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info@marketpublishers.com

Serbia, Montenegro and Kosovo Business Forecast Report Q2 2014

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Abstracts

Core Views

As we expected, the new Serbian government has embarked 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 makes one-off payments to smooth the planned restructuring and privatisation of state-owned enterprises, Serbia's medium-to-long-term fiscal sustainability prospects are brighter. As such, we forecast the budget deficit to narrow from 7.3% of GDP in 2014 to 2.7% by 2018.

Having gained EU candidate status on March 1 2012, Serbia was to start 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. We do not expect the country to join the bloc before 2020.

Major Forecast Changes

The harsh austerity measures envisioned in the 2014 budget – focusing on VAT hikes and public sector wage and pension cuts – will weigh on household consumption in 2014. As such, we have revised down our forecasts for 2014 and 2015 real GDP growth, from 2.4% to 1.6% in 2014 and from 3.6% to 1.9% in 2015. In the long term, however, the government's demonstrated willingness to implement structural reform, by way of reducing its role in the economy and generous subsidies to unprofitable state-owned enterprises, bodes well for growth, underpinning our fairly sanguine forecasts.

We expect the National Bank of Serbia to continue its aggressive rate-cutting cycle in 2014 as disinflationary demand-side pressures and tepid economic growth tip the balance in favour of looser monetary conditions.

Key Risks To Outlook

Our relatively positive long-term view on Serbia is grounded in EU accession providing a policy anchor for the Serbian government. While the path towards EU membership is much clearer now that an agreement has been reached with Kosovo, continued progress in implementation and enforcement of the accord is required. There is strong opposition to the deal from both sides given deep-seated ethnic divisions and strong nationalist sentiments, and the potential for unrest to disrupt further progress remains elevated.

Core Views

Asaccession talks get under way, Montenegro will need to adhere to the EU's acquis communautaire accumulated legislation, which will require the incorporation and implementation of all EU norms and regulations into the country's legal system. Given the still substantial gap that needs to be bridged between the Montenegrin and EU legal systems, we expect that accession talks will last at least until the latter half of the decade.

Deleveraging is going to continue dragging on economic growth into 2014. The private sector accumulated large amounts of debt in the run-up to the financial crisis, requiring it to deleverage over the last few years. Government spending, coupled with robust tourism inflows, supported growth as this process unfolded. However, we expect the government to significantly curtail spending as it struggles with rising debt levels, leaving only services exports, namely tourism, to drive growth.

Major Forecast Changes

The Montenegrin economy will remain under pressure in 2014 and 2015, as the country's biggest industrial plant is now officially bankrupt, and private sector balance sheets are only gradually recovering from the credit bubble years. We forecast real GDP to grow by 1.6% in 2014 and by 1.9% in 2015, while the export sector, and a pickup in private consumption, will drive a more robust growth from 2015 onwards

Key Risks To Outlook

As volatility in the international financial bond markets is unlikely to ease over the course of 2013-2014, we highlight the risk that Montenegro may have to pay a substantial premium to place its bonds and may therefore quickly slip into a debt spiral that would lock it out from global financial markets, preventing it from borrowing to finance the current account deficit, even in the short run. D espite not being part of the eurozone, Montenegro has adopted the euro as its currency since it went into circulation in 2002. As a consequence, the country is highly exposed to a potential disorderly breakdown of the eurozone. Although this is not our core scenario, we highlight that the dissolution of the currency bloc would leave Montenegro vulnerable to sharp capital outflows and soaring imported inflation, or the Central Bank of Montenegro could be forced to artificially fix its new exchange rate to a future core European currency.

Core Views

An EU-brokered accord between Kosovo and Serbia is the first official acknowledgement of the legal authority of Pristina over northern Kosovo by Serbia. Although tensions are likely to remain elevated, with unrest in the north remaining a risk, a major hurdle in the way of eventual EU accession is now cleared. The Kosovan economy faces significant challenges, including a low level of development and a very high level of unemployment, and the country remains one of the poorest in Europe in GDP per capita terms. However, recent progress towards eventual EU accession could boost long-term growth potential and expedite improvements in the domestic economy.

Major Forecast Changes

We have revised down our 2014 real GDP growth forecast to 4.4%, from 4.8% previously, as growing tensions in the northern provinces ahead of municipal elections are likely to further hamper private sector spending.

Key Risks To Outlook

We caution that failure to rein in spending or secure short-term financing from international lenders would result in a fiscal crisis for Kosovo, with substantial repercussions for economic and political stability in the region. Social unrest could lead to a fall of Prime Minister Hashim Thaçi's government, pushing the country to yet another early election. A strong international military and diplomatic presence would prevent an escalation of violence, but the country's bid towards progressive political normalisation would face another blow.

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