8. International Environment

Global growth has slowed down in most of the largest economies with the exception of the United States where recovery is continuing. That is why there has been a divergence in monetary policy where the central banks of China, the Eurozone and Japan have strengthened their expansive monetary policies while the US FED has finished its quantitative easing and will probably raise its key policy rate next summer. The G20 has announced investments in structural reforms which should raise the GDP of those countries from 2.1% by 2018 while the European commission announced a five year investment plan. Inflation is dropping because of a drop in oil prices. In eastern Europe, growth was somewhat higher than expected and low inflation provides room to lower key policy rates while the costs of debts are mainly falling as the consequence of the new measures introduced by the European Central Bank (ECB).

The World

The International Monetary Fund (IMF) has once again lowered its prediction for the world-wide growth rate for 2014 but minimally from 3.4% to 3.3%. The prediction for next year has been lowered from 4% to 3.8%. The reason for the lowered prediction for this year is the slowing down in the Eurozone: Germany (from 1.9% to 1.4%), Italy which is in recession (from 0.3% to –0.2%) and France while the prediction for Spain was slightly raised. The difference between the countries on the outskirts of the Eurozone and the central countries is narrowing. Besides the Eurozone, Japan is also slowing down (from 1.6% to 0.9%) as is Brasil while Russia has entered a recession. The drops would be even greater if the prediction for the United States had not been raised (from 1.7% to 2.2%) and India (by 0.2 percentage points). For China there were no changes in prediction this time although the latest data indicate that growth is also slowing down in China. The growth rate dropped in developing countries as well from 4.5% to 4.4% this year and from 5.2% to 5% for next year. It is important to bear in mind that the IMF report early in October also did not include the latest slowdown in the Eurozone and the very bad results recorded by Japan in Q3.

The two biggest economies of the Far East are slowing down and are continuing their expansive monetary policy because of that. The growth of the Chinese GDP in Q3 stood at 7.3% which is the lowest results in the past five years. The central bank is trying to slow down the excessive growth of the construction industry and direct additional credit to sectors which will stimulate personal spending and employment. Also, in order to stimulate the economy which is slowing down, the key policy rate was lowered from 6% to 5.6%. Unexpectedly, Japan recorded the second negative quarter in a row in Q3 and technically it is in recession. Because of the slowing down of growth and the risk of a drop in inflation, the Central Bank of Japan announced a new wave of quantitative easing with an additional 720 million Dollars and the state pension fund announced more purchases of company stocks.

Besides the mentioned monetary measures, the G20 summit also announced structural reforms and investments in infrastructure. The member state accepted the obligation of increasing the growth of the GDP by an additional 2.1% by 2018 and submitted a list of 800 new measures which they intend to implement. They also drafted an agreement on lowering gas emmissions which cause the greenhouse effect. However, there were agreements on structural reforms earlier and even though the member states seem to be more serious about their implementation this time, economists are skeptical about the realization of those measures.

Structural reforms and fresh investments continued in the European Union. European Commission President Jean Claude Juncker announced a five year investment plan worth 315 billion Euro whose mainstay is a fund for infrastructure projects financed by governments while the remaining funds should be invested by commercial banks with the help of the European Investment Bank. That plan should secure 1.3 million new jobs. As with the G20 agreement, we do not know how successful the plan will turn out to be primarily because it is uncertain whether the banks will support the projects that the European Commission views as priorities.

The Eurozone

The new European Commission started working on November 1 this year. Its main economic priorities are increasing growth and investments (mainly in the production of energy, transport infrastructure, investments in education, research and investments which will help young people find jobs). The idea is to improve the situation on the labor market without any significant added expenses. For example, the unification of the digital market will stimulate growth of employment and offer new business opportunities and the new trade agreement with the United States will open new markets. The announced investments will have a small share of state funding in order to prevent a growth of public debts. There are also plans to decrease the energy dependency on natural gas (because of the crisis with Russia) and set up an Energy Union which will buy natural gas for all European Union countries, dispose of reserves and use a common network. The EU should become the world leader in renewable sources of energy under that plan.

The growth of GDP in Q3 in the Eurozone stood at 0.2% compared to the previous quarter, that is at 0.8% at annual level. In Germany that growth was low standing at just 0.1% compared to the previous quarter while Italy recorded negative growth of –0.1%, the second quarter in a row that this country has technically been in recession. Unlike the situation earlier, the difference between the peripheral and central countries of the Eurozone narrowed and in Q3 compared to previous quarters Greece recorded a growth of 0.7% and Spain of 0.5%. The slowdown in Italy and Germany had a negative effect on Serbia's exports and on the inflow of direct investments. Polls indicate a stagnation or slight drop in industrial production in Q4 which means a speedy recovery is not expected in the Eurozone.

Overall inflation, altough below the targetted 2% continues to drop in the Eurozone and it stood at 0.3% in November compared to 0.9% in the same month of 2013. Base inflation also dropped and stood at 0.9% in August and 0.7% in November. Since demand was low, base inflation will not recover significantly in the next quarters. The overall drop in inflation was influenced by the drop in oil prices of 30% in the past few months and if that trend continues, the low level of inflation of 0.3% could become negative. Also, even if there is no further drop in oil prices, the danger lies in the fact that inflationary expectations have been dropping for some time, in both the short and medium term. Inflationary expectations could affect real inflation and launch a so-called self-generating spiral. Due to the low inflationary expectations and danger of a further drop in oil prices leading to deflation, the European Central Bank will have to use the instruments it has available to prevent the negative effects of possible deflation in the period of slow growth.

Due to the danger of deflation the European Central Bank in September lowered the key policy rate from 0.15% to 0.05%. Since political resistance meant that it could not expand its program of purchasing bonds, it implemented the heterodox mechanism which all the large central banks avoided – the rate on deposits was lowered to below zero. Now that all instruments have been activated and the risk of deflation is rising, political resistance has dropped and the European Central Bank will enter into some form of quantitative easing. Most probably it will purchase different types of bonds to the value of about 1,000 billion Euro. Unfortunately, the effects of the quantitative easing will be far less than those in the United States because the decision was delayed, the European banking system operates differently and the European Central Bank cannot be an adequate replacement for the lack of a consensus on fiscal policy within the EU. The program will most probably include a significant purchase of state bonds, including those of the peripheral countries, and there is a risk of politicians in those countries loosing their motivation to adhere to their own consolidation programs. The European Central Bank's announced quantitative easing will increase the demand for Eurozone member state bonds which will lower the costs of those countries' debts. Investors will be interested in bonds with higher yields and Serbia will benefit since the demand for its bonds will be higher. The escalation of the war in the Ukraine and accompanying new EU sanctions imposed on Russia could have a negative effect on the demand for Serbia's bonds since investors will purchase the safest Eurozone bonds because of the increasing geo-political risks.

The risk of deflation, high public debt of many states, low economic growth and bad demography has led some economists to believe that the Eurozone is similar to Japan and that it now faces a "lost decade" as well. Structural reforms and new regulations for the banking sector are needed to avoid that scenario.

The unemployment rate in the Eurozone has not changed since June and in September it continued to stand at 11.5%. Over the past year, the biggest drop in the unemployment rates was recorded in Hungary where it dropped from 10% to 7.6% and in Spain from 26.1% to 24% as well as Portugal from 15.7% to 13.6%. Youth unemployment stood at 23.3% in September and was highest in Spain (53.7%) and Greece (50.7%). In Italy unemployment rose from 12.9% in September to 13.2% in October which is the highest rise since 1977.

The United States

The growth of the GDP in Q3 was above expectations (3.5%) primarily due to the growth of public spending and exports. However, the question is whether that growth can continue at this pace in the same manner because the rest of the world economy is slowing down which will decrease exports and fiscal policy will be in a position to support that growth to any significant degree only in 2016. A cause for concern lies in the fact that domestic demand has slowed down, especially private investments. This indicates that the private sector is not fully confident of the recovery.

In October the FED ended its biggest program of purchasing bonds in its history, known as quantitative easing. The placement of the central bank increased because of that by 3,500 billion Dollars (the size of the German economy). Practically, the program was not fully completed because the FED will reinvest in new bonds on the basis of income from old bonds that have fallen due. Economists still do not agree on whether the program was ended too soon or too late or even whether it should have been launched at all. The influence of this program was huge on developing countries because global liquidity was increased significantly and last year when its end was announced many of the currencies in those countries were devalued. This time when the program finally did end, the effects were minimal but the next risky stage will be raising the key policy rate. The key policy rate was left at its old level at a meeting in October and its increase is expected in June next year. However, if China and the Eurozone continue to slow down, this decision could be postponed so that it would not have a negative effect on global growth.

Consumer prices have been stagnating for three months at the level of 1.7% which is a slight drop compared to the summer when the average was about 2%. It is important to bear in mind that although inflation is stagnating, that is happening despite the drop in oil prices and inflationary pressure has appeared which some economists are citing as confirmation that the key policy rate needs to be raised in June 2015. Base inflation rose slightly in October (1.8%) compared to the previous two months (1.7%) but it is still lower than the level of last summer. If base and overall inflation rise over the next few months, the FED will have to raise the key policy rate according to expectations.

For nine months in a row, employers have been taking on more than 200,000 new employees which is a significant improvement compared to the previous year. The unemployment rate dropped from 6.7% in March to 5.8% in October but the workforce participation rate has been stagnating for some time and the rise of real salaries has not exceeded 2%. The low growth of salaries is caused primarily by the low productivity growth. That is why the impression of an increase in employment does not paint the complete picture of the state of the American economy. About

70% of new jobs created in October are temporary jobs in health care and the restaurant and hotel business while industry and processing are not recording higher employment because of slow productivity growth.

Eastern Europe

Hungary

The annual growth of the GDP slowed down from 4% in Q2 to 3.2% in Q3 and the quarterly from 0.8% to 0.5%. That growth was achieved thanks mainly to industrial production which increased its exports and agriculture thanks to favorable weather conditions. Next year a growth of some 2% is expected because of a slowing down of investments but that growth could be higher if personal spending recovers because of an increase in available income. In October, annual inflation continued to be negative (-0,4%) but it could draw closer to the target (3%) next year due to an increase in tax rates, the end of the effects of base because of an administrative lowering of fuel prices and relatively high economic growth compared to other EU member states. The Hungarian currency, the Forint, strengthened thanks to expectations of a monetary stimulation in the Eurozone and a surplus of the Hungarian trade balance.

Despite the depreciation of the Forint the central bank did not lower its key policy rate (2.1%) and it will probably remain unchanged to the end of 2015. A more active approach to the exchange rate policy is expected next year when interventions on the foreign currency market would stop appreciation and fill the foreign currency reserves which are at lower levels than they were earlier. Also, the interventions would secure a profit and they are a better solution than the lowering of the key policy rate. Interest on 10 year state bonds brought a yield of just 3.6% which is the historic minimum.

Prime Minister Orban's government, following the victory at parliamentary and local elections, has huge support and can continue the heterodox economic policy. The government introduced several taxes as of the start of 2015. The public debt will be lowered in the next few years from 50% to 45% and the budget deficit will be cut down to below 3% by 2016. Also, the population will be allowed to convert housing loans in foreign currency into the domestic currency to eliminate currency risks.

Hungary is under pressure from the West because it is refusing to abandon its economic plans with Russia. The plans include the construction of a nuclear power plant in cooperation with a Russian company and the Hungarian government is planning to sell MOL shares in Croatia's INA oil company to a Russian company. Hungary was subjected to criticism from the European Commission because of that and 10 of Prime Minister Orban's associates have been placed on a US sanctions list. The Hungarian government will bow down under pressure to some extent since new elections are not coming for another 3 years.

Romania

Romania's GDP grew 3.2% at annual level in Q3 which is faster compared to Q2 when it stood at 1.2%. The growth was higher than expected because the level of investments dropped less than predicted while the growth of personal spending is higher than expected. Current demand is reflected only in personal spending while investments, both public and private, are very low. The European Commission predicted growth this year of 2.3% and if 2.5% in the next year.

Inflation at annual level in October stood at 1.4% while base inflation stood at around 1% which indicates a drop in demand. Because of the low inflation which now stands below the target, the central bank lowered its key policy rate from 3% to 2.75% in November. Another reduction to 2.5% is expected early next year. Also, the level of mandatory reserves in foreign currency was lowered from 16% to 14% to free up funds for bank loans. A lowering of the mandatory reserve to bring them closer to the European Central Bank level.

Presidential election favorite Ponta was unexpectedly defeated by Johanis, a candidate of the center right. A reshuffle of the government is possible if they disagree over the budget for next year. Measures need to be adopted to neutralize the growth of public spending prior to next year's budget. Measures need to be imposed to neutralize the growth of public spending prior to the elections, The IMF and European Comission.

Croatia

Croatia recorded a GDP drop of –0.5% at annual level. Personal spending and investments continuo to be low but services and net exports primarily due to the drop in imports. The recession will probably continue in Croatia into next year when the GDP will drop by –0.5%. The shortage of private investments is compensated insufficiently by EU funds and exports will be under pressure from the slowdown in the Eurozone.

The Croatian government has put forward a budget for 2015, with a deficit of 3.8% GDP (this year's plans 5%). Despite expectations, there were no small expenses for salary costs and the Croatian government probably will not be in a position to maintain the deficit at planned level. That led to the attitude towards the GDP and will start from 90% %. Because of the lack of structural reform and measures to improve the business climate, we are expecting a growth of the cost of debts.

Croatia is preparing for presidential elections late this December and they are not all that important in regard to setting policy but they will influence the balance of power among the main parties at next year's elections.

After nine months of deflation, inflation was achieved in October standing at annual level at 0.4% but the increase of 70% was caused by a rise in electricity prices which last year recorded a drop following a liberalization of the market. The unemployment rate rose from 1 percentage point to 18.7% in October because the positive effects of the previous season is dropping.