Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

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NEW EUROPE
ECONOMICS & STRATEGY

March 11, 2011

FOCUS NOTES: SERBIA

Central Bank hikes rates again after short pause in February

Written By:

Ioannis Gkionis:
Research Economist
Coordinator of Macro Research

- On March 10th, NBS raised its key policy rate by 25 bps to 12.25%.
- The new rate hike strikes a balance between two important factors: High inflationary risks that prompt the Central Bank to be proactive versus concerns over further domestic currency gains from the increased interest in local T-bills.

On March 10th, NBS raised its key policy rate by 25 bps to 12.25%. This was the seventh rate hike since the Central Bank terminated its policy easing cycle in early August. The Central Bank has delivered 425bps of cumulative rate hikes since then in an attempt to combat intensifying inflationary pressures.

According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (13 out of 22) expected no rate change; 8 out of 22 expected a 50bps rate hike, while there was one analyst who expected a 50bps rate cut. The latter was despite recent statements to the opposite by the NBS Governor.

In a statement released after the policy meeting, the Central Bank cited once again the inflationary impact of higher agricultural product prices and their ensuing impact on processed food prices. In addition, there was an explicit reference to the recent dinar appreciation trend and its positive impact on imported prices and subsequently, to the non-food component of inflation.

Note that domestic consumer prices have been on a rising trend in recent months, reaching a two-year high of 11.2% yoy in January 2011. This was mainly the result of higher food inflation (+1.9% mom/+13.3% yoy in January 2011 vs. -1.2% mom/+0.7% yoy in last July) due to the poor domestic crop and the rally in world commodity prices. The impact on headline inflation was magnified by the significant weight of food prices (~37.8%) in the domestic CPI basket. To complicate things further, regulated prices have also been on a rising trend in recent months. Tobacco and Alcohol products have taken the lead since January (+7.7% mom/+15.5% yoy in January vs. 0.1% mom/+9.5% yoy in last July), a month in which traditionally hikes in excise taxes take place. Furthermore, the state power utility has announced increases in the electricity prices (13.5% for households and 15% for corporates) effective from March 1st, that would further weigh on the domestic inflation outlook. All in, the Central Bank sees inflation peaking around 14.5% in late Q1 or early Q2. Then, disinflation is seen resuming in the 2H, assisted by favorable base effects.

The last CPI reading deviated further from the upper boundary of the Central Bank's band for January 2011 (6%+/-2%). The tolerance band is defined for each month so that the Central Bank monitors the target throughout the year. From that point of view, it appears that the Central Bank may find it difficult to attain the end-2011 official inflation target (4.5% +/- 1.5%). In fact, the attainability of this year's inflation target has already stirred intense public debate domestically. Given that the Central Bank missed last year's target by a wide margin, it is important that this year's target is attained

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so that some credibility is still maintained.

In our view, the hike designated that NBS made only a pause in its February meeting. We had warned in our January issue of New Europe Economics & Strategy that even though the Central Bank left interest rates unchanged at 12% on February 12th, it still maintained a tightening bias. The hikes attempt to contain elevated inflation expectations from triggering a second round of price increases and thus avert a wage-inflation spiral. The Gallup and Bloomberg surveys in the latest inflation report presentation, showed evidence that this has been partially accomplished.

As we have already stipulated in our previous issues of New Europe Economics & Strategy, we anticipated that the Central Bank would be less aggressive with interest rate hikes going forward. The Central Bank has stated that it mobilized the tool of the minimum reserve requirements in order rely less on the policy rate in the future. The minimum reserve requirement for short-term deposits (maturities of less than two years) was lifted from 25% to 30%.

As a result, the hike strikes a balance between two important factors: High inflationary risks stemming from the aforementioned factors that prompt the Central Bank to be proactive versus concerns over further domestic currency gains from the carry trade. Central Bank governor, Mr Dejan Soskic, has expressed his concerns over further Dinar gains triggered by higher rates and increased borrowing costs for consumers. Additionally, he said that the NBS should use all available methods to fight inflation, except the exchange rate, which would hurt exporters if left to appreciate. Motivated by the strong demand for local T-Bills from local banks and foreign investors, the Dinar has recouped some of its earlier losses during the first months of 2011. On March 10th, the Dinar strengthened to 102.9/€ compared to 105.9/€ at the end of last year and a historic low of 108.1/€ recorded on October 28th.

For that reason, there is a good chance that although we may have not seen the peak of the policy rate, we may stand near to the completion of the latest tightening cycle. That said, provided there are no other nasty surprises with respect to inflation, we anticipate rates to peak in the next couple of months at the level of 12.5-13%.

On the other hand, the Central Bank will be increasingly confronted with additional risks that will not allow cutting rates equally aggressively: the oil prices shock from the ongoing geopolitical events in Middle East and North Africa, the prospective tightening by the ECB, and the onset of the pre-election cycle in the country (parliamentary elections are officially scheduled for next May).

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Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

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