8. International environment

Global recovery continues. Advanced economies, particularly the USA and the euro area, are growing more rapidly. On the other hand, many developing countries are suffering the consequences of capital outflow. The Fed and the ECB tightened their expansionary monetary policy, and central banks in many developing countries are raising the interest rates to prevent depreciation of the national currencies. Budget deal between Republicans and Democrats would increase consumer demand in the USA, and the fiscal deficit in the euro area is narrowing to an acceptable level. There is a dichotomy between the price rise in developed and developing economies – the former keep the inflation down at a quiet low level while the latter are facing high inflation. Inflation is going down in the Eastern Europe and in developed countries. Macroeconomic crisis and lower growth in developing countries and escalation in Ukraine crisis are the major threats to global economic growth. Developing economies are facing increased political instability.

World

According to the IMF's forecasts from January, global growth is projected to increase slightly in 2014, to 3.7%, while the growth rate in 2015 remains at the level anticipated in the previous report, i.e. 3.9%. Growth in advanced economies in 2014 is targeted at 2.2% and in developing economies at 5.1%. Growth rates in Russia and Brazil have been revised downward, from 3.0% to 2% and from 2.5% to 2.3% respectively, while the growth rates in China and India have been revised upward, from 7.2% to 7.5% and from 5.2% to 5.4% respectively. The IMF advises that structural reforms be made both in developing and advanced economies, that expansionary monetary policy continue to be pursued in advanced economies until the recovery, and that measures intended to increase financial and macroeconomic stability be implemented in developing countries.

The Fed decided to tighten its monetary policy in December. Consequently, investors started to withdraw the "hot money" from developing countries causing increase in borrowing costs, drop in stock values and depreciation of national currencies. However, the Fed should not be held solely responsible for this. As of the last summer, after the Fed announced their plan to follow a less expansionary monetary policy, the turmoil in developing markets started, and the phrase "fragile five"[1] (Brazil, India, Turkey, South Africa and Indonesia) became popular among economists. These five countries are faced with some common problems – high inflation and current account deficit, growth slowdown, and big political risks in some of them. More rapid growth in the USA and the euro area, and consequently capital outflow from developing to these markets driven by higher risk premiums, exacerbated the situation. However, GDP growth in advanced economies boosts demand for products from developing economies and thus helps them expand. Growth in advanced economies, therefore, affects developing countries in two opposite ways – capital outflow and increased demand for products from these economies. Short-term net effect could be negative, but in the long run, growth in advanced economies will probably boost developing economies.

Many developing countries are experiencing increased political instability, often in the form of mass demonstrations, which undermines financial stability and hinders economic growth. The IMF emphasizes that structural reforms in most of developing countries are needed to overcome the macroeconomic weaknesses, and that some forms of control over the volatile flow of foreign capital can be useful.

Similar like earlier when the IMF and ECB had different opinions on the intensity of austerity measures across the Euro zone, these two institutions now disagree on how to avoid deflation.

1 The term BRIK was coined by Goldman Sachs' economists, and similarly the phrase "fragile five"was coined by the Morgan Stanley. The acronym BIITS is also used for these five countries. The "fragile five" take up 7% of the world economy.

The ECB economists take a more conservative approach to this issue and do not perceive deflation as such a serious threat as the IMF economist do. The IMF says that the recovery in the Euro area has just started and that further drop in prices should be prevented in time because it could be harmful if the euro-zone economy slowed down again.

The Eastern European states have not been exposed to such intense pressures as the "fragile five" have been due to the Fed's exit strategy. However, escalation in Ukraine crisis could cause a large capital outflow. Investors are not adequately informed about the Eastern European countries so, out of precaution, they could withdraw their capital from these countries only because they are geographically close to Ukraine. This happened in Poland and Hungary at the beginning of Ukraine crisis. If the armed conflict arose or if the West imposed sanctions against Russia, the growth in Euro area would slow down, capital outflow from Eastern Europe would occur and the oil prices would rise, which would produce synergistic harmful effect on the Eastern European economies. We must emphasize that Serbia and the "fragile five" have many macroeconomic weaknesses in common. Therefore, if the Ukraine crisis deepened, Serbia could find itself among the most seriously affected countries, and its borrowing costs would increase, as well as dinar depreciation risks.

Euro area

Since the recovery is speeding up, GDP growth in the euro area in 2014 has been revised upward by the European Commission, from 1.1% to 1.4%. Quarterly growth increased from 0.1% q/q in Q3 to 0.3% q/q in Q4. GDP growth was negative in 2013 (-0.4%). Growth across the euro area is more balanced and the recovery is now underway in countries at the periphery of the euro area – quarterly growth in Spain in Q4 was 0.2%, in Italy 0.1% and in Portugal as much as 0.5%. Growth achieved in Germany and France was beyond expectations (0.4% q/q and 0.3% q/q respectively). The growth in the euro area was mainly driven by exports and investments, while stocks and public consumption produced adverse effects (public consumption went down for the first time since Q3 2012). Surveys show that the growth will speed up in Q1 2014.

Since the rate of inflation was much below the targeted (0.8% instead of 2.0%), the ECB's intervention was expected by many economists. However, the ECB neither reduced its refi rate[2] nor used any other instrument of monetary policy to halt the drop in prices or stimulate growth. Consequently, euro has strengthened against dollar considerably. They are not planning to change the monetary policy in the foreseeable future. Faster economic growth is expected to push up the prices, so the unchanged monetary policy will increase economic activity because the real refi rate will go down as the inflation goes up. Not until 2016 will the inflation reach the targeted rate. Credit growth is still low, and public debt and private debt are large, which slows down the process of "cleaning up" the Euro zone corporate and state balance sheets.

Inflation in the euro area remains low, though it was stable in February and stood at the January rate (0.8%). Monthly inflation rate continued to fall in Germany, Spain and Italy. The euro area core inflation rose slightly, to 1%. Inflation will remain low due to low domestic demand. Not until the next year will the inflation increase to 1.5% thanks to faster economic growth.

After an aggressive fiscal consolidation in the euro area during the previous years, fiscal deficits should continue to narrow, but at a slower pace. Austerity measures helped reduce the euro area fiscal deficit in 2013 by 0.6 p.p. to 3.1%. Fiscal deficit in 2014 is projected to shrink to 2.6% and remain at that level afterwards. Greece primary budget surplus of EUR 1.5 billion exceeded the expectations, and allowed debt rescheduling and rise in social spending on austerity-hit citizens.

Unemployment in the euro area stands at 12% as of October. Austria and Germany have the lowest unemployment rates (4.9% and 5% respectively), while Greece and Spain have the largest number of the unemployed (28% and 25.8% respectively).

2 Refi rate stands at only 0.25% so there is not much room for its further reduction.

The euro area current account surplus increased to EUR 66.8 billion in Q4, which is by EUR 24 billion larger than in Q3. This increase primarily came from the trade surplus. Faster growth in the euro area stimulates economic growth in Serbia, especially because the recovery in Italy, as the major importer of Serbian products, continues.

U.S.

U.S. growth in Q4 fell to 3.2%[3] relative to 4.1% in Q3 2013. However, if we take a closer look at the growth structure we will see that the slowdown is not a bad news. Growth rate in Q3 primarily came from sharp increase in stocks, so it was reasonable to expect the growth to slowdown in the following quarter due to decrease in stocks. Stocks had minimum impact on growth rate this time. However, investments in fixed capital, having been quite small for a while, finally showed a considerable increase (6.9%), and exports growth rate shot up to 11.4%. Domestic demand remains sluggish. Additionally, residential investments, public spending and investments in business facilities slowed significantly in Q4.

The Fed tapered the monthly securities purchase by USD 10 billion both in December and February, and thus tightened its monetary policy. The Fed still faces communication problems. Their decision not to scale down quantitative easing made in September came as a big surprise. It was equally surprising when they reversed the decision in December. Economists predict Fed's interest rate hike in the first half of the next year. Tighter monetary policy and the expected interest rate stabilization prompted capital outflow from developing countries to the USA, and consequently destabilized many financial markets, pushed down stock and bond prices, and weakened developing countries' currencies. Rise in the overall US inflation rate started in October (1%) and reached 1.6% in February. Core inflation is quite steady (1.6% in February).

In his budget for 2015, President Obama proposes tax breaks for people on a low income and elimination of tax loopholes that the rich exploit to pay lower effective tax rates, often lower than those paid by the people on average income. Additionally, investments in infrastructure, technology innovations and training of the unemployed, intended to overcome the structural problems in US economy, are planned. This budget proposal is also intended to energize the voters because the Congress and House of Representatives elections will be held this year. Furthermore, budget deficit forecasts have been revised downward so the deficit is projected to narrow to 1.6% by 2024. Democrats emphasize that the budget deficit has been almost halved since President Obama's first term in office, which proves the effectiveness of their fiscal consolidation, and therefore believe that more aggressive austerity measures proposed by Republicans are not necessary.

Unemployment stands at 6.7% and it is close to the Fed's unemployment goal, but the problem is low labour force participation rate. Labour reports from December and January are quite adverse, but it is not clear why – due to low temperatures and bad weather during the winter, or because economy slowed down.

Central and Eastern Europe

Eastern European countries were not hit by the Fed's decision to tighten its monetary policy as seriously as other developing economies, primarily because the inflow of "hot money" into these countries was much lower than into other developing markets, while the inflow of EU funds often covers the current account deficit, and they have substantial foreign exchange reserves. Yields on bonds issued by some Eastern European countries, such as Slovakia and Czech Republic, are getting closer to the yields on German bonds. This indicates that the gap between the Eastern European countries is widening. Regarding public debt and fiscal deficit, Serbia, Slovenia and Croatia are the most vulnerable countries in the region. Many countries cut inflation which then allows them reduce reference rate and thus stimulate economy. Agricultural production boosted economic growth in the region.

3 SAAR – seasonally adjusted annualized quarterly growth rate used in the USA

Eastern European countries do not have close trade relations with Ukraine, so escalation in Ukraine crisis would not affect these countries considerably in that respect. Foreign investors could however withdraw their capital from the region due to small geographical distance from Ukraine. They often perceive geographical distance as a significant geopolitical risk factor, especially in countries they are not properly informed about. Escalation in crisis, which is quite unlikely, would have multiple negative effects on the Central and Eastern European countries: it would affect energy supply, capital inflow would decline etc.

Croatia experienced decrease in GDP by 1.2% in Q4, primarily due to low domestic demand. Private consumption declined by 1.8% and investments fell by 3.3% annually. Public consumption and net exports show annual growth of 1.8% and 3.3% respectively. Croatian economy is expected to stagnate in 2014. Low demand pushes the inflation down. Monthly inflation rate in January was negative (-0.1%), while annual inflation rate was slightly above zero (0.1%). If pressures on kuna increase, low liquidity, huge public debt and large fiscal deficit will push up borrowing costs. Croatia has the second highest public debt-to-GDP ratio in Eastern Europe, after Hungary, and the second largest fiscal deficit, after Serbia. Due to these risks and pressures from the European Commission, Croatian Government had to rebalance the budget to reduce 2014 fiscal deficit to 4.5%. To increase public revenues, they are considering relocation of payment for people with reduced service years for retirement from second-pillar pension fund to the state pension fund (European Commission does not object), or increase in health contributions rate to 15%.

Hungary experienced an unexpected annual GDP growth of 2.7%, while the quarterly GDP rose by 0.5%. Private consumption showed annual increase of 1% after a longer period. Investments, public consumption and exports also went up. Similar to many other Eastern European countries, Hungary experienced a marked increase in agricultural production. GDP growth in 2014 is projected at 2%. Inflation rate reached its 40-year minimum falling from 0.9% in October to 0% in January, primarily due to administrative price control. Unorthodox monetary policy was undertaken to reduce reference rate from 3.4% in October to 2.7% in February and thus stimulate economy. However, many economists believe that such a sharp reduction in reference rate can be dangerous because the effects of administrative price control will soon wear off, and the inflation rate will probably rise to about 1% at the end of the year. Borrowing costs are quite stable thanks to a quite large share of domestic borrowing. However, large foreign debt and its short average maturity could increase interest rates on government bonds. Unemployment declined to 8.9%, primarily due to increase in numbers of public work employees, as an instrument of social policy.

Romania experienced an unexpected growth in Q4 (1.5% q/q) and annually (5.2%). This came from large volume of exports, rise in stocks and increase in agricultural production. GDP is projected to grow by 2% in 2014. The National Bank of Romania is planning to reduce reserve requirements and thus boost demand for domestic bonds. Inflation rate dropped from 1.9% in October to 1.1% in February. This allowed for several reductions in the reference rate from 4.25% in October to 3.5% in February. Liberals brought down the Government because they failed to get support for their programme. Social Democrats won 60% of the vote in the Parliament to form the new Government. Investors reacted positively to this because borrowing costs went down and leu appreciated.