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FOCUS NOTES: SERBIA

Central Bank initiated a monetary policy easing cycle

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- NBS cut interest rates further by an additional 25 bps to 11.75% on July 7th, on top of the 50bps cut delivered on June 9th
- Inflation decelerated to 13.4% yoy in May, compared to 14.7% in April, strengthening the view that that inflation has already peaked
- Current account deficit deteriorated to 14.3% yoy in Jan-April, financed primarily by portfolio inflows

NBS initiated a monetary policy easing cycle, delivering a cumulative of 75bps on June 9th and July 7th

On July 9th, the NBS decided to cut its key policy rate by another 25 bps to 11.75%. This is the second 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.

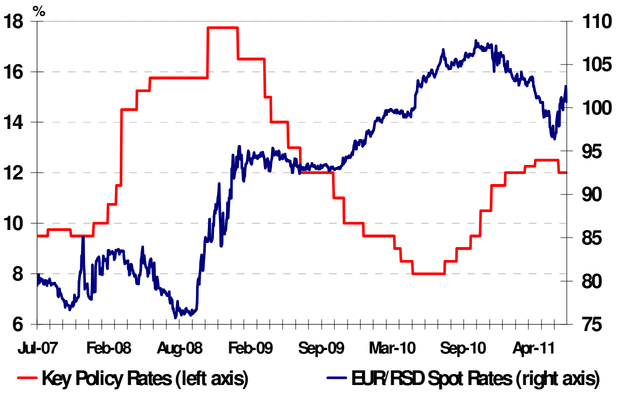
According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (8 out of 22) expected no rate change; 6 expected a 50 bps rate cut and 7 expected a 25bps cut. In the monetary policy meeting on May 12th, the NBS had left interest rates unchanged at 12.5%. The Central Bank had explicitly mentioned that monetary policy tightening had come to an end. However, the NBS had stated that it would 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 opinioned too that the Central Bank would be very cautious to engage in any monetary policy easing as inflation uncertainties remained elevated. However, the move of the Central Bank is quick but not a total surprise. Yet, the previous monetary policy cycles lasted on average only few months (minimum 6-maximum16 months) after the adoption of the semi-inflation targeting regime in September 2006. Additionally, turnarounds in the monetary policy cycles have been relatively quick from a time point of view:

- The previous monetary policy easing cycle lasted 16 months: The NBS delivered a total of 975bps from 17.75% in Jan 2009 to 8% in May 2010. The NBS remained on hold for only 3 months.
- The latest monetary policy tightening cycle lasted nine months-from August 2010 to May 2011. During the last cycle, the Central Bank delivered a cumulative of 450 bps (from 8% to 12.5%) in eight rate hikes. However, the NBS remained on hold for only 2 months before cutting rates.

Figure 1

NBS initiated the monetary policy easing cycle in early June



Source: Bloomberg, Eurobank Research

Inflation decelerated to 13.4% yoy in May compared to 14.7% in April, strengthening the Central Bank's view that that inflation has already peaked

In the last statement released, the Central Bank looks convinced that some of the inflation uncertainties have already subsided. Inflation has already peaked at 14.7% yoy in April and will continue declining over the coming period. The main driver behind the expected disinflation is expected to come from the sharply declining food prices. In fact, the Executive Board assessed that once the new agricultural season sets in, food prices will probably have a negative impact on inflation. The negative impact will reinforced by a full spillover effect of lower global wheat and corn prices which is yet to be felt in the Serbian market.

In addition, the full effect of past monetary policy measures, the low domestic demand pressures are also expected to contribute positively on inflation in the near future. Furthermore, inflation expectations have stabilized at 8% according to the latest surveys providing more ammunition to advocates of rates cuts.

Inflation in May recorded its lowest month on month increase during 2011. Consumer prices decelerated to +0.4% mom/+13.4% yoy in May vs. +1.1% mom/14.7% yoy in April. News from the food prices, the main driver behind inflation rally in recent months is finally encouraging. The prices of food & beverages decelerated to +0.4% mom/+19.3% yoy in May vs. 0% mom/+22.1% yoy in April. The second most important factor, alcohol and tobacco (4.9% weight in the CPI basket) slipped to -0.1% mom /+19.4% yoy in May from -1.6% mom /+19.8% yoy in April.

All in, we hold the view that inflation is going to retreat further in the coming months. Provided that there are no other supply-side shocks, inflation would gradually retreat more visibly towards the targeted band from Q3 2011 onwards. However, although there is good chance that year-end inflation will end in single digit, it will still lie significantly above the Central Bank target (4.5%+/-1.5%). That said, we still see room for additional 125-150 bps rate cuts from the current levels as we have already described in our previous New Europe Economics & Strategy.

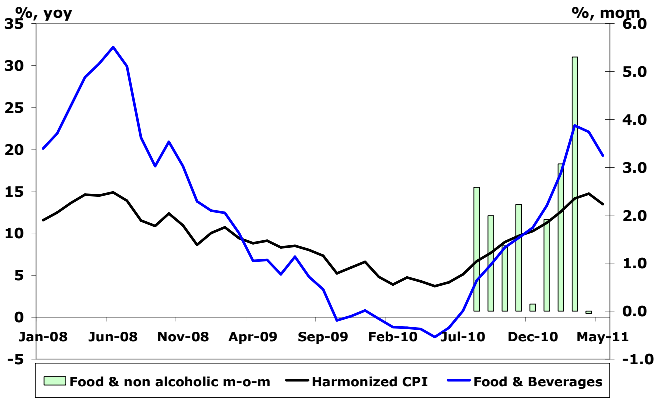
More specifically, food inflation is expected to subside further in the coming months, driven by favorable base effects and the positive impact of the new agricultural season starting in July. While the possibility of a new oil price shock as a result of the ongoing geopolitical tensions in the Middle East and North Africa cannot be ruled out, oil prices must have peaked after the IEA (International Energy Agency) decision to release strategic oil supplies to meet the disrupted supply from Libya's production.

Additionally, inflation will benefit from the recent appreciation of the local currency. Even though the dinar appreciation is losing steam, the Dinar is still holding some of its gains since the beginning of the year. Dinar started losing ground on concerns over potential spillovers from the ongoing Greek sovereign crisis in mid June. Dinar 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. On July 11th, dinar stood at 100.8/€, higher by approximately 5% compared to the end of 2010. On the other hand, there are a few upside risks to the inflation outlook. 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 effective from June. Last but not least, the onset of the political cycle (parliamentary elections are scheduled in May

2012) hides the risk of undue fiscal relaxation which may prompt the Bank to be more cautious in further rate cuts.

Figure 2

Food inflation is about to subside further in the coming months



Source: National Statistics, Eurobank Research

Current account deficit expanded by 14.3% yoy in Jan-April, financed primarily by portfolio inflows

The current account deficit expanded by 14.3% yoy in the first four months of 2011. Exports maintained their strong momentum, growing by 30% yoy. The rally in exports is supported by the high commodities prices worldwide. Base metals-iron and steel products-comprise a large component in the exports portfolio (around 20%). In addition, high demand for corn and other cereals boosted agricultural products exports. Despite the increased energy bill, total imports still lagged behind by 21.2% yoy in the same period. As a result, the trade deficit deteriorated marginally by 5% yoy in nominal terms. Yet, the exports to imports coverage ratio improved further to 61% in Jan-April compared to 57% a year ago. Overall, the current account deficit on a twelve month rolling basis deteriorated marginally to 7.3% of GDP in Jan-April against 7% at the end of 2010 and 6.3% in Jan-April 2010.

In addition, balance of services improved from a €15.3mn deficit to a €52.3mn surplus. Current transfers continued to run a surplus of €0.8bn, boosted by the last drawing tranche of the IMF loan agreement that was received in last April. However, the surplus was still lower by 7.2% compared to the previous period, partially due to reduced remittances (-10.7% yoy) and higher government transfers (+43%). Furthermore, the balance of incomes run a deficit of €0.17bn (up 3.3% yoy vs. the same period a year earlier)

On the financing side, Serbia benefits from the resumption of capital inflows to the emerging markets. The rebound of capital inflows (up by 41.4% yoy in Jan-April) was underpinned by a surge in portfolio inflows (up by 902% to €604mn). The rise in portfolio inflows stemmed from the high demand for government T-bills. The turnaround in foreign investors' perception is still driven primarily by the high real yields, the recent appreciation dinar trend and the favorable developments in the sovereign risk premia.

Despite the absence of any significant privatization, FDI inflows showed encouraging signs of resumption in the first months of 2011. Net FDI inflows picked up by 17%, reaching €419mn against €359mn in the same period last year. Equally importantly, the bulk of FDI inflows headed towards the sectors of manufacturing and financial intermediation.

However, the prospects of attracting significant new FDI inflows are limited given that that the privatization of Telekom Serbia was cancelled until at least parliamentary elections (officially scheduled for May 2012). We anticipate that even if the recent rising trend continues, full-year FDI inflows would not even come close to our initial forecast of €2bn in 2011. Taking into account the latest developments, we have downgraded our forecast of FDI inflows this year to €1.2bn.

Attracting FDI inflows is critical not only in terms of new capital investments in the country. Moreover, FDI inflows would provide a more sustainable source of balance-of-payments financing in contrast to portfolio inflows which are by nature more volatile. From this point of view, the completion of the privatization program is of great importance in terms of attracting more FDI inflows in the country. Net FDI inflows have been on a downward trend in the aftermath of the international financial crisis. FDI inflows reached €860mn in 2010 compared to €1.3bn in 2009, down by 37% yoy. Net FDI covered only 41% of the current account in 2010 compared to 65.8% in 2009.

In contrast, other financial account elements turned into red. The surplus of "other investments" turned into deficit in the first four months of 2011. In essence, this primarily reflects the impact of the repayment of short term lending by the banking sector and the absence of new long-term external debt from the private sector. Inflows from new long term government borrowing and foreigners' deposits in the banks were not enough to fill the gap. The overall result was that "other investments" recorded a minor deficit of €67mn compared to a surplus of from to €257mn a year ago.

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