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FOCUS NOTES: SERBIA

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The unexpected resignation of the Minister of Finance illustrates the implementation difficulties of structural reforms

- **The economy is edging towards recession in 2014, the third in the last five years, on weak economic data from the recent catastrophic floods and the lack of thorough reform**
- **The Minister of Finance resigned unexpectedly on disagreements with the Prime Minister over the scale and depth of the required reforms**
- **The NBS has left interest rates unchanged at 8.5% factoring in potential macroeconomic risks in the period ahead**

High frequency data came out weak in the aftermath of the catastrophic floods

The releases of high frequency economic indicators came out very weak in the aftermath of the catastrophic floods in last May. On top of the human casualties and the mass evacuation of areas where a lot of activities in farming and agriculture take place, the floods disrupted major infrastructure facilities such as the Kolubara mining and the biggest thermal power plant- Nikola Tesla - which generates half of the electricity capacity of the country.

As a result, the severe floods –the worst in the contemporary history of Serbia-had a dramatic impact on industrial production pushing industrial production in 2 year lows. Industrial production contracted by -7% yoy in May, bringing the overall performance in Jan-May down to only +0.2% yoy. The subsectors of energy and mining were hit the most, contracting by -20.3% yoy and -18.7% yoy respectively in May, bringing the overall performance to date -4.1% yoy and -1.4% yoy respectively in Jan-May.

Retail sales in volume terms slipped in red in May (-0.3% yoy) and remained subdued in Jan-May (+1.4% yoy). The main driver behind the weak retail activity was the large decline in fuel sales (-9.2% yoy) which was not offset by the subsequent due to the floods rise in food stuff sales (+4.2% yoy) and non-food sales (+1.6% yoy).

The impact from the catastrophic floods on agriculture and industry is putting more pressure on an already decelerating economy

The revised real GDP data of the first quarter of 2014 disappointed. Real GDP growth was revised down to +0.1% yoy down from +0.4% yoy in the flash estimate, against +1.1% yoy in the consensus survey forecast. Real GDP decelerated sharply to +0.1% yoy in Q1-2014 down from +3.0% yoy in Q4-2013 and +2.8% yoy in Q1-2013. Overall, the economy is flirting with recession from a technical point of view. Real GDP contracted for a second consecutive quarter by -0.3% qoq on a seasonally adjusted basis in Q1-2014 vs. -0.5% qoq in Q4-2013.

A number of key sectors registered large output losses in the first quarter. On the supply side, agriculture (-3.0% yoy), wholesale & retail trade (-2.0% yoy) and construction (-7.8% yoy) were among those heavy weighted GDP economic sectors with the largest declines. Following a very good harvest in 2013, agriculture performance was a source of uncertainty for the growth prospects in 2014. In addition, the contraction in construction slowed down to -7.8% yoy in Q1-2014 from double digits in 2013.

From a demand side point of view, domestic demand is still in recessionary territory. Private and public consumption contracted by -2.1% yoy. On a more worrying note, investments showed a steep contraction for a fourth quarter in a row. Gross fixed capital formation contraction accelerated to -6.1% yoy in Q1-2014 vs. -4.9% yoy in Q4-2013. The good news is that exports held up well at +14.2% yoy in Q1-2014 vs. +16.7% in Q4-2013. The deceleration in imports (+3.2% yoy in Q1-2014 vs. +4.5% in Q4-2013) helped net exports maintain a positive contribution and facilitate a further decline in the trade deficit.

All in, there is a high probability that the economy will contract if not stagnate during 2014. From that point of view, we have downgraded our growth forecast to flat growth in 2014 to reflect those issues. If a new round of recession unfolds, it will be the third in the last five years. After a lackluster growth recovery in 2010-2011, the economy slipped again into recession in 2012, only to rebound by 2.4% in 2013.

Last year's growth rebound was driven by the outperformance of agriculture and the beginning of automobile exports from the FIAT factory. The sustainability of this export boom was already in question in late 2013, while the need for further fiscal adjustment weighted negatively on domestic demand prospects in 2014. At the same time, the long needed reforms to remove structural bottlenecks in the product and labor markets and improve the rigid business environment have been delayed.

In conclusion, the economy is not in a good shape. The revised weak economic data in the recent months compounded by the damages of the recent catastrophic floods underline the challenges that Serbia is confronted with. The preliminary assessment of the damages adopted by the government official report brings the damages at around €1.5 bn or 5% of GDP. On the other hand, Serbia qualifies now for up to EUR 1bn per year in solidarity aid from the EU since the damage is certain to have exceeded 0.64% of GDP (around € 0.2bn).

The catastrophic floods pose a serious threat to the growth outlook of this year. Agriculture (11% of GVA in 2013) and energy sectors (4% of GVA in 2013) have already suffered from this setback. Construction & Real estate activities (3.3% and 11.1% of GVA respectively in 2013) are expected to benefit from the reconstruction activity in the 2H-2014.

The Minister of Finance resigned unexpectedly on disagreements with the Prime Minister over the scale and depth of the required reforms. The government kick started the painful but absolutely necessary reforms adopting the new labor and pension law

The resignation of Minister of Finance on July 12th came as a surprise in Serbia. The resignation came right after the adoption of a new labor and pension law by the government. The former Minister, Mr. Lazar Krstic, resigned on disagreements with the Prime Minister over the scale and depth of the reforms required. His aim to push for a comprehensive and thorough fiscal austerity package met not only the resistance of trade unions but also his own party colleagues in the government who deemed the proposed reforms as very painful.

The initial fiscal consolidation proposal included cuts of 15% for public wages and 20% for pensions, 160k public sector lay-offs and a 30% utilities hike. The adopted pension and public wages cuts were milder (10% across the board) and are deemed as insufficient to produce the expenditure savings required to bring down the fiscal deficit. Mr. Krstic, a thirty year old former Mckinsey professional, had assumed the post ten months ago and was regarded as a pro-reformist member of the government. His withdrawal from the cabinet is a setback for the government efficiency and undermines government credibility ahead of the negotiations with IMF on a new regular SBA in autumn. More importantly, the unexpected resignation of the Minister of Finance illustrated the implementation difficulties of the long-waited structural reforms.

Meanwhile, the fiscal performance in the first five months has already demonstrated the need for a budget revision. The consolidated government deficit came at 103bn RSD in Jan-May2014, up by 24.6bn from a year ago. In terms of projected GDP, the consolidated government deficit stood at 2.7% of GDP up from 2.2% a year ago. The underperformance of revenues was the main driver behind the deterioration. Even though the administration has adopted a number of revenue enhancing measures, total revenues stood only 1.7% yoy higher (compared to a +6.3% yoy revenue target increase on the republican budget level) while total expenditure was up by 5.3% yoy (vs. a 5.8% yoy rise envisaged at the republican budget level). Total revenues stood at 15.2% of projected GDP in Jan-May2014 down from 15.7% a year ago driven by VAT (-0.5% yoy) and PIT revenues (-15.8% yoy) underperformance. Total expenditures stood almost unchanged at 18% of projected GDP driven by the higher debt servicing (+27.4% yoy), procurement spending (+4.5% yoy) and pensions limited indexation (+3.5% yoy).

A new round of recession plus the costs of reconstruction will put further strain on the deteriorating public finances. The initial consolidated fiscal deficit target including items below the line stood at 7.1% of GDP in 2014, but it is now projected to exceed

8% of GDP if no new measures are adopted. Provided this happens, the public debt is now expected to exceed the 70% of GDP threshold in 2014 up from 63.8% in 2013 and only 29.2% in 2008. Overall, the country is in urgent need of a credible fiscal consolidation plan and a new regular IMF agreement. Both have already delayed. Financing is still on track with domestic issuance providing the bulk of funding needs (around 55% of this year's refinancing needs) but also assumes Eurobond issuance in Q3-Q4 under normal market conditions and the disbursement of a tranche from the bilateral loan with UAE.

The NBS maintained interest rates unchanged at 8.5% in July citing macroeconomic risks

After a 50bps rate cut in June, the Central Bank maintained interest rates unchanged at 8.5% on July 10th in line with Bloomberg consensus (16 out of 22 predicted no change). In the statement released, the NBS cited the potential risks for the economy out of the recent floods but also stressed that it is watchful of "an ongoing presence of international risks that may affect liquidity in the international capital markets". Serbia is highly vulnerable-dependent on Russian gas imports and subject to sudden shifts in investors sentiment in emerging markets. From that point of view, a further escalation in the Ukraine-Russia conflict may put more pressure on Serbia. Moreover, the NBS stated that the negative impact on economic sectors from the floods will be mitigated by subsidized loans, flood damage reconstruction works and the implementation of the South Stream project.

The lower inflation readings in the first months of 2014 allowed NBS to deliver two rate cuts in Q2-2014 on top of those 100bps delivered in the last quarter of 2013. NBS cut the key rate by a cumulative of 100bps in May and June to 8.5%. Inflationary pressures have remained subdued despite the recent devastating floods. Inflation came at +0.1% mom/+1.3% yoy in June down from +0.1% mom/+2.1% yoy in last May, below the lower end of the NBS 4+/-1.5%. The reading is a new historical 50-year low but is also expected to be the lowest reading in 2014.

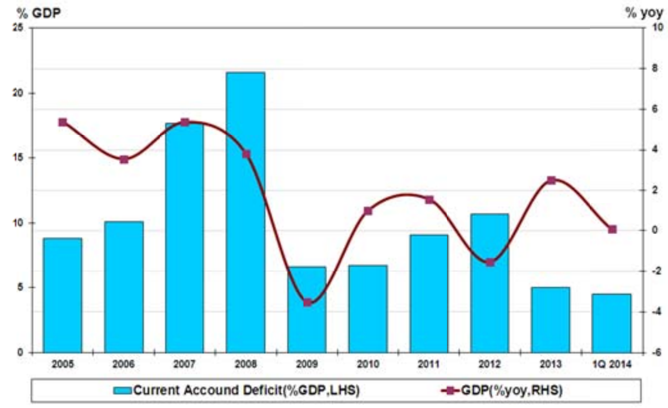
In our view, the cautious and prudent decision of the NBS reflects not only the concerns from unfavorable international developments but also uncertainties in the domestic scene. The delay of decisive fiscal consolidation-the budget revision is still pending- and the need to help economic activity after the damages of the catastrophic floods have been crystallized weighs on the NBS decision making and the Dinar outlook. From that point of view, the news of the resignation of the Minister of Finance has sparked some volatility in the Dinar. On July 23rd, Dinar traded at 116.73/€ or -1.8% year to date. The NBS has spent a net of €640mn in FX reserves to reduce volatility since the beginning of the year.

Inflation is expected to trend higher but still stay within the NBS target band on negative base effects from last year's overperformance in agriculture, the supply side shock from rising food and energy prices in the 2H-2014. The gas hike which is expected to take place in August together with the rising food and vegetable prices reflecting the impact of the recent floods on agriculture will most probably push inflation higher towards 5% yoy, so that the average inflation will reach 3%. In contrast, the weak domestic demand will most probably play a major disinflationary role amid contained inflationary expectations. The implementation of cuts on public wages and pensions as a part of the government fiscal consolidation plan weighs negatively on consumer spending. Provided the inflation outlook remains supportive and there are no more unfavorable developments in the international scene that will shift the balance in favor of further policy easing. That will take place most probably in Q3-2014, when the uncertainties from a new regular IMF agreement and the implementation of the fiscal consolidation plan clear out. Yet we don't anticipate NBS to maintain the aggressive pace of easing but we see room for another 50bps cuts until the end of 2014.

Serbia: Eurobank Forecasts				
	2011	2012	2013	2014f
Real GDP (yoy %)	1.6	-1.5	2.5	0.0
Inflation (yoy %)				
CPI (annual average)	11.2	7.3	7.8	3.0
CPI (end of period)	7.0	12.2	2.2	4.5
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-5.0	-6.6	-5.0	-7.7
Gross Public Debt	48.2	60.2	63.6	71.5
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	8.50	8.50	8.00	8.00
EUR/RSD	116.73	117.00	117.00	120.00

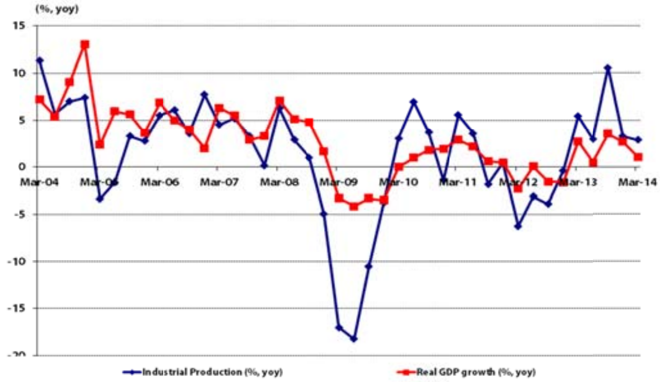
Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1: GDP Growth & CA Deficit in Serbia



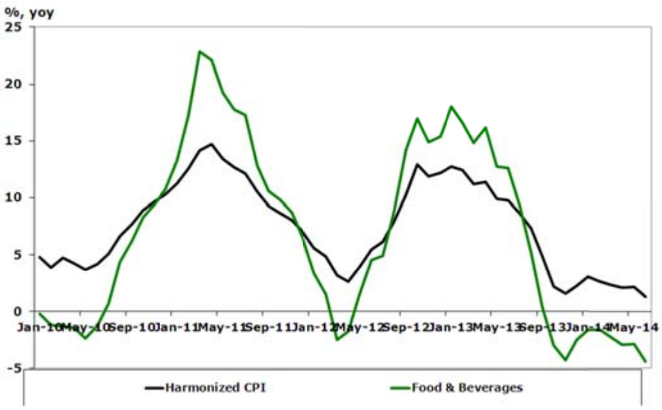
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia

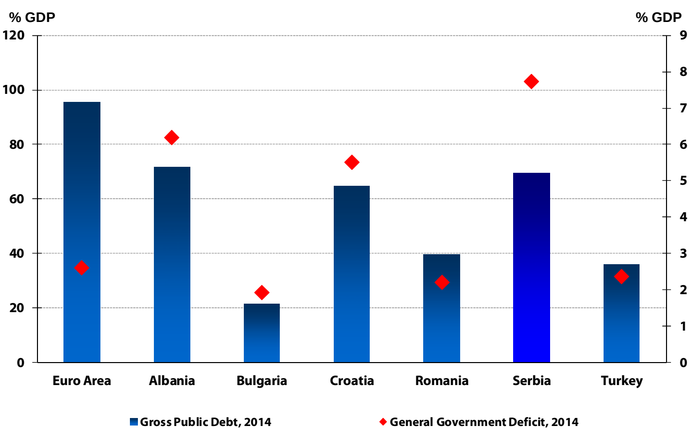


Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate in Serbia

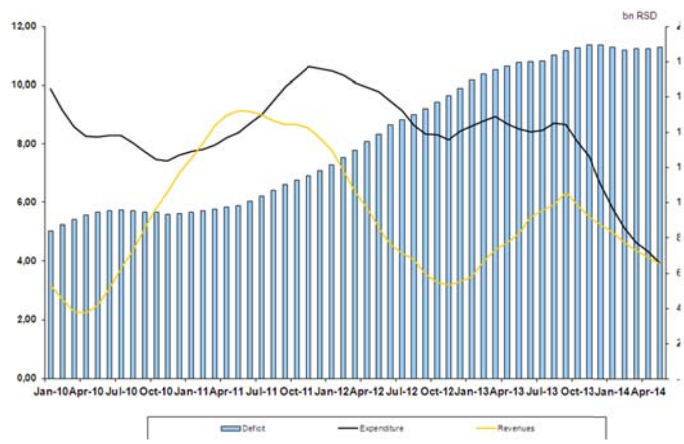
Source: NBS, Bloomberg, Eurobank Research

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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