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FOCUS NOTES: SERBIA

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Serbia: More fiscal policy effort is required

- **Real GDP contracted by -3.7% yoy in Q3 down from -1.1% yoy in Q2, as a result of the catastrophic floods**
- **The long waited budget revision shifted the full year target of the republican budget from 4.6% to 5.4% of GDP, but further consolidation measures are anticipated in the budget of 2015**
- **NBS maintained interest rates at 8.5% for a fourth consecutive month in a row, citing the domestic and external risks for monetary policy**
- **S&P placed Serbia's ratings on negative credit watch with negative implications ahead of the 2015 budget and pending details of the medium term fiscal consolidation plan**
- **A new IMF agreement is essential to provide an anchor in the implementation of fiscal policy & structural reforms and consolidate investors' confidence**

Recession deepened in Q3-2014 as a result of the catastrophic floods. The new round of recession, the third in the last five years, will most probably extend in 2015 as well

According to the flash estimate real GDP contracted by -3.7% yoy in Q3 down from -1.1% yoy in Q2 as a result of the catastrophic floods. High frequency data came out very weak in the aftermath of the floods. The sectors of energy (-44.5% yoy in Q3 vs. -34.8% yoy in Q2) and mining took the biggest hit, recording steep declines. Industry and especially manufacturing suffered less (-5.9% yoy in Q3 vs. -2.0% yoy in Q2), helped by the automobiles production. Retail activity performed stronger in Q3 (+3.3% yoy in Q3 vs. +1.4% yoy in Q2), which is interpreted as a temporary boost from the purchases and stocking of consumer (food and staples) goods plus the consumption of fuels in the aftermath of the floods.

Overall, the deterioration of the macroeconomic outlook has prompted us to revise further downwards the forecasts of 2014-2015. Driven by the poor performance in the second and third quarter, real GDP is expected to contract by -1% 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 dramatic impact 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 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.

In our past research pieces, we had an extensive analysis on the disequilibria of the Serbian economy. Those include and are not limited to unsustainable public finances, high unemployment, low investment share, unwinding macroeconomic imbalances, rigid business environment, and high levels of Euroization etc. Those constraints prohibit Serbia's medium term growth prospects. From that point of view, long before the catastrophic floods, we had expressed our concerns on the growth outlook of 2014-15. The sustainability of the growth rebound recorded in 2013 was in question, as it was driven by the FIAT factory automobile export boom and the outperformance of agriculture. The catastrophic floods in the spring of 2014 only exacerbated the multiple economic challenges that Serbia is confronted with.

The policy mix response so far has made small (law on labor market, SOE bankruptcy & restructuring) -but not ambitious enough- steps to address the urgent issues. In that direction, a new IMF agreement is essential to provide an anchor in the implementation of fiscal policy, structural reforms and consolidate investors' confidence. Without the shield of a new IMF agreement, Serbia could find itself in a vulnerable position in case markets or economic stress in Emerging Europe reemerges.

The long waited budget revision failed to produce enough fiscal consolidation. Additional measures will be required to bring down the fiscal deficit in 2015-2017

The long waited budget revision was adopted on October 22nd. The full year target for the republican budget deficit was raised from 182.5bn RSD to 224.7bn RSD. Thus, the target of the republican budget deficit was revised from 4.6% to 5.7% of projected GDP. The target for total revenues has been downgraded by 3.5% down to 897bn RSD vs. 929bn RSD envisaged in the initial budget (the target for VAT revenues has been revised down to 398bn RSD vs. 430bn RSD). At the same time, the target for total expenditures has been revised to 1121.9 bn RSD vs. 1112.5 bn RSD.

The budget revision incorporated the fiscal consolidation measures for pension and wages in order to replace the solidarity tax. The measures, effective from November 1st, envisage a 10% linear public wage cut on all public wages above 25,000 RSD. In addition, pensions above 22,000 RSD will receive a 22% cut and those above 40,000 RSD will receive a 25% cut. The impact on the wage bill and the pensions is expected to be 5% and 10%, respectively.

Meanwhile, the fiscal performance in the first nine months had already demonstrated the need for a budget revision. The consolidated government deficit came at 135bn RSD in Jan-Sep2014, up from 140bn RSD a year ago. In terms of projected GDP, the consolidated government deficit stood at- 3.7% of GDP little down from 3.9% 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 +4.1% yoy higher (compared to a +6.3% yoy revenue target increase on the republican budget level), while total expenditure was up by +3.8% yoy (vs. a 5.8% yoy rise envisaged at the republican budget level). Total revenues stood slightly higher at 26.6% of projected GDP in Jan-Sep 2014 up from 26.2% a year ago driven by VAT (+4.1% yoy) and PIT revenues (-8.5% yoy) underperformance. Total expenditures expanded to 29.9% of projected GDP up from 29.4% a year ago, driven by the higher debt servicing (+23.5% yoy), procurement spending (+1.6% yoy) and pensions limited indexation (+1.5% yoy).

In our view, the budget revision comes too late in order to reconcile the budget metrics with the adverse fiscal performance and macroeconomic developments. The macroeconomic assumptions upon the previous budget were built (GDP growth forecast in 2014: +1%, average annual inflation: +5%) had been long outdated. Currently, Eurobank Research forecast for GDP growth stands at -1% and annual average inflation stands at 3%.

Moreover, the budget revision fails to produce enough savings in time. Meaningful fiscal consolidation is postponed for yet another year, as wage and pensions cuts will be effective in the last two months of 2014. The savings from the wage and pensions, the restructuring of SOEs and the reduction in subsidies and procurement spending are expected to show up in the budget of next year and, thus, accrue in 2015. The full year cost-cutting in public wages and pensions is contained at 8.3bn RSD and 5.5bn RSD respectively in 2014. In addition, the revision includes a rise in subsidies (+12.8bn RSD) to account mainly for the failure of the privatization of "Zelezara Smederevo" steel producer. Last but not least, the budget revision doesn't include any revenue enhancing measures-to increase collection efficiency or medium-term planning.

The Fiscal Council, an independent organization, has already assessed that the budget revision will result in savings of only €400mn. The Fiscal Council has recommended a one-off 15% cut on wage and pensions instead in order for savings to reach €700-800mn. As a result, the consolidated government deficit including below the line items is now projected to overshoot the 7.1% of GDP target, and is almost certain to even surpass 8% in 2014. Inter alia, this means that the public debt is now projected to exceed the 70% threshold already in 2014-the latest projection stands at 75% of GDP. In order for the public debt to stabilize and the fiscal deficit to decline below 3% of GDP by 2017, new consolidation measures will be required in the medium term fiscal framework.

On the positive side, the revision of the nominal GDP data after the adoption of ESA 2010 standards by around 7% on average will push the public indebtness ratio lower. As a result, the revised public debt to GDP ratio is expected to reach around 69.5% in 2014 vs. 59.6% in 2013 and only 28.3% in 2008. However, even after the revision, Serbia would still be ranked among the most indebted countries in the region. The fiscal position of the country has shown no signs of improvement. The public debt to GDP ratio has already surpassed the 60% Maastricht level and the 45% threshold of the fiscal rule. More importantly, a concrete and holistic approach towards fiscal consolidation is still missing. The authorities have yet to establish a credible record of commitment to fiscal discipline.

NBS maintained interest rates unchanged at 8.5% for a fourth consecutive month in October

On October 16th, the Central Bank maintained interest rates unchanged at 8.5% in line with Bloomberg consensus (20 out of 23 predicted no change). In the statement released, the NBS cited both the domestic and the external risks for monetary policy for this decision. NBS stressed that the current geopolitical tensions and the anticipated Fed's tapering may have a negative impact on capital flows on the countries of the region including Serbia. The rise in the country risk premium plus the depreciation pressures on the local currency is illustrative of those external risks. In addition, according to NBS, the consistent implementation of fiscal consolidation measures and structural reforms may have a positive impact on the risk premium and shield the country against the previously aforementioned external risks.

In our view, the cautious and prudent decision of the NBS reflects not only concerns from unfavorable international developments, but primarily uncertainties in the domestic scene. Although Fed's tapering and the latest geopolitical developments are not supportive of further monetary easing either, there are also a number of domestic issues that prohibit NBS from further easing at this point. The delay of decisive fiscal consolidation-the budget revision has failed to provide tangible evidence and credibility-weighed on the NBS decision making. More importantly, the absence of a new IMF agreement, and the subsequent low appetite for domestic bonds on behalf of foreign investors who have adopted a wait and see attitude towards Serbian risk, weighs even more negatively on further easing.

Rating agencies have picked up the delays recorded in pushing thorough fiscal consolidation. On October 10th, Standard & Poor's placed Serbia ratings (BB-) on negative credit watch. The main reason behind this decision is the deteriorating fiscal metrics. In the rating agencies thinking, meaningful fiscal reforms have yet to be launched despite the strong mandate the government received in last April elections even though the rating agency took note of the recently adopted labor and pension laws, the bankruptcy, privatization and restructuring of state-owned-enterprises (SOEs). The government's main challenge in the period ahead, fiscal consolidation, is doubtful to occur, unless there is the policy anchor of a new IMF agreement.

On the other hand, there is an urgent need to support the reconstruction activity after the damages of the catastrophic floods have been crystallized. The flash GDP estimate in Q3 is illustrative of the necessity to support the economic activity (-3.7% yoy in Q3 vs. -1.1% yoy in Q2).

Inflation outlook has that far been predictable. Inflation is now expected to trend higher (Sep14 reading: 2.1% yoy vs. Aug14 reading:1.5% yoy, annual average inflation Jan-Sep: 2.1% yoy) 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 hikes (by 4.8% in October and further by 3.6% in November) in the pipeline, together with the rising food and vegetable prices reflecting the impact of the catastrophic floods on agriculture, will most probably push inflation higher towards 5% yoy, so that the average inflation will stand around 3%. In contrast, the weak domestic demand still plays a major disinflationary role amid relatively contained inflationary expectations. The implementation of cuts on public wages and pensions as a part of the budget revision will most probably put even more pressure on consumer spending.

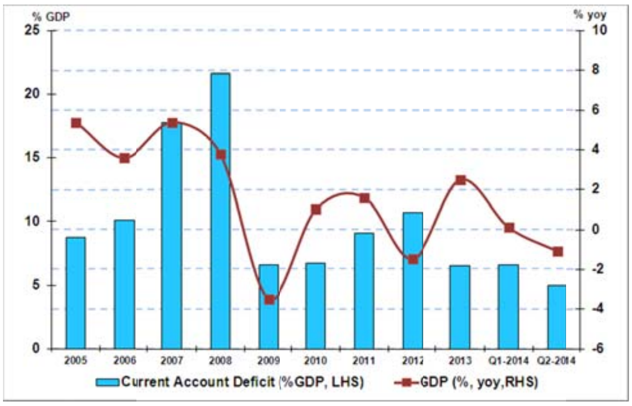
Further easing is on the cards provided the inflation outlook remains predictable and supportive and there are no more unfavorable developments in the international scene. However, we now expect that that it will most probably not take place until at least uncertainties with respect to a new regular IMF agreement plan disappear, a new Eurobond issue has been placed in international markets and the details of a credible fiscal consolidation plan in the budget of next year are finalized. All in, we see room for another 50bps cuts at least not before the end of the current year, but most probably during Q1-2015.

Serbia: Eurobank Forecasts

	2011	2012	2013	2014f
Real GDP (yoy %)	1.6	-1.5	2.5	-1.0
Inflation (yoy %)				
CPI (annual average)	11.2	7.3	7.9	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	-8.0
Gross Public Debt	48.2	60.2	63.8	73.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	23.0	23.9	22.1	19.5
Wage Growth *(total economy)*	11.1	8.9	5.7	2.0
External Accounts				
Current Account (% GDP)	-10.5	-12.3	-6.5	-5.2
Net FDI (EUR bn)	1.8	0.7	1.2	0.8
FDI / Current Account (%)	63.7	21.1	77.5	55.0
FX Reserves (EUR bn)	12.1	10.9	11.2	10.5
Domestic Credit	**2011**	**2012**	**2013**	**Q2-2014**
Total Credit (%GDP)	72.2	66.2	60.8	61.2
Credit to Enterprises (%GDP)	40.5	36.1	30.7	26.8
Credit to Households (%GDP)	22.0	19.3	18.6	18.9
Private Sector Credit (yoy%)	5.9	9.7	-4.5	-3.9
Loans to Deposits (%)	141.9	144.6	136.9	137.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	8.50	8.50	8.00	8.00
EUR/RSD	119.45	121.00	122.00	120.00

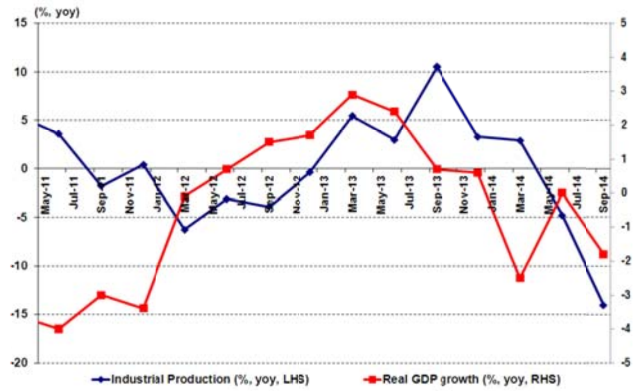
Source: National Sources, IMF, Eurobank Research & Forecasting

Figure 1: GDP Growth & CA Deficit in Serbia



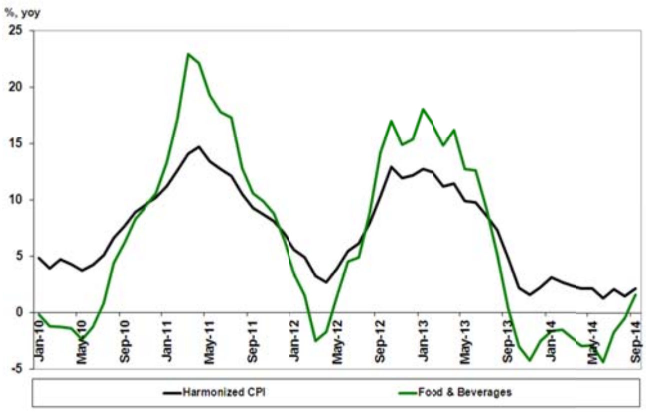
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia

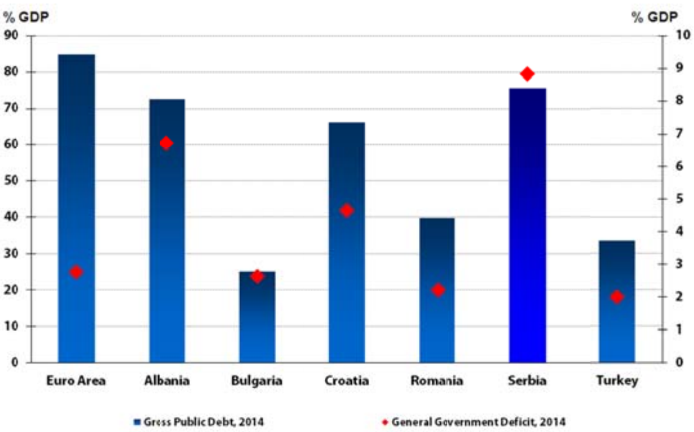


Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate in Serbia

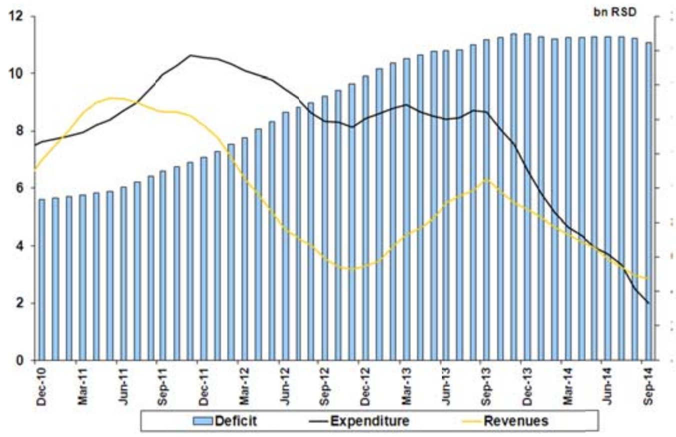
Source: NBS, Bloomberg, Eurobank Research

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



Source: IMF WEO October 2014, Eurobank Research

Figure 6: Deficit from 2010 in Serbia



Source: Ministry of Finance, Eurobank Research

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