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FOCUS NOTES: SERBIA

Eurobank EFG

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Central Bank hikes interest rates again, struggling with an accelerating inflation

CONOMICS & STRATEGY

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- NBS raised its key policy rate by a further 100 bps to 11.50% yesterday, in a move to address accelerating inflation and continuing depreciation pressures on the dinar.
- Increased price pressures in the domestic economy suggest that Central Bank will miss year-end inflation target and may find it more difficult to attain next year's inflation target too
- On December 10th, NBS raised its key policy rate by 100 bps to 11.50%. This was the fifth rate hike since the Central Bank terminated its policy easing cycle in early August. In a statement released after the policy meeting, the Central Bank cited once again the inflationary impact of higher agricultural product prices as a result of a poor domestic wheat crop and the Russian export ban. In addition, there was an explicit reference to the dinar depreciation and its negative impact on the domestic inflation outlook
- According to the Bloomberg survey, the majority of economists polled (11 out of 21) expected a 50bps hike. Six out of the 21 expected a 100bps hike while four foresaw no change. The new NBS rate hike and its magnitude hardly came as a surprise to us. In both our previous issue of New Europe Economics & Strategy in late November and the Focus note on Serbian economy on Nov 11th, <u>our call was for a 100bps hike</u> in the last monetary policy meeting for 2010
- The announcement of the November Retail Prices Index reading (+1.8%/+10.9% mom/yoy), which is a leading indicator of consumer prices made it apparent that domestic inflation pressures intensify and that consumer prices may reach double digit levels by the end of the current year.
- Consumer price inflation came in at 8.9% yoy in October, up from 7.7% yoy in the prior month and 4.8% yoy in January 2010. Since August, food prices are a positive contributor to inflation because of the poor domestic crop and the rally in world soft commodity prices. Their impact on headline inflation is magnified by their significant weight in the CPI basket (~37.8%). The oligopolistic or even monopolistic market structure in key sectors of the Serbian economy makes only things worse with respect to inflation.

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September 29, 2010 ECONOMICS & STRATEGY
FOCUS NOTES: SERBIA
The Central Bank hikes attempt to contain accelerating inflation expectations which may trigger a second round of price increases. However, Central Bank has not been quite efficient to anchor the

expectations of the carry-traders who were used to have relatively high real positive interest rates in the

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Serbian market in the near past

- On top of that, inflation volatility undermines the de-Euroization strategy of the government: Given the traumatic experiences of hyper inflation and bank defaults of the 1990s, the level of confidence in the domestic currency as a storing value means is low. This is reflected in the high Euroization level in the economy. FX deposits have a lion's share in total deposits: FX deposits comprised 72% of total deposits.
- In our view, the aforementioned developments will have two important consequences: The latest CPI readings suggest that the inflation target (6%+/-2%) will be missed this year, for the first time since the introduction of the inflation targeting regime in August 2006. It appears that the Central Bank may find it difficult to also attain the official inflation target for next year (4.5% +/- 1.5%). In fact, the attainability of next year's inflation target has already stirred intense public debate domestically. For that reason, the Central Bank is currently in discussions with the government on the possibility of deploying administrative measures aiming to stabilize domestic food prices.
- On the other hand, the most important factor that weighed on the NBS's policy decision was the rapid pace of dinar depreciation in recent months, the weak capital inflows as well as the low demand for Dinar denominated securities. It is worthwhile to point out that the last three month Treasury bills auction was undersubscribed. More specifically, the Ministry of Finance managed to attract 49% of the requested funds (RSD 2.44 bn with an average yield 12.3%)
- Since September 2009, the dinar has come under significant depreciating pressure that intensified in the summer months despite repeated central bank interventions in the FX market. Officially, the Central Bank does not have an explicit exchange rate target. Yet, it has spent some €2.5bn (more than the IMF assistance received so far-€1.5 bn) from its FX reserves so far this year in an attempt to smooth excess volatility in the market
- When the dinar reached a new historic low at 107.04/€ on August 2, the Central Bank was, apparently, forced to hike interest rates. The domestic currency recouped some of its losses before starting to reweaken again, reaching 105.6/€ on September 6. This prompted the Central Bank to intervene again. After remaining broadly flat at levels around 105/€ for a short period of time, the dinar started to depreciate again. On October 28th, it reached 108.05/€, a new historical low. Dinar traded at 107.15/€ on December 11th, right after the announcement of the hike, slightly below the historical low. At the current level, the Dinar has lost nearly 11 percent since January, and about 40 percent since the start of the global financial crisis in 2008.

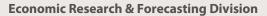
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