDS) of the former President Boris Tadic won 5.9% and obtained 20 seats while the Democratic Party (DS) won 5.5% of the votes and 18 seats. Three ethnic minority parties - that do not face the 5% entry level threshold- will be represented in the new parliament: ethnic Hungarian of Voivodina (SVM) with 6 seats, ethnic Bosniac (Sanjak's Party of Democratic Action) with 3 seats and ethnic Albanian (PPD) with 2 seats.

Although SNS gained absolute majority in the new parliament, it opted to form a multi-party coalition in order to get more public support for reforms. SNS agreed to form a coalition government with SVM initially. SPS also joined the government coalition so that the overall parliamentary backing of the coalition came at 198 MPs.

On the positive side, the convincing victory of SNS put an end to political uncertainty. The effectiveness of the previous cabinet was limited as the outgoing government remained a hostage of the slim and fragile multi-party parliamentary majority. Thus, the sweeping victory of SNS in the early parliamentary elections has amplified expectations for the acceleration of fiscal consolidation and structural reforms in the country. SNS got the highest electoral percentage in the post Milosevic era that equipped the ruling party with enough political capital to implement a clear pro-reform mandate.

Yet the key question which has arisen is if the new cabinet will be able to deliver. The new government is confronted with multiple challenges and a long list of overdue structural reforms. On the negative side, there will be no grace period for the new cabinet. In our previous trip notes to Belgrade, we described extensively the multiple challenges the Serbian economy is confronted with. The political will is going to be soon tested. The new government will be inclined to revise the budget of 2014 in order to include €400mn in extra savings so as to conclude a new precautionary agreement with IMF.

Fiscal target was slightly outperformed in 2013. The budget implementation throughout the first quarter of 2014 has already demonstrated the need for a republican budget target revision

The full year fiscal outcome slightly outperformed the revised target in 2013. The consolidated government deficit came at RSD 179bn, lower by RSD 20bn than the level

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[1]projected in the budget revision of autumn 2013. As a percentage of GDP, the consolidated government deficit stood at 5% of GDP vs. a revised target at 5.3% down from 6.5% in 2012.

If the items below the line are included, then the overall fiscal result came at -5.7% of GDP down from -6.6% in 2012. The costs associated with the items below the line include the recapitalization of state-owned banks, the cost of restructuring, the activation of debt guarantees for state-owned enterprises and the elimination of arrears. The additional cost on top of the headline consolidated budget deficit amounted to 0.9% of GDP in 2013 and is projected to increase up to 1.7% of GDP in 2014.

Looking ahead, the fiscal framework of 2014 is more realistic compared to that of 2013. The macroeconomic assumptions are closer to reality (the budget is built around a forecast of GDP growth of 1%-5.5% average inflation rate in 2014). However, the fiscal framework targets overall lack ambition. The republican budget (a stricter definition of the central government) provides for total budget revenues of RSD 930 bn, total expenditures of RSD1.113 bn and a deficit of 182.5 bn, or 4.6% of projected GDP more or less the same as in 2013.

The initial fiscal target set in the budget of 2014 is not ambitious enough to facilitate fiscal consolidation in the medium term. If items below the line are included in the fiscal result, the consolidated government deficit is expected to reach 7.1% of GDP in 2014, and then decline to 5.2% in 2015 and further to 3.2% in 2016. Even if the fiscal strategy is implemented with success that would be enough to stabilize the public debt at very high levels around 75% of GDP in 2017.

Secondly, under the current circumstances the fiscal target of 2014 will be hard to achieve while the targets of 2015-2017 are not well supported by fiscal measures. The efficiency of the fiscal measures announced in last October as part of the consolidation program is strongly questioned. According to the calculations of the Fiscal Council, the net impact from the measures announced in October will be 1-1.2% of GDP instead of 2% in the government initial calculations. That said additional measures-savings of 0.8-1% of GDP need to be adopted in order to achieve the announced target. In addition, the Fiscal Council has presented a number of items - namely the project loans from Azerbaijan and China -not included in the initial calculation that inflate the republican budget up to 5.2%.

The budget implementation throughout the first quarter of 2014 has already demonstrated the need for a republican budget target revision. The republican budget deficit had already reached RSD 71.8bn or 39% of the full year target in Q1-2014. Total expenditures have already reached RSD261bn expanding by 13% yoy vs. a full year target of 5.8% yoy. Total revenues were lagging behind target rising by 5.3% yoy (tax revenues increased by only 2.3% yoy broadly in line with inflation dynamics) vs. an official target of 6.5% yoy. On a more positive note, the consolidated government deficit stood a bit lower at RSD 64.5bn in Q1-2014 or 1.8% of projected GDP vs. a 5.5% target at the consolidated government level, as the local administration budgets and state pension funds registered a small surplus.

Overall, the fiscal position of the country has continued deteriorating in 2013-2014. Serbia is ranked among the most indebted countries in the region. The public debt to GDP ratio has already surpassed the 60% Maastricht level and the 45% threshold of the fiscal rule, reaching 63.6% of GDP in 2013 up from 60.2% of GDP in 2012, and only 29.2% in 2008. According to the latest IMF forecast (WEO, April 2014), public debt is expected to reach 69.7% by the end of 2014.

A concrete and holistic approach towards fiscal consolidation is still missing. More importantly, credibility is missing. On the other hand, there are important implementation risks surrounding the fiscal consolidation package. The authorities have not established a credible record of commitment to fiscal discipline. Although there is significant room to increase revenues and public sector efficiency, the bulk of fiscal consolidation ought to come from expenditures cuts. Mandatory spending represents two thirds of total government spending. The largest items of public spending are pensions and public wages. The wage bill in terms of GDP stood above the emerging markets average and close to that of the advanced economies in 2012. To make things worse, the level of pension expenditure in terms of GDP stood significantly above those in the emerging markets and the advanced economies.

In a broadly unexpected move, NBS cut rates by 50 bps to 9.5% on May 8th

On May 8th, NBS cut rates by 50 bps to 9.5%. The move was broadly unexpected by the market but still had no meaningful impact on the exchange rate. Dinar remained relatively unchanged at 115.85/€ having depreciated by around 1.1% year to date.

Most analysts (15 out of 24), anticipated the NBS to maintain a more prudent stance in line with the guidelines of the previous monetary policy meeting in April. In contrast, in the NBS's view

[1] For a more detailed analysis on the announced fiscal package please see our Trip Notes to Belgrade back in autumn 2013: http://www.eurobank.gr/Uploads/Reports/06_New%20Europe%20-%20Trip%20-%20SERBIA%2013%20November%202013F.pdf

there is no negative impact on the country's sovereign risk premium and external trade from the Ukrainian crisis and the US Fed's ongoing tapering so far.

In addition, inflationary pressures have been extremely low while inflation expectations have stabilized. The hike in the reduced VAT rate from 8-10% together with excise taxes hikes provided a short-lived and marginal boost to headline inflation in January-February (3.1% yoy in January and 2.6% yoy in February). On the other hand, several other factors exert downward pressure on price dynamics. The statement of the Central Bank named the negative weak credit activity, the adverse developments in the labor market and the disinflationary impact from low food prices. Inflation fell to 2.3% yoy in last March and further to 2.1% yoy in last April, below the central bank target band of 4% +/-1.5% for the second time since October 2013.

On top, the NBS had provided some forward guidance in the previous monetary policy meeting that the implementation of fiscal consolidation measures would allow room for monetary policy easing. However, the landslide victory of the SNS has cleared uncertainties with respect to the implementation of the fiscal policy even though the incoming government coalition has not yet presented a concrete fiscal consolidation plan.

We were surprised at the magnitude of this rate cut. In our focus note in last January, we thought that the Central Bank would maintain its easing bias but abstain from any aggressive moves until at least H1-2014 even though relatively low inflation readings could justify further easing. Having said, we still believe that there is room for further cuts in the next 6-9 months (50 bps from the current level) as long as the negative market spillovers for the domestic currency from the Ukraine crisis are still contained, there is no unpleasant prices shock (the impact on food prices from the recent floods disaster is too soon to assess) and the government implements a credible fiscal consolidation plan within the framework of a new precautionary agreement with IMF.

Downside risks to the growth outlook of 2014 increase after the catastrophic floods

Driven by the exceptional performance of exports (+16.6% yoy) and agriculture (+20.2% yoy) on the supply side, output performance came at 2.5% in 2013 surpassing consensus expectations. Despite the positive fourth quarter data, domestic demand remained in red in 2013. Private consumption and gross fixed capital formation contracted by -1.5% yoy and -7.5% yoy respectively reflecting both cyclical and structural factors such as lower wage and pension indexation, lower government spending, tightened credit conditions and high unemployment to name a few. The growth outlook for 2014 was clouded with concerns over the sustainability of the exports boom and the fiscal drag on domestic demand. From that point of view, the performance in the first quarter was disappointing. Real GDP expanded by +0.4% yoy in Q1 much lower than the 1.1% yoy in the consensus survey.

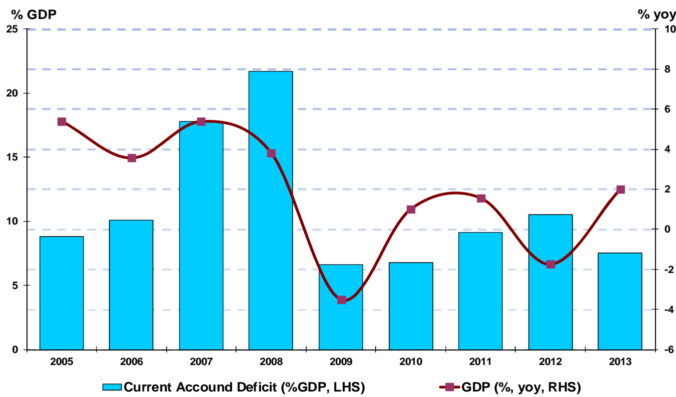
To make things worse, Serbia was hit by severe floods –the worst in its contemporary history-in the past week. News media report that human casualties have already reached 20 people and at least 30,000 have been evacuated. The region most hurt by floods includes the villages of Obrenovac and Sabac, by the river Savva, where a lot of activities in farming and agriculture take place. More importantly, the biggest thermal power plant- Nikola Tesla - which generates half of the electricity capacity of the country, is at risk. For the time being, the current damages in the plant have been contained at €100mn.

Although the evaluation of the damages has not even started, officials report that damages could reach hundreds of € millions if not €1bn. On the positive side, Serbia qualifies now for up to EUR 1bn per year in solidarity aid from the EU since the damage will exceed 0.64% of GDP (around € 0.2bn). At the same time, the catastrophic floods will have a profound negative impact on the growth outlook of 2014. Although uncertainties and risks are still high, agriculture (11% of GVA in 2013) and energy sectors (4% of GVA in 2013) are almost certain to suffer from this setback. As a result, we have put our growth forecast under review in order to downgrade it to 0.8% vs. 1.2% in our previous analysis and 1% in the current official NBS inflation report forecast. On a more alarming note, the new precautionary IMF agreement ought to become a top priority now given the situation in public finances.

Serbia: Eurobank Forecasts				
	2011	2012	2013	2014f
Real GDP (yoy%)	1.6	-1.5	2.5	0.8
Inflation (yoy%)				
CPI (annual average)	11.2	7.3	7.8	4.1
CPI (end of period)	7.0	12.2	2.2	5.5
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-5.0	-6.6	-5.0	-7.1
Gross Public Debt	48.2	60.2	63.6	69.7
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	23.0	23.9	22.1	21.0
Wage Growth *(total economy)*	11.1	8.9	5.7	5.0
External Accounts				
Current Account (% GDP)	-9.1	-10.7	-5.0	-4.5
Net FDI (EUR bn)	1.8	0.2	0.8	1.2
FDI / Current Account (%)	63.7	7.4	48.5	67.3
FX Reserves (EUR bn)	12.1	10.9	11.2	10.5
Domestic Credit	**2010**	**2011**	**2012**	**2013**
Total Credit (%GDP)	74.3	72.2	66.2	60.8
Credit to Enterprises (%GDP)	41.5	40.5	36.1	30.7
Credit to Households (%GDP)	23.1	22.0	19.3	18.6
Private Sector Credit (yoy%)	26.2	5.9	9.7	-4.5
Loans to Deposits (%)	144.3	141.9	144.6	136.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	9.00	9.00	8.50	8.50
EUR/RSD	115.64	116.00	117.00	120.00

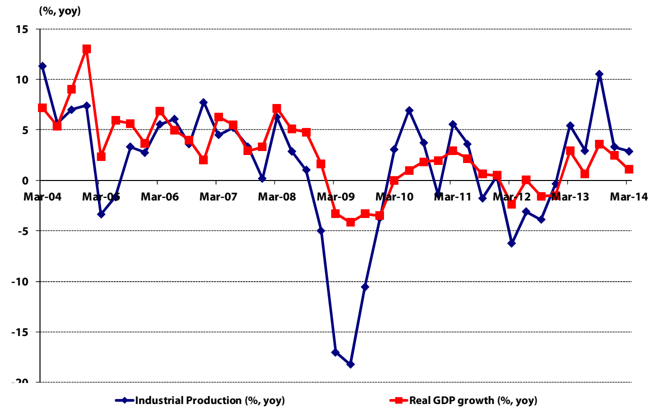
Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1: GDP Growth & CA Deficit in Serbia



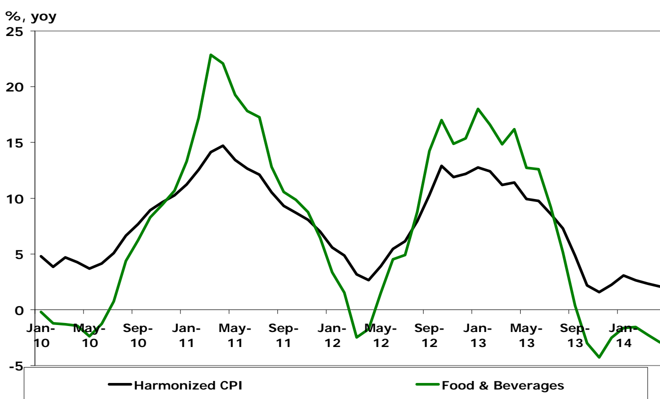
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



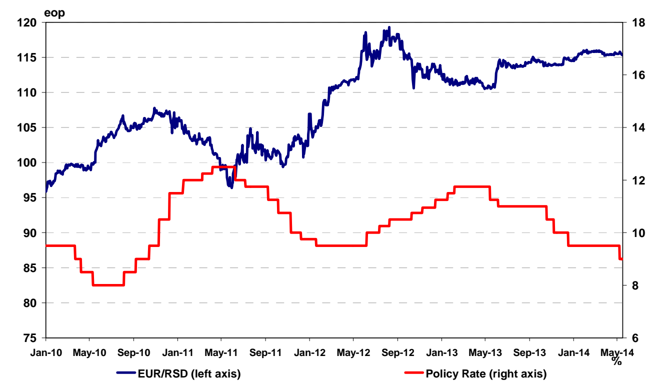
Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia



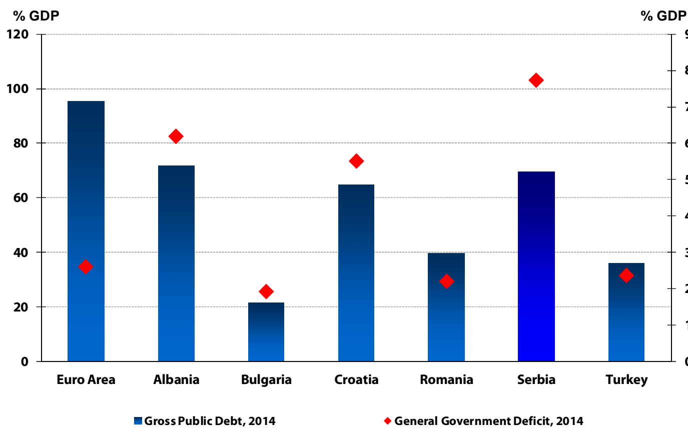
Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate in Serbia



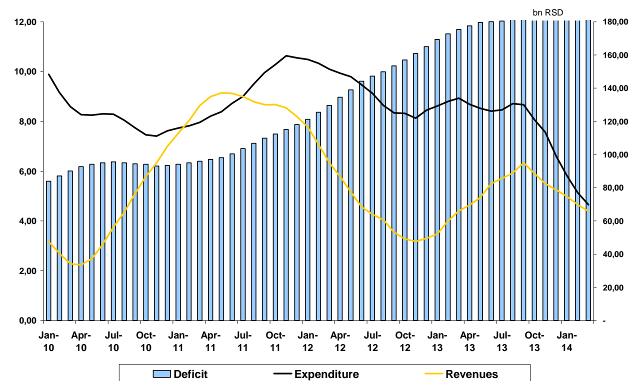
Source: NBS, Bloomberg, Eurobank Research

Figure 5: Debt & Deficits in Euro area & New Europe



Source: IMF WEO April 2014, Eurobank Research

Figure 6: Deficit from 2010 in Serbia



Source: Ministry of Finance, Eurobank Research

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