Serbia | Macro Outlook

Growth figures better than expected
NBS enabling credit-driven recovery
Liquidity remains an issue for the longer-end of the curve
EUR/RSD stable

Economy (%)	2020e	2021e	2022e
GDP (real, y/y)	-1.0	5.0	4.0
Unempl. Rate	9.5	10.3	9.8
CPI (y/y)	1.7	1.8	2.4
Retail Sales (y/y)	6.0	7.5	7.0
Ind. Prod. (y/y)	-0.2	5.5	3.5
Public Debt/GDP	60.8	60.2	58.6

Source: Erste Group Research

Market	Spot	20Q4	21Q1	21Q2
EUR/RSD	117.56	117.60	117.50	117.40
USD/RSD	99.55	99.66	99.58	97.83
Target Rate (%)	1.25	1.25	1.25	1.25
3M Rate (%)	1.03	1.02	1.00	1.00
2Y Bond (%)*	2.00	1.90	1.90	1.80
5Y Bond (%)*	2.63	2.55	2.50	2.40

Source: FactSet, Erste Group Research

Rating	Current	Outlook
Moodys	Ba3	pos
S&P	BB+	stable
Fitch	BB+	stable

Source: Erste Group Research

General	2020
Population mn	6.9
GDP/Capita EUR	6,721

Source: Erste Group Research

Spot Rates as of:
09th Sep. 2020

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Note:
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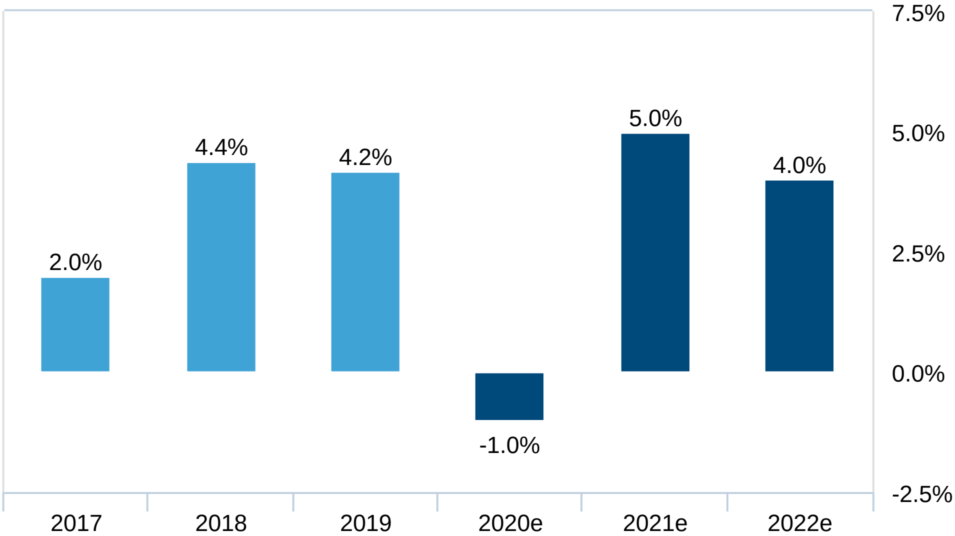
The resilience of the Serbian economy comes from its structure and the high share of the basic goods industry. We continue to expect a contraction in both remaining quarters, albeit a smaller one. Big-ticket public sector infrastructure investments, alongside high private sector credit growth, underpin the economy, while risks stem from the labor market, which is dependent on government subsidies as well as a possible slow(er) recovery of the euro area as a key trading partner. The overall risks now seem balanced; we hence slightly upgraded our 2020 and 2021 GDP forecasts to -1% y/y and 5% y/y, respectively.

Inflation picked up after bottoming out in April, but remains stable. With the achieved 1pp cuts of the key rate year-to-date, monetary policy is now more focused on enhancing the transmission mechanism. The sizeable fiscal aid package from the government can be well observed in the budget expenditure figures, with the subsidies category practically tripling compared to last year. The overall deficit should not exceed our earlier estimate of EUR 3.5bn, or 7.5% of GDP. As expected, the ruling SNS party achieved a landslide victory in June's elections, although a government still has not been formed. Progress was made in the relationship with Kosovo.

GDP (real,y/y)



Source: Erste Group Research

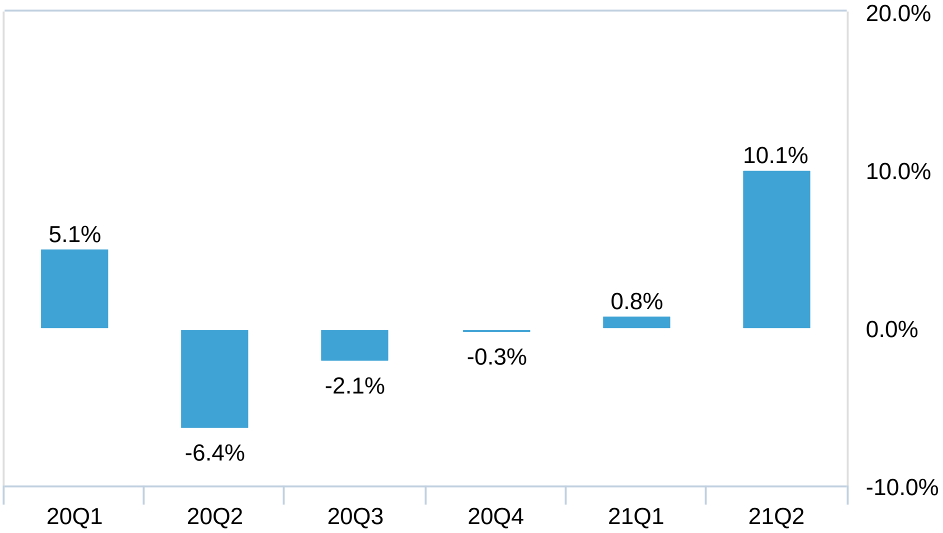
GDP

Growth figures better than expected

After a strong start to 2020, 2Q20 GDP contracted 6.4% y/y due to measures aimed at curbing the pandemic. Despite the strongest quarterly drop in 20 years, the figure was a positive surprise. Outperformance in the second quarter can be contributed to the structure of industry, solid agricultural season output and work on several public large-scale infrastructure projects. Private consumption was the biggest drag, falling 8% y/y, followed by investments, which decreased 11.9% y/y. Combined, they shaved a total of 8.2pp from headline GDP. Public spending rose 8.9% y/y, adding 1.6pp to overall GDP. Net exports also contributed positively to growth.

The margin of error when forecasting remains wide. We still expect contraction in both 3Q20 and 4Q20, albeit smaller than in 2Q. Overall, the risks seem balanced. Strong household credit growth (7.5% YTD in 7M20) suggests that domestic demand should recover quickly. On the other hand, the COVID-19 virus is still curbing day-to-day activities. There is also uncertainty about the true state of the labor market, as sizeable government aid and constraints over data collection kept the unemployment rate stable in 2Q20. Bottom line, we have slightly adjusted our 2020 and 2021 GDP forecasts upwards and now expect a 1% y/y decline this year, while 2021 GDP recovery is seen at 5% y/y.

GDP Quarterly (real, y/y)



Source: Erste Group Research

Annual	2018	2019	2020e	2021e	2022e
GDP real	4.4%	4.2%	-1.0%	5.0%	4.0%
CPI (y/y)	2.0%	1.9%	1.7%	1.8%	2.4%
Private Consumption	3.0%	3.2%	-2.1%	3.3%	3.2%

Source: Erste Group Research

Inflation

Inflation rebounded and remains stable

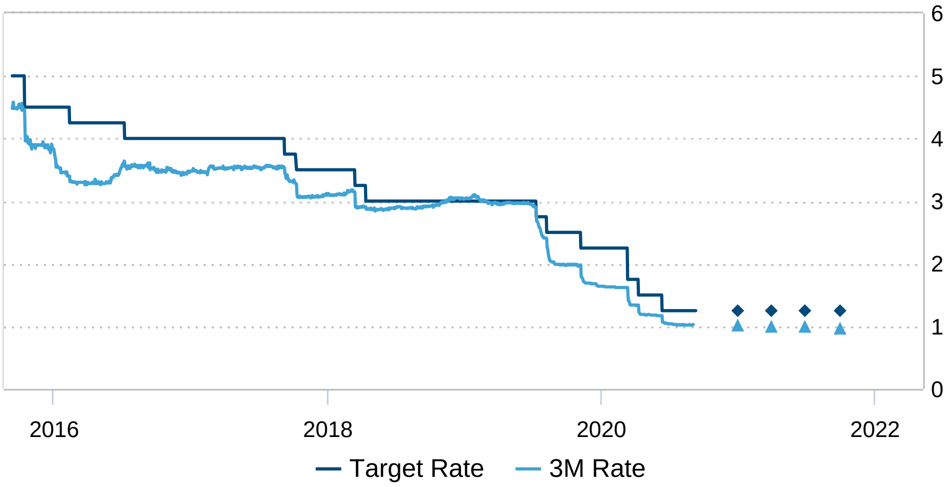
After bottoming out in April (0.6% y/y), inflation picked up and stabilized around the 2% y/y mark by mid-year. The initial low inflation was mainly due to the high base effect in vegetable prices, which disappeared in June, and low gas prices. On the other hand, the contribution of fruit prices was notably higher in 2Q, pushing overall food prices higher. Despite an unprecedented 2Q in terms of mobility of goods and services, there were no significant shortages of supply, thus keeping inflation pressures anchored. Overall, inflation is still expected to remain stable, with 2020 and 2021 average CPI is expected at 1.7% y/y and 1.8% y/y, respectively.

Monetary Policy

NBS enabling credit-driven recovery

After cutting the key rate by a total of 100bp YTD and safeguarding FX stability, the NBS is now focusing on spurring credit growth. In late July, they announced that all banks offering a 0.5pp lower-than-ceiling credit rate under the state guarantee scheme will receive a 0.5pp higher renumeration rate on its allocated dinar reserve. Effectively, the NBS is subsidizing corporate credit and thus ensuring that the fallout from the crisis is contained. Rate path ahead remains sensitive to external developments, the inflation outlook and stability of the exchange rate. Overall, we see the risks as balanced and expect the NBS to remain on hold in 2020.

Short Term Yields



Source: FactSet, Erste Group Research

Market (%)	Spot	20Q4	21Q1	21Q2	21Q3
Target Rate	1.25	1.25	1.25	1.25	1.25
3M Rate	1.03	1.02	1.00	1.00	0.97

Source: FactSet, Erste Group Research

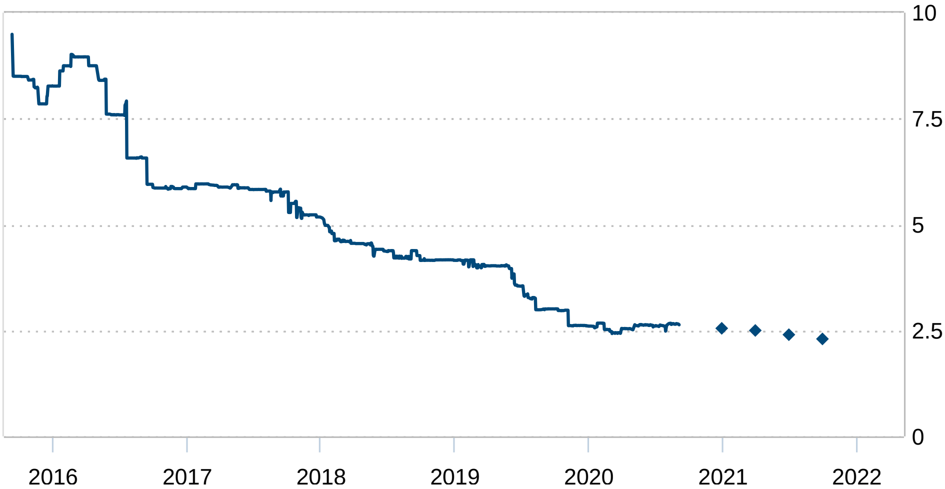
Bond Yields

Liquidity remains an issue for the longer-end of the curve

The consolidated budget gap after 7M20 stands at EUR 2.8bn (6% of GDP), due mostly to the 24.4% y/y rise in expenditures, while the revenue drop stands at 5% y/y. As subsidies have practically tripled, reaching EUR 1.3bn, and with additional relief measures in place for 2H20, the gap will be substantial. We expect a budget deficit of EUR 3.5bn, or 7.5% of GDP. From a funding perspective, the situation is stable. With May's EUR 2bn international launch, strong activity on the local debt market early in the year and bilateral loans in place, most of this year's financing needs are covered.

The short end and belly of the curve saw yield declines compared to mid-year in both the RSD and EUR area, although both still have yields above early year levels. The long end continues to suffer from low liquidity. The defensive stance of investors was clear in the last three auctions of the 12Y dinar bond, prompting the MoF to lift the yield by 15bp this week. The MoF is pushing for the longer-end auctions to qualify for Euroclear, which would bring demand up and costs down. Given economic overperformance relative to peers, stable inflation and currency, we see value in the long-end.

Generic 5Y Govt. Bond Yield (%)



Source: Datastream, Erste Group Research

Market	Spot	20Q4	21Q1	21Q2	21Q3
2Y Bond*	2.00	1.90	1.90	1.80	1.70
5Y Bond*	2.63	2.55	2.50	2.40	2.30

Source: Datastream, Erste Group Research

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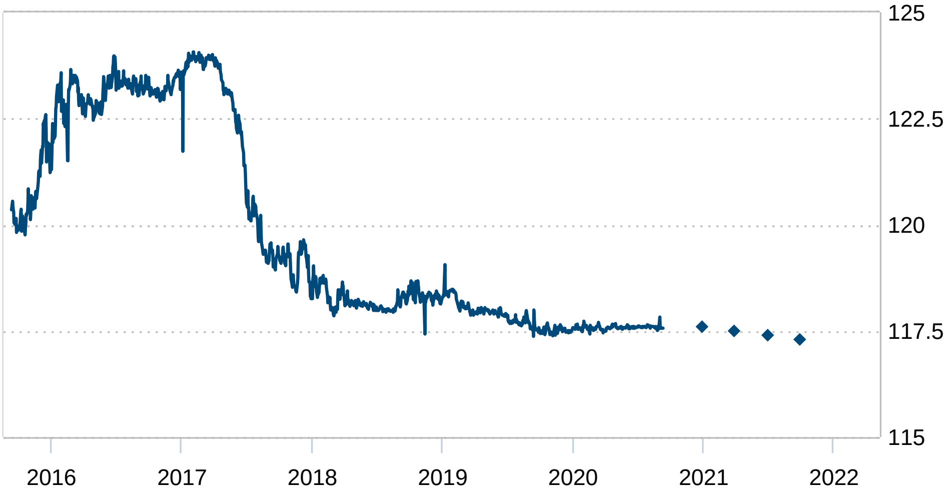
Serbian Dinar

EUR/RSD stable

Little, if anything, has changed regarding FX developments in Serbia since our last quarterly update. The phrase 'don't fight the central bank' continues to nicely sum up FX developments in Serbia. The dinar remains one of the most stable currencies in the world YTD, with day trading in a narrow range between 117.4-117.6, as the NBS is reluctant to allow any swings. In the first seven months, the CB sold a net amount of EUR 1.35bn, but total foreign reserves are still EUR 800mn higher compared to the same period last year.

We remain confident that the NBS has more than enough ammunition at its disposal to ensure FX stability, as FX reserves stand at a solid 29% of GDP. With a rising share of dinar loans in both the household and corporate segment, the NBS will likely remain vigilant so as not to allow dinar depreciation. Additionally, should LCY bonds become euro clearable, which is the MoF target, the foreign stock flow into dinar assets should rise and thus further act in favor of a stronger local currency.

EUR/RSD



Source: FactSet, Erste Group Research

	Spot	20Q4	21Q1	21Q2	21Q3
EUR/RSD	117.56	117.60	117.50	117.40	117.30
vs. Spot		*0%*	*-0.1%*	*-0.1%*	*-0.2%*
USD/RSD	99.55	99.66	99.58	97.83	97.75
vs. Spot		*0.1%*	*0%*	*-1.7%*	*-1.8%*

Source: FactSet, Erste Group Research

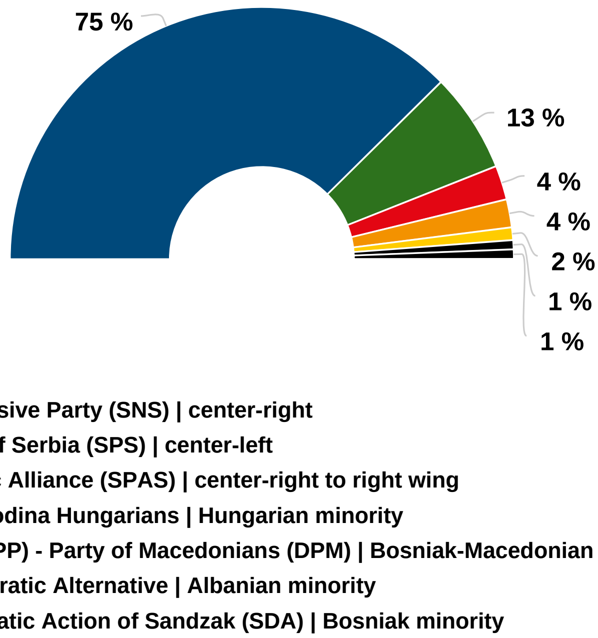
Politics

Awaiting new government amid mounting international pressures over Kosovo

Only three parties entered the parliament following the June elections, which were again marked by a landslide victory of the ruling SNS. That part of the opposition that boycotted the elections has raised the question of parliament credibility, while there was also some street unrest. The situation calmed quickly and it was mostly connected to a post-election spike in coronavirus infections. A government has not yet been formed, with the deadline being November 3. Most recent statements suggest the new government will be sworn in the end of September.

The formation of the government depends on the outcome of the recent extremely dynamic initiatives from the US administration and European Union in respect to the resolution of the Serbia-Kosovo conflict. A Washington meeting hosted by the US president and wording from Brussels about finding a sustainable solution as soon as possible are putting decisive pressure on both Belgrade and Pristina. Those meetings yielded very solid results, but there is still a long way to go. It appears that economic cooperation will spearhead the political negotiations between Serbia and Kosovo.

Parliament Seats



Source: Erste Group Research

Last Election:
2020, June

Next Election:
2024

Forecasts

Annual	2014	2015	2016	2017	2018	2019	2020e	2021e	2022e
Real GDP growth	-1.6	1.8	3.3	2.0	4.4	4.2	-1.0	5.0	4.0
Inflation (CPI, avg)	2.1	1.4	1.1	3.2	2.0	1.9	1.7	1.8	2.4
Unemployment rate (avg)	18.9	17.7	15.3	13.5	12.7	10.4	9.5	10.3	9.8
Retail sales growth	2.8	2.0	8.0	3.8	4.1	9.7	6.0	7.5	7.0
Industrial output growth	-7.0	7.3	5.3	3.9	1.4	0.4	-0.2	5.5	3.5
Private consumption growth	-0.1	-0.5	1.3	2.0	3.0	3.2	-2.1	3.3	3.2
Fixed capital formation growth	-3.4	4.9	5.4	7.3	17.8	16.4	-4.8	10.4	9.8
Percent of GDP									
Trade balance	-11.4	-11.3	-9.9	-11.1	-13.2	-13.7	-12.8	-13.3	-13.2
Current account balance	-5.6	-3.4	-2.9	-5.2	-4.8	-6.9	-5.9	-5.5	-5.5
Foreign direct investment	4.3	5.9	6.3	6.4	8.1	8.3	6.3	7.1	7.3
Budget balance	-6.2	-3.5	-1.2	1.1	0.6	-0.2	-7.5	-1.5	-0.5
Public debt	64.2	69.5	67.6	59.3	53.7	52.0	60.8	60.2	58.6
External debt, gross	72.4	73.5	72.1	65.3	62.6	61.8	67.5	61.5	58.5
FX, money market									
USDLCY average	88.54	108.85	111.29	107.50	100.28	105.28	103.19	98.25	97.67
EURLCY average	117.31	120.73	123.12	121.34	118.27	117.85	117.55	117.40	117.20
EURLCY eop	121.38	121.52	123.40	118.21	118.33	117.60	117.60	117.40	117.20
(percent)									
CB policy rate (avg.)	8.86	6.23	4.16	3.89	3.07	2.69	1.38	1.25	1.25
3m interbank offer rate (avg.)	8.25	6.08	3.42	3.40	2.96	2.50	1.19	0.99	0.96
2Y Yield (average)*	n.a.	n.a.	n.a.	n.a.	n.a.	2.66	2.00	1.78	1.55
5Y Yield (average)*	11.89	9.25	6.34	5.80	4.00	3.53	2.59	2.36	2.06

Source: Erste Group Research

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