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FOCUS NOTES: SERBIA

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Serbia: EU candidate status by year-end

- The arrest of fugitive general Ratko Mladic gives a boost to the country's EU candidate status
- NBS left unchanged its key policy rate at 12.5% signaling the end of the tightening cycle-Inflation climbed further at 14.7% in April, the highest reading in the last 34 months.

The arrest of fugitive general Ratko Mladic gives a boost to the country's prospective EU candidate status

On May 26th, the alleged war crime fugitive general Ratko Mladic was arrested by the Ministry of Interior security forces. General Mladic, indicted by the International Criminal Tribunal for the former Yugoslavia (ICTY) with charges for genocide during the 1992-95 Bosnian war, has been on the run in the past 16 years. The arrest of General Mladic is a flagstone on the road to EU membership. EU has conditioned Serbia's accession on full co-operation with ICTY. The co-operation with ICTY has always been a controversial and sensitive issue in Serbia's struggle for EU integration. The current government coalition has made steady progress in the last three years. After the arrest of Bosnian-Serb leader Radovan Karadzic in 2008 and general Mladic, the Croatian-Serb leader Goran Hadzic is the only high profile case left.

In retrospect, EU-Serbian relations have been steadily improving during the last three years. EU integration was set as a key government priority for the coalition in the beginning of its term. From that perspective, the results have been impressive.

- The Stabilization and Association agreement (SAA), the most important contractual agreement between Serbia and EU, was signed in April 2008. Although Serbia has made steady progress in complying with SAA requirements unilaterally, the agreement has not been ratified by all EU members
- Serbia applied for EU membership in a symbolic gesture in December 2009. At the same time, EU visa restrictions for Serbia citizens were abolished for the first time since the nineties. In addition, EU agreed to unblock the interim trade agreement, the most significant part of (SAA). The Interim Trade Agreement, the first step towards European trade integration was entered into force in February 2010
- In fact, the SAA agreement ratification procedure by EU members was not launched until June 2010. Ever since, only 11 of the 27 member states have completed the process. Some EU members (e.g. Holland) were refusing to ratify the agreement on the grounds of insufficient Serbian

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co-operation with the ICTY. The ratification procedure is very important as it is the prerequisite for eventually grant Serbia an EU candidate status and access to increased pre-accession funds assistance

- In October 25th 2010, EU foreign ministers agreed to ask the EU Commission to prepare a formal assessment on Serbia's application. Shortly after, the EU Commission sent a questionnaire with 2,500 questions to the Serbian authorities in order to assess its readiness to join EU. The EU Commission is anticipated to express its opinion on this subject by next October
- On January 19th 2011, the Euro-parliament ratified with an overwhelming majority of 90% the Stabilization and Association agreement. In addition, the Euro-parliament welcomed Serbia's reform progress and steps "in the process of raising awareness of the atrocities that happened in the recent past and of regional reconciliation" with a separate resolution

The arrest of General Mladic and his extradition to the ICTY will only improve sentiment toward Serbia within EU members. Serbia was under intense pressure from the international community to provide tangible results in the area of co-operation with the ICTY. Reportedly, the ICTY general prosecutor was about to submit a very negative report that would have complicated things further.

In contrast, the arrest of the fugitive general provides evidence of the Serbian authorities' commitment towards co-operation with the ICTY. At this point, EU members will most probably accelerate SAA ratification procedures, thereby giving a boost to the country's prospective EU candidate status. Yet, it will be no substitute for full EU membership. In the most optimistic scenario, the Serbian authorities' aspiration is to get a date as early as spring 2012 for pre-accession talks to begin. Even if all technical issues are resolved, the issue of Kosovo status will remain an impediment towards EU accession. Notwithstanding EU enlargement fatigue, Serbia's accession to EU could reach as far as 2017.

Last but not least, the arrest of the long wanted fugitive marks the end of an era and the beginning of

a new for the Serbian society. "We ended a difficult period in our history and removed the stain from the face of the members of our nation wherever they live", President Tadic commented in the press conference. More importantly, public reaction to the arrest did not spur a generalized wave of violence throughout Serbia. In earlier times, public reaction would have been more negative. This is the combined result of two evolving trends within the society. Firstly, both the judicial and the police authorities are less lenient with ultranationalist violence. Secondly, the support for ultra nationalistic ideas is waning away, so is the support for those political parties carrying those views.

NBS left unchanged its key policy rate at 12.5% in May, signaling that the end of the current cycle of monetary policy tightening may have been reached

On May 12th, NBS left the key policy rate unchanged at 12.5%. After eight rate increases, three of them during 2011, the Central Bank made a pause. The Central bank delivered 450bps of cumulative rate hikes in an attempt to combat rallying inflation. According to a Bloomberg survey conducted ahead of the monetary policy meeting, 10 participants (out of 21) expected no rate change, 7 expected a 25bps hike, and 3 expected a 50bps hike, whereas 1 expected a 25bps cut.

In the statement released after the policy meeting, the Central Bank signaled that the end of the monetary policy tightening cycle may have been reached. According to the statement, the key policy rate has reached or is very near a peak of its current cycle. However, the statement hinted that the NBS will be cautious with respect to any prospective monetary policy easing, taking into account all available instruments.

In our last issue of New Europe Economics & Strategy, we had elaborated on the probability that the monetary policy tightening was close to its end. First of all, the Central Bank had already stated its decision to be less aggressive on policy rate hikes going forward after having mobilized the tool of the minimum reserves requirements. Secondly, the

Central Bank has stated that the full effect of past monetary policy measures is yet to be felt on inflation. However, the most important element that the Central Bank took under consideration was that the future path of inflation has finally become more predictable. That said, inflation must have probably peaked in April or is about to peak in May according to the Central Bank projections. In addition, the Dinar strengthening course provides an additional tool for inflation containment.

Looking ahead, we still hold the view that the Central Bank would be very cautious to engage in any monetary policy easing as inflation uncertainties are still very high. The international environment will be characterized by relatively high energy and food prices, while the possibility of a new oil price shock as a result of the ongoing geopolitical tensions in the Middle East and North Africa cannot be ruled out. In addition, both the ECB and other regional Central Banks will stay on a tightening mode that will not enable the NBS to move aggressively with rate cuts.

Last but not least, a number of country specific factors come into play. Namely, the regulatory prices adjustment has already exceeded the limits set by the mutually agreed framework with the government. On top of the electricity prices adjustment, effective from April 1st, gas prices are expected to rise as well. In addition, the onset of the pre-election cycle raises the risk of fiscal slippage; Serbia's parliamentary elections are officially scheduled for next May. Once inflation uncertainties recede, the Central Bank is expected to resume monetary easing sometime within H2:2011. Our year-end forecast for interest rates stands currently at 11.5%, 100bps lower than the peak.

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