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# NEW EUROPE ECONOMICS & STRATEGY

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FOCUS NOTES: SERBIA

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## Output contraction slowed down in the second quarter of 2012

- GDP contraction slowed down to -0.8% yoy in Q2-2012 compared to -2.5% yoy in Q1-2012 driven by improved manufacturing and retail trade sectors performance
- The government tapped successfully international markets in early October
- The NBS hiked interest rates by 25bps to 10.75% for the fourth time since June 2012
- EU Commission decided to postpone the date of Serbia's EU accession negotiations on insufficient progress on the Kosovo issue

### Output contraction slowed down on a yearly basis in the second quarter on improved manufacturing and retail trade sectors performance

After contracting for four consecutive quarters on a seasonally adjusted basis, output growth moved into positive territory in the second quarter. GDP growth expanded by 2.1% qoq in Q2-2012 vs. a -1.9% qoq contraction in Q1-2012. However, economic activity remained in red on a yearly basis for a second consecutive quarter. GDP growth came at -0.8% yoy in Q2 down from a -2.5% yoy in Q1 (heavily revised from an initial -1.3% yoy estimate).

In terms of supply side growth drivers, agriculture was the main drag on growth. Agriculture contracted by -17.2% yoy in Q2 compared to -19% yoy in Q1 on severe weather conditions in the 1H-2012 (from heavy snowfall in Q1 to summer draught in the end of Q2). The positive news of the reading is the rebound of the manufacturing and retail trade sectors. Manufacturing expanded by +3.2% yoy in Q2-2012 vs. -3.1% yoy in Q1-2012, the first positive reading since Q2-2011. The recovery in the manufacturing sector was supported primarily by the positive base effects stemming from the relaunching of industrial production activities in Q2 after heavy winter. In addition, wholesale and retail trade recorded a positive reading (+2.0% yoy in Q2 vs. -2.2% yoy in Q1) for the first time since Q4-2010. Most probably, retail trade benefited from the surge in pre-election spending.

Construction, a sector which posted double digit growth in the previous quarters landed to single digits. Construction slowed to 1.2% yoy in Q2 down from 10.3% yoy in Q1 and 10.6% yoy in Q4-2011 which reflects the postponement of public infrastructure investment projects. Besides retail and wholesale trade, transportation (+4.2% yoy), information technology (+11.7% yoy) and financial services (+4.2% yoy) displayed dynamic performance as well.

The latest growth reading validates the view we expressed in our last focus note (http://www.eurobank.gr/Uploads/Reports/14_

New%20Europe%20Focus%20SERBIA_19-09-12.pdf) on Serbia that recession is deepening. The heavy downward revision of the first quarter's data (from -1.3% to -2.5%) brought 1H-2012 output losses at -1.7% already. A number of headwinds, both in the domestic and international macroeconomic environment, have materialized for the Serbian economy. The Euroarea sovereign crisis has had a negative impact on net exports (more than 60% are heading towards EA) which translates into lower manufacturing activity. At the same time, volatile weather conditions had a negative impact on key economic sectors such as agriculture, mining and energy production in the 1H-2012. The eruption of a fiscal crisis in the post election landscape made things only worse. On the other hand, the initiation of the FIAT automobile plant production, the reintroduction of subsidized loans programs for exporters are good news and can contain output losses in the 2H-2012.

Overall, the economy has slipped into a new round of recession, the second in the past three years. After posting an anemic growth rebound of 1% in 2010 and 1.6% in 2011 the economy is set to contract by -1.5% in 2012 according to our latest forecast. On the grounds described above, the NBS has revised downward its growth forecast to -1.5% in 2012 from -0.5% previously. In its latest regional economic prospects reports, EBRD revised its growth forecast to -0.7% in 2012 vs. a marginal +0.1% previously.

**Supported by the favorable market conditions, the government of Serbia tapped international markets successfully in early October**

Motivated by the favorable market conditions, the government tapped the international markets on October 5th. The government utilized last year's 10 year Eurobond issue (2021 maturity) to raise an additional $1bn at 6.625% yield. The demand for the Serbian government bonds was strong. The bid to cover ratio was four times, an illustration of the high investors demand for Serbian government bonds. The successful tapping of the international markets is an event of particular importance. Firstly, the government accomplished to issue those bonds at lower cost than last year. Indeed the spread over US bonds came at 497bps compared to 561bps a year ago. Secondly, the demand for the issuance was strong despite the visible deterioration in the macro environment and the fiscal situation and the downgrade of the Standard & Poors by one notch to BB- in early August. More importantly, the government was able to tap the international markets with the IMF precautionary agreement on freeze. Effectively, the IMF put the precautionary agreement on freeze since last February, because it challenged the outgoing government commitments on the agreement framework. The precautionary IMF agreement serves a cushion for external financing needs and acts as an anchor of expectations for investors, thus reducing the risk premium of the country. Lastly, the successful issuance enabled the government to cover a large part of the financing needs of the remaining year according to the funding plan (€1bn out of the 1.5€ bn).

Looking ahead, the government has expressed its intention to tap the markets again to start addressing the financing needs of 2013. The Minister of Finance Mr. Mladan Dinkic has stated that the government may issue new bonds before the end of November if market conditions remain favorable. The Treasury may initiate another Eurobond sale issuance ($500 mn) if yields donot exceed the threshold of 5.5%. In any case, although the situation is still manageable, it will be harder to get access to funding in 2013 given the difficulties posed by the Euroarea sovereign debt crisis, the riskier sovereign profile of Serbia and the size of public financing needs (approximately €4bn according to Ministry of Finance estimates).

**EU Commission enlargement report ties Serbia's accession to European Union upon progress in the Kosovo issue**

The EU Commission adopted its annual progress report on enlargement (the so-called European Enlargement package) on October 10th. The report contained an assessment of the progress made by Serbia towards EU accession over the past year. The Commission concluded that Serbia continues on its way to sufficiently fulfilling the political criteria and the conditions of the Stabilization and Association process.

However, the report tied the opening of EU accession negotiations upon the full normalization of relations with Kosovo. The latter lingo is interpreted by the Serbian authorities as an equivalent of de-facto recognition of Kosovo sovereign independence, which EU officials have persistently denied.

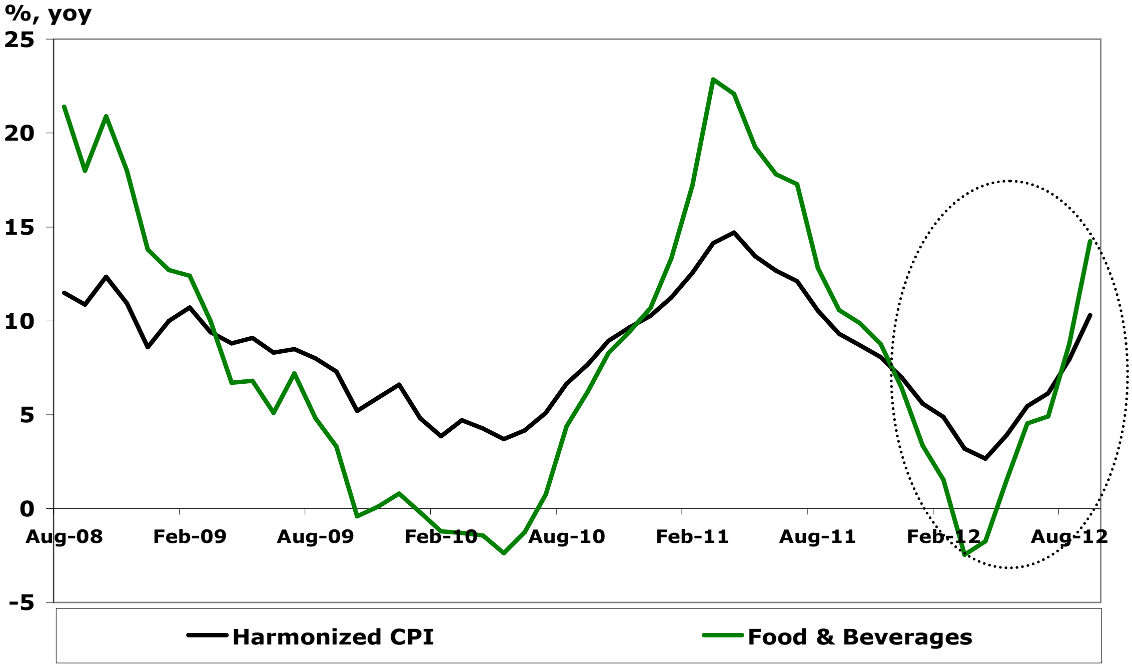
In the previous round of negotiations before May parliamentary and presidential elections, there was limited progress in a number of areas. However, both parties remain still far away from establishing a working relationship. The incoming government coalition has stated that it will not recognize the sovereign independence although it will respect the agreements reached by the outgoing government. Yet, the new cabinet has not kick started the process again. In conclusion, the Kosovo dispute may push the date of accession negotiations even further back. On the other hand, the support of Serbian citizens towards EU membership is waning. According to the latest surveys, the popularity of EU membership has dropped to the lowest level of the last five years.

**The NBS hiked interest rates by 25bps to 10.75% for the fourth time since June 2012**

On October 9th, the NBS hiked interest rates by 25bps to 10.75%. This was the fourth hike since June 2012 when the rate hiking cycle begun, bringing the cumulative hikes at 125bps. In a statement released after the policy meeting, the Central Bank cited the inflationary effect of higher agricultural product prices, the anticipated rise in administered prices, the hike in the VAT tax and excise taxes and their ensuing impact on inflation expectations as the main reasons for the rate hike. Yet, NBS underlined the temporary nature of the supply side shock and that low aggregate demand will have a strong disinflationary impact on consumer prices.

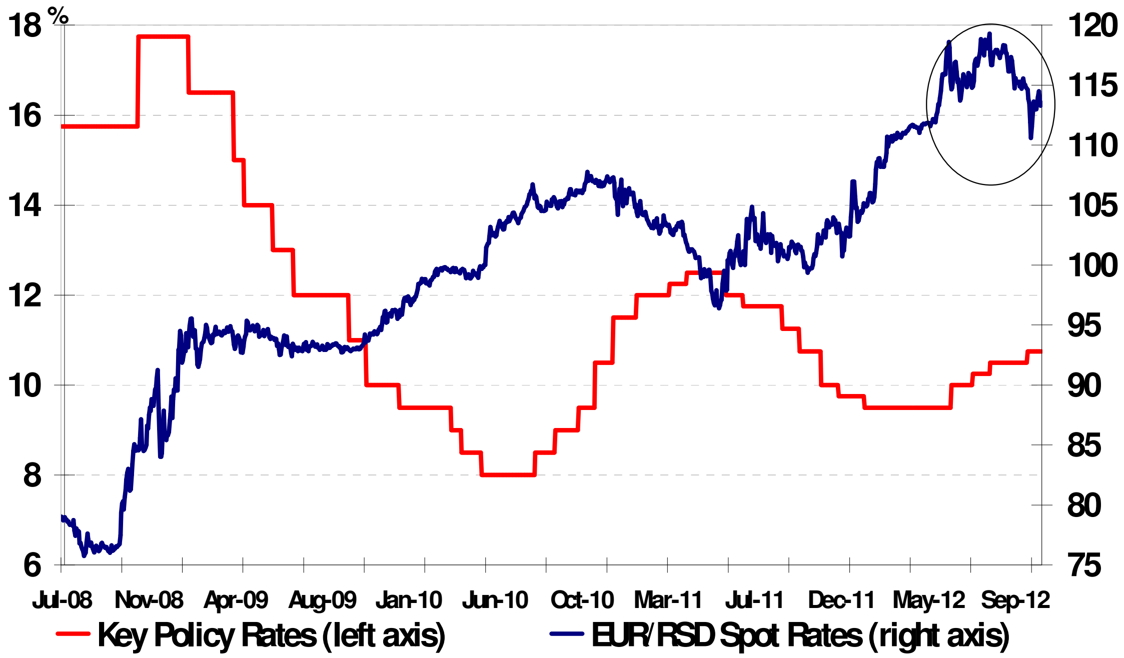
After bottoming out in April, inflation started accelerating in the summer months. Inflation has now reached 10.3% yoy in September compared to 7.9% yoy in August against only 2.7% yoy in last April (Figure 1). We now see inflation trending even higher at 12-13% by year-end, significantly above the target band of the Central Bank (4+/-1.5%). According to the Central Bank projection inflation will peak in 1H-2013. Then, disinflation is seen resuming in the 2H, assisted by favorable base effects. Looking ahead, the Central Bank has conditioned further hikes upon the impact of the fiscal consolidation strategy of the government, the success in containing inflation expectations and the impact of the external environment. Moreover, two important factors will weigh decisively by the end of the year. Firstly, an appreciation of the Dinar in the last quarter of the year could help contain inflationary pressures. The Dinar has recovered modestly in the last two months recouping some of its earlier losses in the year (trading at 113.87/€ on October30th against a year low at 119.3/€ on August 8th) (Figure 2). Dinar has benefited from the recent increase of the Dinar allocation in FX required reserves and the introduction of a new FX-indexed subsidized loan program for exporters. Secondly, the approval of a new regular IMF agreement could reduce sovereign risk premium. Ceteris paribus, we currently see room for further rate hikes of as much as 100bps in the last two policy meetings of this year.

**Figure 1**
**Inflation skyrocketed to 10.3% in September against only 2.7% in last April on food prices rally**




Source: National Statistics, Eurobank Research

**Figure 2**
**Dinar recouped some of its losses against € in September-October**




Source: NBS, Eurobank Research

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