The International Environment

Global recovery continued somewhat more quickly in developed countries (primarily because the Eurozone got out of the recession) but developing countries slowed down. Financial markets are preparing for the quantitative easing by the US FED and capital is being withdrawn from developing countries which raised the cost of their debts, devalued currencies and lowered the value of shares. Quick growth of GDP in Q2 in most eastern European countries. The main risks in continuing global growth are the further slowing down of developing countries and the negative effects of military intervention in Syria. The United States and the Eurozone continued fiscal consolidation. Developed countries are still implementing expansive monetary policies but the FED will start gradually decreasing the amount for monthly purchases of stocks and bonds. Inflation in developed countries is still low and there is a danger of increased inflation in the developing countries. The continued recovery of the Eurozone will have a positive effect on Serbia's economic growth.

The World

According to the International Monetary Fund (IMF) predictions in July, global growth will continue in 2013 and will reach about 3%. In expectation of a less expansive FED policy, long-term interest rates have rise in developed countries. That along with the slowdown in developing countries led to a drop in prices on the stock markets of developing countries, a rise in the cost of their debts, outflow of capital and devaluation of their currencies. Growth in the USA was partially hampered by the restrictive fiscal policy (the IMF predicted a growth of 1.7% in 2013) while Japan achieved a higher than expected growth because of the rise of its net exports and domestic consumption. Although the Eurozone officially got out of the recession in Q2 there is still no confirmation of a definite recovery of the Eurozone because Spain and Italy have seen a drop in GDP and many risks which could slow growth are still present (primarily because of the insufficient speed in implementing institutional reforms and structural changes). The IMF predicted a drop of 0.6% in the Eurozone in 2013 but an upwards revision of that prediction is expected because of the higher than expected growth in Q2. The difference in the growth rate in developing and developed countries is growing smaller because the predicted growth rate for developing countries has dropped from 5.3% to 5% for 2015 and from 5.7% to 5.4% for 2014. There was no change in the predicted growth rates for eastern Europe. The growth rate for China for this year was reduced from 8.1% to 7.8% and for next year from 8.3% to 7.7%. The greatest negative correction of growth rates was for Brazil, Russia and South Africa. The risks of a fiscal cliff in the US and financial crisis in the Eurozone have been drastically reduced and now the main risks to global recovery are the slowdown of growth in developing countries and the negative consequences of military intervention in Syria. Capital has started withdrawing from developing countries because of the confusion over the FED exit strategy (and its timing) which could lead to a macroeconomic imbalance and additional slowdown of growth in those countries, especially those with high current deficits. The deepening of the crisis in developing countries could have a negative effect on the level of the cost of debts in Serbia.

The Eurozone

The Eurozone achieved a y.o.y. drop of 0.7% in Q2 but compared to the previous quarter it achieved a growth of 0.3%[1], (more than the expected 0.2%) and the official view is that the recession is over. However, Italy and Spain are still in recession (negative quarterly growth) while the population of the Eurozone has not felt the exit from the recession since unemployment continues to be high (12.1%) and the effect of low base is still present since growth in Q1 was fairly low. In Germany, quarterly growth stood at 0.7% after growth slowed down in the previous quarter primarily due to bad weather. The construction and processing industries saw strong

1 Seasonally adjusted growth compared to previous quarter

and fast growth in Q2 in Germany and the business environment improved. The biggest surprise was France which had a quarterly growth of 0.5% which was higher than the expected growth of 0.2%. That country saw its automobile and aircraft industries recover the most. Portugal recorded a positive growth of the GDP at quarterly level after a long time. Fiscal policy continues to be restrictive in the Eurozone which prevented a significant recovery of personal spending in the Eurozone.

The European Central Bank (ECB) did not change its key policy rate since May (0.5%) but the novelty is that it started using the phrase "the key policy rate will be low in the long term" similarly to what the FED is telling the public. Analysts believe that the low rate will stay in place probably to the end of 2014. The ECB chairman said that the low rate will remain in place to support economic recovery as long as inflation does not pose a threat.

Overall inflation dropped again following the recovery in Q2. Overall inflation in June stood at 1.6% and at 1.3% in August while base inflation in June stood at 1.2% and at 1.1% in August.

Unemployment in the Eurozone has been stable since April and is at a historic high of 12.1%. The lowest unemployment was in Austria (4.8%) and Germany (5.3%) and the highest was in Greece (27.6%) and in Spain (26.3%).

The trade balance in the Eurozone was positive in Q2, standing at 43.7 billion Euro which is more than the surplus in Q1 which stood at 39.1 billion Euro. While Eurozone exports recorded growth, imports saw a drop and the trade surplus increased. Germany had the biggest surplus in the first five months of this year (8.1 billion Euro) and the biggest deficits were recorded in France (32.9 billion Euro), Great Britain (26.1 billion Euro) and Greece (8 billion Euro). If the recovery results in a rise in imports Serbia's economic growth could be stimulated.

The United States

The United States achieved a GDP growth of 1.6% at annual level in Q2. As in the previous quarter, personal spending contributed the most to growth and the reduction of public spending had a negative effect because fiscal consolidation is underway because of the high public debt of the US. Companies recorded growth of investments and supply levels while imports rose. The construction industry continued its recovery. After tax exemptions were abolished for the poor and middle class and higher taxes were introduced for the rich, personal spending continued to grow at a similar pace as before.

The fiscal deficit will stand at less than 4% this year with a downward trend which is a significant success. For example, in 2009 the deficit stood at 10.8%. Congress needs to take a fresh decision on the extent of budget expenses when the risk of a fiscal cliff could resurface although that scenario is less probable than before. The planned deficit for next year is 3.3% and 2.1% in 2015 but the Republicans will probably demand an even lower deficit rate.

The FED did not change its key policy rate nor did it correct existing interventions on the open market but it is expected to slowly decrease the amount of stocks and bonds which the FED buys every month which is part of the third stage of quantitative easing. However, since no specific date has been announced, there is confusion about when the easing of the intensity of the interventions on the open market will begin. Because of that, long-term interest rates have risen (early in May the rate for 10 year US state bonds stood at around 1.6% and now it is almost 3%) as well as the return of capital from developing countries to the US. There is a danger that if the growth of long-term interest rates continue it could block the recovery of the real estate market.

Overall inflation, following the drop in March and April to 1.1%, rose and now stands at 2% while base inflation stands at 1.7% at annual level which is a drop compared to March when it stood at 1.9%.

The situation on the labor market is improving and the unemployment rate fell from 7.6% in March to 7.4% in July. The US economy will probably continue creating some 200,000 jobs a month but

that is not enough to normalize the situation on the labor market completely. That trend will gradually decrease the unemployment rate but the pace will slow down unless the level of participation of the workforce increases on the labor market and it is currently at a fairly low level. The growth of wages will not speed up unless there is a significant drop in unemployment rates.

Central and Eastern Europe

Fears of the FED easing its expansive monetary policy led to a rise in the cost of debts and a devaluation of currencies in Eastern Europe but to a lesser extent than in Brazil, India and Russia. As in the Eurozone, the growth of the GDP speeded up slightly in many east European countries and polls show that this trend could continue over the next quarters. The possible increase of imports into the countries of eastern Europe increase could have a positive effect on exports from Serbia.

Hungary achieved a growth of its GDP of 0.2% at annual level in Q2. The main contributions to that growth came from agriculture and the construction industry while industrial production and services stagnated. Helped by EU funds, capital investments (state) also recovered while personal spending saw a modest growth following 8 quarters of decline. Net exports had a saw negative effect on growth (exports rose 3% and imports rose 4.7%) but automobile production is expected to increase the level of production in the autumn. Fiscal policy was slightly expansive but the government continued its unorthodox taxes on companies and as a result capital investments by companies remained at a low level. The IMF predicted zero growth this year with inflation at 3.2%. There are plans to convert loans in foreign currency into Forints under favorable conditions. The central bank continued its sharp reduction of the key policy rate which was lowered several times from the 5% level in March to 3.8% now. In conditions of relatively low inflation and weak domestic demand, the key policy rate is aimed at stimulating economic activity and exports by weakening the Forint. From the start of the year, overall inflation dropped and stood at just 1.8% in July which is much lower than the target of 3%. Hungary has managed to reduce its budget deficit to a level below 3% and help from EU funds will not be withheld.

Romania achieved a GDP growth of 0.5% q/q (y.o.y. growth of 1.4%) in Q2. Industrial production rose by 1.4%, agriculture by 0.6% while the construction industry saw a drop of 0.5%. Net exports saw a growth of 6%. The trade deficit was cut in half in the first six months and, together with very successful agricultural production, Romania recorded a surplus in its current account in the first six months of the year. A new stand-by arrangement will be signed with the IMF as a measure of caution and the focus of that agreement will be raising the competitiveness of the Romanian economy. The IMF predicted a growth of 2% this year with a budget deficit of 2.3% (somewhat larger than the earlier plan of 2.1% because of additional expenses in health care and regional development). The plan is to reduce VAT on bread to 9% (the standard VAT is 24%) and raise duties on alcoholic beverages along with a new tax on luxury cars, gold, jewelry and weapons. In order to reform the economy and raise competitiveness, Romania plans to sell shares in several public companies.

Croatia recorded a GDP drop of 0.7% at annual level in Q2 which is somewhat better than expected and is the least bad result over the past six quarters. Most probably, personal spending was somewhat higher than earlier with a solid tourist season but the fact that Croatia quit CEFTA and the restructuring of the shipbuilding industry had a bad effect on industry. Most investments were financed by the state and the level of private investments continues to be low. The prediction is that the GDP would see a negative growth of 0.8% in 2013. In August, the S&P agency lowered its predicted rating for Croatia from stable to negative. The autumn is expected to see a new government economic plan as well as a budget plan for 2014 which will be important for budget income due to weak economic activity and the servicing of the public debt (which is approaching the level of 60% of the GDP with a budget deficit of more than 4% this year) is increasingly expensive. Because of that the new economic plan must include a reduction of budget expenses and structural reforms.