ISSN: 2241-4843

Eurobank Research
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NEW EUROPE ECONOMICS & STRATEGY

August 1, 2013

FOCUS NOTES: SERBIA

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Sustained and sizeable fiscal consolidation effort still missing

- **Driven by exports of automotives and petroleum products, GDP expanded by 0.5% qoq/+2.1% yoy in Q1-2013**
- **The prospective cabinet reshuffle is expected to have a negative impact on fiscal consolidation effort**
- **The consolidated government deficit is widely expected to overshoot the revised target of 5.2% of GDP in 2013**
- **Monetary easing paused: NBS unexpectedly left interest rates unchanged at 11% on July 11**

Economy has turned the corner in the first quarter on automotives and petroleum products industry boost

GDP growth in the first quarter was the first positive reading after Q4-2011 (-0.5% qoq/+0.8% yoy). Real GDP growth came at +1.9% qoq /+2.1% yoy in Q1-2013 up from –0.3% qoq /-2.1% yoy in Q4-2012 and -1.9% qoq/-2.6% yoy in Q1-2012. The recovery was entirely driven by net exports. Exports expanded by +13.5% yoy in Q1-2013 compared to +5.8% yoy in Q4-2012 and up from -5.1% yoy in Q1-2012. The expansion was underpinned by the rise of exports in petroleum products and automotives. The NIS refinery, which has been privatized to Gazprom and the automobiles factory in Kragujevac, owned by FIAT, were the main exporters. On the other hand, imports declined to 1.1% yoy vs. 2.2% a year earlier. To sum up, the contribution of net exports amounted to 4.5pps up from -3.6pps a year ago. In contrast, all other domestic demand components remained in red in Q1-2013. Private consumption edged lower by -1.1% yoy, gross fixed capital formation contracted by -3.9% yoy and government consumption by -3.2% yoy (Figures 1,2).

From a sectorial point of view, agriculture (+16.7% yoy), manufacturing (+2.4% yoy) and information technology (+8.1% yoy) were among those sectors who made the biggest positive difference. In contrast, retail trade were among those few sectors with negative performance (-4.0% yoy), an illustration of weak consumption dynamics. To make things worse, construction recorded a steep decline (-24.7% yoy) having not recovered from the earlier recession.

Overall, the first quarter GDP reading is encouraging. In our view, the economy has turned the corner in order to start recovering from the double dip recession. Looking ahead we see a modest growth rebound in 2013-2014. Our forecast stands at 1.5% up from 1% in the beginning of the year, yet still below consensus. The government official forecast stands at 2% as well as the current NBS forecast (downgraded from 2.5% previously). Although favorable base effects from last year's bad agricultural performance will kick in and the automotives exports have started, the economy is still confronted with many challenges. Downside risks to our forecast arise from the significant fiscal drag on the economy stemming from the deficit cutting measures, the recession in the Euroarea and the absence of a new IMF agreement. In our view, the prospects of 2013-2014 will depend on the preservation of social and political stability.

Sustained and sizeable fiscal consolidation effort still missing. The government was inclined to revise the republican budget deficit target from 3.6% of GDP to 4.7% in late June.

Despite some fiscal consolidation measures introduced by the incoming government cabinet in the 2H-2012, the fiscal position of the country showed no visible signs of improvement in the past year. The adoption of a supplementary budget did not prevent a significant post-election current expenditures fiscal slippage. To make things worse, lower than projected nominal growth plus the recapitalization costs of non-viable state-owned banks weighed further negatively on the fiscal result. As a result, the general government deficit on a cash basis ended at 6.4% of GDP (or 7.6% of GDP in 2012, including the resolution costs of state-owned banks which the government treats as items below the line) up from 5.1% in 2011.

The fiscal target of 2013 was initially set at 3.6% of GDP. However, the budget implementation throughout the 1H illustrated that the fiscal target was already more or less out of reach and underlined the challenges of fiscal consolidation in 2013. The consolidated government (central government plus social security institutions and local governments) fiscal deficit narrowed by 26% yoy to RSD 82.7bn in 1H 2013 vs. RSD 111.2bn in 1H 2012. In terms of projected GDP, the consolidated government deficit stood already at 2.2% in 1H-2013 down from 3.3% in 1H-2012. The overall assessment of the fiscal performance was that the budget expenditures (+1.5% yoy) were more or less under control in the 1H. In contrast, revenues performance (+6.2% yoy) disappointed because of VAT underperformance (Figure 6).

As a result, the government was inclined to adopt a supplementary budget and introduce measures of 1% of GDP in order to contain fiscal slippage. Those measures included the cap of public sector wages and pensions' indexation at 0.5% in Oct 2013-0.5% in April 2014 and further by 1% in Oct2014, the discretionary spending cuts in ministries spending by RSD 37bn, extra savings from n subsidies and capital expenditures spending cuts and the restructuring of public sector loss making companies. The target at the central government level (republican budget) was revised to 4.7% and to 5.2% of GDP at the consolidated government level in late June.

IMF recognized that those measures were an essential though incomplete step towards fiscal consolidation. Even after the revision of the budget, the target of this year is deemed to be overly ambitious. For that reason, IMF called for the adoption of additional measures and the implementation of structural reforms in the areas of the broader public sector and pension system. The Fiscal Council, an independent institution, warned that unless additional measures are adopted, the consolidated government deficit is expected to overshoot the revised target reaching 6% of projected GDP.

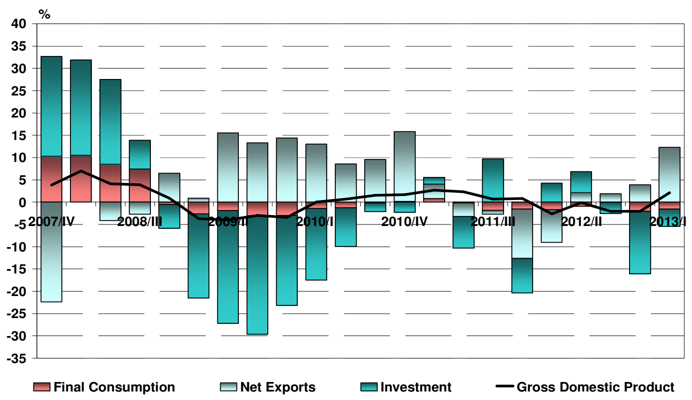
Overall, the lack of a sustained and sizeable fiscal consolidation strategy sends an alarming message concerning the deterioration of the fiscal position of the country. The highly expansive policy followed by the previous administration led to an unsustainable widening of the fiscal deficit in 2008-2012. The consolidated government deficit widened from 2.6% of GDP in 2008 to 5.1% in 2011 and further on to 6.4% in 2012. Accordingly, the public debt to GDP ratio reached 59.3% of GDP in 2012 (61.8% according to the latest IMF assessment), significantly above the 45% threshold of the fiscal rule compared to 48.2% in 2011 and only 29.2% in 2008. Those metrics put Serbia among the most indebted countries in the region (Figure 5). 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 Central Bank made a pause in the easing cycle in July, leaving the key policy rate unchanged at 11.75%

On July 11th, the NBS left the key policy rate unchanged at 11.75%. This is the first time the Central Bank left interest rates unchanged since the beginning of the easing cycle in last May. The NBS cut rates by a cumulative 75bps in the last two meetings in May and June. The move was not widely expected by Bloomberg consensus (only 9 out of 24 analysts expected no rate change). In the statement released, the Central Bank assessed that given the low demand side pressures and the prospect of lower food prices as a result of the very good agricultural season, inflation will have returned with the tolerance band by October (4+/-1.5%). Driven primarily by higher food prices and regulatory prices hikes, inflation peaked at 12.9% in last October. Inflation declined at single digit levels for the first time in the last twelve months at 9.9% yoy in May and further at 9.8% yoy in June driven by favorable base effects and low aggregate demand pressures. In contrast, food inflation from seasonal agricultural products (e.g. vegetables) persisted, thus maintaining inflationary pressures high (Figures 3,4).

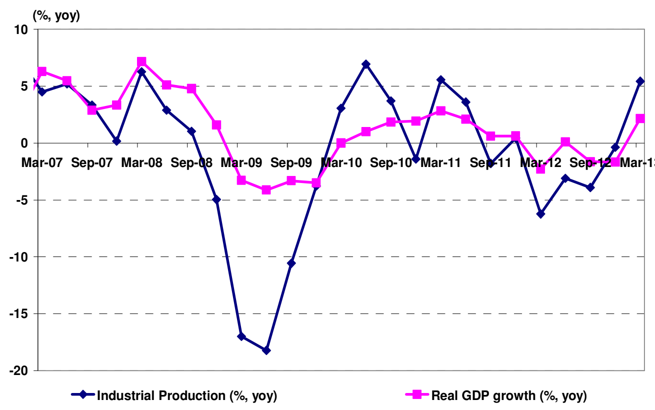
In addition, the Central Bank cited the unfavorable movements in international financial markets that have sparked an increase in risk premia and depreciation pressures almost throughout the region. In our view, the Central Bank made a pause in the motivated by the volatility in the financial markets and their negative impact on the Dinar and the uncertainty from the implementation of additional fiscal consolidation measures. From that point of view, the IMF has advised against further monetary policy easing to avoid risks to inflation, Dinar stability and economic stability. Looking ahead, we anticipate that Central Bank will maintain its easing bias. However, NBS will be equally cautious in delivering further easing in the period ahead for two additional reasons. First, the sentiment in the emerging markets space remains fragile. Secondly, there are upside inflation risks from the prospective electricity prices hikes effective from August 1st for both consumers and businesses (10.9% for households and 12.8% for corporates).

Figure 1: GDP growth drivers



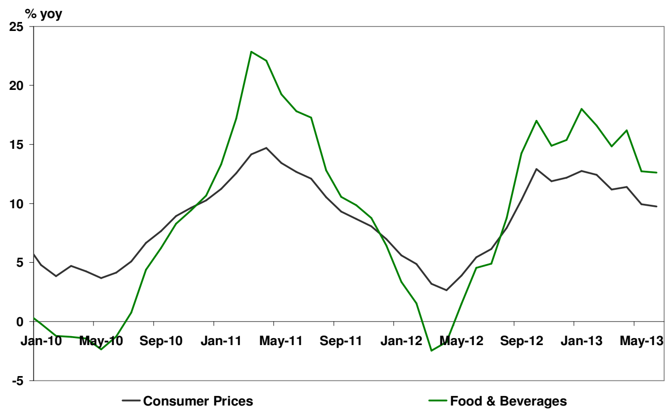
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production



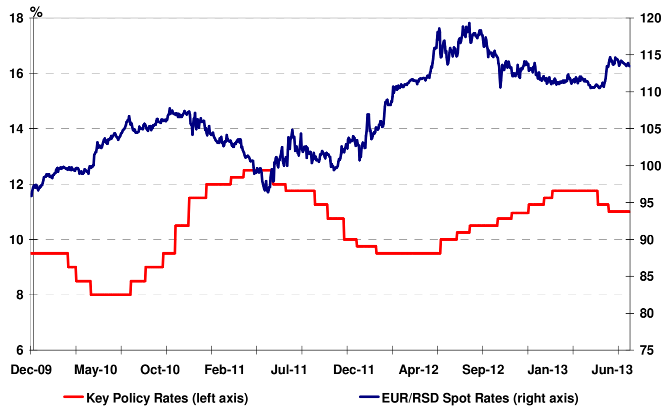
Source: National Statistics, Eurobank Research

Figure 3: Food prices impact on inflation



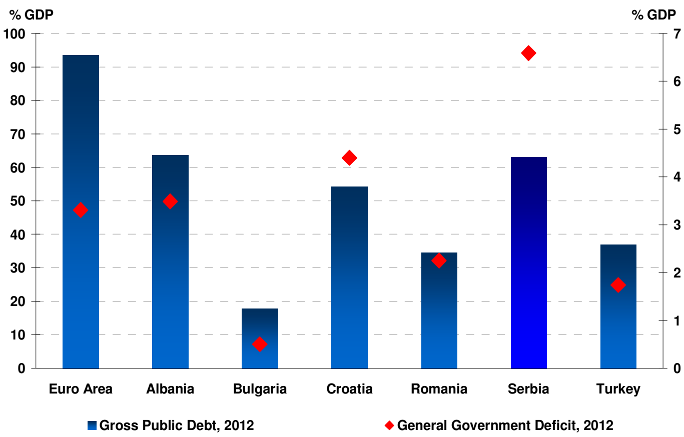
Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate



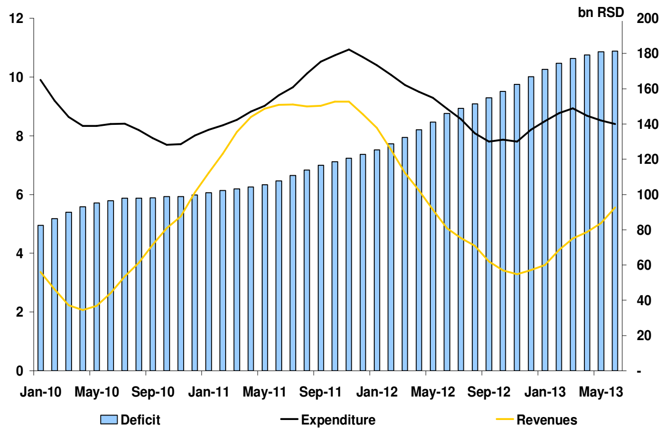
Source: NBS, Bloomberg, Eurobank Research

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



Source: IMF WEO, Eurobank Research

Figure 6: Fiscal Deficit in 2010-2013



Source: Ministry of Finance, Eurobank Research

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ISSN: 2241-4843