Eurobank Research

Eurobank EFG

New Europe Economics & Strategy

www.eurobank.gr/research

Thursday, May 20, 2010

Focus Notes: Serbia

Serbia: Central Bank keeps key policy rate unchanged at 8.00%

- ✓ On May 19, the Serbian Central Bank kept its key policy rate unchanged at 8.00%. The lingering fiscal crisis in the Euro area weighted on the no-policy-change decision, while, the recent turmoil in global financial markets has instigated some further pressure on the Dinar despite favorable domestic inflation developments.
- ✓ The current level of the NBS's key policy rate is the lowest since 2006. The Central Bank has so far delivered 975bps of cumulative rate cuts since late 2008, when it first started its latest monetary easing cycle. The Central Bank last cut its key rate on May 4 (by 50bps to 8.00%).
- ✓ The favorable inflation developments in Q1 allowed the Central Bank to reduce interest rates by a total 150bps year-to-date, which took by surprise analysts. Inflation moderated further in April to 4.3% yoy against 4.7% yoy in March and 6.6% yoy in December last year. Inflation is expected to trend lower near-term, falling to 3.6% by June, below the 4-8% target band of the Central Bank.
- ✓ The NBS has stated in its latest inflation report issued in May that it will maintain its easing bias. In that direction, Deputy Governor Bojan Markovic expressed the view that the Central Bank is likely to keep cutting rates, but at a slower pace than in the last three months. However, the Central Bank stressed that its future policy decisions will be determined by a number of factors, including among others: a) the evolution of domestic demand dynamics b) food price inflation developments c) perceived risk premia and d) the pace and extent of any further Dinar depreciation.
- ✓ In our view, the scenario of inflationary pressures reemerging carries a significant probability in the case pensions and wages are unfrozen. The coalition government has sought to freeze public wages and pensions for a second year in a row in 2010, as part of the IMF program's commitments. Yet, public discontent and the prospect of a growth rebound in 2010 have led to growing voices both within the government and the opposition for an unfreezing of wages and

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

Disclaimer: This report has been issued by EFG Eurobank – Ergasias S.A and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank – Ergasias S.A., as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank – Ergasias S.A. and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank – Ergasias S.A., as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.

pensions. We expect the latter to be a hotly-debated issue during the 4th IMF review of the loan agreement taking place during this week.

- ✓ The depreciation of the Dinar is another risk factor in the near-term economic outlook. The Dinar has lost ca 8.3% of its value against the Euro since last September, moving lately beyond the crucial psychological level of 100/€. On May 18, the local currency hit a new time low of 101.70/€, broadly shrugging off earlier repeated interventions by the NBS to stem its pace of depreciation against the Euro.
- ✓ The Central Bank has spent over €729.5mn so far this year in Dinar-supporting interventions. Yet, it foreign exchange reserves reached a record high at EUR 10.8bn at the end of April, supported by IMF loan.
- ✓ In our view, the depreciation of the Dinar is a double-edged sword for Serbia. On the one hand, it helps boosting export competitiveness and thus, growth (exports grew by 13.9% yoy in Q1). On the other hand, it increases inflationary pressures because of a 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.
- ✓ In our latest New Europe Economics & Strategy monthly issues we repeatedly highlighted the risk of further depreciation of the local currency. Maintaining the Dinar stable will be a contentious and critical issue for the rest of the year. The new governor Mr Soskic, who will be replacing Mr Jelasic in early June, will have to strive to maintain confidence in the local currency, which is presently the key focus of market attention.

Ioannis Gkionis, Research Economist
igkionis@eurobank.gr