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FOCUS NOTES: SERBIA

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Early parliamentary elections looming

- **Early parliamentary elections are looming in spring together with municipal elections in Belgrade**
- **Fitch downgraded the long term sovereign rating from BB- to B+ citing the continued deterioration of the fiscal position**
- **Central Bank maintained interest rates unchanged at 9.5% contrary to analyst expectations**
- **EU accession negotiations begun formally with the first intergovernmental conference on January 21st**

Speculation over early parliamentary elections has increased over the past weeks

The probability of early parliamentary elections in spring has increased. Comments from the leader and senior officials of the biggest coalition party-the SNS (Serbian Progressive Party) - have given rise to speculation that early parliamentary elections may take place together with the municipal elections in Belgrade. The leader of the SNS party- deputy Prime Minister Mr. Alexander Vucic stated that his party is ready for early parliamentary elections. In an editorial published in the party's magazine, the leader wrote that "The SNS is ready for elections, to test the power, legitimacy and trust that each party enjoys with the people of Serbia".

Early parliamentary elections have been lingering for quite some time. The stability of the present government coalition, which relies on a slim and fragile majority in parliament (134 out of 250 MPs), was already at stake after the departure of the minor coalition party of the regions (URS-led by Mr. Mladan Dinkic) in late summer 2013. The reshuffling of the government averted early parliamentary elections only temporarily.

On the other hand, the high popularity of the SNS which is based on its anti-corruption campaign provides it a high incentive to withdraw its support from the current government in order to provoke parliamentary elections. The popularity of the SNS leader, Mr Aleksandar Vucic who succeeded the current President of the Republic, Mr. Tomislav Nikolic, in the leadership of the party is the highest among politicians.

The recent opinion polling suggests that SNS, which collected 24% of the vote in May2012, might be able to collect over 40% of the vote. As an illustration of its high popularity, the party earned convincing wins in local elections in three municipalities (49.8% in the Belgrade municipality of Vozdovac, 48.18% in Odzaci in northern Serbia and 45.51% in Kostolac in the east). Winning a victory with a sizeable margin over the main opposition Democratic Party (DS) will enable SNS to rule without its current coalition partner-the Socialist party (SPS).

The beginning of EU accession negotiations and the forthcoming municipal elections in Belgrade give further rise to speculation for early parliamentary elections

Further on, early parliamentary elections could depend upon two more issues: The beginning of accession talks with the EU authorities and the forthcoming early municipal elections of Belgrade in next spring. The repercussions of those events could create a political momentum that would lead to early parliamentary elections held at the same period.

This government can claim credit for the improvement in the EU accession project. Serbia was awarded EU candidate status only in March 2012 while the EU council decided in late June 2013 that accession negotiations could begin by the end of January 2014.

The first intergovernmental conference took already place on January 21st. The prospects for EU accession talks could be made easier by the progress recorded in the implementation of the landmark agreement reached in last April with Kosovo authorities in order to normalize relationships.

The forthcoming municipal elections of Belgrade next spring are another issue that could trigger early parliamentary elections. This is an extremely high profile case because of the large size of the electorate of the capital city and the circumstances under which elections were provoked. Socialists and Progressives in the city assembly voted to dismiss the mayor of Belgrade, Mr Djilas. Mr Djilas, the outgoing mayor of Belgrade took over the leadership of the Democrats from the outgoing President, Mr Tadic. Socialists, which had been part of the city's governing coalition together with the Democrats, turned against him.

Looming early parliamentary elections may put the fiscal consolidation and the structural reforms program at risk

Early parliamentary elections may have a paralyzing impact on the parliament and governmental work. The current government coalition has initiated the implementation of an ambitious fiscal consolidation and structural reforms program since last October.

The new program aims to stabilize public finances and stimulate growth. More specifically, the fiscal consolidation package aims to reduce the fiscal deficit by a cumulative 4.5%-5% of GDP in 2014-2017. At the same time, the government aims to push for structural reforms in a number of areas (public enterprises, social security, pension system, labor market, tax system, public administration, and healthcare) to improve the business environment and increase government efficiency.

The implementation risks surrounding the economic reforms package are important. The package so far has stirred both public and internal debate between the factions within the coalition government that has reduced the speed and efficiency of implementation. In addition, early parliamentary elections could complicate and delay both the issue of negotiations on a new IMF agreement and the bilateral loan with UAE.

On the other hand, if the election results give a clear victory to the SNS, that may provide Mr. Alexander Vucic with a strong mandate to implement difficult economic reforms, remove bargaining power from other smaller parties and give new impetus to the implementation of the structural reforms program.

Fitch downgrade of Serbia's sovereign rating came as no surprise

On January 17th, Fitch downgraded the long term sovereign rating from BB- to B+ citing the deterioration of public finances. Fitch analysts underlined the rise of consolidated government deficit for the fourth consecutive year to 7.1% of GDP in 2014 from 6.5% in 2013 and the subsequent continuous deterioration in debt dynamics. Fitch anticipates public debt to reach 70% of GDP by 2015 from a current level of 63% driven by fiscal slippage and sluggish growth. At the same time Fitch expects average growth to remain below 2% during the next two years. More importantly, Fitch puts emphasis on the lack of credibility for the implemented policies because of the delays in fiscal consolidation and the weak record of structural reforms.

The reaction of the domestic financial markets has been relatively muted. The downgrade doesn't come as a surprise. The risks stemming from the lack of meaningful progress in fiscal and structural reforms are already priced in. Dinar had already embarked in a sliding path since the end of May 2013, but has also remained relatively stable so far in 2014. NBS has been fairly active in the FX market (€190mn year to date) to curb Dinar volatility since the beginning of 2014. The Dinar traded at the level 115.43/€ on January 23rd, having depreciated by almost 1%% year to date (Figure 4).

Central Bank left rates unchanged at 9.5% contrary to analyst expectations

On January 16th, the NBS maintained interest rates unchanged at 9.5%. This is the first time the Central Bank left interest rates unchanged after three consecutive cuts. The NBS cut rates by a cumulative 150bps in the last two meetings in November and December 2013. The move was not widely expected by Bloomberg consensus. Most analysts (20 out of 24) motivated by the benign inflation readings in the last two months were expecting a rate cut.

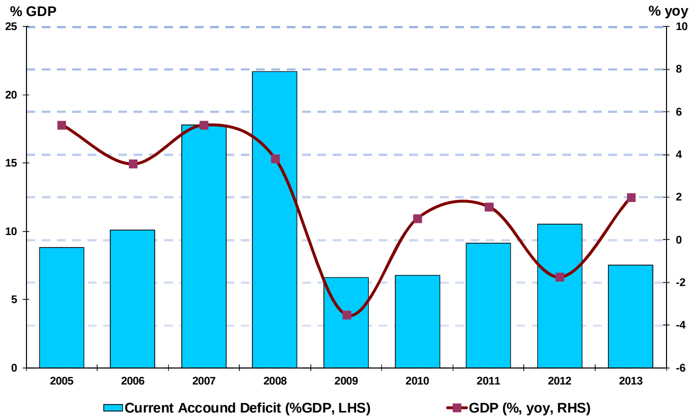
In the statement released, the Central Bank assessed that the inflation decline below the Central Bank target range (4.5%+/-1.5%) is only temporary and unsustainable. Driven by favorable base effects stemming from the food inflation rally throughout 2012, inflation embarked on a downward trend in 2013. As a result, inflation dropped from 12.8% yoy in January 2013 to a multi-year low at 1.6% yoy in November 2013. Inflation spiked to 2.2% yoy in December 2013 vs. 12.2% yoy in December 2012, below the Central Bank target range (4.5%+/-1.5%) (Figure 3).

Inflation is now expected to trend higher in Q1-2014 driven by the excise taxes increase and the hike of the special VAT rate by 2pps to 10% in January. Yet it is widely expected to fluctuate within the target range supported by weakened inflation expectations, anemic domestic demand, and the lack of anyfood inflationary pressures

Looking ahead, we anticipate that Central Bank will maintain its easing bias. At the same time, we see limited room for further aggressive easing until at least 1H-2014. Even though low inflation readings would justify further monetary easing, we anticipate the Central Bank to adopt a more prudent approach given the lingering external and internal risks.

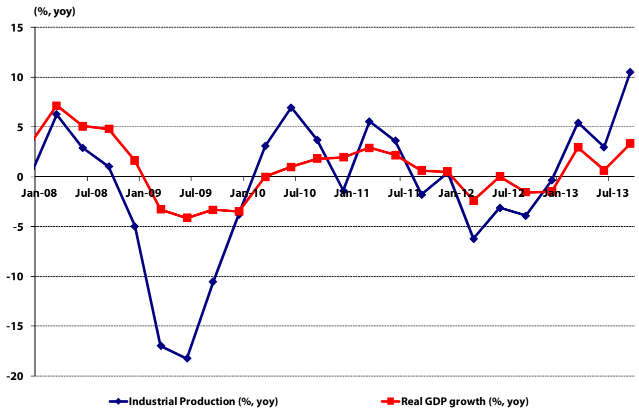
Those include and are not limited to the high probability of early parliamentary elections, the uncertainty surrounding a new IMF agreement, the negative impact from the FED tapering, and the implementation risks of the fiscal consolidation plan, the need for high real yields for T-bills in the domestic market. From that point of view, the IMF has long before advised against further monetary policy easing to avoid risks to inflation and Dinar stability. When those risks subside, then Central Bank would be more motivated to deliver 100bps more easing by the end of 2014 in an attempt to provide more support to domestic economic activity.

Figure 1: GDP Growth & CA Deficit in Serbia



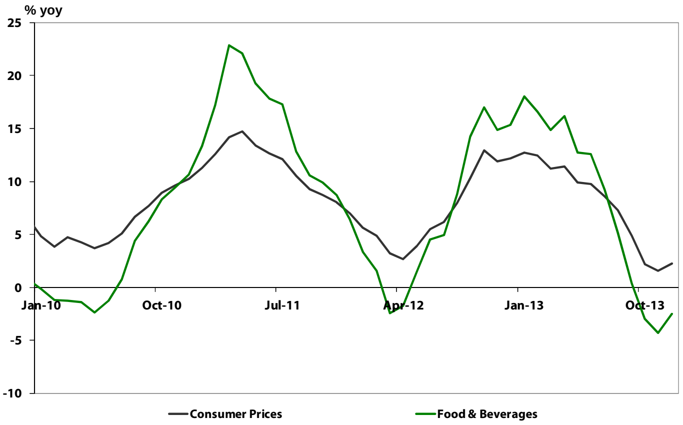
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



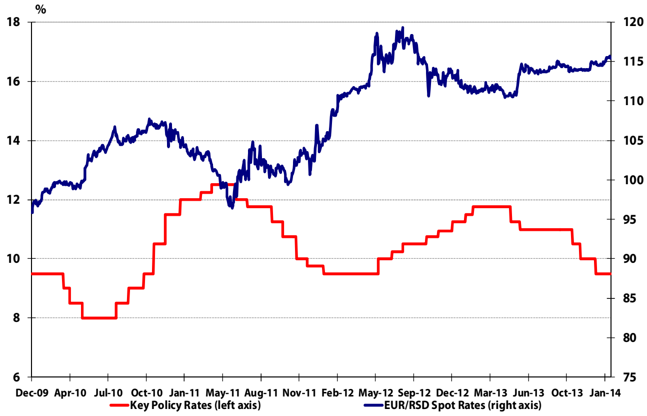
Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia



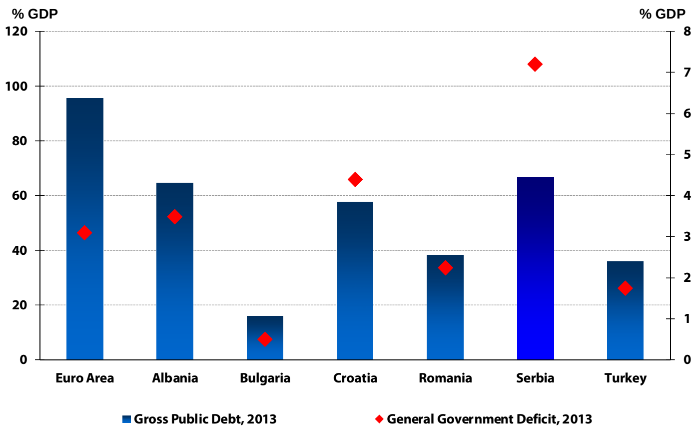
Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate in Serbia



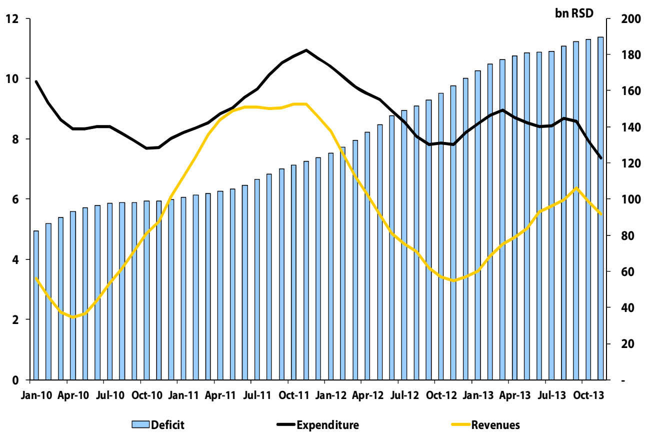
Source: NBS, Bloomberg, Eurobank Research

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



Source: IMF WEO October 2013, Eurobank Research

Figure 6: Deficit from 2010 in Serbia



Source: Ministry of Finance, Eurobank Research

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