

Serbia, Montenegro and Kosovo Business Forecast Report Q4 2014

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Abstracts

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Core Views

The new government is likely to embark on a fiscal consolidation drive motivated by a growing foreign debt burden and longer-term goals of EU accession. Although the budget shortfall will remain elevated in 2014, as the government allocates emergency funds to address damages from the May floods, Serbia's fiscal sustainability prospects have brightened in the medium-to-long term. As such, we forecast the budget deficit to narrow from 8.1% of GDP in 2014 to 3.3% by 2019. Having gained EU candidate status on March 1 2012, Serbia began formal talks on EU membership on January 21, meaning that the path towards EU integration is firmly set. While this will provide an important policy anchor for the country and encourage much needed investment, problems in the contentious northern district of Kosovo – Mitrovica – will continue to bedevil Serbia's progress on becoming a member of the EU – which we do not expect to take place before 2020.

Major Forecast Changes

We have downgraded our forecast for Serbia's export growth for 2014 on the back of the May floods, meaning Serbia's current account deficit will be wider in 2014 than we previously anticipated.

We reiterate our expectation for persistent current account deficits, and Serbia's ability to attract external financing in the coming years will be predicated on credible structural reform and fiscal overhaul in 2014-2015.

We have revised down our domestic demand and export growth forecast for Serbia in 2014 to take account of the damages inflicted by the May floods. However, foreign direct investment in the export-oriented manufacturing sector will underpin relatively robust export growth in the coming years, and will remain the dominant driver of real GDP growth.

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Mounting Challenges To Vucic On Both Domestic And Foreign Policy Front

We see mounting challenges to Serbian Prime Minister Aleksander Vucic's government's domestic and foreign policy agenda. Public support for Vucic will wane over the next few years, as painful austerity measures begin to bite, while difficult relations with Kosovo will delay Vucic's main goal of EU membership.

Table: Political Overview

Long-Term Political Outlook

Unresolved Tensions Remain Despite Agreement With Kosovo

Unresolved regional tensions and a fractious domestic political environment are expected to continue to hang over Serbia's political risk profile over the long term. In turn, the country's EU accession prospects and economic growth profile could suffer as a result. However, owing to the large diplomatic presence in the region, which we expect to persist over the long term, we believe it is very unlikely that lingering disputes will devolve into open conflict.

CHAPTER 2: ECONOMIC OUTLOOK

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May Floods Darkening Growth Outlook

We have revised down our domestic demand and export growth forecast for Serbia in 2014 to take account of the damages inflicted by the May floods. However, foreign direct investment in the export-oriented manufacturing sector will underpin relatively robust export

growth in the coming years, and will remain the dominant driver of real GDP growth.

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2014-2015.

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We have revised slightly our forecast for the National Bank of Serbia's benchmark rate for 2014 - to 7.75% from 8.50% previously, as the May floods will necessitate more aggressive easing by the NBS. In addition, we have revised down our forecast for real GDP growth

Table: Monetary Policy

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The adopted 2014 budget revision in Serbia envisions harsh austerity measures, however the budget shortfall will remain elevated in

2014, AS THE GOVERNMENT MAKES ONE-OFF PAYMENTS TO ADDRESS THE DAMAGES FROM THE MAY FLOODS. IN THE MEDIUM-TO-LONG TERM, HOWEVER,

Serbia's fiscal consolidation prospects have brightened, and we forecast the budget deficit to narrow from 8.1% of GDP in 2014 to 3.3% by 2019.

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Serbia's convergence process with the more developed states of Western Europe is expected to continue apace over the long term, with the harmonisation of the underlying domestic legal and regulatory framework with that of the EU being a fundamental factor driving growth. This will lead to marked improvements in Serbia's business environment, enabling greater access to the export markets of EU member states and enhancing the country's appeal to foreign investors in the process. That said, we caution that political instability, particularly around Kosovo, poses the greatest risk to our forecasts, although the April 2013 agreement should go some way to cooling tensions at a governmental level.

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