8. International Environment

Although the global recovery is continuing, it is below expectations, primarily because of the slowing down in the United States, the Eurozone and China. The European Central Bank (ECB) announced new measures of HOV purchase to stimulate credit growth while the FED is drawing closer to the end of its "quantitative easing" although it is still uncertain when the key policy rate will be raised depending on indicators on the labor market. A new European Commission President has been named and he laid out a plan to stimulate the European Union economy while China also announced a program of measures to stimulate growth which includes a fiscal package. The main risks to global recovery are geopolitical – the crises in the Ukraine and the Middle East could slow growth and cause oil prices to rise. In Eastern Europe, the main risks continue to be the slowing down of the Eurozone and negative effects of the impending raising of the FED key policy rate which could raise the cost of debts and a drop in currency value especially in countries which have a high level of public debt and current account deficit.

The World

The International Monetary Fund (IMF) reduced its prediction for the world growth rate for 2014 from 3.7% to 3.4%. That prediction was lowered because of the slower growth in the US and China whose growth slowed because of a drop in domestic demand. The sanctions imposed against Russia affect not only domestic growth but also the economy of the Eurozone. The predicted growth rate for the US in 2014 was lowered from 2.8% to 1.7%, for China from 7.6% to 7.4% and from Russia from 1.3% to 0.2%. The growth rates for Japan, Germany, Spain and Great Britain were increased and lowered for France, Italy, Brazil and South Africa. The growth rate for the Eurozone was not changed (1.1%) and was raised for eastern Europe from 2.4% to 2.8%.

Since bank interest rates have been lowered in developed countries due to expectations that the expansive monetary policy would be longer lasting, capital has been placed in bonds of developing countries for the sake of higher income and the conditions of financing for those countries have improved and their currencies have grown stronger. In response to the slowing of growth, China has announced a fiscal package, reduced taxes for small and medium sized companies, started infrastructure projects and reduced the mandatory reserves in banks which, taken all together, will stimulate growth. The ECB has expanded its program of purchasing HOV to motivate banks to offer credit to companies and the new president of the European Commission has announced new measures to stimulate the economy. The new risks to global growth are geopolitical – a possible escalation of the conflicts in the Ukraine and the Middle East which could result in higher oil prices. The risk to developing countries is a possible growth of the cost of debts if the interest rates in the US rise quicker than predicted.

Besides the slowing down in the Eurozone, the sanctions which the EU imposed against Russia have had a negative effect on the growth of the Eurozone and will have a similar effect on growth in Serbia unless the Serbian economy increases its exports to Russia as an alternative to European companies but the chances of that happening are relatively small. Also, the sanctions are having a negative effect on growth in Russia and Russian demand for Serbian goods is dropping.

The Eurozone

The European Parliament elected Jean Claude Junker as the new President of the European Commission. His agenda includes a number of economic and institutional reforms. A total of 300 billion Euro have been earmarked for public and private investments in economic infrastructure in the next three years. Small and medium sized companies are faced with complicated bureaucratic procedures and a simplification of those procedures will stimulate entrepreneurship. In order to cut down dependency on Russia, the New Energy Union will include new countries from which fuels will be imported and domestic production will focus on renewable sources. Industrial policy is aimed at increasing the industry share of the GDP in the EU from the current 16% to the 20% of earlier years by the year 2020. Stricter control of banks has been announced as well as an integrating of the capital market along with support for TTIP arrangements with the US. Junker's statement that no country will become a full EU member in the next five years indicates that the anti-European block is exerting pressure over further expansion even though negotiations are underway with 6 countries, including Serbia. The agenda includes greater democratization in the EU with a greater role to be played by the European Parliament and influence on decisions by the European Commission.

The growth of the GDP in the Eurozone during Q2 stagnated at quarterly level while the growth rate at annual level stood at 0.7% which is below what economists expected. Personal spending showed a growth of 0.3% q/q, but investment spending dropped –0.3% q/q and state spending showed a slight growth of 0.2% q/q. Imports showed a lower growth (0.3% q/q) than exports (0.5%q/q), and the net exports had a positive effect on growth. Economic activity is still under the influence of fiscal consolidation and the plan is for the budget deficit to be lower in 2014 and 2015 by 0.5 percentage points each year. The Eurozone cannot be expected to have a growth higher than 1% this year and since the economy is slowing down some countries might get a free pass if they do not meet the budget consolidation plans. Spain and Portugal recorded GDP growth in Q2 of 0.6% q/q and Greece recorded the first positive quarterly growth following 16 negative quarters which indicates that the consolidation and structural measures probably had a positive effect on competitiveness. The GDP in Germany dropped by –0.2% q/q because of lower external demand due to the conflict in the Ukraine and a drop in business sentiment and partly because of the high growth in Q1. The growth in Germany in 2014 will probably stand at around 2%. Italy also recorded growth in Q2 – 0.2% q/q, but that is the second consecutive negative quarterly result which technically puts Italy back in recession. Growth in Italy will probably not be higher than 0.2% this year. The slowing down of growth in Italy and Germany will have a negative effect on Serbia's exports.

Although the ECB lowered its refinancing rate to 0.15% in June with the aim of stimulating the growth of credit and lowering real interest rates, the growth of bank credits continues to be slow, just slightly higher than in Q1. The lowering of the refi rates and other ECB measures did not have any great influence on the cost of credit for companies but did have an effect on the cost of credit for states. Interest on bonds from peripheral countries were lowered. In order to increase the influence of monetary policy on the economy through monetary channels and reduce the risk of deflation, the ECB lowered the refi rate in September to 0.05% and the rate on deposits to -.2%. Also, to stimulate banks to give credit, the purchase of ABS bonds was announced but a detailed plan will be revealed in October. The announced measures were partly unexpected and the Euro dropped to below 1.3 to the Dollar. Since the political situation in the Eurozone is complex there is not quantitative easing of the kind implemented by the FED but if growth slows down further and inflation continues to fall, the ECB will have no choice but to start a comprehensive purchase of Eurozone state bonds.

Overall inflation in the Eurozone dropped in Q2 from 0.7% in April at annual level to 0.3% in August. Base inflation is relatively stable – oscillating at around 0.8%. Low inflation has a positive effect on the purchasing power of consumers, especially since salaries are stagnating, but the negative effect is the fact that it makes it harder for the population and the state to repay their debts. Low inflation is caused by low personal spending and lower food prices. Negative inflation in July was recorded in Bulgaria (-1.1%), Greece (-0.8%), Portugal (-0.7%), Spain (-0.4%) and Slovakia (-0.2%). The highest inflation in July was in Austria (1.7%) and Romania (1.5%).

The unemployment rate in the Eurozone dropped slightly from 11.6% in April to 11.5% in June which is a reduction of about 450,000 people. The lowest unemployment rate was in Austria (5%), Germany (5.1%) and the highest in Greece (27.3%) and Spain (24.5%). The unemployment rate is dropping in the peripheral countries – Spain, Portugal and Ireland which is another sign that fiscal consolidation and structural reforms are probably starting to show positive effects.

The United States

In Q2, the US achieved a growth of 1% q/q and 2.4% at annual level, which is a speeding up compared to Q1 when growth stood at 0.5% q/q.

Final spending was higher than expected which indicates that the lower unemployment rates are starting to affect demand slowly and the level of available income is higher for the population. However, the rise in income is having an influence on increasing savings more than on spending and the continued rise in spending will depend on how sure the population is that the economy is recovering. State spending in Q2 contributed to higher than expected growth because the growth rate was higher than in Q3 2012, primarily at local level. Unlike demand which is seeing improvement, the situation is different with demand. Companies are investing less than expected into fixed investments and they have downgraded their profit predictions.

The FED has lowered its monthly purchases of HOV from 35 to 25 billion Dollars as expected and the quantitative easing will be finished in October. There were no changes in interest rates. Since the earlier target for the unemployment rate has already been achieved (6.5%), the question now is what will make the FED decide to start raising the key policy rate. Since a further drop in unemployment is expected and the recovery is not yet certain, the FED will start using other target activities on the labor market to base its decision on when to start raising the key policy rate. That will most probably bee a rise in real salaries. The FED board members do not agree on whether the incomplete capacities of the economy have been caused by lower domestic demand or whether the reason lies in the structural difference between offer and demand on the labor market. The market expects a higher key policy rate in mid-2015.

The unemployment rate in August stood at 6.1% but that figure does not make it simple to draw conclusions on the situation on the labor market. That low unemployment rate is caused to a great extent by the low participation on the labor market. Although the unemployment rate is dropping, there is no significant increase in wages rates which means that there is no significant inflationary pressure on the labor market. Those will most probably appear once the unemployment rate drops to around 5.5%.

Eastern Europe

Growth in Eastern Europe will be higher than last year on the average but the situation is different in each country. The crisis in the Ukraine and the slowing down in the Eurozone have had a negative effect on growth in Eastern Europe. The lowering of interest rates in developed EU countries has increased demand for state bonds in Eastern Europe and most countries have secured financing for this year. However, despite that the greatest challenges in terms of public debt are facing the countries of the former Yugoslavia which are mainly late in implementing structural reforms. Possible risks to the level of cost of credit and stability of their currency can appear once the FED specifies when it will start raising the key policy rate. The countries which will be especially vulnerable will be those with high levels of public debt and current account deficits. It is possible that the negative effects of the FED decision can be eased if the ECB starts a massive purchase of state bonds which would increase the demand for the bonds of Eastern European countries and reduce the cost of credit. Inflation is low in Eastern Europe and many central banks are using this by lowering their key policy rates to stimulate the economy.

Romania

Romania has achieved a growth in Q2 of 1.2% at annual level but its quarterly growth was negative –1% q/q. The main reason for the low growth are disappointingly low investments (-4.4% q/q) and investments in equipment at annual level dropped by 16%. State projects stalled and companies are postponing new investments because they are repaying old credits in foreign currency. Imports and exports also showed a negative quarterly growth. The GDP is predicted to grow in 2014 by about 3%.

Prime Minister Ponta ended his cohabitation with President Basescu and elections are due to be held in November. After the dues paid by employers were lowered by 5 percentage points, the risk rose that the goal of a budget deficit below 3% appeared because, despite criticism from the IMF, the government did not specify how the lower income (200 million Euro) caused by those measures would be compensated. The government has no intention of lowering salaries and pensions prior to the elections and the cost of credit could possibly rise while the "silent war" with the IMF is ongoing. A temporary exceeding of the planned budget deficit level will most probably be short-term and Romania's public debt will not go over 40% of the GDP in the next few years.

Work over the winter which the government organized as a kind of social measure were completed in Q2 and the unemployment rate is expected to rise slightly (7.1% in June) in the second half of the year. The central bank has kept its key policy rate at the level of 3.5% but has lowered the rate of mandatory reserves for foreign currency from 18% to 16% which will release some 300 million Euro in the banking system. This surplus of funds will be used to pay dues to the head offices of foreign banks, invest in companies and state bonds. Overall annual inflation in June stood 0.7% and a drop in prices was registered at monthly level primarily because of a drop in food prices. That was the sixth month that overall inflation stood under the target of the central bank of 2.5% +/-1%. If inflation continues to be below the target, the central bank will probably continue to lower its key policy rate.

Croatia

Croatia recorded negative GDP growth at annual level (-0.8%) in Q2 once again. Domestic demand continued to be low, personal spending is under pressure from high unemployment while fiscal consolidation has a negative effect on investments. The tourist season had a positive effect on the current account balance but foreign direct investments are still low and Croatia is not making sufficient use of EU funds. The GDP growth rate will be negative again this year (about – 0.5%). The central bank's monetary policy is still accommodative to raise liquidity and credit growth. The main risk to monetary policy is higher volatility of the exchange rate. Croatia had deflation during Q2 with inflation in June standing at –0.4% at annual level. Inflation will start to rise in the second half of the year because the effects of the low base will be gone. According to Eurostat data, the unemployment rate is dropping and has gone from 17% in April to 16.3% in June but we won't know until the end of the tourist season whether the drop in unemployment is just temporary. The Fitch credit agency lowered the rating level for Croatian bonds to BB because the budget deficit will be higher than planned, structural reforms are not being implemented and the GDP growth rate continues to be negative. Health care dues will be increased following a reduction and there are plans to raise property taxes. Ways of filling the budget through the income side have been exhausted because Croatia has higher tax rates than most countries in the region. Structural reforms are necessary to increase the flexibility of the labor market, restructuring and the privatization of public companies.

Hungary

The GDP growth rate in Q2 stood at 3.9% at annual level and 0.8% at quarterly level which is higher than expected. Although Hungary has significant economic ties with Russia and the Ukraine, the Hungarian economy has managed to annul the negative effects. Primarily the production of automobiles was stimulated by increased capacities of Audi and Mercedes and the construction industry was helped by state infrastructure projects. Better results in almost all sectors caused the prediction of the growth rate for 2014 to rise to above 3%.

The Hngarian central bank ended the cycle of lowering the key policy rate which it started in August 2012 when that rate stood at 7% and it was reduced in July to 2.1%. That level secures the desired inflation and stimulates growth. The European Commission warned Hungary that the insufficient reduction of the public debt requires added fiscal consolidation. Finance Minister

Varga then announced a new package of austerity measures worth 110 billion Foring (0.35% of the GDP) to keep the deficit at the level of 2.9%.

Hungary has kept its budget deficit below 3% for years but that is not enough to reduce the debt to GDP ratio. The debt will increase because of plans to build a nuclear power plant through Hungarian-Russian cooperation and that will cost 10% of the GDP. That continues Hungary's economic policy which differs from the desires of the European Commission. But, the Hungarian government proved determined to resolve deficit problems which gives it credibility despite the disagreements with the EU. An example of the government's unorthodox economic policy is the decision aimed at reducing expenses for the population that banks should bear part of the cost of housing loans because of the rise of the Swiss Franc against the Forint. Banks will have to convert mortgage loans into the domestic currency at exchange rates which are not market rates which means a burden on banks of about one billion Euro.

The consumer price index dropped 0.3% in June at annual level but there is no great risk of deflation since monthly inflation was positive and the base inflation stood at 2.6% at annual level. The main causes of the drop in consumer prices was the administrative reduction of expenses for households and low food prices because of the successful agriculture season but since their effects are fading inflation is expected to stand at 1% by the end of the year.

The unemployment rate in July stood at 7.9% which is the lowest in the previous six years. However, even though the private sector contributed to the reduction of the unemployment rate, the cause lies primarily in the state programs of temporary employment without which unemployment would stand at 11.2%.