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Focus Notes: Serbia

Serbia: Central Bank hikes interest rates again on rising inflation risks, increasing risk premia

- ✓ NBS raised its key policy rate by a further 100 bps to 10.50% today, in a move to address rising inflation risks and continuing depreciation pressures on the dinar.
- ✓ Increased price pressures in the domestic economy suggest that Central Bank may miss year-end inflation target

NBS hikes key policy rate for the fourth month in a row to arrest dinar depreciation, heightened inflation pressures

On November 11th, NBS raised its key policy rate by 100 bps to 10.50%. This was the fourth 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 potential implications for the domestic inflation outlook.

The new NBS rate hike hardly came as a surprise to us. The announcement of the September CPI reading (+1.3%/+7.7% mom/yoy) made it apparent that domestic inflation pressures continue to intensify. This casts doubts on the achievement of the year-end target (6%+/- 2%) at the first place. However, the most important factor that weighed on the NBS's policy decision was the rapid pace of dinar depreciation in recent months, as well as the recent rise in sovereign risk premia. 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. When the dinar reached a new historic low at 107.04/€ on August 2, the Central Bank was,

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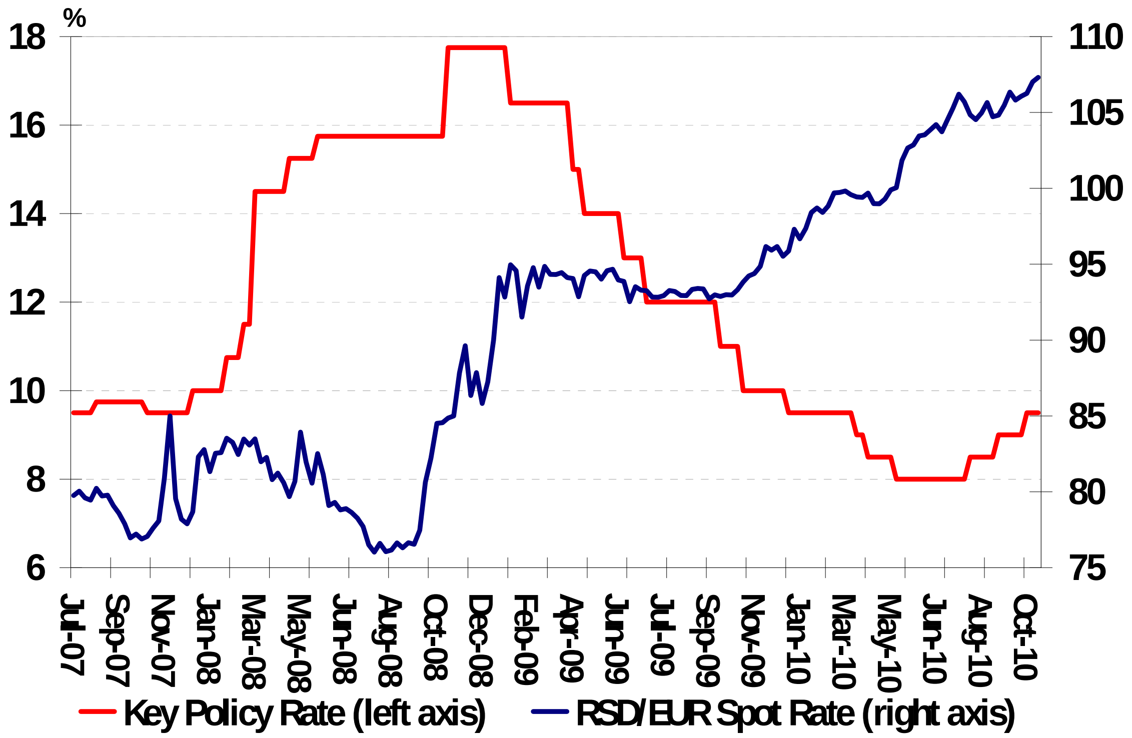
apparently, forced to hike interest rates. The domestic currency recouped some of its losses before starting to re-weaken again, reaching 105.6/€ on September 6. This prompted the Central Bank to intervene again. After remaining broadly flat at levels around 105/€ for a short period of time, the dinar started to depreciate again. On October 28th, it reached 108.05/€, a new historical low. Dinar traded at 107.08/€ on November 11th, right after the announcement of the hike, slightly below the historical low (Figure 1).

Figure 1: Dinar depreciation continues despite higher policy rates and central bank interventions



Source: Bloomberg, Eurobank Research

Officially, the Central Bank does not have an explicit exchange rate target. Yet, it has spent some €2.2bn (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. The depreciation of the dinar is a double-edged sword for the Serbian economy which complicates things for the Central Bank. On the one hand, it helps to boost export competitiveness and thus, growth. The fragile economic recovery has so far been mainly driven by higher exports (+14.5% yoy in Jan-Aug 2010). On the other hand, it increases inflationary pressures because of a high pass-through (0.2-0.3 in the current quarter and 0.6 in the next 12 months). On top of that, further Dinar depreciation hurts the ability of unhedged borrowers to service their debts, thus increasing the probability of NPLs rising more (NPLs ratio at 17.5% in Q2).

Inflation en route to overshoot year-end target; NBS expected to hike rates again in December

Headline CPI rose further in September, moving closer to the upper side of the Central Bank's target band (6%+/-2%). Consumer price inflation came in at 7.7% yoy in September, up from 6.7% yoy in the prior month and 4.8% yoy in January 2010. This brought the annual average inflation to 5% yoy in year-to-September, compared to 8.9% yoy over the same period a year earlier. Strong pressures are already apparent in the regulated as well as the market-driven segments of consumer prices. 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%). Food prices rose by 2% mom/6.2% yoy in September vs. 3.6% mom/4.4 yoy in August.

The second biggest monthly increase came from the categories of education (+12% yoy/+1.8% mom) and restaurants& hotels (+8.5% yoy/+1.7% mom), with the alcoholic beverages & tobacco category registering an equally big increase (+14.4% yoy/+1.3 mom). Regulated prices also inched up in September, reaching 10.3% yoy compared to 10.0% yoy in August. On the other hand, transportation prices, which have been a key driver of domestic inflation in the previous months, eased further to 10.3% yoy in September from a peak of 11.4% yoy in May.

The September CPI reading was still within the official target band (4-8%) for 2010, but the Central Bank anticipates the spike in food prices to continue in the following months. The latter coupled with the lagged pass through effects of the dinar depreciation (imported prices account for ca 1/3rd of the CPI basket) and the elevated inflation expectations is expected to push consumer prices to levels above 8% yoy in October and, most probably, to double digit growth by the end of 2010. The first indication in this direction is reflected in the evolution of two leading indicators, the retail price index (RPI) and the cost of living, which accelerated to 9.9% yoy and 8.6% yoy respectively.

In our view, the aforementioned developments will have two important consequences:
First and foremost, it appears that the NBS does not have much choice but to hike policy rates further (we expect at least another 50bps, if not 100bps, of rate hikes delivered in the last meeting of the current year in December). These hikes will aim to contain inflation expectations, which may trigger a second round of price increases. In addition, the Central Bank is currently in discussions with the government on the possibility of deploying measures aiming to stabilize domestic food prices.

Secondly, the latest CPI readings suggest that the inflation target will likely 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. Local media reported that the IMF has allegedly encouraged the Central Bank to change the current inflation targets in order to make them more attainable. IMF rebutted those reports as "erroneous", supporting the current inflation targeting framework.

Short-term dinar outlook remains bearish

In our recent *New Europe Economics & Strategy Monthly* issues we expressed a strong bearish view on the dinar, emphasizing that attaining dinar stability would prove a contentious and critical task for the rest of the current year. Looking ahead, we continue to see limited scope for a meaningful recovery of the local currency in the foreseeable future, continuing to anticipate a move towards 110/€ by year end. There are a number of reasons supporting that view:

✓ In principle, it was the NBS that first 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. In addition, the recently-released government strategy document titled "Serbian post-crises economic growth and development model 2011-2020", incorporated as one of its key underlying assumptions that the dinar would continue to depreciate by about 2 percent per annum until 2015. This implies that a weaker dinar is considered as a key element of the strategy upon which the new post crisis growth model will be based on.

✓ Low export competitiveness compared to other peers: According to the IMF, Serbia's euro wage levels, taking account of labor productivity growth, seem in line with most transition peers. However, they significantly exceed those of key regional competitors, including Bulgaria and Slovakia

✓ Inflation volatility: 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. The current inflation volatility only hampers the de-Euroization strategy of the government.

✓ In addition, capital inflows remain weak. Net FDI inflows, one of the most important components of BoP, decreased by 42.2% yoy year-to-August 2010, covering just 34.2% of the corresponding current account deficit. There is still a large stock of state-owned enterprises to be privatized in order to attract more FDI inflows in Serbia. However, market conditions are such that there is little prospect of a strong recovery in FDI or other capital inflows. The government plans to sell a 40% stake in the Telekom Serbia through an international tender. When this finally takes place, most probably in the beginning of 2011, it is going to boost FX reserves in a one-off sales transaction, giving more ammunition to the Central Bank rather than directly affect the FX rate since the Central Bank is going to store them.

✓ The switch to monetary policy tightening has not been effective so far in containing depreciating pressures on the dinar. That is because it appears that the CB is still behind the curve in its fight against inflation.

✓ Last but not least, the ongoing sovereign crisis in the Euro area complicates things further. The fiscal crisis had exerted downward pressure on all regional currencies, in all regional currencies including the Dinar. However, the lack of market confidence in the prospects of a rebound in the Dinar, doesn't benefit it now that the Euro is appreciating.

On the other hand, financial markets seem to have ignored the positive news flow of economic data:

✓ The improvement in the macroeconomic environment: The Serbian economy has exited recession, recording positive real GDP growth in 1H. The revised Q2 data showed that economic recovery is gaining ground. GDP grew by 2% yoy in Q1, overshooting the initial flash estimate of 1.6%. This comes on top of 0.6% yoy in Q1, bringing the growth performance at 1.2% yoy in 1H. What is more important, the sources of growth become more differentiated and sustainable compared to the recent past: Growth is switching to a more balanced mix between net exports and domestic demand.

✓ The government is on track with the IMF program. The implementation has been smooth so far, which is now at the stage of the fifth review. All the quantitative targets for end June were met, including that of the fiscal deficit. In fact, the authorities withdrew only €56 mn of the latest loan tranche (€383 mn in late August), bringing the overall disbursements at €1.5bn out of a total financial package of €2.9bn. The sixth review will most probably be completed by end of November, with one more left for next February.

✓ What is more important, the government is successfully implementing the required structural reforms. The government is at the final stage of completing or has already implemented most of the politically-sensitive structural reforms including, among others, the pension system reform and the downsizing of the central government sector personnel by 10%. In that respect, the Serbian government is complying with IMF program requirements more effectively than other governments who run similar programs in the New Europe region.

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