8. International Environment

The global growth continued but at a slower pace. Of the large developed economies only the United States has entered a mature stage of recovery and we expect a divergence in monetary policy. The FED is planning to raise the key policy rate in June or September. On the other hand, China, Japan and the Eurozone are continuing their expansive monetary policies. The European Central Bank (ECB) has launched a program of quantitative easing valued at more than a trillion Euro. Low overall inflation is causing a lowering of key policy rates in many developing countries. The divergence in monetary policy has caused the Dollar to grow stronger against other currencies. Inflation is dropping at global level because of a drop in oil prices and a slowing down of growth. Increased liquidity due to ECB measures will certainly soon cause lower costs of debts in Serbia.

Global recovery is slowing down, the International Monetary Fund (IMF) has lowered its predicted growth rate in the world by 0.3 percentage points for 2015 and 2016. The slowing down is present in both developed and developing countries and of the more significant economies, only the US has a positive correction of the predictions for 2015 from 3.1% to 3.6%. The prediction for the Eurozone has gone from the 1.4% earlier to 1.2%, the prediction for Italy has been lowered from 0.9% to 0.4% and for Germany from 1.5% to 1.3%. The growth rates in 2015 have been corrected downwards for all the BRIC countries – for China from 7.1% to 6.8%, for Russia from 0.5% to –3%, for Brasil from 1.4% to 0.3% and for India from 6.4% to 6.3%. Interestingly, the government of China has lowered the target GDP growth rate from 7.5% to 7% which is the lowest target in the past 15 years.

Besides the slowing down of growth in the world, a drop in oil prices is present along with a rise of the Dollar. The drop in oil prices of more than 50% since September will have a positive effect on world-wide spending. The drop in oil prices was primarily caused by the increased supply of oil since OPEC member states have not lowered their production this time around even though oil prices are low. The increased demand was helped by the production of shale in the US and Canada. The negative effects of the drop in oil prices is primarily evident in Russia, Venezuela and Nigeria where the currencies are growing weaker and the financing of public debts is increasingly difficult. The Eurozone will benefit the most from the low oil prices since it is a large-scale importer and that will help the relatively low personal spending. The slowing down of the world economy and the drop in oil prices has led to a drop in world-wide inflation and 21 central banks have lowered their key policy rates since the start of the year. In periods of low inflation many central banks are using the situation to stimulate the economy with lower rates.

Many developing countries are already feeling negative effects due to the expectations of a rise in key policy rates in the US. Many currencies are dropping in value because of this and the composite index of the Dollar rose by more than 20% in a 12 month period which has not happened for 30 years. The strengthening of the Dollar leads to the "fleeing of hot capital" from developing countries especially those which have high current account deficits and depend on foreign sources to finance their public debts.

The Eurozone

The GDP growth, compared to the previous quarter, speeded up slightly from 0.2% in Q3 to 0.3% in Q4 with the y.o.y. growth standing at 0.9%. Germany showed a solid growth (1.5% at annual level) but Italy had a drop of 0.5% and while the German GDP level is significantly below the level prior to the crisis, the Italian GDP continues to stand 10% lower. Spain recorded a growth of 2% to lead the countries of the periphery while Poland, despite a drop in trade with Russia, saw a growth of 3.2%. Polls show that the Eurozone growth will continue in the first quarter of 2015.

Personal spending is recovering in the Eurozone since retail activity in Q4 grew by 0.4% compared to the previous quarter. Investments in fixed investments is slowly rising and exports are stimulated by the weaker Euro while public spending grows slightly. The drop in oil prices contributed to the growth since the Eurozone is a large-scale importer.

Overall inflation in the Eurozone dropped in Q4 and it dropped from 0.4% in October to –0,3% in February and was negative in the previous three months. The main reason for the drop is the low price of oil but base inflation also dropped slightly from 0.7% in October to 0.6% in February primarily because of the drop in the price of industrial products (intermediary goods and consumer goods).

The ECB started its quantitative easing. The purchase of 1.1 trillion Euro was announced and it will not buy bonds whose yield is below the rate on ECB deposits (-0.2%) in order to increase the effect on lowering interest rates as much as possible. Also, the amount of bonds which will be bought will not exceed the level of 33% of those overall available from one country which is an elegant way to avoid buying Greek bonds which are already exceeding that limit and the purchase will continue in July when some bonds fall due which will continue the pressure on the Greek government. The purchase will continue until inflation reaches the target of around 2% (medium term). This will not include corporate bonds and the due date of purchased bonds will be between two and 30 years with the common risk not exceeding 20% while the remaining 80% of risk will be borne by national central banks.

Low inflation and weak demand because of high unemployment led to the prediction that the ECB will raise its interest rate after 2018 or even after 2020. The quantitative easing was launched late because of political resistance and the Eurozone will probably resemble Japan over the next few years because of that. Like Japan, the Eurozone has bad demographics, slow growth and low inflation and the yield on state bonds will remain low for another few years. A fourth of Eurozone bonds have negative yields already.

Quantitative easing will not be efficient unless accompanied by structural reforms in the Eurozone. The mechanism is not the same as in the US since Europe the majority of company financing is done through banks and not through financial markets. Also, a smaller number of the Eurozone population own shares and the effects on personal spending because of low share prices will be lesser than in the United States.

The unemployment rate has dropped from 11.5% in October to 11.2% in January. Despite the progress, the relatively high unemployment rate coupled with austerity measures is preventing any significant rise in demand in the Eurozone and recovery will take a long time.

Increased liquidity will probably cause lower costs of debts in Serbia. Croatia has already had a very successful auction of bonds in Euro which can be explained as the consequence of ECB quantitative easing since Croatia continues to have low growth, budget deficit problems and a high level of public debt along with a stalling of reforms… We can realistically expect investors who are looking for higher yields to increase their demand for Serbian bonds.

The USA

The growth of the GDP in the US in Q4 stood at 2.2% which is much lower than in Q3 (5%) and in Q2 (4.6%). The American economy still has not entered a stage of stable recovery because the growth in 2014 stood at 2.4% which is just slightly higher than the 2.2% in 2013. Although growth has slowed down significantly and is below expectations, personal spending has started speeding up (2.8%) as has the construction of housing. On the other hand, business investment has slowed down which means that companies still are not completely convinced in the recovery and are postponing their investments even though they have sufficient funds available. Primarily due to the stronger Dollars, exports have slowed down and imports have speeded up so that the net imports have once again had a negative effect on the growth of the GDP. Investments in stock was lower than expected and in Q1 companies will probably increase their stock levels which will have a positive effect on growth in the next quarter.

The slowing down of the automobile industry also contributed to the low growth as did lower public spending because of a cut in military spending. The US still has a higher growth rate than the other large developed countries.

The consumer price index dropped in Q4 from 1.7% in October to −0.1% in January at annual level which is the first deflation in five years. Since the drop in prices was caused primarily by a drop in fuel prices, this can be considered a good deflation because it will cause a rise in the purchasing power of the population. For now, the population still have not started significantly increasing their spending but are saving their money most probably because they are not sure whether the drop in oil prices is temporary or not. Usually, a drop in oil prices has a positive effect on spending but not immediately. Base inflation has dropped from 1.8% in October to 1.6% in January and is somewhat under the target level of 2%. The FED will probably increase the key policy rate in the second half of the year because the unemployment rate is approaching a level considered to be full employment (5.5%). Prior to the crisis, the key policy rate at full employment level stood at 3-4% and now it is close to zero. If the increase in the key policy rate is postponed, there is a risk of uncontrolled inflation growth once growth speeds up and balloons appear on the financial markets. The key policy rate will not be raised if base inflation continues to drop. Because of the expected increase of the key policy rate, the Dollar has grown stronger in the previous period, stimulated by the mass lowering of key policy rates by other central banks across the world as well as the announced quantitative easing by the ECB. A strong Dollar causes a lowering of the prices of imported goods which will cause a drop in base inflation. However, data shows indications of an increase in salary inflation (in January) and domestic demand is growing stronger so that the scenario under which base inflation drops further and a deeper deflation comes along is not very probable. Usually, in periods of deflation all index components are lowered together while now the cost of housing is increasing.

Besides inflation, the level of employment is very important for the FED policy. Despite the extremely low temperatures, lay offs in the energy industry because of the drop in oil prices and dock workers strikes, the pace of new employment has picked up and the unemployment rate dropped from 5.8% in October to 5.5% in January which is the framework level of full employment. For a year now, there have been 200,000 new jobs a month which close to the historic record and the number of people with jobs rose by more than three million. However, since the start of the crisis there has been no significant change in wages even though the unemployment rate is at a low level. In January the monthly rise in wages stood at 0.5% but in February it stood at just 0.1% which is in accord with the trend of low rise since the start of the crisis. Economists mainly believe that the pressure on wages did not appear with this low rate of unemployment because the rate of participation on the labor market continues to be low and if employment continues at the same level a shortage of manpower is expected to appear and wages will start to rise which will further increase demand and speed up the recovery. For now the rise in wages is limited with the even lower rise in productivity (less then 1% over the past four years) which means that individual labor expenses are growing and that there is an inflation of earnings. A rise in productivity requires companies to invest in new equipment and we mentioned earlier that those investments are being postponed because of a lack of confidence in the recovery. Pressure on wages due to a shortage of manpower would probably motivate companies to invest because then their growth would be more certain and that would further move the recovery forward.

History tells us that when the FED raises the key policy rate, developing countries could have problems with an outflow of capital which causes their currencies to drop in value and that could cause economic instability in those countries. For example, the Turkish Lira has lost significant value because of the announced normalization of the FED policy (more than 10% in January alone). There is often talk in public that the raising of the FED rate could start a currency crisis in Serbia. Those fears are not realistic for several reasons. First, "hot capital" has not come to Serbia in any great amount since the start of the crisis. Second, the quantitative easing will significantly increase demand for Serbian bonds. Third, the signed agreement with the IMF is a significant motivation for investors especially in the Balkan countries. The only scenario that could destabilize the Serbian economy because of the FED decision is the bankruptcy of some of the countries of Eastern Europe (probably the Ukraine) leading investors to withdraw from the entire region. That scenario is not very probable and if it does happen Serbia would get through the crisis quickly.

Eastern Europe

Croatia

The growth of the GDP in Q4 stood at 0.3% at annual level primarily because of low domestic demand. Personal spending saw a drop of 0.6% at annual level and investments a drop of 3.7%. A rise in exports of 4.5% helped keep the results positive at quarterly level. In 2014, Croatia had a GDP growth of –0.4% and this year that drop will be at a similar level so that this will probably be the seventh year of recession. Industrial production in January dropped 5% at annual level and no sector reported growth. Unemployment stood at 20.3% in January. There is a danger of permanent deflation because prices dropped in December and January. Croatia had a very successful Eurobond auction. It sold bonds worth 1.5 billion Euro and achieved an interest rate of 3.25% which is a record low rate. That successful auction cannot be explained with Croatian parameters – a high public debt and budget deficit, very low growth, the central bank forced to defend the currency from depreciation… The only explanation is the effect of ECB quantitative easing which caused high liquidity. Investors are looking for alternatives to Eurozone bonds which have negative interest and are prepared to take greater risks. That is the first sign that Serbia will benefit from the expansive ECB policy in regard to financing costs.

Romania

Romania achieved a Q4 GDP growth of 2.5% at annual level and 0.5% compared to the previous quarter. The main carriers of growth were industrial production and telecommunications. The central bank lowered its key policy rate by 0.25 percentage points to 2.25% to increase domestic demand in the period of low inflation which is far from the target. Overall inflation is dropping in Romania. It dropped from 1.8% at annual level in October to 0.4% in February. Another cut in the key policy rate is expected in March or April. Following the successful auction in Croatia, Romania announced its own auction worth 2 billion Euro to make use of the high liquidity and secure favorable financing conditions. The finance minister indicated that the VAT rate would be lowered this year from 24% to 20%. Also, a lowering of the rate on dues paid by employers and employees has been announced from 2017 and a lowering of the tax rate on personal income to 14% in 2019. The lowering of the VAT rate this year will be a risk step and the IMF is opposed to that measure. Although Romania achieved a deficit of –2.1% of the GDP last year, it is probable that the lowering of the VAT rate would increase the deficity – highly unlikely that the lost income from the lower VAT would be compensated by suppressing the gray economy.

Hungary

The Hungarian GDP rose 3.4% at annual level in Q4, primarily because of the construction industry, agriculture and the processing industry. The trade surplus stood at 6.4 billion Euro in 2014 and the export of machines and equipment in December rose by 8.9% at annual level. Hungary had a GDP growth of 3.6% in 2014 and expected a growth of more than 2.5% in 2015. Overall inflation at annual level dropped from –0.3% in October to –1.4% in January. The government is supporting the weak Forint in order to stimulate exports and since inflation is below the target of 3% the central bank will probably start lowering its key policy rate again. Budget income is growing because of an improved collection of VAT and the budget deficit is planned to stand at 2.4% this year. Confidence in budget control will have a positive effect on investors and Hungary is expected to see a drop in the cost of debt. The unemployment rate stands at 7.4%.