ISSN: 2241-4843

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

Eurobank

NEW EUROPE
ECONOMICS & STRATEGY

September 10, 2013

FOCUS NOTES: SERBIA

Written By:

Ioannis Gkionis:
Research Economist
New Europe Specialist

Successful cabinet reshuffle averts early parliamentary elections

- **The departure of the party of the regions (URS) from the government coalition has decreased parliamentary backing to a slim and fragile majority**
- **Even though budget performance improved in July, sustained and sizeable fiscal consolidation effort is still missing**
- **Monetary easing paused: NBS left interest rates unchanged at 11% for a second consecutive month in August and is expected to leave them unchanged again in September**

Domestic political noise during the summer led to cabinet reshuffle in early September

Tensions among coalition partners led to a mini political crisis during the summer. The tensions between the minor coalition partners Socialist Party of Serbia (SPS) and the party of the regions (URS) culminated in a cabinet reshuffle which was completed in early September. In the aftermath of the reshuffle, the ministers nominated by the party of the regions (URS) departed from the cabinet and the party withdrew its parliamentary support.

The resignation of the party leader, Mr. Mladan Dinkic, from the post of Minister of Finance & Economy led to the split of the Ministry into two individual posts and another minister without portfolio was added. The post of Minister of Finance was assumed by Mr. Lazar Krstic nominated by the SNS (Serbian Progressive Party). Consequently, the cabinet grew to 22 members compared to 17 previously.

After long discussions during the summer, the endorsement of the new cabinet by the parliament took place on Sep 3rd. The cabinet received support from the parliament members of the two biggest coalition parties (SPS and SNS) plus two minor parties (PUPS and SPO-DHSS group) and various independent MPs. As a result, the cabinet was endorsed by 134 MPs out of a total 250 MPs, 65 were against while 51 abstained.

In our view, the cabinet reshuffling may entail some serious implications for the domestic political and economic landscape. On the positive side, early parliamentary elections that would endanger the fragile economic sentiment were averted at the moment. Yet, the cabinet reshuffle has increased worries over the stability of the present government coalition. The departure of Mr. Mladan Dinkic from the government coalition has decreased parliamentary backing to a slim and fragile majority.

In addition, the reshuffled government cabinet will be confronted with significant challenges with less political capital. First of all, economic growth remains relatively weak and unemployment is still at very high levels (24% in Q2-2013). The growth rebound in 2013-2014 is expected be modest. The economy has just turned the corner the corner driven by the automotives and petroleum products industry boost in order to start recovering from the double dip recession. GDP growth slowed down to 0.7% yoy in Q2 down from 2.1% yoy in Q1. Although negative base effects from last year's second quarter kicked in, economic activity moderated in a number of key sectors (industry and services).

Our full year forecast stands higher 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 contribution of domestic demand remains negative and fails to support economic growth (Figures 1,2).

In addition, the new Minister of Finance has vowed to come up with spending cuts to bring down the fiscal deficit to 4% of GDP by the end of 2014 down from an official projection at 6.5% in 2013. Savings ought to come from the expenditure side. From that point of view, pensions and public wages look particularly vulnerable. Yet, implementing spending cuts may again be a point of confrontation between the coalition partners. Spending cuts in pensions are strongly opposed by PUPS which controls 12 seats in the parliament.

Moreover, the agenda of the reshuffled government includes also the implementation of structural reforms in the areas of public enterprises and pension system reform with an eye on negotiations about a new IMF agreement. Inevitably, the tensions between partners may rise again leading to early parliamentary elections. In our view, the prospects of 2013-2014 will depend on the preservation of social and political stability.

On the other hand, this is not the first time the party of the regions and its leader has ever withdrawn from a government coalition. The party of the regions (URS) was a coalition partner in the previous administration as well. The previous Prime Minister, Mr. Mirko Cvetvovic had dismissed Mr. Mladan Dinkic in February 2011. That led to another political crisis and subsequently to another cabinet reshuffle. In contrast, the party of the regions has withdrawn its parliamentary support this time which has increased the probability of early parliamentary elections.

The Central Bank of Serbia (NBS) left the key policy rate unchanged at 11% for a second consecutive month in August. In a broadly expected decision, the Central Bank of Serbia (NBS) left the key policy rate unchanged at 11% for a second consecutive month on August 8th. The beginning of the easing cycle took place in last May. Ever since, the NBS cut rates by a cumulative 75bps in the last two meetings in May and June. The move was expected by Bloomberg consensus (14 of 24 analysts expected no rate change).

In the statement released, the Central Bank assessed that given low demand side pressures and the prospect of lower food prices, 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 October2012. 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 July, inflation slowed further down to 8.6% yoy, displaying a monthly decrease of 0.9%, which reflected of the seasonal drop in vegetable prices. (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 after the FED signaled a reduction in the QE.

In our view, the Central Bank made a pause in the motivated by the volatility in the financial markets and the negative impact on the Dinar against a backdrop of domestic political uncertainty triggered by the unfinished at that time cabinet reshuffle. Even before the eruption of political uncertainty, the urgent need for additional fiscal consolidation measures weighed negatively on further rate cuts. 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).

Budget performance improved in the first seven months of the year on better VAT revenues collection and cuts in capital spending.

Budget implementation improved in July both on the republican (central government) and consolidated government level. The monthly deficit at the republican level came at a record low of RSD 2.8bn in July down from RSD 4.3bn in June. At the consolidated government level, the deficit was contained at RSD 2.3bn, the lowest reading since the beginning of the year.

The overall assessment of the fiscal performance was that the budget expenditures (+2% yoy) were more or less under control in the first seven months. Spending remained subdued as a result of large cuts in the areas of capital spending (-38% yoy), subsidies (-6.9% yoy) and goods & services (-2.8% yoy). In contrast, interest expenditure (+52.2% yoy) and personnel expenditure (+6.3% yoy) weighed negatively on the cost containment effort.

On the other hand, budget revenues performance (+6.2% yoy in Jan-July) improved yet it remained below inflation. On the positive side, VAT revenues (+9.9% yoy) and excise taxes collection (+18.1% yoy) were those categories of current revenues with the highest nominal growth. The improvement trend is explained by the VAT rate hike in last October as well as zero tolerance policy on tax offenders imposed by the Ministry of

Finance in the last couple of months.

All in, the consolidated government (central government plus social security institutions and local governments) fiscal deficit narrowed by 26% yoy to RSD 83.3bn in Jan-July 2013 down from RSD 111.2bn in Jan-July 2012 vs. a full-year target of RSD 195bn. In terms of projected GDP, the consolidated government deficit stood already at 2.3% in 7M-2013 down from 3.3% in the same period of 2012. (Figure 6)

Sustained, consistent and sizeable fiscal consolidation effort is required to restore fiscal position soundness and improve investors' confidence

The lack of a sustained and sizeable fiscal consolidation strategy has sent 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).

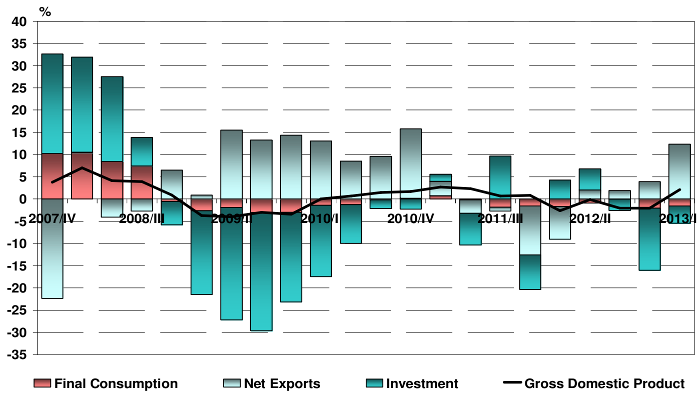
Despite some fiscal consolidation measures introduced by the incoming government cabinet in the 2H-2012, the fiscal position of the country showed no visible signs of improvement in the past year. The adoption of a supplementary budget did not prevent a significant post-election current expenditures 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. 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.

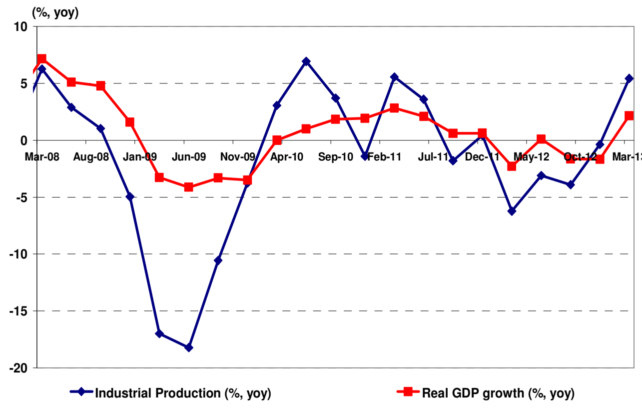
The Fiscal Council, an independent institution, warned that unless additional measures are adopted, the consolidated government deficit is expected to overshoot the revised target reaching 5.5-6% of projected GDP in 2013. For that reason, tangible fiscal consolidation and additional restraint, particularly on the expenditures side, is needed (total expenditures accounted for 49% of the projected GDP in 2012).

Figure 1: Quarterly GDP components



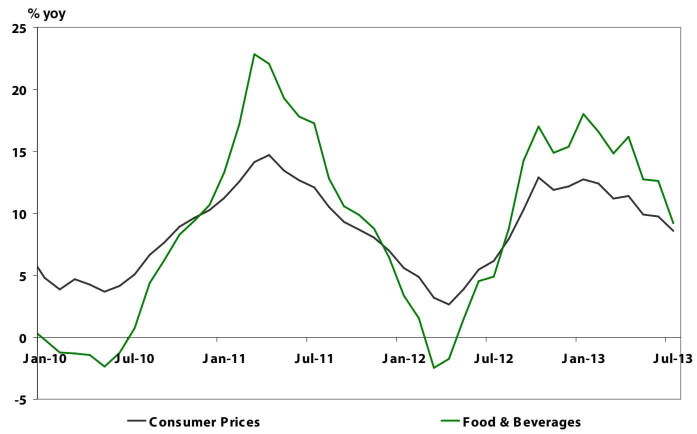
Source: National Statistics, Eurobank Research

Figure 2: Industrial Production in Serbia



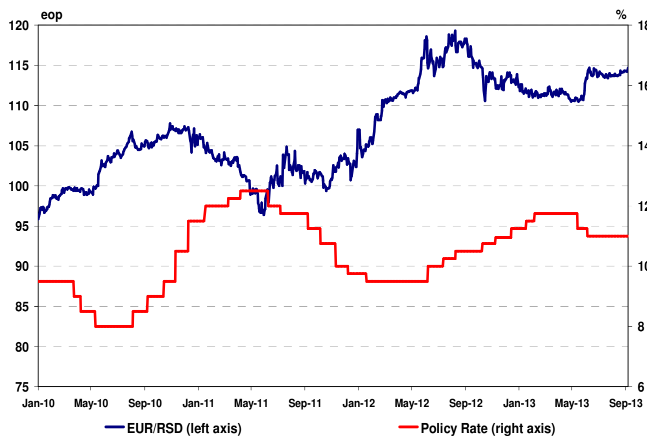
Source: National Statistics, Eurobank Research

Figure 3: Inflation measures in Serbia



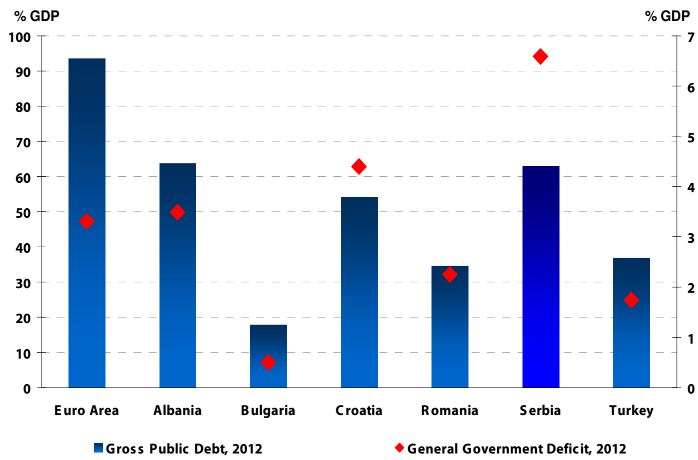
Source: National Statistics, Eurobank Research

Figure 4: FX & Policy rate



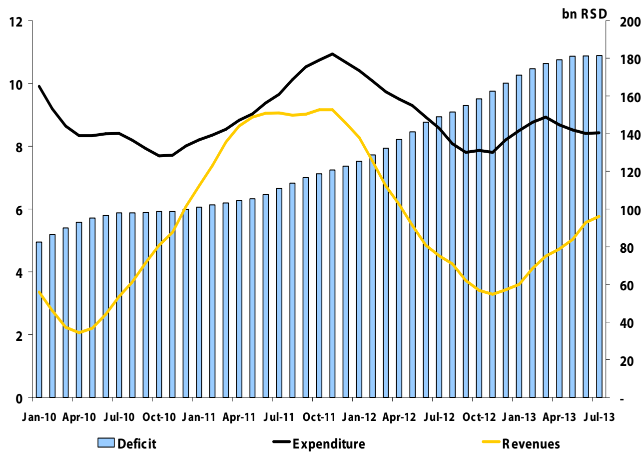
Source: NBS, Bloomberg, Eurobank Research

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



Source: IMF WEO, Eurobank Research

Figure 6: Deficit from 2010 in Serbia



Source: Ministry of Finance, Eurobank Research

Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank Group

Financial Markets Research Division
Platon Monokroussos: *Head of Financial Markets Research Division*
Paraskevi Petropoulou: *G10 Markets Analyst*
Galatia Phoka: *Emerging Markets Analyst*

Economic Research & Forecasting Division
Tasos Anastasatos: *Senior Economist*
Ioannis Gkionis: *Research Economist*
Vasilis Zarkos: *Economic Analyst*
Olga Kosma: *Economic Analyst*
Maria Prandeka: *Economic Analyst*
Theodosios Sampaniotis: *Senior Economic Analyst*
Theodoros Stamatiou: *Research Economist*

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

ISSN: 2241-4843