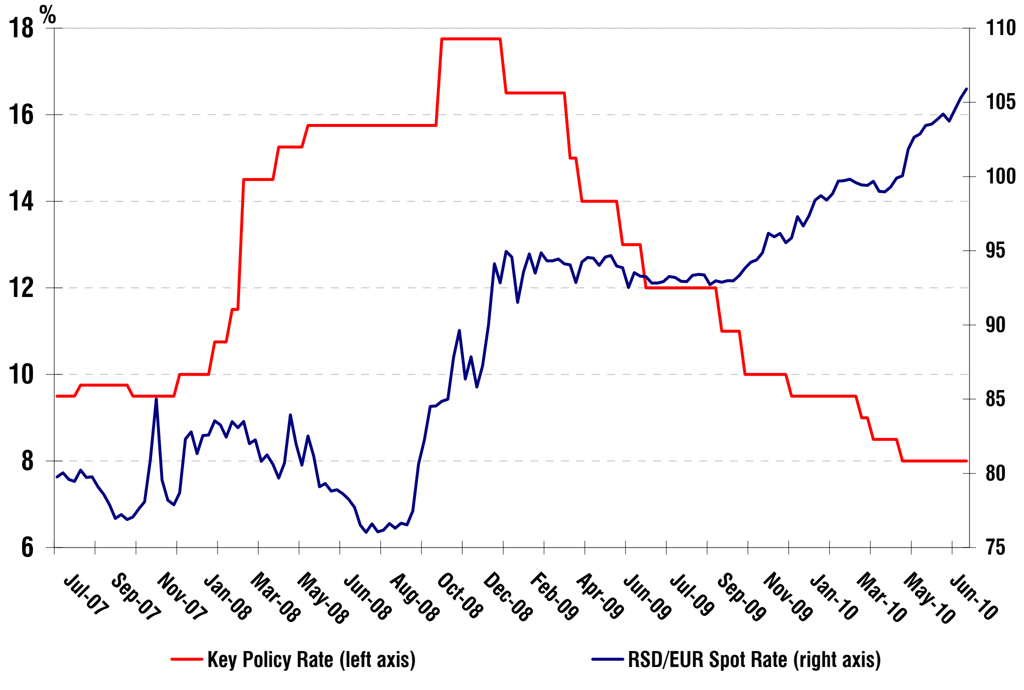
Eurobank Research
Eurobank EFG
New Europe Economics & Strategy
www.eurobank.gr/research
Thursday, July 29, 2010

Focus Notes: Serbia

Serbia: Dinar depreciation continues unabated

The Dinar just crossed the crucial level of 106/€, ending the day at 106.10/€ on July 29th. The current level represents a new historic low for the Dinar which has lost ca. 13.7% of its value since last September. We had expressed a strong bearish view on the Dinar in all recent *New Europe economics & strategy* issues and continue to see limited scope for a meaningful recovery in the foreseeable future. We anticipate that Dinar is going to reach the level of 110/€ by the end of 2010.

Dinar hits a new historic low



In essence, the current level of the Dinar is the inflection point towards further depreciation rather than the level where the recent depreciation wave ends. Maintaining the Dinar stable will be a contentious

Research Team:
Gikas Hardouvelis, *Chief Economist and Director of Research*
Platon Monokroussos, *Head of Financial Markets Research*
Tassos Anastasatos, *Senior Economist*
Ioannis Gkionis, *Research Economist*
Stella Kanellopoulou, *Research Economist*
Galatia Phoka, *Emerging Markets Analyst*
Theodoros Rapanos, *Junior Economic Analyst*

Sales Team:
Fokion Karavias, *Treasurer*
Nikos Laios, *Head of Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Petropoulos Theodore, *Institutional Sales*
Karanastasis Kostas, *Retail Sales*

EFG Eurobank Ergasias, 8 Othonos Str,GR 105 57, Athens,Tel:(30210) 3718 906, 3718 999, Fax:(30210) 3337 190, Reuters Page: EMBA, Internet Address: http://www.eurobank.gr

and critical issue for the rest of the year. The new governor Mr Soskic, who just replaced Mr Jelasic, will have to strive to maintain confidence in the local currency, which is presently the key focus of market attention.

Depreciation pressures on the Dinar continued unabated throughout June despite repeated central bank interventions (€20-50mn spent in June alone to support the local currency). The Central Bank has spent a total amount of over €1.5bn so far this year in supporting interventions, without accomplishing even to stabilize the Dinar. Total Central Bank reserves stood close to a record high at EUR 10.7bn at the end of May supported by IMF loan, more than enough to address the financing requirements.

In principle, the Central Bank has embraced the notion of the transition of the Serbian economy from a domestic demand-driven to an exports-oriented model of development. In our view, this entails implications for the FX policy, on the basis that the exports-driven growth model the NBS envisages may not be compatible with a sustainably strong Dinar. Dinar had already incurred over 90% appreciation in real effective terms during the boom years in 2004-2008.

In fact, the new NBS governor, Mr. Dejan Soskic, stated recently that monetary policy should not allow for a (real or nominal) appreciation of the local currency in the upcoming period. Along these lines, Mr. Soskic has rebutted arguments in favor of a change in the present flexible exchange rate regime to a more rigid framework. According to Mr. Soskic, the introduction of such a regime could result in a depletion of FX reserves or the need for high real domestic interest rates that could strangle the still sluggish economic recovery.

However, the depreciation of the Dinar is a mixed blessing for the domestic economy. On the one hand, it helps to boost export competitiveness and thus, economic growth. Exports showed signs of revival growing by 16.7% yoy in Jan-May 201. Those pushed GDP growth in positive territory in Q1 of the current year (+0.6% yoy) for the first time since Q4 2008.

On the other hand, it increases inflationary pressures because of the high pass-through. The Central Bank has estimated the pass through effect at 0.2-0.3 in the current quarter and 0.6 in the next 12 months. Central Bank officials have stated that inflation pressures are not going to surface until Dinar breaches the threshold of 110/€. As a result, inflation (+4.2%YoY in June) is expected to remain within the official target range (4-8%) in the remainder of this year.

Ioannis Gkionis, Research Economist
igkionis@eurobank.gr