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NEW EUROPE
ECONOMICS & STRATEGY

Octomber 12, 2011

FOCUS NOTES: SERBIA

Serbia: A new 50bps interest rate cut from NBS

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- NBS cut rates by another 50bps at 10.75% on October 6th, bringing the cumulative cuts to 175bps from the beginning of the easing cycle in early June
- NBS now anticipates inflation to land to single digits in September on low demand pressures and stabilized food prices
- The new precautionary IMF agreement and the successful Eurobond sale have a positive impact on the macroeconomic outlook of Serbia

Shortly after its cut in September, the NBS delivered another cut in its October meeting. On October 6th, the NBS decided to cut its key policy rate further by another 50 bps to 10.75%. This is the fourth rate cut since June 7th when NBS had first initiated the monetary policy easing cycle (cutting interest rates by 50bps from 12.5% to 12%). According to the Bloomberg survey conducted ahead of the policy meeting, the majority of participants polled (10 out of 22) expected a 25bps cut; four expected a 50 bps rate cut and eight 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 given the latest world and domestic economic developments. The latter comes on top of the stabilization of food prices and slower growth in regulated prices. More specifically, food inflation (37.8% weight in the consumer basket) rallied throughout the second half of 2010 and the beginning of 2011 peaking at 22.9% yoy in last March.

Ever since, food prices decelerated to 17.3% yoy in July only to land sharply to 12.8% yoy in August. 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. In addition, inflation expectations are showing a nascent decline (by a full percentage point), according to the Bloomberg survey.

We have always advocated in our previous New Europe Economics & Strategy issues that inflation was the result of the supply-side shock from food prices. Inflation gradually retreated more visibly towards the targeted band in Q3 2011, after having peaked at 14.7% yoy in April. Indeed, inflation scaled down to +0% mom/+10.5% yoy in August, the lowest reading so far in the year, against -0.5% mom/+12.1% yoy in July. Provided that there are no other supply-side shocks, year-end inflation will end in single digit. Yet it will still lie above the Central Bank target (4.5%+/-1.5%).

On the other hand, the recent high-frequency indicators point to a weakening of the domestic economic activity (industrial production down by 1% on seasonally adjusted terms in August). The prospect of a more pronounced global economy slowdown, if not a global recession puts more strain on Serbian exports and thus on the Central Bank to maintain a more accommodative stance. It is evident from the rhetoric used in the statement that NBS has changed its bias. The focus of the Central Bank has shifted gradually from concerns about inflation to growth. All in all, we still see room for additional 25-50 bps rate cuts from the current levels by year end in line with our analysis in all our previous New Europe Economics & Strategy.

There are two more important factors which will weigh on the domestic macro-outlook: the new IMF agreement and the successful Eurobond sale in last September. The new agreement endorsed by the IMF board on Sep 30th, provides a cushion in case of a new global downturn and reduces the sovereign risk premium of the country. On top of that, Serbia was able to launch the first in its sovereign history Eurobond issuance successfully on September 23rd during turbulent market conditions. The new 10 year bond issuance (€1bn, 7.5% coupon) received bids of €2bn, twice as much and was priced at 7.75%.

However, the yield soon climbed at 8.1% because of the wider sell off in the credit markets as a result of the deepening Euroarea sovereign crisis. The Eurobond sale already satisfied some of the pressing government borrowing needs (sale receipts represent around 16% of the government financing requirements for this year). In a more important note, Serbia puts itself on the map of CEEMEA credit gaining access to long-term sources of financing.

In contrast to its regional peers, 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 October 11th, dinar stood at 100.8/€, higher by approximately 5% compared to the end of 2010.

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