8. International Environment

The global recovery is continuing but the developed countries, especially the USA and Eurozone, recorded lower than expected growth in Q1. Financial markets stabilized in developing countries but economic activity continues to be relatively low level. China is implementing structural reforms which have slowed down growth while Russia is probably already in recession because the sanctions imposed by the West. The FED is slowly preparing for the end of its aggressive monetary policy while the European Central Bank (ECB) is doing the opposite and introducing unconventional measures to prevent deflation and a strengthening of the Euro. Inflation is dropping globally. Geopolitical risks are increasing. The US and European Union will probably sign a trans-Altlantic agreement later this year while China and Russia have already signed an energy agreement.

The World

According to the latest International Monetary Fund predictions, the growth rate for the world has dropped slightly (by 0.1 percentage point) for this and the next year. Growth in 2014 should stand at 3.6% and at 3.8% in 2015. There were no changes of predictions for developed countries which should see a growth of 2.2% this year and of 2.3% next year. The predictions for developing countries for 2014 was lowered by 0.2 percentage points to 4.9%. The biggest reduction was for Russia which the IMF says is probably already in recession and instead of the earlier 1.9% it should see a growth of just 0.2% in 2014. The prediction for Eastern Europe was lowered from 2.9% to 2.4%.

The IMF defined the three currently greatest dangers to global growth – possible negative effects on growth of low inflation in developed countries, increased risks in developing countries and a higher level of geopolitical risks. The danger of low inflation (and even deflation) is the highest in the Eurozone while the risk of capital fleeing and slower growth is a trait of developing countries with high current and budget deficits. The geopolitical situation is growing more complicated and the relations of the West with Russia and China are deteriorating. Namely, the trans-Atlantic agreement will probably more deeply integrate the US and EU while Russia and China and have signed an energy agreement. Financial markets in the developing countries have stabilized temporarily and the outflow of capital has been stopped but growth continues to be relatively low level.

East European countries suffered the negative consequences of the continuing crisis in the Ukraine but those were less than expected. There were no higher costs of loans because of the geographic proximity of the Ukraine. Moreover, the opposite happened but for different reasons: since the interest rate on state bonds were lowered on the outskirts of the Eurozone, investors looked for higher income and raised the demand for state bonds in Eastern Europe which caused a drop in the cost of loans in the region. Also, the rise in the GDP in Eastern Europe in the first quarter was higher than predicted. Favorable credit conditions and a faster growth of the GDP meant that many states sold bonds with a longer due date to improve the time structure of their public debt. Risk assessment agencies increased the ratings of several East European countries.

The recovery in Eastern Europe could have a positive effect on Serbia's exports but the continuing crisis in the Ukraine could have a negative effect on the Serbian economy. The first negative effect of that crisis on the Serbian economy is the uncertainty over the construction of the Southern Stream gas pipeline. The construction of the Southern Stream was to have been one of the biggest investments in Serbia this year but the delay will have a negative effect on overall investments and will weaken the already low level of economic activity. If the Ukrainian crisis does not end soon, we can expect rising EU and US pressure on Serbia to impose sanctions on Russia. From the point of view of the economy, choosing one side or the other in the Ukrainian crisis would mean that Serbia faces a choice of two bad options – worsening relations with the EU and US or deteriorating relations with Russia.

The Eurozone

The GDP growth rate in Q1 in the Eurozone was less than expected (0.2%). Growth was slow in Italy (-0.1% q/q), Portugal (-0.7% q/q) and the Netherlands (-1.4% q/q). Germany recorded the fastest growth (0.8% q/q), France stagnated (0% q/q) and Spain recorded a higher rate than expected (0.4%) and continued its recovery. A divergence appeared again in the growth by country but that is most probably temporary. The divergence was caused by the mild winter and in places construction activity was high while energy production was low. That caused the growth in the Netherlands to be low since that country's energy sector is significant while the construction industry showed increased activity in Germany because of the good weather. However, Germany is expected to see a drop in exports because of the slowdown in China and the looming recession in Russia. And it wasn't only the weather that defined results. In Spain, domestic demand was strong and growth speeded up while in France, because of fiscal consolidation, private spending was low. The slowing of growth in the Eurozone, especially in Italy, is a bad signal because it will have a negative effect on Serbia's exports.

The ECB lowered the key policy rate from 0.25% to 0.15% and the rate on bank deposits with the central bank from 0% to –0.1%. Both measures were expected because they had been announced earlier but their effects are uncertain since deposits are at a low level while the key policy rate was already close to zero even before the changes. Cheap credit was offered to commercial banks and the sum will be defined by the amount of credit which commercial banks place with companies. Unlike the FED, the ECB cannot simply implement quantitative easing. First, the choice of country from which bonds will be bought is a political issue and second, the mechanism of quantitative easing would have less effect in the Eurozone because companies are financed through banks and not through the financial market. What is more important than those measures is the fact that the ECB lowered the predicted inflation rates, sending a signal to investors to make realistic assessments of the risk of deflation and that it will react to prevent the consequences. That ECB policy prevents the Euro from growing stronger but for now the ECB is not buying unconventional measures such as buying bonds because that is certainly not necessary yet. Overall inflation in the Eurozone dropped in the first quarter and then rose slightly in April. But, in May it dropped again to just 0.5% at annual level which is far below the 2% target. Services inflation had the highest value (1.1%) while the prices of energy and industrial goods stagnated in May (0%). Base inflation dropped from 0.7% in April to 0% in May.

Unemployment in the Eurozone dropped slightly from the start of the year from 11.8% in January to 11.7% in April. The lowest was in Austria (4.9%) and Germany (5.2%) while the countries on the outskirts saw unemployment start to drop – Greece (26.5%), Spain (25.1%) and Portugal (14.6%). The Eurozone saw the trend of dropping unemployment rates among the working population continue and it dropped from 70.3% at the start of the crisis to 68.3% in 2013 while the unemployment rate for the segment of the population between the ages of 55 and 64 constantly rose. The cause of that is the increasingly low level of youth employment. The European Union 2020 strategy plans to increase the average employment rate to 75%. The lowest employment rate is in Greece (53.2%) and the highest in Sweden (79.8%).

In Q1, the Eurozone trade balance surplus stood at 43.9 billion Euro which is just 0.2 billion less than in Q4. The continued slowing of exports and imports in Q2 lowered predictions of growth in the Eurozone.

The United States

For the first time after three years, the US has recorded a negative quarterly growth rate – 1.0%. Personal spending was at a similar level as in the previous quarter but the drop in supply was significant as did the negative effects of net exports. Private citizens are maintaining their level of spending with lower savings which means that once the labor market recovers and personal income increases, they will have to save more and the recovery will be at a lower level than planned to date. Exports have dropped and imports have risen slightly so that net exports in Q1 lowered the growth rate by 0.9%.

Economists expected weak growth primarily because of low temperatures and accumulated supplies in Q3 but that low level of growth was a surprise. All growth components, except for personal spending, showed negative growth. Cause for concern comes from the slowing down of business investments and the construction sector. Data will show soon whether the slowing down is just temporary as most economy experts thing or if it means a end of the recovery. Unlike economists, investors are fairly skeptical and that is shown by the interest rate on 10 year US bonds which has dropped from 3% to under 2.5%. The difference in perception is easiest to demonstrate with the fact that no economist covered by a Bloomberg poll has predicted that the rate will be under 3% by the end of the year and the fact that the average prediction was 3.25%. Time will tell whether the caution of the investors was justified and if the economists are right in regard to the continuing recovery, the people who have been buying bonds since the start of the year will suffer losses. The US FED continued lowering the monthly amounts of bond purchases in Q1 and is expected to discontinue this unconventional measure by the end of the year. It is uncertain when it will start raising its key policy rate and investors want that to be as late as possible with the market reacting negatively to a statement by the FED chief that the key policy rate could be raised six months after the end of quantitative easing. Overall inflation in the US has started rising and in April it stood at 2% with the same trend present in base inflation which rose from 1.6% in February to 1.8% in April.

Unemployment dropped from 6.6% at the start of the year to 6.3% in April which is the lowest rate in the past five and a half years but the participation of the labor market is the lowest since 1982 for the workforce aged 25 to 54, the age span when they are the most productive. That situation is complicated by the FED policy which can no longer just be defined by unemployment and inflation rates in a situation when participation is at a very low level. Unless there is an increase in participation on the labor market, personal spending will not be able to support the growth of the GDP. It is possible that the raising of the key policy rate will be postponed until participation on the labor market increases.

The trade deficit is growing and in April it stood at 47.2 billion Dollars which is the highest deficit since April 2012. Imports are rising while exports stagnate because of the slowdown in Europe and China.

Central and Eastern Europe

Croatia recorded a negative GDP growth rate (-0.4%) at annual level in the first quarter which is the 10th consecutive quarter in which the Croatian GDP has dropped. Short term indicators show a rise in exports, a drop in imports and continued weakening personal and investment spending. Fiscal consolidation is lowering personal spending, investments are not recovering and export growth is modest with the recent floods cutting down agricultural production. Croatia is also recording a slight deflation during the first quarter (April and March –0.1%, February –0.2%) but no negative effects are expected from the drop in prices because that is probably a passing occurrence since it was caused mainly by the drop in prices of raw materials on the world market. Liquidity is at a sufficient level in Croatia and there will probably be no further lowering of the key policy rate. Structural reforms to raise competitiveness are needed to bring the country out of recession better than stimulation of aggregate demand by lowering the key policy rate. The Fitch and Moody's agencies lowered their prediction ratings into the negative because public finances are in danger due to low growth levels and the lack of reforms. Despite that, a successful auction of 8 year bonds worth 1.25 billion Euro, instead of the planned one billion, was held in May thanks to investor interest.

Hungary had a GDP growth rate of 3.5% at annual level in Q1 primarily because of strong industrial production and construction. The processing industry showed a growth of 9.6% and construction of 25.2%. EU funds eased the realization of infrastructure work. Hungary has no problem with inflation (in that country inflation in Q1 was close to zero), the national currency the Forint has grown stronger, investors are interested in state bonds and since the ECB will lower its key policy rate conditions will be created for the Hungarian Central Bank to continue its aggressive reduction of the key policy rate. The central bank lowered its key policy rate from 2.7% in February to 2.4% in May, cutting it down in several installments. We can expect the key policy rate to be brought down to the level of 2.2% but the aggressive monetary policy will probably be discontinued at the end of the year. The Forint has strengthened against the Euro. The S&P Agency upgraded its prediction rating for Hungary from negative to stable. The unemployment rate is expected to rise by 0.2 – 0.3 percentage points (it stood at 8.1% in April) because the government program of public works, which is an instrument of social policy, is ending.

The GDP growth rate in Romania stood at 3.8% at annual level in Q1 which is the highest growth rate in the European Union. The causes of that high rate are a recovery of personal spending and net exports. The Romanian central bank will probably start lowering the rate of mandatory reserves because of low inflation to stimulate credit for companies in the domestic currency. In April, loans in domestic currency rose by 6.1% at annual level. Romania has managed to successfully place 30 year Eurobonds and has increased the average due date of its debt. The national currency the Leu reached its highest level last summer (4.4 Leu to the Euro). The S&P Agency raised Romania's rating to the level of investment grade and the Moody's Agency changed its prediction rating from negative to stable because the external debt and budget deficit are being reduced. During a visit by US Vice-president Joe Biden, an agreement was reached on wider cooperation with the aim of increasing American investments in the Romanian economy because the US investor presence in the country is very low.