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# Serbia: New precautionary IMF agreement

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- The Serbian government reached an agreement with IMF mission on a new €1bn precautionary agreement
- NBS cut rates by another 50bps at 11.25% on September 8th, bringing the cumulative cuts to 125bps from the beginning of the easing cycle. Inflation scaled down further at 12.1% in July compared to on reduced food and energy prices

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**New precautionary €1bn agreement with IMF will shield Serbia in case of a new global downturn**

On Aug 31st, the Serbian government reached an agreement with the IMF mission on a new precautionary lending agreement to succeed the expired Stand by Arrangement. The new agreement envisages an €1bn funding available for a period over the next 18 months. The aim of the agreement is threefold: first protect the country against an external shock, secondly act as an anchor for fiscal policies and thirdly improve investment climate through better management of state-owned enterprises and improving property rights security.

The fiscal policies were in the epicenter of negotiations between the government and the IMF. Firstly, the weaker economic activity prospects in Europe led the mission to downgrade the GDP growth forecast of 2011 from 3% to 2%. Accordingly, the GDP growth forecast of 2012 was revised downwards from 5% to 3%. The downward revision of growth forecasts led inter alia to a revision of the fiscal projections in 2011-2012. More specifically, the budget deficit target was revised upwards to 4.5% of GDP against the original plan of 4.1% in 2011. This is translated into a revision of the fiscal target from RSD140bn to RSD153bn in nominal terms. The central government deficit was revised from RSD120 bn to RSD132 bn.

On the revenues side, the revision of growth forecast resulted in downward revision of budget revenues by RSD 22bn in 2011. On the expenditures side, the indexation of public wages and pensions to inflation, provided by the previous IMF agreement will result in an increase of spending by RSD 13.4bn. In addition, there has been a mutual agreement for a provision of RSD 3.9bn for additional social expenditures. Nevertheless, in order to achieve the revised target the government has decided to slash current (subsidies and provisions) as well and capital expenditures in order to save another RSD15-20bn.

The endorsement of the supplementary budget by the parliament is an important conditionality for the new SBA to be approved by the IMF board in early October. In addition, the government will have to submit a property restitution bill (properties confiscated during the previous communist regime) in line with the fiscal responsibility legislation during September.

A new precautionary agreement was our main scenario in all previous issues of New Europe & Economics Strategy. In our view, the importance of the agreement is significant. Firstly, it provides a cushion in case of a new global downturn and reduces the sovereign risk premium of the country. Secondly, it increases the credibility of the implemented fiscal policies. It is important to note that the revised targets are in line with the fiscal rule which was recently adopted as part of the expired

IMF agreement. Thirdly, the new agreement is a good opportunity to push for long waited structural reforms in the investment climate not completed during the previous program.

**Inflation continues to scale down to 12.1% in July on reduced food and oil prices; NBS cut interest rates by 50bps to 11.25% on September 8th after a short pause in August**

After a short pause in August on renewed market concerns over the deepening EMU crisis, the NBS cut interest rates again. On September 8th, the NBS decided to cut its key policy rate by another 50 bps to 11.25%. This is the third rate cut since June 7th when NBS had last cut interest rates by 50bps (from 12.5% to 12%) initiating the monetary policy easing cycle. According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (9 out of 22) expected a 25bps cut; five expected a 50 bps rate cut and seven anticipated a no rate change.

In the statement released, the Central Bank emphasized the strong disinflationary impact of low demand side pressures on headline inflation in the coming period. The latter comes on top of the expected stabilization of food prices and slower growth in regulated prices. More specifically, food inflation (37.8% weight in the consumer basket) has already peaked and is expected to subside further in the coming months. The sharp decline of food prices is driven by favorable base effects and the positive impact of the new agricultural season which started in July.

Inflation registered a negative month on month reading for a second consecutive month in July. Consumer prices scaled down to -0.3% mom/+12.1% yoy, the lowest reading during 2011, after peaking at +1.1% mom/14.7% yoy in April. In our view, inflation is going to retreat further in the coming months. Provided that there are no other supply-side shocks or some undue fiscal relaxation because of the onset of the political cycle, inflation would gradually retreat more visibly towards the targeted band from Q3 2011 onwards.

Although year-end inflation will most probably end in single digit, it will still lie significantly above the Central Bank target (4.5%+/-1.5%). In conclusion, we still hold the view that the Central Bank will maintain its easing bias until the end of 2011. For that we still see room for additional 75-100 bps rate cuts from the current levels in line with what we have already described in our previous New Europe Economics & Strategy.

On another note, Dinar started losing ground on concerns over potential spillovers from the ongoing EMU sovereign crisis since mid June. Lower real yields and market contagion fears eliminate most Dinar gains since the beginning of the year. Investors' interest in government securities has weakened on higher country risk premium (evident in the EMBIG spreads), after strong portfolio inflows for T-bills in the 1H. Dinar had strengthened as low as 98/€ on June 10th, compared to 105.9/€ at last year end and an historic low of 108.1/€ on October 28th, 2010.

Even though the dinar appreciation trend is reversing, the Dinar is still holding some of its gains since the beginning of the year. On Sep 9th, dinar stood at 101.46/€, higher by approximately 4% compared to the end of 2010. However, the attractiveness of the Dinar carry trade is fading away. The combination of lower interest rates, the downward revision of several key macro figures and analyst & Markets' concerns over potential spillovers from the ongoing EMU sovereign crisis and global growth slowdown concerns paint a gloomier outlook for the local currency until the end of the year.

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