ISSN: 2241-4843

Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

Eurobank

NEW EUROPE
ECONOMICS & STRATEGY

January 21, 2015

FOCUS NOTES: SERBIA

Written By:

Ioannis Gkionis:
Research Economist
New Europe Specialist

Serbia: The tentative precautionary IMF agreement buys time for the fiscal consolidation program

- The economy is expected to remain in recession in 2015 as well undermined by very weak domestic demand, a less supportive external environment and the lasting impact from the catastrophic floods
- NBS stayed put in January factoring in both the external environment uncertainties, negative base effects from food prices and the impact of anticipated regulatory price hikes
- A new three year precautionary IMF agreement has been reached on the staff level and will be reviewed by the board in next February
- Rating agencies remain on hold in anticipation of the implementation results of the fiscal consolidation program and the tentative IMF agreement

NBS stayed put in January factoring in both the external environment uncertainties, negative base effects from food prices and the impact of future regulatory price hikes

After cutting interest rates by another 50bps in the meeting of November, NBS maintained interest rates unchanged at 8% in December and January in line with Bloomberg consensus. At the same time, NBS reduced reserve requirements further in order to stimulate lending. More specifically, NBS lowered FX reserve requirements from 27% to 26% for assets with maturities up to 2Y, and from 20% to 19% for assets with maturities exceeding 2Y. In addition, the structure of FX required reserves was amended so that the share of dinar allocations increased from 36% to 38% and from 28% to 30%, depending on the maturity of the sources of funding.

In the statement released, NBS cited both domestic and external factors behind the decision. The external conditions in the last quarter have not been supportive of further monetary policy easing. The domestic currency has been losing ground versus the Euro and the USD. The lack of strong support from the NBS through FX reserves sales combined with the weak demand for T-bills only made conditions tighter.

On the other hand, the historically low inflation and the recessionary economic conditions advocate for further easing. Inflation has remained well below the target band for quite some time. Even though inflation edged up to 0% mom/+2.4% yoy in November vs. -0.2% mom/+1.8% yoy in October, it ended at -0.4% mom/+1.7% yoy in December.

Thus, inflation remained below the lower level of the target band (4+/-1.5%) for a tenth consecutive month and reached the lowest level since the introduction of CPI basket in 2007. The postponement of utility hikes in the last minute, the absence of any demand side pressures, the strong decline in the prices of major agricultural and energy commodities in the past six months, has offset partially both the pass through effect from Dinar depreciation and the negative base effects on food prices from last year's over performance in agriculture. As a result, inflation is now expected to reach the middle point of the target band only by mid-2015.

Overall, the previous rates cuts from the NBS came much earlier than we had expected. In our previous New Europe Economics & Strategy we had alluded that there was room for a 50bps rate cut but NBS would do such a move when the uncertainties on a number of contentious issues cleared out. Namely, those issues include and are not limited to a new IMF agreement, a new Eurobond issue, and a credible fiscal consolidation plan. We still anticipate that NBS will maintain its easing bias in 2015 (another 75-100bps from the current levels). In our view, there is room for further easing, provided the inflation outlook remains predictable and supportive, there are no more unfavorable developments in the international financial markets and finally fiscal risks subside.

The cumulative output contraction came at 1.8% in the first nine months of 2014.The new round of recession, the third in the last five years, will most probably extend in 2015

The revised estimate confirmed that recession deepened in Q3. Real GDP contracted by -1.1% qoq/-3.7% yoy in Q3 vs. -1.1% qoq /-1.3% yoy in Q2 primarily as a result of the catastrophic floods. From a demand side point of view, exports and investments were the negative surprises in the third quarter numbers. Private consumption contracted by -1.2% yoy in Q3 vs. -1.1% yoy in Q2 down from -0.2% yoy in Q3-2013. Government consumption contracted by -1.6% yoy in Q3 vs. +0.2% yoy in Q2 down from +2.5% yoy in Q3-2013. Gross fixed capital formation was in deep red, contracting by -7.6% yoy in Q3 vs. -0.6% yoy in Q2 down from -9.8% yoy in Q3-2013. On the external front, exports declined by -5.7% yoy in Q3 vs. +9.5% yoy in Q2 down from +31.7% yoy in Q3-2013. Accordingly, imports decelerated sharply to +1.9% yoy in Q3 vs. +8.2% yoy in Q2 down from +9.6% yoy in Q3-2013.

Overall, the cumulative output contraction stood at 1.8% in the first nine months of 2014. Even though the last quarter's performance is expected to be much better than in Q3, the FY-2014 real GDP is expected to have contracted by -2% in 2014. The new round of recession, the third in the last five years, will most likely extend into 2015 as well. The latter projection reflects not only the lasting effect of the catastrophic floods – the worst in the contemporary history of Serbia-on economic activity but also the fiscal drag from the recent cuts in public wages and pensions, the need for further fiscal consolidation and the indirect spillovers from the Russia-Ukraine conflict. On the positive side, the reconstruction activity is expected to benefit construction and real estate activities.

A new three year precautionary IMF agreement has been reached on the staff level

On November 20th, the IMF announced that a new precautionary agreement was reached on the staff level. The new agreement envisages a €3bn funding available for a three year period, aimed to bolster the FX reserves. The new agreement, the first after the suspension of the previous one in February 2012, aims at implementing an ambitious fiscal consolidation and structural reforms program. Allegedly, the Serbian government has agreed with the IMF mission on €1.3-1.5 bn additional savings in a three year period, in order to bring the fiscal deficit down to 4-4.25% of GDP by 2017. In our view, the new agreement was an essential first step to provide an anchor in the implementation of fiscal policy and structural reforms, the government's main challenge in the period ahead. The recently adopted labor and pension laws, the bankruptcy, privatization and restructuring of state-owned-enterprises (SOEs) are a welcome first step towards fixing the long-term disequilibria of the Serbian economy. However, a credible fiscal consolidation plan is still missing, 9 months after the government received a strong mandate in the parliamentary elections of last April. In our understanding, the new IMF agreement is expected to increase the credibility of fiscal policies and ensure the sustainability of the public debt. At the same time, the new agreement will provide a safety net against a new global markets downturn, thus maintaining sovereign risk at low levels.

The stance of the rating agencies changed slightly after the agreement with IMF had been reached. On January 9th, Fitch affirmed the long term ratings at B+ (outlook stable). On January 16th, Standard and Poors affirmed ratings at BB- but also removed them from credit negative (outlook negative). In the rating agencies thinking, the staff level agreement buys time and ensures market access for the time being. The adoption of a number of fiscal consolidation measures in the budget of 2015 (wage and subsidies cuts) and the restructuring plans of state-owned enterprises may be useful at reducing the fiscal gaps, nevertheless they are still subject to implementation risks. In our view, rating agencies still remain cautious until the fiscal consolidation program shows tangible results.

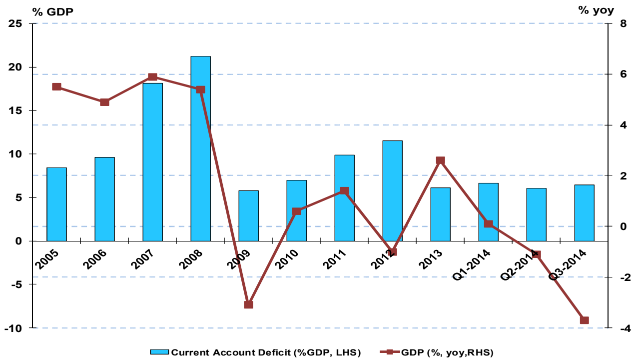
Co-written by
Spiros Reveniotis
Junior Economist Analyst

Serbia: Eurobank Forecasts

	2012	2013	2014	2015
Real GDP (yoy%)	-1.0	2.6	-2.0	-1.0
Inflation (yoy%)				
CPI (annual average)	7.3	7.9	2.1	3.5
CPI (end of period)	12.2	2.2	1.7	4.5
Fiscal Accounts (%GDP)				
Consolidated Government Deficit	-6.1	-4.7	-8.0	-6.0
Gross Public Debt	56.2	59.6	70.5	76.5
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	23.99	22.1	19.5	19.0
Wage Growth *(total economy)*	8.9	5.7	2.0	-5.0
External Accounts				
Current Account (% GDP)	-11.5	-6.1	-6.0	-4.5
Net FDI (EUR bn)	0.7	1.2	1.3	1.5
FDI / Current Account (%)	21.1	77.5	65.0	80.0
FX Reserves (EUR bn)	10.9	11.2	10.5	11.5
Domestic Credit	**2011**	**2012**	**2013**	**Q3-2014**
Total Credit (%GDP)	58.0	62.5	56.7	59.9
Credit to Enterprises (%GDP)	32.6	34.1	28.6	28.3
Credit to Households (%GDP)	17.7	18.3	17.4	18.5
Private Sector Credit (yoy%)	5.9	9.7	-4.5	-0.3
Loans to Deposits (%)	141.9	144.6	136.9	136.1
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.0	7.50	7.00	6.75
EUR/RSD	122.07	122.00	122.00	120.00

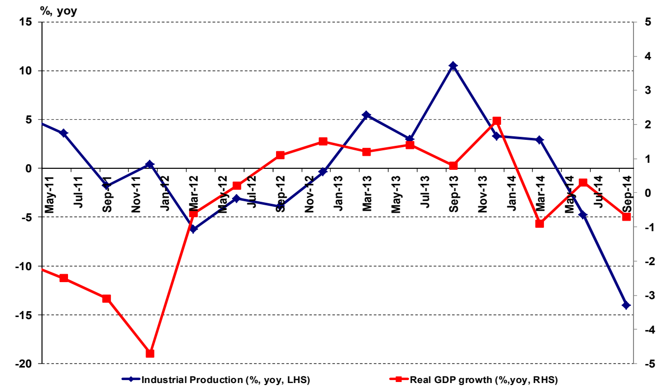
Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1: GDP Growth & CA Deficit in Serbia



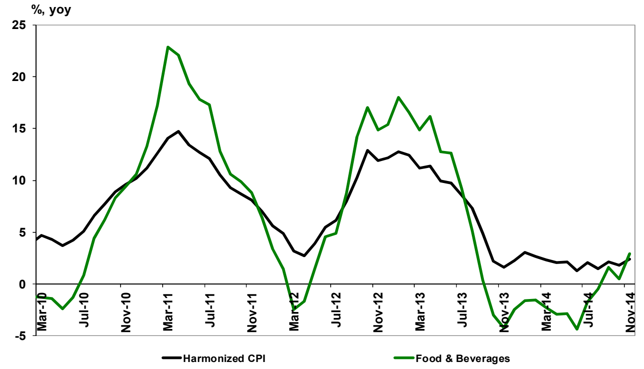
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



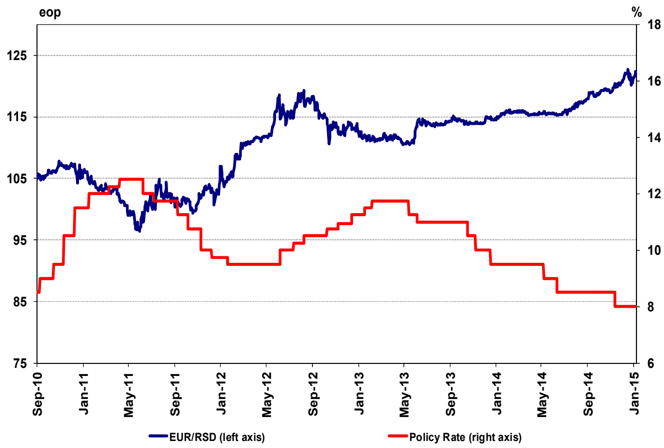
Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia



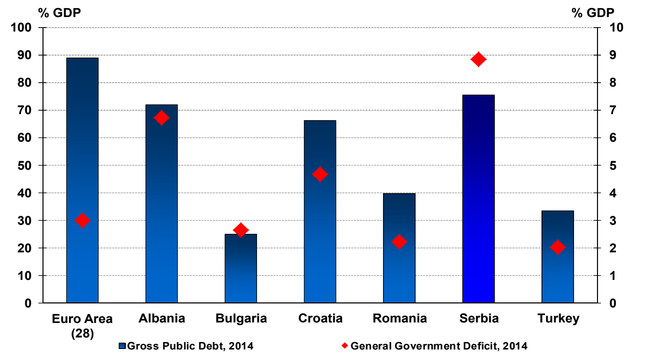
Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate in Serbia



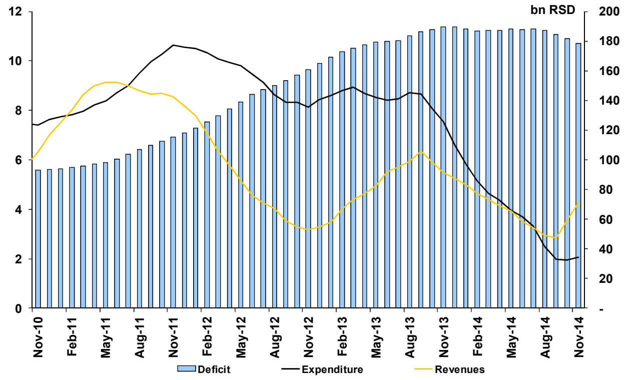
Source: NBS, Bloomberg, Eurobank Research

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



Source: IMF WEO JANUARY 2015, Eurobank Research

Figure 6: Deficit from 2010 in Serbia



Source: Ministry of Finance, Eurobank Research

Economic Research Team

Economic Research & Forecasting Division
Ioannis Gkionis: *Research Economist*
Stylianos Gogos: *Economic Analyst*
Vasilis Zarkos: *Economic Analyst*
Olga Kosma: *Economic Analyst*
Arkadia Konstantopoulou: *Research Assistant*

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

Eurobank Economic Research

More research editions available at http://www.eurobank.gr/research

- **New Europe**: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- **Economy & Markets**: Monthly economic research edition
- **Global Economic & Market Outlook**: Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research
Follow us on twitter: http://twitter.com/Eurobank_Group

ISSN: 2241-4843