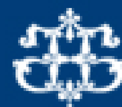

National Bank of Serbia

2020
August

INFLATION REPORT

August 2020

INFLATION REPORT

NATIONAL BANK OF SERBIA
Belgrade, Kralja Petra 12,
Tel: +381 11 3027-100

Belgrade, Nemanjina 17,
Tel: +381 11 333-8000

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Introductory note

The *Agreement on Inflation Targeting* between the Government of the Republic of Serbia and the National Bank of Serbia, effective as of 1 January 2009, marks a formal switch of the National Bank of Serbia to inflation targeting as a monetary policy regime. The main principles and operation of the new regime are defined by the Memorandum on Inflation Targeting as a Monetary Strategy.

Since one of the underlying principles of inflation targeting is strengthening the transparency of monetary policy and improving the efficiency of communication with the public, the National Bank of Serbia prepares and publishes quarterly *Inflation Reports* as its main communication tool. The Inflation Report provides key economic facts and figures that shape the Executive Board's decisions and underpin activities of the National Bank of Serbia.

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide an analysis of underlying macroeconomic developments. It also seeks to explain the reasoning behind the Executive Board's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this *Report* are the inflation projection for eight quarters ahead, assumptions on which the projection is based and an analysis of key risks to achieving the target.

The information contained in this *Report* will help raise public understanding of monetary policy implemented by the central bank and awareness of its commitment to achieving the inflation target. It will also play a role in containing inflation expectations, as well as in achieving and maintaining price stability, which is the main statutory task of the National Bank of Serbia.

The August *Inflation Report* was considered and adopted by the NBS Executive Board at its meeting of 13 August 2020.

Earlier issues of the *Inflation Report* are available on the National Bank of Serbia's website (http://www.nbs.rs).

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

ABBREVIATIONS

bp – basis point
CPI – Consumer Price Index
EBRD – European Bank for Reconstruction and Development
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
EU – European Union
FAO – UN Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
FOMC – Federal Open Market Committee
GDP – gross domestic product
GVA – gross value added
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mn – million
NAVA – non-agricultural value added
NPL – non-performing loan
OFO – other financial organisation
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
RHS – right hand scale
RMCP – real marginal cost of processed food production
s-a – seasonally-adjusted
SDR – Special Drawing Right
SORS – Statistical Office of the Republic of Serbia
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Macroeconomic projections presented in the Report were concluded on 31 July.

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I Overview

With the gradual relaxation of containment measures, signs of economic recovery started cropping up globally as of May, also supported by accommodative fiscal and monetary policy measures of a large number of countries. However, due to the renewed spread of the virus, the global recovery prospects for the period ahead were revised downward.

Upon the outbreak of the coronavirus pandemic and the introduction of public health measures, the world economy faced an unprecedented crisis. In the majority of countries, the crisis peaked in March and April, while the improvement in the epidemiological situation and gradual relaxation of containment measures paved the way for signs of **global economic recovery** since May, **also supported by accommodative fiscal and monetary policy measures of a great number of countries**. The recovery is expected to persist in the period ahead, but economic activity is bound to greatly underperform last year's. According to the current estimates of leading international organisations, global growth outlook additionally deteriorated relative to the last *Report*, while the risks remain pronounced and tilted to the downside, as the virus continued to spread in a number of countries around the world. In the euro area, our most important trade partner, the recovery began in May and, judging by the leading economic activity indicators, extended into June and July, but the growth outlook was revised downward as the pandemic effects were estimated to be stronger than anticipated earlier.

Volatility in the international financial market subsided since the last Report, resulting in invigorated investor sentiment and a decline in the risk premia of emerging economies. Despite the rising trend of the oil price, inflationary pressures are generally expected to remain subdued globally due to lower aggregate demand.

In the period since the last *Inflation Report*, **global financial markets saw less volatility** thanks to the monetary and fiscal stimuli of leading world economies, while investor sentiment was also bolstered by the relaxation of social distancing measures and the nascent signs of economic recovery. This led to a **decline in the risk premia of emerging economies**, including Serbia. On the other hand, **global prices of primary commodities**, primarily oil, **exhibited higher volatility**. Although rising since May, the oil price remained considerably lower than at end-2019, slowing down global inflation in recent months. While some countries have seen prices rising and cost-push pressures building up against the background of economic contraction, the general expectation is that inflationary pressures will remain subdued globally, due to lower aggregate demand.

The NBS continued its monetary policy easing, aiming to minimise the negative effects of the coronavirus on economic activity and employment, and to speed up the recovery of our economy as much as possible.

As the global scale of the crisis calls for additional support to the domestic economy in order to minimise the negative effects of the crisis and ensure as fast as possible recovery of our economy, the NBS Executive Board continued with **monetary policy easing, while at the same time preserving price and financial stability**. In June, the key policy rate was lowered by additional 25

basis points, to 1.25%, which together with the previous March and April cuts added up to a reduction of 100 basis points compared to the pre-pandemic level. Apart from key policy rate cuts, the NBS also provided a significant amount of liquidity to support the real sector – via direct repo operations and bilateral purchases of dinar government securities from banks, as well as FX swap auctions. More favourable terms of dinar financing of corporates should also be supported by the NBS's decision adopted at the extraordinary meeting in July to pay to banks which approve dinar loans under the Guarantee Scheme at rates lower by at least 50 bp than the maximum rate (one-month BELIBOR + 2.5 pp) a 50 bp higher remuneration rate on the amount of dinar required reserve allocations equivalent to the amount of loans approved at lower rates.

In Q2, lending terms were favourable, encouraging further lending growth.

Continued monetary policy easing was conducive to **a further fall in interest rates in the interbank money market and on dinar loans, which supported further lending growth**. The acceleration of lending to 13.9% y-o-y in June was also propped by the Guarantee Scheme loans to micro, small and medium-sized enterprises and entrepreneurs, and the moratorium on the repayment of credit liabilities, which was in the meantime extended for additional two months. Corporate loans continued to provide a higher contribution to lending, their stock rising by 15.9% y-o-y in June. Investment loans remained the greatest contributors, despite the fact that liquidity and current assets loans recorded higher growth in recent months. Over EUR 630 mn worth of loans were approved by end-June within the Guarantee Scheme, over a half of which in dinars, which pushed the degree of dinarisation of receivables to the record level of 34.6%. Owing to government measures of support to the private sector to cope with the pandemic, the lending growth and moratorium, i.e. a respite in the payment of credit liabilities, resulted in a significant rise in corporate and household deposits in banks, without fuelling inflationary pressures.

The one-off increase in the deficit and public debt this year planned in order to adequately support corporates and households in fighting the pandemic does not jeopardise the sustainability of public finances.

The initial programme of measures adopted by the Government at end-March amounting to 11% of GDP (resulting in a consolidated budget deficit of around 7% of GDP this year) was additionally expanded in July by around 1.2 percentage points of GDP and is intended for the segment of micro, small and medium-sized enterprises and entrepreneurs. The largest part of planned assistance measures, which directly reflect on the Serbian budget, have already been implemented, resulting in the consolidated fiscal deficit of around RSD 311 bn in six months (close to 4/5 pertaining to Q2). Relative to the same period of 2019, public revenue in the first six months fell 7.5% in real terms, reflecting the economic

contraction in Q2 and the adopted anti-crisis measures. The largest effect on lower revenue stemmed from the deferred payment of profit tax advance in Q2 and lower non-tax income, while other categories stagnated or increased only slightly. Public expenditure went up by 23.2% from the same period last year, mainly due to the one-off assistance paid to the adult population and minimum wage payouts to corporates. Capital expenditure also increased y-o-y, indicating that infrastructure works were not discontinued during the pandemic. The funds for deficit financing and the repayment of regular liabilities were ensured through the successful eurobond issue in the international financial market worth EUR 2 bn, as well as the issues of dinar government securities in the domestic market, which pushed public debt to 57.3% of GDP in June, with the expected share of around 60% by the year-end. According to our estimate, the one-off increase in the deficit and public debt does not jeopardise the sustainability of public finances, while moderating the fall and speeding up the economic recovery, which will generate higher government revenue going forward.

Consistent with our expectations, due to the coronavirus--induced crisis, Q2 saw a contraction in the current account deficit.

Against the background of lower external demand, economic shutdowns and the implementation of containment measures, **Serbian foreign trade** expectedly contracted in Q2, with a sharper fall in goods and services imports (20.9% y-o-y) compared to exports (20.3% y-o-y). With the lower primary income deficit, this pushed the current account deficit down by 11.0% y-o-y, to EUR 1.3 bn since the start of the year. The current account deficit was more than fully covered by the net FDI inflow, which in the first six months of this year came close to EUR 1.5 bn. Portfolio investment recorded the same amount of net inflow, mostly as a result of the eurobond issue in the international financial market. In our estimate, in annual terms, the falling external demand and limitations on the supply side will dampen exports, but imports are bound to decline more, due to contraction in domestic demand. Coupled with favourable terms of trade on account of a lower oil price, this will help to reduce the current account deficit to around 5% of GDP this year. In the medium term, based on increased export capacities and expected global economic recovery, the current account deficit share in GDP is likely to drop mildly, at a pace dictated by the investment cycle dynamics in the coming period.

Serbia felt the strongest negative effects of the pandemic in April, while May ushered in a recovery which was supported by undertaken monetary and fiscal policy measures and which turned out faster than expected in the majority of production and service sectors.

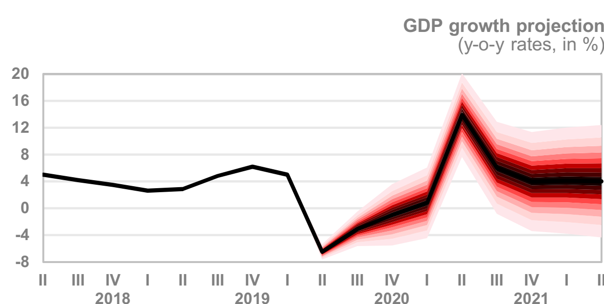
The fall in external demand and the containment measures dented **economic activity** in Q2, but movements of available indicators signal that negative effects of the pandemic turned out weaker than estimated in May, thanks to timely and robust monetary and fiscal policy measures. A faster than expected recovery since May, on the production side, has been recorded in the

majority of production and service sectors. According to the Statistical Office's estimate, economic activity contracted by around 6.5% in Q2 y-o-y or 10% s-a q-o-q, as opposed to the earlier expected -8% y-o-y and -10.9% s-a. On the expenditure side, a smaller than initially estimated negative contribution came from private consumption.

The growth projection for the Serbian economy in 2020 was kept at -1.5%. Given the timely and adequate response of economic policy makers and the maintained favourable medium-term outlook for Serbia, in the next year the country is expected to more than fully recover and post an economic growth rate of around 6%.

The remainder of the year is likely to see **further economic recovery**, aided by the implemented and announced government and NBS measures and the gradual recovery of external demand, which according to the leading economic activity indicators was in the expansion phase in July. Despite a better agricultural season, the adopted additional economic measures and the fact that the negative effects of the pandemic on domestic economic activity in Q2 were weaker than expected, we kept the May forecast of a 1.5% fall in GDP in real terms, taking into account the forecast of relevant international institutions which, due to the renewed spread of the virus, project slower global recovery in the remainder of the year than three months ago. In our new projection, the negative contribution, on the production side, will stem from service and production sectors, save for agriculture. On the expenditure side, domestic demand will contract, while net exports will give a positive contribution, since imports are expected to fall more sharply than exports. The next year is likely to see a speedy economic rebound and growth of around 6%, driven by domestic demand and exports, supported by a timely and adequate response of economic policy makers in Serbia and the maintained favourable medium-term outlook of the country, warranting the return to a stable medium-term growth path of around 4% a year. Risks to the GDP growth projection mostly stem from uncertainty as to the duration of the pandemic and the speed of economic recovery on a global scale, which will influence the developments in the international commodity and financial markets. The risks to this year's projection stemming from the international environment are tilted to the downside and mainly concern the speed of the recovery in the euro area, while the risks originating from the domestic environment are tilted to the upside, since domestic demand may recover faster than expected.

GDP growth projection
(y-o-y rates, in %)



Since the start of 2020, y-o-y inflation has moved consistent with NBS expectations, and its dynamics in Q2 was determined by the base effect for vegetable prices and by petroleum product prices.

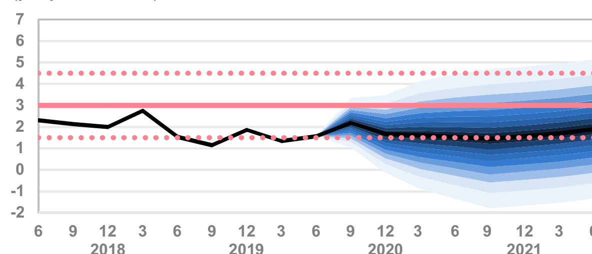
In line with our expectations from the May *Report*, after running below the lower bound of the target tolerance band in April and May, **y-o-y inflation returned within the target band in June, reaching 1.6%**. The initial inflation slowdown was determined mainly by the high base effect in vegetable prices, which peaked in April, only to fully disappear in June. A negative contribution to inflation also came from significant cheapening of

petroleum products, in place since February, caused by the oil price slump against the background of a poorer global growth outlook induced by the pandemic. On the other hand, the contribution of fruit prices was somewhat higher in June than in March, while that of services, processed food and non-food industrial products was almost unchanged. All the above indicates that even in conditions of the changed structure of demand caused by the pandemic, the market remained fully supplied with goods, which kept inflationary pressures at bay. This is also confirmed by **core inflation**, which remained stable in Q2, measuring **1.4% y-o-y in June**.

Under the central August projection, in the remainder of 2020 and in 2021, **y-o-y inflation** will move within the lower half of the target tolerance band, closer to the lower bound. Such inflation movements will be supported by relatively weak aggregate demand, inflation in the international environment and global prices of primary agricultural commodities, while the effect of the global oil price slump will gradually wane. With the expected recovery of demand, buttressed by the adopted accommodative monetary and fiscal policy measures, inflation will gradually move towards the target midpoint in 2022. Nevertheless, over the projection horizon, i.e. next two years, it is expected to remain below the target midpoint of 3%. Uncertainty surrounding the inflation projection still largely stems from the international environment and mainly concerns the pace of the global growth and trade, capital flows to emerging economies and prices of oil and other primary commodities. The risks to the projection also relate to the speed of recovery of domestic demand and movement in administered prices at home. On the whole, the risks to the inflation projection are judged to be symmetric. **Monetary policy decisions** in the coming period will depend on the assessment of the impact of past monetary policy easing, but also on anticipated movements in key factors from the domestic and international environment and their influence on inflation, financial stability and the speed of economic recovery. The Executive Board emphasises that the NBS stands ready to respond to potential further effects of the pandemic at home and abroad.

Compared to the May projection, the new inflation projection is higher in the short term, primarily due to higher prices of fruit and vegetables than assumed in May, and lower in the medium term because of the stronger disinflationary effect of demand, mostly from the international environment.

Inflation projection
(y-o-y rates, in %)



II Monetary policy since the May *Report*

Assessing that the scale of the global crisis caused by the coronavirus pandemic required additional monetary policy support for economic recovery, the NBS Executive Board cut the key policy rate by 25 bp in June, to 1.25%, its lowest level in the inflation targeting regime. Additional monetary support to corporates and households, without jeopardising price and financial stability, was possible because Serbia faced this crisis in a much better macroeconomic position than it was the case with the previous crises.

The Executive Board kept the key policy rate unchanged in July and August, primarily having in mind that, in conditions of high bank liquidity, the previous cuts continued to impact financial and real sector developments and contribute to the preservation of favourable financing conditions of corporates and households and the increase in their disposable incomes. Also, the Executive Board took into account the expected effects of the sizeable fiscal aid package, which provided support to the private sector with a view to encouraging the fastest possible recovery of our economy from the effects of the pandemic. Still, in July, the Executive Board undertook activities ensuring even more favourable conditions of corporate lending within the Government's Guarantee Scheme.

The Executive Board emphasised that the NBS, in coordination with the Government, stands ready to respond to potential further effects of the pandemic in the domestic and international environment.

In the period since the May *Inflation Report,* the key policy rate was additionally trimmed by 25 bp in June, to 1.25%, its new lowest level in the inflation targeting regime. Together with previous cuts in March and April, the key policy rate was cut by a total of 100 bp since the start of the crisis, with a view to minimising the negative effects of the coronavirus pandemic on economic activity and employment and ensuring the fastest recovery possible of our economy. In addition to cutting the key policy rate and in order to support the banking and real sector, the NBS injected considerable dinar and FX liquidity through direct repo operations, swap auctions and bilateral purchase of dinar government bonds from banks.

In deciding to cut the key policy rate in June, the Executive Board had in mind that the scale of the global crisis caused by the pandemic required additional monetary policy support to the domestic economy in order to mitigate the negative effects of such crisis and stimulate economic growth in the future. The Executive Board took into account the previously adopted measures of significant monetary policy easing and fiscal stimuli, but also the fact that, thanks to the responsible economic policy, **Serbia faced this crisis in a much more favourable macroeconomic position than the previous crises** – with the average growth rate of 4.3% in the past two years, low and stable inflation for the seventh year in a row, eliminated fiscal and significantly reduced external imbalances and record high FX reserves. This opened room for additional monetary policy accommodation and support to economic recovery.

The Executive Board especially pointed out the fact that by further cutting the key policy rate, together with the previously adopted monetary and fiscal policy measures, the effects of the pandemic on the Serbian economy will be significantly mitigated. As in most European countries, it is almost certain that the greatest effects of the crisis in Serbia were felt in April, but also that there will be a recovery in the following months, driven by monetary and fiscal policy measures, leading to a GDP growth rate of at least 6% in 2021. Serbia's monetary policy and public finances have the capacity to tackle the current crisis without jeopardising the achieved low and stable inflation and other indicators of macroeconomic stability.

The Executive Board decided to further lower the key policy rate in an environment of low and stable inflation. As expected, the inflation slowdown continued, primarily due to the high base effect of vegetable prices and lower prices of petroleum products reflecting a significant decline in global oil prices. The Executive Board stated that inflation should move around the lower bound of the target tolerance band until the end of the year (3±1.5%) amid weaker aggregate demand and lower import prices. It is expected to gradually converge to the target midpoint in the medium term, which should be aided by the recovery in demand, driven by monetary and fiscal measures.

The decision to lower the key policy rate was also determined by the fact that it was becoming increasingly evident that the opening, i.e. recovery of the global economy would be gradual, which is why economic growth projections for many developed and emerging countries were revised down. Particularly important for Serbia is the recovery of the euro area, which should be driven, among other things, by the measures adopted by the ECB, aimed at increasing liquidity and providing support to favourable financing conditions. A coordinated response of monetary and fiscal policies in many countries of the world should ensure better financing conditions and economic recovery going forward. In deciding on further monetary policy easing, the Executive Board bore in mind that the prices of primary commodities in the global market, mainly oil prices, would stay relatively low, due to a weaker global growth outlook.

At its meetings in July and August, the Executive Board kept the key policy rate on hold. It had in mind that the previous cuts of the key policy rate would continue to impact financial and real sector developments, amid high bank liquidity, and contribute to the preservation of favourable financing conditions of corporates and households and the increase in their disposable incomes. One should also add the expected effects of the sizeable fiscal aid package (in total amount of over 12% of GDP), which provided support to the private sector with a view to encouraging the fastest possible recovery of our economy from the effects of the pandemic.

Although the initial phase of the pandemic was followed by gradual easing of public health measures and gradual recovery of economic activity, international developments are still marked by uncertainty. This is primarily associated with the global course of the pandemic and recovery of the economy in the coming period. The uncertainty is further increased by economic tensions between the USA and China. The recovery of the euro area, which is especially important for Serbia, should be supported by the ECB measures aimed at increasing liquidity and providing support to favourable financing conditions. In deciding not to change the key policy rate, the Executive Board was also guided by the uncertainties in the commodity market, most notably in terms of movements of global primary commodity prices, especially the oil price, which is still lower than last year, with indications of a growth trend since May.

In conditions of global uncertainty caused by the coronavirus pandemic, the NBS set up **a precautionary repo line with the ECB**, whereby additional euro liquidity can be provided to the domestic financial system, in case of need. The NBS reiterated that neither dinar nor FX liquidity of the domestic banking sector was jeopardised and that the country's high FX reserves provided more than sufficient potential to ensure a response to any potential FX liquidity shock. The precautionary repo line with the ECB is just another type of assurance that euro liquidity can be provided to Serbian financial institutions, in case of need. Thus, the NBS demonstrated that it is taking all possible measures to support the domestic economy and preserve macroeconomic stability in conditions of heightened global uncertainty due to the pandemic.

At its extraordinary meeting in July, the Executive Board adopted the decision on paying a higher remuneration rate on allocated dinar required reserves by 50 bp to banks which approve dinar loans under the Guarantee Scheme at interest rates lower (by at least 50 bp) than the maximum rate (1M BELIBOR + 2.5 pp). This should contribute to more favourable terms of dinar corporate lending, thus increasing dinarisation and further strengthening financial stability.

The Executive Board emphasised that the NBS stands ready to respond to potential further effects of the pandemic in the domestic and international environment. As so far, full coordination of monetary and fiscal policy measures will continue, which will diminish potential further negative shocks from the international environment and the economic fallout from the spread of the coronavirus on domestic economy. In coordination with the Government, the NBS has implemented and will implement all necessary measures to preserve the achieved price and financial stability and ease the position of households and corporates in the current extreme circumstances.

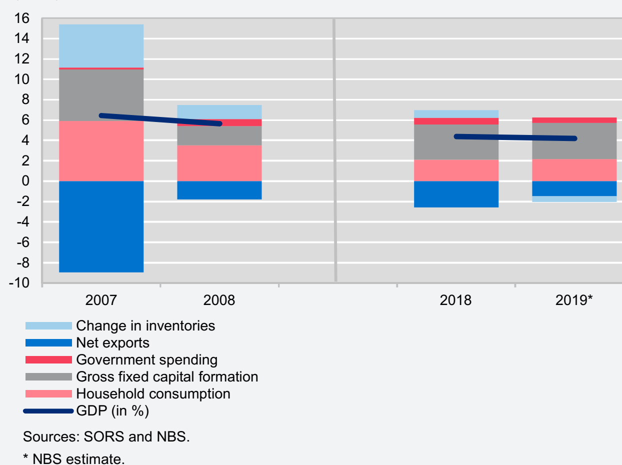
Text box 1: A comparison of Serbia's macroeconomic position before the previous global economic crisis and the crisis caused by the coronavirus pandemic

After the global economic and financial crisis of 2008–2009, early in 2020 the world economy was swept up in the crisis caused by the coronavirus pandemic. Unlike the crisis in 2008, which broke out in the financial sector and then spilled over onto the real economy, the new crisis first hit the real sector, as soon as containment and social distancing measures were introduced, and then spread onto the financial sector due to the spike in investors' risk aversion and rechanneling of investments into safer forms of assets. The global financial crisis caused a negative shock on the demand side, notably in the lending and real estate markets, while the coronavirus pandemic triggered an exogenous shock on both the demand and supply sides. A common feature of both crises is the fact that central banks acted as an important line of defence against the negative effects of the crisis, striving to preserve financial and price stability, and ensure the necessary liquidity to the private sector.

The current crisis, marked as the "great lockdown", is unique in two aspects: 1) it was caused by a reduction and suspension of activity in some sectors in order to save lives and prevent the further spread of COVID-19, and 2) comprehensive fiscal, monetary and prudential policy measures were taken, much larger in scope and depth than the measures used in the response to the global financial crisis. In Serbia's case, this was possible because when the crisis broke out, we were in a much better macroeconomic and fiscal position, thanks to the narrowing of internal and external imbalances, as well as the structural reforms implemented in the prior period.

In the years leading up to the global economic crisis, Serbia had relatively high economic growth (around 6.0% annually in the period 2007–2008), but its composition was unfavourable, given that it was mostly driven by rising final consumption. Growth in domestic demand was higher than the rise in GDP, and the gap was covered by the import – mostly of consumer goods, mainly financed from private sector borrowing (direct borrowing from abroad or via domestic banks, whose significant source of funds for lending also came from across the border), while FDI covered less than 50% of the current account deficit. This culminated in record-high foreign trade and current account deficits (of around 24% and 19%, respectively, on average in 2007 and 2008), and the outbreak of the global economic crisis at end-September 2008, which caused a sharp turn in capital flows, resulted in relatively strong adjustments of the current account deficit already in 2009 (to 6.3% of GDP). In other words, macroeconomic weaknesses created in the period leading up to the crisis were additionally pronounced during the world economic crisis.

Chart O.1.1 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

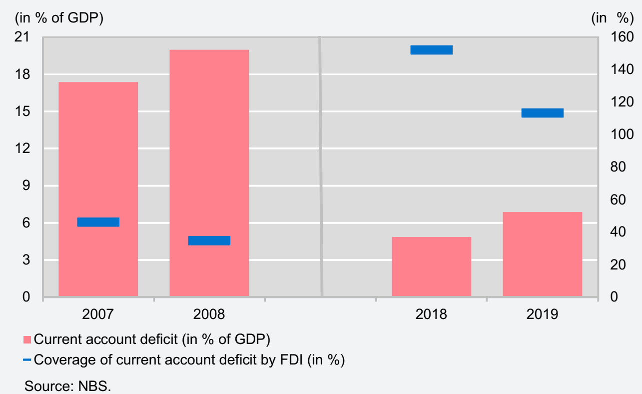
The fiscal policy was procyclical in the pre-crisis period. Privatisation revenues were mostly used for financing consumption, instead of debt repayment and savings, which prevented automatic (fiscal) stabilisers from being more effective and narrowed the room for the fiscal policy's countercyclical effect during the crisis. Though the share of Serbia's public debt in GDP declined to around 27% at end-2008 due to the high rates of economic growth and the real appreciation of the dinar, as well as the agreement that was reached with international financial institutions and the London and Paris Club creditors about the write-off of the bulk of former Yugoslavia's debt, during this period public debt was greatly exposed to the FX risk, given that its currency composition was extremely unfavourable. More than 97% of the total debt was in foreign currency, as well as the bulk of the internal debt. The situation in terms of public debt

sustainability changed drastically as of 2009. A stepped-up increase in public debt and large exposure to FX risk raised the question of public debt sustainability, which resulted in the deterioration of the country's credit rating and a significant rise in risk premium, measured by EMBI (exceeding 1,300 bp in December 2008).

Consumption growth was also supported by credit activity, which rose excessively (at the annual rate of 37.8% in 2007 and 25.6% in 2008) and, measured by the share in GDP, it moved above the trend, despite interest rates on dinar loans of around 20%, while rates on euro-indexed loans were around 10%. Against such backdrop, monetary policy measures in the period leading up to the crisis were mainly directed at curbing lending growth and anchoring inflation expectations in order to rein in inflationary pressures, which led to a rise in the key policy rate to almost 18% at end-2008. As the crisis escalated, economic activity dwindled and disposable assets for financing lending declined, resulting in an increase in the share of NPLs in total loans by 4.4 pp in 2009 alone, though the NPL share was relatively high at end-2008 as well (11.3%). Possibilities for more significant monetary policy easing by the NBS during the crisis, in order to provide an impetus to recovery, were restricted by the large currency mismatch between the balance sheets of corporates, households and the government, with a high share of FX and FX-indexed liabilities in total liabilities, a relatively high spill-over effect of the exchange rate on inflation, an underdeveloped financial market, unanchored inflation expectations and the raised issue of sustainability of public finances.

The inability of the fiscal and monetary policies to exert a stronger countercyclical effect during the crisis resulted in weak growth of the Serbian economy in the first years after the crisis and deeper external and internal imbalances. This culminated in 2012 with a current account deficit of 11% of GDP and a fiscal deficit of 6.4% of GDP. In addition, the coverage of the current account deficit by FDI measured only around 20% in 2012, which gave rise to strong depreciation pressures and the spill-over of the local currency's weakening vis-à-vis the euro onto inflation, which at one point reached 12.9%.

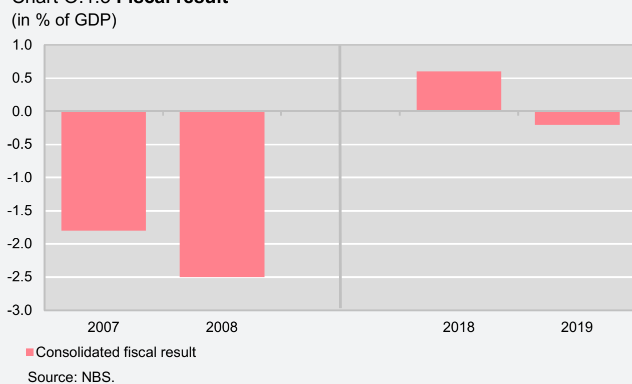
Chart O.1.2 **Current account deficit and its coverage by FDI**



Source: NBS.

Chart O.1.3 **Fiscal result**

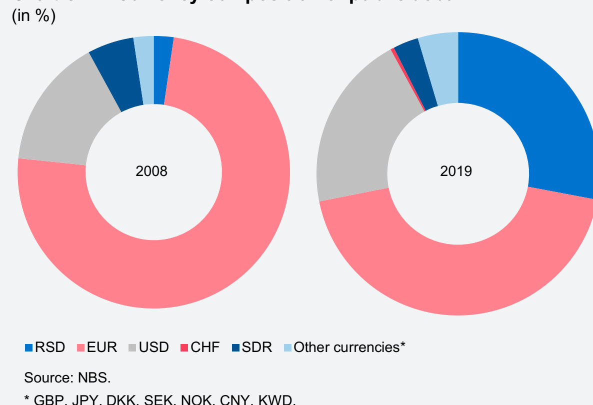
(in % of GDP)



Source: NBS.

Chart O.1.4 **Currency composition of public debt**

(in %)



Source: NBS.

* GBP, JPY, DKK, SEK, NOK, CNY, KWD.

Owing to responsible and adequate economic policy, and even more so to the full coordination of the monetary and fiscal policies, the implemented fiscal consolidation and structural reforms, during the past eight years Serbia has

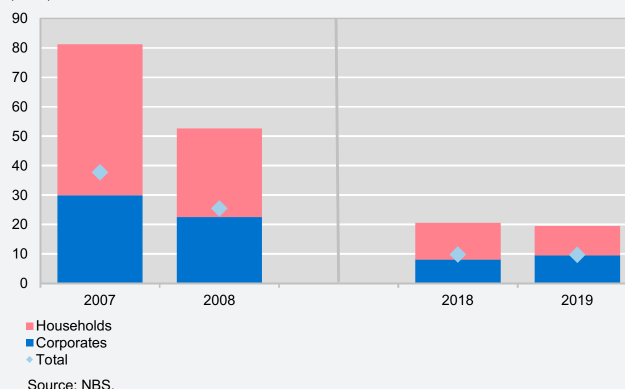
transformed into a growing economy with low inflation, balanced fiscal position, dwindling share of public debt in GDP, lower external imbalances and a recovered labour market, which helped our economy respond readily to the challenges of the pandemic.

During 2018 and 2019, as in the prior six years, inflation was low and stable, averaging 2%, and both short and medium-term inflation expectations also moved within the bounds of the NBS target tolerance band (3±1.5%). The ensured relative stability of the exchange rate played an important role in the establishment and maintenance of price stability and in anchoring inflation expectations, at the same time helping to strengthen financial stability.

Strengthening the domestic economy was the basis of the relative stability of the exchange rate, and it overcame the negative effects of turbulences in the international financial market. The NBS intervened in the FX market solely in order to ease excessive short-term oscillations of the exchange rate, without any intention of affecting its trend. Given that as of 2017 there were higher and more frequent pressures towards strengthening the dinar, FX market interventions were mostly on the side of FX purchase. This drove gross FX reserves up to their highest level on record (EUR 13.4 bn at end-2019), whereby an appropriate hedging system was created, in case the country is faced with external shocks.

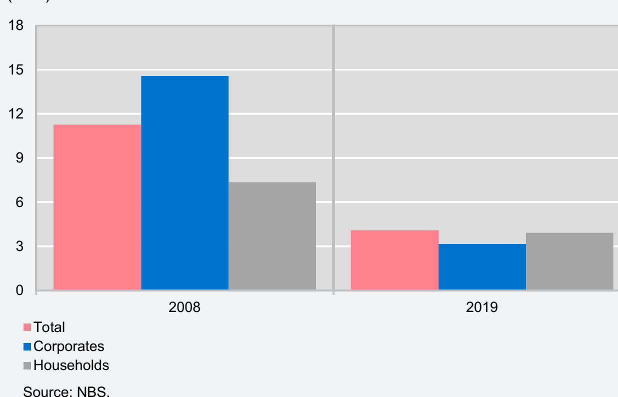
Another contribution to Serbia's improved external position was the decreased share of the current account deficit in GDP (4.8% in 2018 and 6.9% in 2019). In 2019, for the fifth year in a row, it was fully covered by the net FDI inflow of a record EUR 3.8 bn. Also, for some time now the FDI inflow has been diversified by project and channelled mostly to tradable sectors, which is also conducive to the country's external sustainability. Despite a slowdown in external demand since H2 2018, the rise in the export of goods and services remained relatively high in both 2018 (9.6%) and 2019 (10.5%), thanks to new production capacities and new export destinations. Moreover, owing to increased diversification of exports in terms of geography and production, Serbia lowered its exposure to disturbances in individual segments of external demand. Parallel with the increase in export, we recorded a rising import activity (13.0% in 2018 and 10.7% in 2019), mainly prompted by stepped-up production and investments, with more than 70% of this growth pertaining to the import of intermediate goods and equipment, which is in line with the ongoing investment cycle.

Chart O.1.5 **Contributions to total lending growth rate**
(in %)



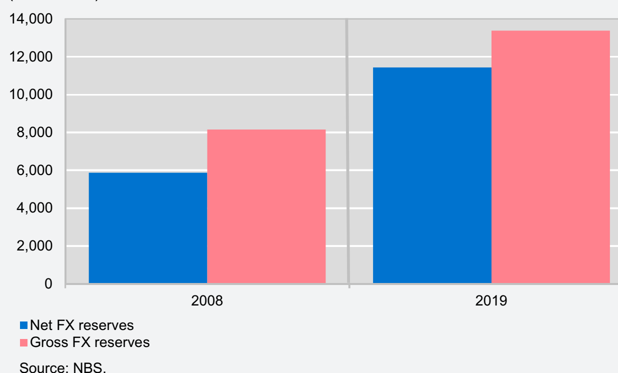
Source: NBS.

Chart O.1.6 **NPL share in total loans**
(in %)



Source: NBS.

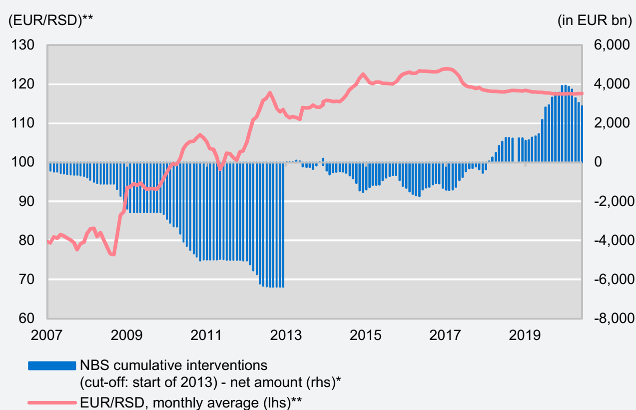
Chart O.1.7 NBS FX reserves
(in EUR mn)



Source: NBS.

Putting inflation under control on a more permanent basis allowed for monetary policy easing as of mid-2013, which was stepped up further at end-2014 owing to the adoption of a credible fiscal consolidation programme and its subsequent implementation. Monetary policy easing was pivotal in triggering a sharp fall in interest rates in the interbank money market, and in turn on dinar loans to the private sector, which were cut by more than 12 pp from mid-2013 until end-2019. At the same time, the fall in interest rates in the money market did not only decrease the prices of new loans and increase the availability of loans, but it also reflected on lower repayment costs for existing loans. This helped cut the operating costs for corporates and ensure funds for new investments and increased disposable income for households, which additionally supported economic growth.

Chart O.1.8 **Dinar exchange rate and NBS transactions in the FX market**



Source: NBS.
* + net purchase; - net sale.
** EUR 1 in RSD.

Owing to the implemented structural reforms and the resulting improved business and investment climate, increased investments in infrastructure projects, a significant FDI inflow mainly channelled to tradable sectors, and more favourable financing conditions, fixed investments became the main driver of economic growth in the period 2018–2019. Fixed investments accounted for three-quarters of growth, averaging 4.3% annualised. It is important to underscore that this period saw household consumption rise more slowly than total GDP. With a share of around 68% in 2019, household consumption is a dominant component of Serbia's GDP, but this share is much lower than before the global economic crisis, when it measured almost 80% of GDP.

Economic growth is significantly supported by lending activity – almost the entire growth in corporate lending of more than RSD 100 bn in 2019 pertained to investment loans, which rose more than 25% at the year level and came close to EUR 5 bn at the end of the year. Thanks to the adoption and successful implementation of the NPL Resolution Strategy, as well as sustainable growth in lending, the share of NPLs in total loans came down to 4.1% at end-2019, more than 18 pp less than before the Strategy was implemented.

As a result of the successful implementation of fiscal consolidation and full coordination of monetary and fiscal policy measures, fiscal imbalance was eliminated, as confirmed by the consolidated surplus of 0.6% of GDP in 2018 and a slight deficit in 2019 (0.2% of GDP). Positive fiscal developments in this period were facilitated by the rise in economic activity, increased profitability of the corporate sector in the past five years and positive labour market developments, where at end-2019 the unemployment rate came down to single-digit levels for the first time on record. Owing to the eliminated fiscal imbalance, the share of public debt in GDP was brought within sustainable bounds and at end-2019, the central government debt equalled 52.0% of GDP. Of no less importance is the fact that the currency risk and the government refinancing risk were significantly reduced, due to the government borrowing mainly in the domestic market by issuing long-term dinar securities, the maturity and early buyback of a portion of debt under eurobonds issued in dollars, and the trimmed interest rates on borrowing, which resulted in the increase in the dinar portion of the debt to almost 28% at end-2019.

Serbia's risk premium in both 2018 and 2019 was among the lowest in the region (19 bp at end-2019). The fall in the country risk premium was facilitated by global and even more so by domestic factors, the country's favourable macroeconomic prospects, narrowed internal and external imbalances, and bolstered financial stability. In addition, Fitch and Standard & Poor's raised Serbia's credit rating to a notch away from investment grade, noting in their reports the NBS's operational independence and increased credibility of the monetary policy as factors behind the rating upgrade.

Considering the specificities of the global economic crisis and the crisis caused by the coronavirus pandemic, as well as economic developments and indicators in the periods leading up to both crises, we may conclude that Serbia was in a

much better macroeconomic and fiscal position when the current crisis broke out. This is mostly due to the results achieved in terms of the attainment and preservation of overall macroeconomic stability in the past years, to which, in coordination with the Serbian Government, the NBS gave its contribution by maintaining price and financial stability, and providing support to economic growth. This way, a strong foundation was formed and room created for us to face the many challenges that come with the new crisis, in order to preserve the production capacity and jobs, as well as citizens' standard of living.

III Inflation movements

In the period since the May Inflation Report, y-o-y inflation first slowed down to below the lower bound of the target tolerance band, reflecting mainly the high base effect of vegetable prices and the lower prices of petroleum products due to a significant fall in global oil prices in the first four months of the year, only to return within the target tolerance band in June, reaching 1.6%. Low inflationary pressures are also confirmed by the stable core inflation (1.4% y-o-y in June), and by inflation expectations of the financial sector, which stand in the lower part of the target band both for one and two years ahead.

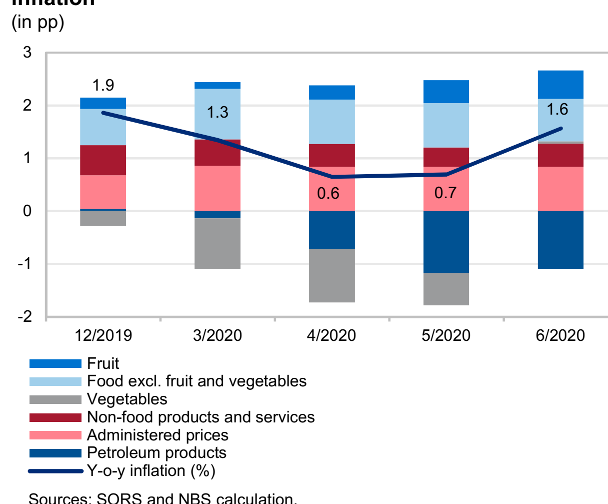
Consumer prices picked up by 0.4% in Q2, driven by higher prices of food and services, while a strong fall in the prices of petroleum products worked in the opposite direction.

Inflation movements in Q2

Consistent with expectations in the May *Inflation Report*, **y-o-y inflation** moved below the lower bound of the target band in April and May, only **to return within the target tolerance band in June, measuring 1.6%**. Y-o-y inflation slowed down mainly due to the high base effect of vegetable prices, which peaked in April (contribution of vegetable prices to y-o-y inflation was -1.0 pp), but fully disappeared in June. A considerable fall in the prices of petroleum products, in place since February (with -1.1 pp contribution to y-o-y inflation in June), worked in the same direction. It resulted from a drop in global oil prices amid weaker global economic growth outlook due to the pandemic, and during April also due to the failure of Saudi Arabia and Russia to reach an agreement on capping production. In contrast, fruit prices picked up in Q2, adding 0.5 pp to the June y-o-y inflation, while other categories of food also provided a positive and stable contribution of around 0.8 pp. All of the above indicates that even with the changed structure of demand due to the pandemic, the market was fully supplied with goods, so there was no strengthening of inflationary pressures. This is also confirmed by **core inflation** (measured by CPI excluding the prices of food, petroleum products, alcohol and cigarettes), which remained stable in Q2, **measuring 1.4% y-o-y in June**.

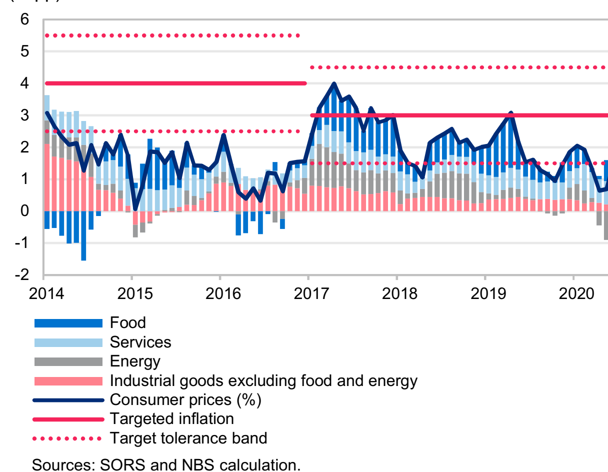
Consumer prices picked up by 0.4% in Q2, driven by the hike in prices of food and non-alcoholic beverages (2.7%, contribution to quarterly inflation: 0.9 pp). Within food, a higher contribution to inflation came from **unprocessed food** (0.7 pp), led by the increase in the

Chart III.0.1 **Contribution of CPI components to y-o-y inflation**
(in pp)



Sources: SORS and NBS calculation.

Chart III.0.2 **Contribution to y-o-y consumer price growth**
(in pp)



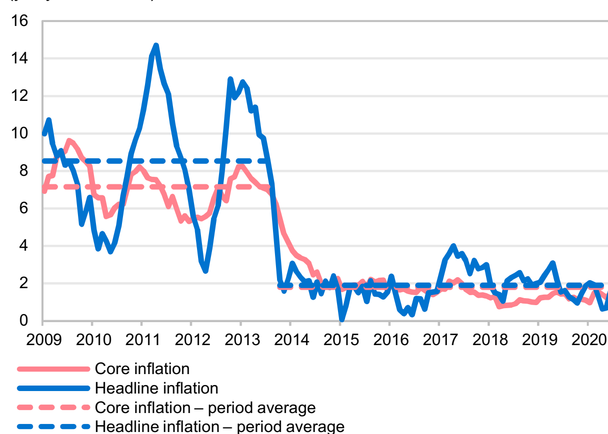
Sources: SORS and NBS calculation.

Table III.0.1 **Growth and contribution of components to consumer price growth in Q2 2020**
(quarterly rates)

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**0.4**	**0.4**
Unprocessed food	6.6	0.7
Processed food	0.7	0.2
Industrial products excluding food and energy	0.4	0.1
Energy	-5.5	-0.8
Services	1.2	0.3
CPI excluding energy, food, alcohol and cigarettes	0.9	0.4
Administered prices	0.0	0.0

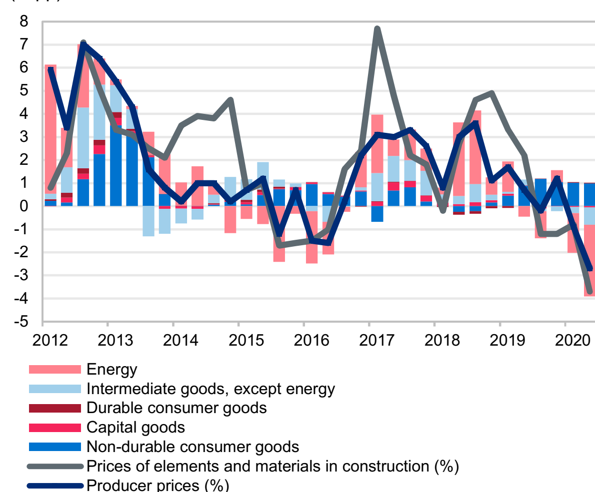
Sources: SORS and NBS calculation.

Chart III.0.3 **Headline and core inflation**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Chart III.0.4 **Contribution to y-o-y producer price growth***
(in pp)



Sources: SORS and NBS calculation.
* Industrial producer prices for the domestic market.

prices of fresh fruit (26.5%) and vegetables (4.3%), while the prices of fresh meat declined somewhat (-0.4%). When it comes to **processed food**, the strongest contribution to inflation came from the higher prices of meat products and milk and dairy products.

The **prices of services** rose by 1.2% in Q2 (0.3 pp contribution to quarterly inflation), predominantly driven by the expected seasonal hike in the prices of travel packages[1] (28.9%, contribution: 0.2 pp). Other categories of services did not contribute significantly to inflation in Q2.

The **prices of industrial products (excluding food and energy)** edged up slightly in Q2 (0.4%, contribution to quarterly inflation: 0.1 pp), mostly on account of the seasonal increase in the prices of clothes and footwear (1.6%), while somewhat lower prices of vehicles and spare parts worked in the opposite direction (-0.3%).

The greatest negative contribution to quarterly inflation came from the drop in **energy prices** (5.5%, contribution: -0.8 pp), almost entirely attributable to a significant decrease in petroleum product prices in the domestic market (-14.9%). In addition, the prices of gas and solid fuels edged down slightly in Q2 (-0.3%).

Administered prices stagnated at the quarterly level, while their y-o-y growth of 4.6% throughout Q2 was largely driven by the February increase in the prices of cigarettes and landline telephony services.

The **prices within core inflation** increased by 0.9% in Q2 (0.4 pp contribution), due to the seasonal increase in the prices of clothes, footwear and travel packages.

Producer and import prices

Industrial producer prices in the domestic market decreased additionally, by 2.7% y-o-y in June (after falling by 0.9% y-o-y in March), indicating that cost-push pressures remained low amid disrupted global supply chains. Such movements in total producer prices were driven by a strong y-o-y fall in the **energy production prices** in Q2 (primarily domestic crude oil and petroleum products), with a concurrent decrease in the prices of intermediate and capital goods. In contrast, **the prices of non-durable consumer goods** recorded

[1] As was the case in other countries, the national Statistical Office used the growth rate from the same month last year for this type of services due to the impossibility to fully cover all the services in Q2 amid the pandemic.

y-o-y growth in Q2, led primarily by higher costs of food production and beverages. After falling by 0.8% y-o-y in March, the **prices of elements and materials incorporated in construction** fell further by 3.7% y-o-y in June, confirming low cost-push pressures in construction as well.

Following the outbreak of the global coronavirus pandemic, **dinar-denominated import prices**[2] (indicator used to track movements in the prices of goods and services imported into Serbia) recorded a sharp y-o-y decrease which stepped up from -2.4% in March to -2.7% in June. The y-o-y decrease in these prices was predominantly driven by a strong decline in global oil prices expressed in USD (with a contribution to total import prices of -1.6 pp in June). A negative contribution also came from the y-o-y reduction in export prices of Germany (-0.9 pp), which are used to approximate prices of imported equipment and intermediate goods, and from lower global food prices expressed in USD (-0.2 pp). On the other hand, euro area consumer prices, which are used to approximate prices of imported services, were in June almost unchanged from a year ago.

Inflation expectations

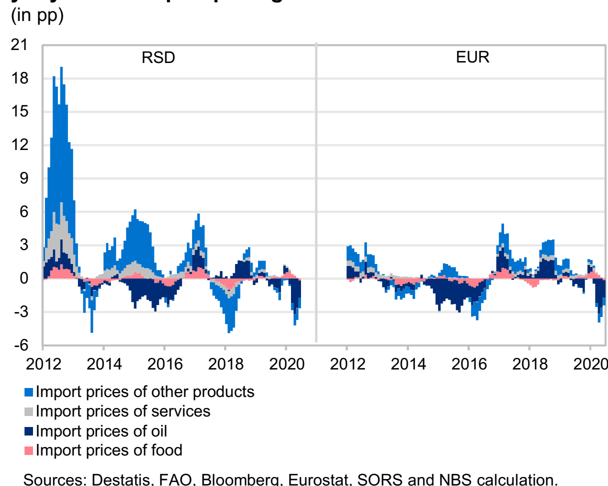
Inflation expectations of the financial and corporate sectors remained low and stable in Q2 as well, indicating market participants' confidence that price stability will be preserved going forward.

According to the results of the Ipsos survey, **one-year ahead inflation expectations of the financial sector** continued to move within the NBS target tolerance band in Q2 and July (3±1.5%), in the range 1.6–2.0%. The Bloomberg survey results point to the same conclusion, with short-term inflation expectations of the financial sector gradually falling from 2.3% in April to 1.7% in July. Looking at a longer horizon, the financial sector has expected inflation to be within the NBS target tolerance band for almost seven years now (since October 2013), which contributes to higher credibility of the NBS.

One-year ahead inflation expectations of corporates were lowered in Q2 (from 1.8% in April to 1.0% in June), probably due to lower oil price and the expectation that the coronavirus pandemic will weaken consumer

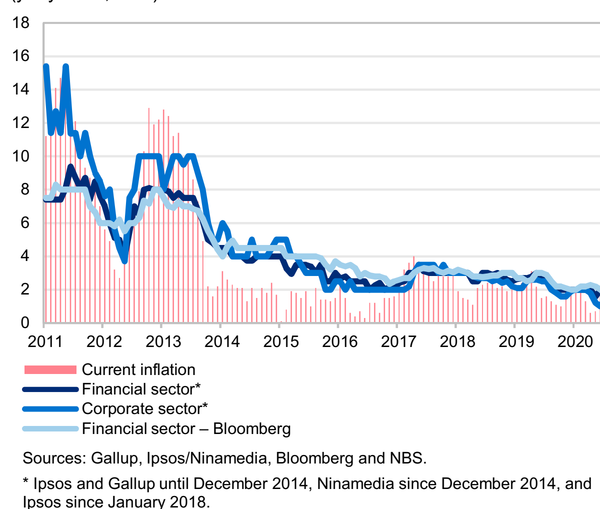
[2] The weighted average of the global Brent oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's most significant foreign trade partners, is used as an indicator of import prices.

Chart III.0.5 **Contribution of individual components to y-o-y rate of import price growth**
(in pp)



Sources: Destatis, FAO, Bloomberg, Eurostat, SORS and NBS calculation.

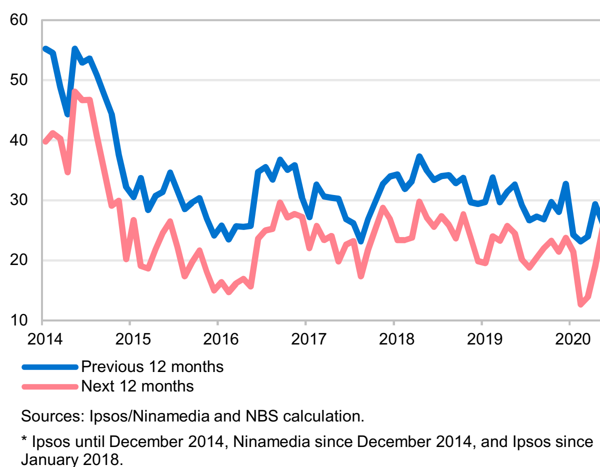
Chart III.0.6 **Current inflation and one-year ahead inflation expectations**
(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

* Ipsos and Gallup until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

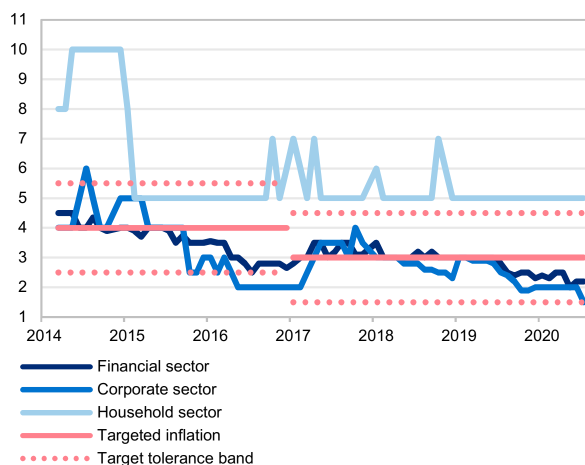
Chart III.0.7 **Household perceived and expected inflation***
(in index points)



Sources: Ipsos/Ninamedia and NBS calculation.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

Chart III.0.8 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS.

* Ipsos until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

demand, while they increased to 1.5% in July. At the same time, more than 70% of corporates expect that the prices of production inputs will not change over the next twelve months.

Typically higher than those of other sectors, **one-year ahead inflation expectations of the household sector** were stable at 5.0% in Q2, the same as in the past year.[3] Speaking in favour of the expected preservation of price stability are also the results of the qualitative survey[4] which show that the index of expected inflation continues to record lower values than the index of perceived inflation. Such movements indicate that households expect inflation to be lower in the next twelve months than in the past year.

Two-year ahead inflation expectations of the financial sector[5] have been anchored within the NBS target tolerance band since their monitoring began (March 2014), moving in Q2 in the 2.0–2.5% range, while **those of the corporate sector** have been stable at 2.0% since December 2019. **Two-year ahead inflation expectations of households** have been stable at 5.0% for over twenty months.

[3] The temporary increase to 8.0% in March 2020 can be attributed to the spread of the coronavirus (COVID-19) and fears that there will be a shortage of basic foodstuffs, while the increase to 7% in July is probably a result of the current fuel price hike.

[4] For more details on qualitative expectations of households see the February 2016 Inflation Report – Text box 2, p. 15.

[5] The results of the July survey indicate that medium-term inflation expectations of the financial and household sectors were unchanged from June and equalled 2.2% and 5.0%, respectively. At the same time, the expectations of corporates fell to 1.5%.

IV Inflation determinants

1 Financial market trends

Continued monetary policy easing reflected on a further interest rate decline in the interbank money and credit markets, thereby providing additional support to economic recovery. The coronavirus pandemic significantly increased government borrowing needs, which have been successfully satisfied, against the backdrop of heightened uncertainty in the financial markets, by additional issues of dinar securities in the domestic market and of eurobonds in the international market. The dinar remained stable against the euro in Q2 as well.

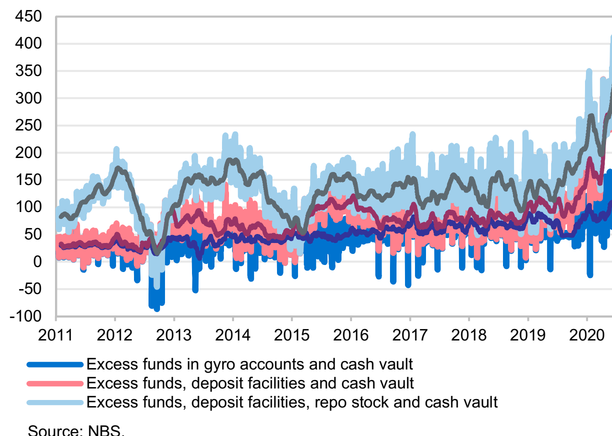
Interest rates

In Q2, the key policy rate was cut twice, by 0.25 pp each, to 1.25% in June, its lowest level in the inflation targeting regime. The average repo rate was also cut by 0.5 pp and was hence equal to the NBS deposit facility rate (0.25%) at end-June.

The monetary policy measures taken in Q2 had a direct impact on the further **fall in interest rates in the interbank money market**, while indirectly contributing to reinforcement of dinar liquidity surpluses. This is evidenced by movements in the interbank overnight money market, in which the average trading volumes contracted from RSD 3.2 bn in Q1 to RSD 1.8 bn in Q2, with BEONIA dropping by 0.6 pp and settling just a tad above the deposit facility rate (0.26%). BELIBOR rates of all maturities also declined, though more sharply for shorter maturities (0.4 pp vs. 0.3 pp for six-month maturity), and they ranged between 0.45% and 1.24% at end-June.

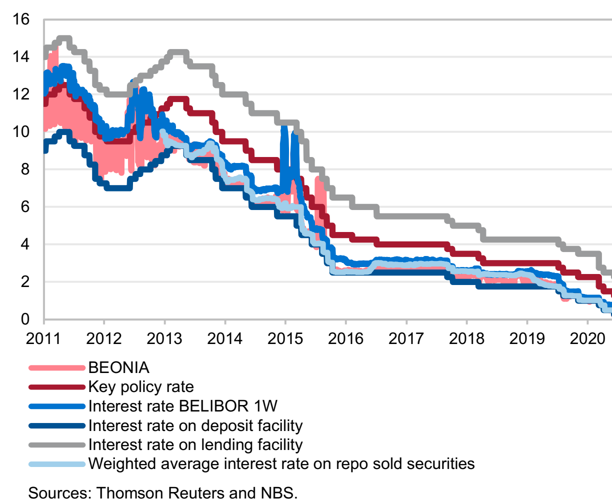
The drop in interest rates in the **primary market of dinar government securities** was halted in Q2 amid heightened uncertainty in the financial markets caused by the coronavirus pandemic. In the three auctions held in Q2 the rates on five-year dinar securities stayed unchanged (2.6%), while the effective rate on twelve-year dinar securities increased by 0.5 pp relative to March, to 3.85% in June.

Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bn)



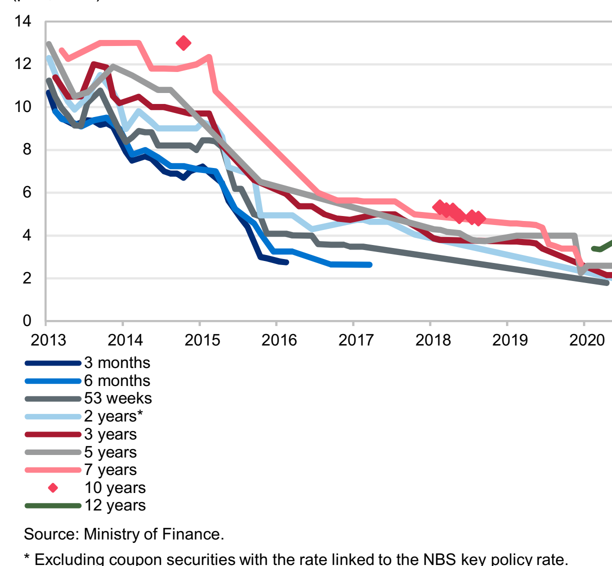
Source: NBS.

Chart IV.1.2 **Interest rate movements**
(daily data, p.a., in %)



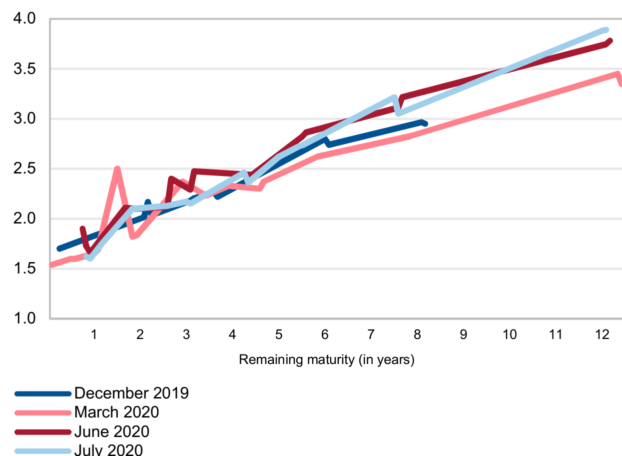
Sources: Thomson Reuters and NBS.

Chart IV.1.3 **Interest rates in the primary market of dinar government securities**
(p.a., in %)



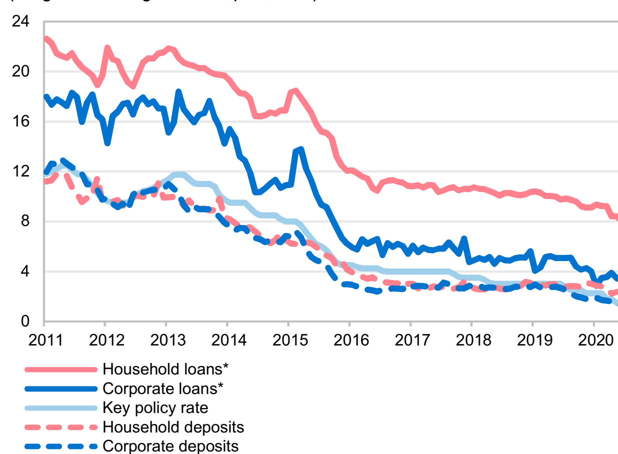
Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.4 **Yield curve in the secondary government securities market**
(average values, p.a., in %)



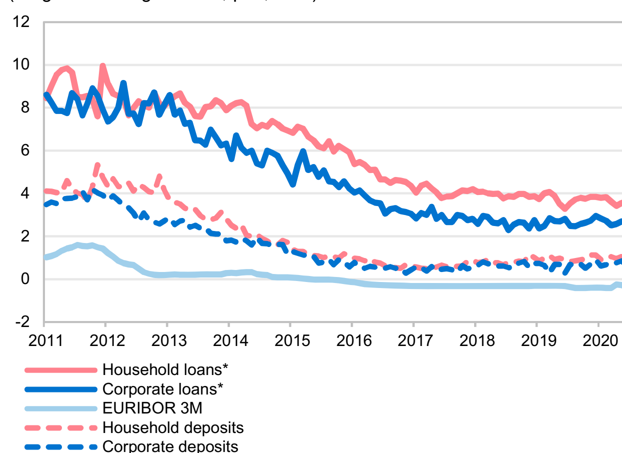
Source: Central Securities Depository and Clearing House.

Chart IV.1.5 **Interest rates on new dinar loans and deposits**
(weighted average values, p.a., in %)



Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart IV.1.6 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



Sources: European Banking Federation and NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

In addition, the government issued 53-week T-bills in Q2 (for the first time since 2017) and two- and three-year bonds. The rates achieved ranged between 1.79% and 2.15%, and they were confirmed in repeated auctions held in May and June.

Despite growing uncertainty in the markets, by selling dinar securities in Q2 the government managed to amortise the maturing of the first three-year benchmark bonds issued in 2017 and seven-year bonds, in total amount of RSD 83.4 bn, and to borrow additional RSD 75.1 bn, so the stock of securities sold at end-June increased to RSD 889.3 bn.

Heightened uncertainty in the financial markets and higher risk aversion globally brought down non-residents' investment in dinar securities in the period March–May. However, this trend reversed in June and the stock of dinar securities sold to non-residents increased by RSD 4.3 bn, to RSD 215.8 bn.

The increase in effective rates at the auction of twelve-year dinar securities was accompanied by the rise in yield rates for longer maturities in the **secondary market**. In June, they ranged from 1.7% for the remaining eleven-month maturity to 3.8% for the remaining twelve-year maturity. In Q2, lower activity was registered in the secondary market, and the total turnover of dinar securities decreased by 31.8%.

In mid-May, Serbia was among the first countries in Europe to have **successfully organised a new issue of eurobonds**. Namely, in the conditions of increased risk in the international financial market, Serbia issued and sold seven-year bonds in the nominal amount of EUR 2 bn, at the rate of 3.375% (coupon rate of 3.125%), using the funds raised for the real sector support programme aimed at alleviating the negative economic effects of the coronavirus.

As the eurobond issue in the international market reduced the government's borrowing needs significantly, there were no auctions of **euro-denominated securities in the domestic market** in May and June. In April, one auction was held, in which two-year euro-denominated securities were sold in the nominal amount of EUR 40.1 bn, at an unchanged rate of 0.5%. The maturing amount of previously sold euro- denominated securities was negligibly higher than the sales amount in Q2 (EUR 7.2 mn), so the stock of euro-denominated securities sold in the domestic market stayed almost unchanged at EUR 2.8 bn.

Interest rates **on new dinar loans** to households declined by 1.2 pp in Q2, to 8.0% in June, their lowest level since

the comparable statistics are available. In the structure of new dinar household loans, interest rates on other non-categorised loans declined from 7.8% in March to 5.5% in June, which can be attributed to lending to corporates with the prescribed maximum interest rate (one-month BELIBOR + 2.5 pp), based on the Decree Establishing a Guarantee Scheme as a Measure of Economic Support to Mitigate the Consequences of the Pandemic. On the other hand, the average interest rate on cash loans, which are the dominant category of new dinar household loans, stayed unchanged relative to March (9.3%).

The weighted average rate on dinar corporate loans declined by 0.2 pp, to 3.4%, which was facilitated by the fall in interest rates on investment loans, while the rates on current assets loans and other non-categorised loans stayed unchanged in Q2. In the structure of current assets loans, interest rates for the segment of micro, small and medium-sized enterprises declined, while those for large enterprises went up.

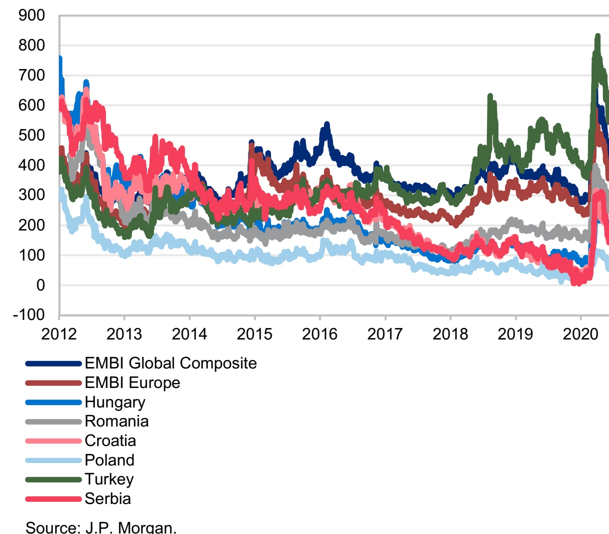
The weighted average rate on euro-indexed household loans stayed unchanged relative to March, and stood at 3.6% in June, and so did the rate on euro-indexed housing loans (2.7%). Interest rates on euro corporate loans edged up slightly in Q2 (0.2 pp), averaging 2.7% in June, mostly as a result of higher interest rates on corporate investment loans, which went up by 0.4 pp, to 3.2%, while those on current assets loans dropped by 0.1 pp, to 2.4%.

Interest rates on household dinar savings declined by 0.2 pp, to 2.45% until June, while those on household savings in euros remained broadly unchanged, measuring 1% in June, same as in March. Interest rates on time euro deposits of corporates also flatlined (0.65%), while those on time dinar deposits declined by 0.4 pp, to 1.3%.

Risk premium

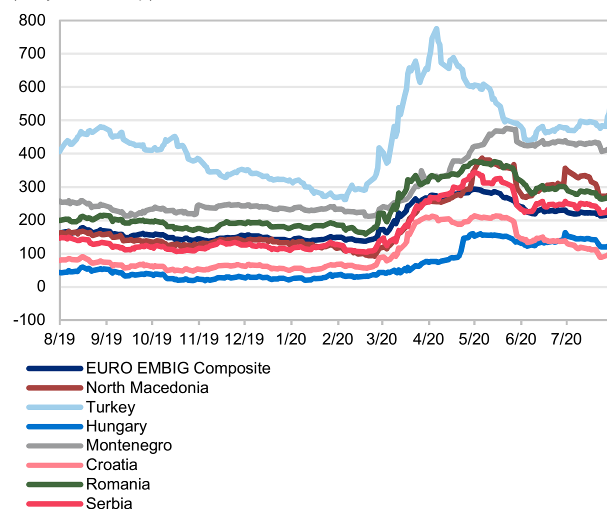
After Serbia's risk premium for dollar-denominated debt, like that of other regional peers, increased in March, driven by heightened global uncertainty caused by the coronavirus pandemic, it averaged around 300 bp in April, and then began to fall in early May. This decline was prompted by the recovered investment sentiment toward emerging economies, mainly owing to the measures of leading central banks, which injected unprecedented liquidity volumes in response to the crisis, and also owing to the relaxation of social distancing measures. Measuring 137 bp at end-Q2, EMBI for Serbia's dollar-denominated debt was more than twice lower than at end-Q1. It continued falling in July, reaching 99 bp, which is significantly lower than EMBI

Chart IV.1.7 **Risk premium indicator for dollar - denominated debt − EMBI**
(daily data, in bp)



Source: J.P. Morgan.

Chart IV.1.8 **Risk premium indicator for euro-denominated debt – EURO EMBIG**
(daily data, in bp)



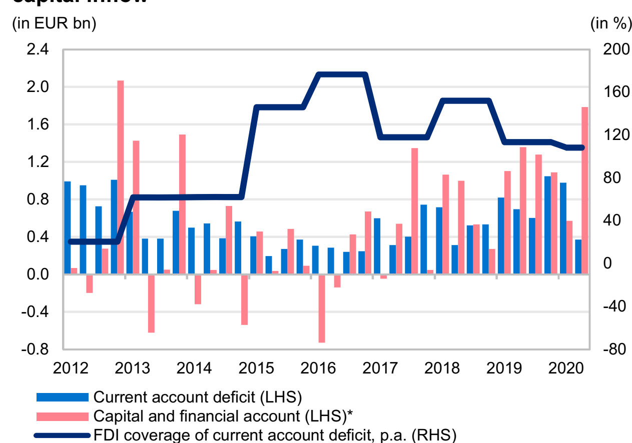
Source: J.P. Morgan.

Table IV.1.1 **Credit rating**
(change of rating and outlook)

	2017	2018	2019	2020
S&P	BB /stable[4]	BB /positive[4]	BB+ /positive[4]	BB+ /stable[2]
Fitch	BB /stable[4]		BB+ /stable[3]	
Moody's	Ba3 /stable[1]		Ba3 /positive[3]	

Source: NBS.
[1] March, [2] May, [3] September, [4] December.

Chart IV.1.9 **Current account deficit and net capital inflow**



Source: NBS.
Note: Preliminary data for Q2 2020.
* Excluding changes in NBS FX reserves.

Global Composite, and among the lowest risk premia for dollar-denominated debt in the region.

Under the impact of global factors, Serbia's risk premium for euro-denominated debt rose in March and April. After EURO EMBIG[6] for Serbia climbed to 344 bp in early May, it started to go down, underpinned by large-scale measures of leading central banks, as well as by the relaxation of restrictive counter-pandemic measures and the first signals of incipient recovery of the global economy. Looking at end-Q2, Serbia's risk premium for euro-denominated debt remained almost unchanged relative to end-Q1, measuring 257 bp[7]. However, it dropped further in July, to 236 bp at the end of the month.

As part of extraordinary rating actions taken globally in response to the pandemic-caused crisis, in May, Standard & Poor's affirmed Serbia's credit rating at BB+, changing the outlook to stable from positive due to the coronavirus pandemic and its impact on global economy and financial flows. Later on, within its regular rating actions in June, Standard & Poor's affirmed Serbia's BB+ rating and a stable outlook. Despite heightened risks associated with the coronavirus, the outlook for further rating upgrades was kept stable owing to a significant increase in Serbia's resilience, as a result of reduced imbalances, boosted FX reserves and greater fiscal space, allowing for fast reactions of economic policy makers in pandemic conditions.

Foreign capital inflow

Thanks to a successful eurobond issue in the international market, the bulk of the capital inflow in the balance of payments financial account in Q2 referred to portfolio investment. The FDI and financial loans taken by residents abroad also generated FX inflows.

Despite the increased uncertainty in the international financial market, **FDI** inflow to Serbia continued, reaching EUR 665.1 mn net in Q2 according to preliminary data. The net FDI inflow in H1 thus came at EUR 1,461.5 mn, providing for the full coverage of the current account deficit (108.4%). Sector-wise, almost one third of investments was channelled into manufacturing and significant amounts were also invested in transport and warehousing, as well as in construction. Same as before, the bulk of investments originated from European countries (almost 80%), but

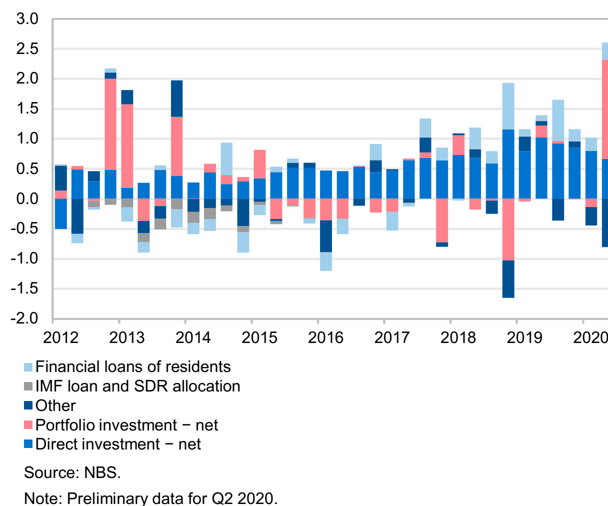
[6] For more information about EURO EMBIG, see the February 2020 *Inflation Report*.
[7] On 30 June, the seven-year eurobond in euros was included in the calculation of EURO EMBIG for Serbia.

investments from Asian countries also expanded, accounting for 17% of FDI inflow.

Thanks to a successful eurobond issue in Q2, **portfolio investment** brought in a net inflow of EUR 1,650.1 mn. In an environment of the global economic crisis caused by the coronavirus pandemic, Serbia issued EUR 2 bn worth of seven-year eurobonds in May, at the coupon rate of 3.125%. Investor demand was several times higher than the planned and realised size of the issue, thanks to which the borrowing price at the auction fell by 50 bp. At the same time, in the domestic market, in conditions of global risk aversion, foreign investors reduced their investment in dinar government securities.

Resident liabilities under foreign **financial loans** increased by EUR 286.8 mn net in Q2. Of that, banks' net liabilities to foreign creditors went up by EUR 197.2 mn, companies' by EUR 83.0 mn and government's by EUR 6.6 mn. On the other hand, outflows were recorded under trade loans (EUR 567.0 mn) and cash and deposits (EUR 233.3 mn), reflecting the increase in banks' balances abroad.

Chart IV.1.10 **Structure of the financial account**
(in EUR bn)



Source: NBS.

Note: Preliminary data for Q2 2020.

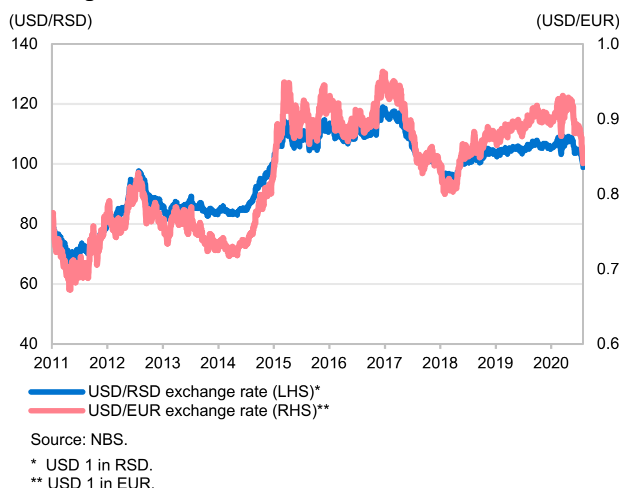
Trends in the FX market and exchange rate

The dinar remained stable against the euro in Q2 even amid the heightened uncertainty induced by the coronavirus pandemic, supported by the NBS's FX liquidity provision to banks against the background of limited supply of foreign exchange and cash. End-of-period, the dinar value against the euro remained almost unchanged in Q2 (0.1% depreciation), while due to the dollar's weakening against the euro, the dinar gained 2.0% on the dollar. Stable movements of the dinar-euro exchange rate extended into July, so its value, both at the monthly level and since the start of this year, remained almost unchanged.

In Q2 domestic companies were a significant factor driving net FX demand, partly due to the lower FX supply in conditions of international economic contraction during the pandemic. Uncertainty in the international financial market reflected on non-resident FX demand in April, and also in May, though to a significantly lesser degree. In June, non-residents were net sellers of foreign exchange due to increased investment in dinar government securities in the domestic market.

As a factor driving FX demand, Q2 saw the net sale of

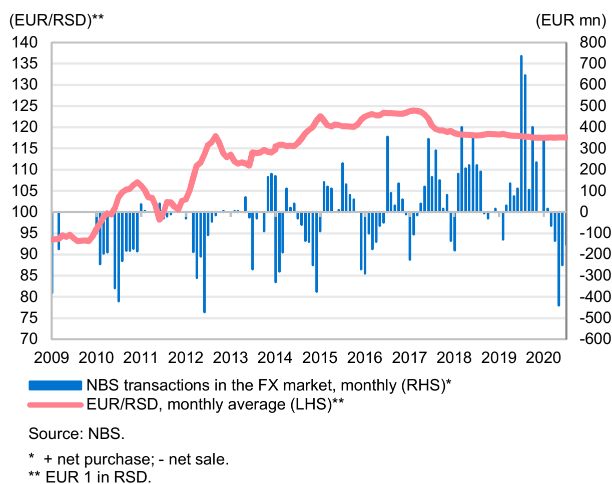
Chart IV.1.11 **Movements in USD/RSD and USD/EUR exchange rates**



Source: NBS.

* USD 1 in RSD.
** USD 1 in EUR.

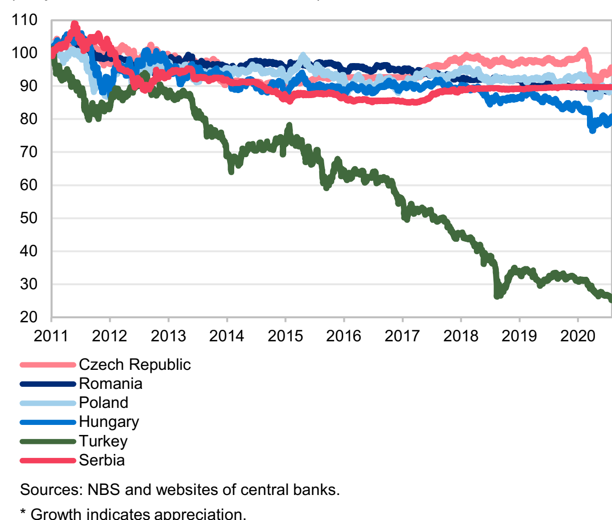
Chart IV.1.12 **Dinar exchange rate and NBS transactions in the FX market**



Source: NBS.

* + net purchase; - net sale.
** EUR 1 in RSD.

Chart IV.1.13 **Exchange rates of selected national currencies against the euro***
(daily data, 31 December 2010 = 100)



Sources: NBS and websites of central banks.

* Growth indicates appreciation.

foreign cash to households and exchange dealers instead of the usual net purchase, due to the lower inflow of remittances and absence of tourist arrivals due to the pandemic. On the other hand, working on the FX supply side was the increasing FX-indexed lending to corporates and households, i.e. growth in FX-indexed bank assets,[8] and to a lesser extent also the longer positions of banks on account of use of payment cards by non-residents.

In order to maintain relative stability in the domestic FX market, the NBS net sold EUR 845.0 mn in the IFEM in Q2. More than a half of that amount referred to the net sale in April (EUR 440.0 mn), the month which saw the strongest effects of the elevated uncertainty in the international financial market.

Q2 saw a lower volume of interbank FX trading compared to Q1 – daily trading in the IFEM averaged[9] EUR 25.1 mn, down by EUR 5.7 mn relative to Q1. The highest trading volume was recorded in June (EUR 26.5 mn daily average).

The NBS continued to provide liquidity support to the domestic financial system via regular FX swap auctions in Q2, while the volume of trading in these auctions expanded compared to Q1. The June auctions were again realised by the method of variable multiple swap points,[10] with equal purchase and sale amounts. In two-week auctions in Q2 the NBS swap bought EUR 57.0 mn from banks and swap sold EUR 193.5 mn to banks, while in three-month auctions it swap bought EUR 169.0 mn and swap sold EUR 180.0 mn.

Currencies of countries in the region running inflation targeting regimes recorded divergent movements in Q2. End-of-period, gaining ground on the euro were the Czech koruna (2.2%), Polish zloty (1.9%) and Hungarian forint (0.7%), while the Turkish lira weakened by 6.4% and the Romanian leu by 0.3%. Despite the recovery of some currencies in Q2, at end-June all currencies remained weaker than at end-2019.

[8] Aiming to balance their open long FX position and thus reduce the exposure to FX risk, banks sell foreign currency, which leads to the strengthening of the dinar.

[9] Excluding the NBS.

[10] Regular auctions at fixed swap points, with the principle that swap purchase and swap sale amounts need not be identical, were held from end-March until end-May 2020.

2 Money and loans

Stable growth in lending and measures of economic support to the private sector to cope with the pandemic contributed to significant growth of monetary aggregates in Q2. Total domestic loans picked up to 13.9% y-o-y in June, reflecting an excellent disbursement in Q1, as of April partly owing to the moratorium effects and after May also thanks to the loans under the Guarantee Scheme.

Monetary aggregates

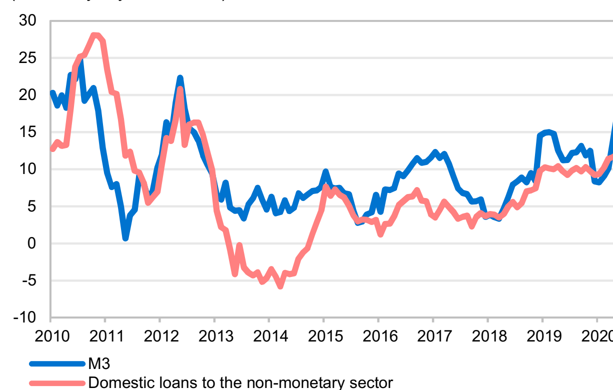
Stable lending growth and increased government spending in accordance with the Programme of Economic Measures to Mitigate the Negative Effects Caused by the COVID-19 Pandemic and Support the Serbian Economy gave a positive impetus to the growth in monetary aggregates in Q2. In Q2, the broadest monetary aggregate M3 increased by 8.9%, and three fourths of this increase originated from the rising dinar component.

In terms of individual categories, **sight deposits** rose by RSD 149.3 bn. The money supply in non-monetary sectors was driven up mainly by government measures for boosting corporate liquidity – tax payment deferral, corporate subsidies in the form of minimum wage payouts to employees, loans under the Guarantee Scheme etc., as well as enabling a moratorium on loan repayment for corporates and households. Accordingly, the highest growth was recorded for transaction deposits of corporates (by RSD 94.6 bn), and of households (by RSD 55.6 bn). The rise was recorded also in accounts of all other sectors.

Time dinar deposits of non-monetary sectors in Q2 went up by RSD 9.9 bn, with increases recorded across the board, except in the local government. Dinar savings of households gained RSD 1.9 bn in Q2, reaching their new maximum of RSD 85.0 bn in June. Such savings trends testify to the household confidence in the banking system and the domestic currency, which gains particular importance amid the rising uncertainty fuelled by the pandemic. Dinar savings are more attractive than FX savings also thanks to higher interest rates and a more favourable tax treatment.

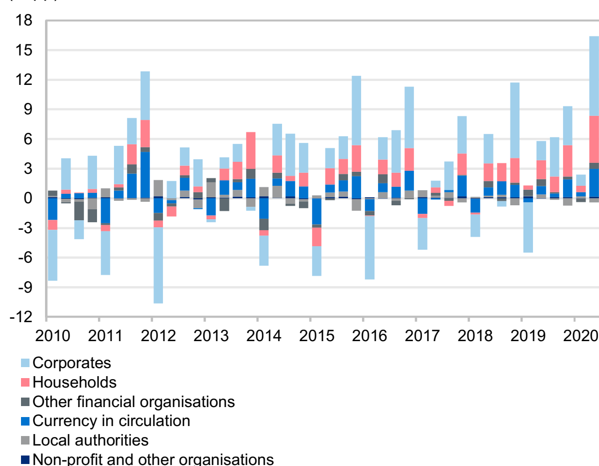
In Q2, **FX deposits** increased by EUR 506.6 mn, mostly due to the rise in corporate FX deposits (by EUR 326.7 mn) owing to the measures taken to mitigate the negative

Chart IV.2.1 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.

Chart IV.2.2 **Contributions to quarterly growth in M2, by sector**
(in pp)

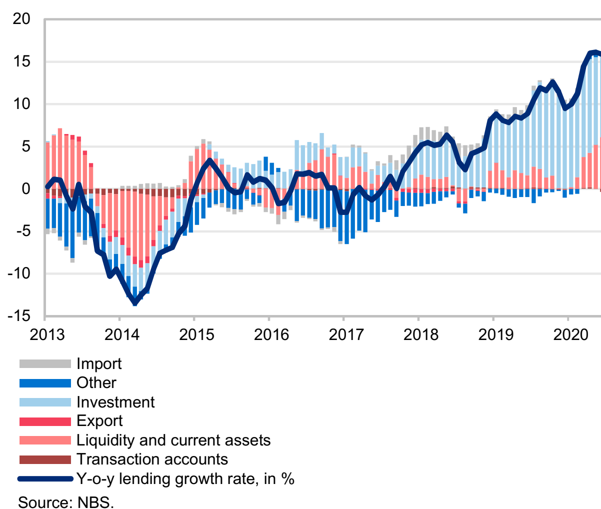


Source: NBS.

consequences of the pandemic, but also due to FX inflows from exports, FDI and external borrowing of corporates. Household FX savings increased by EUR 168.9 mn, reaching EUR 10.6 bn[11] at end-June.

In y-o-y terms, M3 growth picked up to 19.0% in June, driven primarily by the acceleration of its dinar component, to 36.1% in June. However, according to our estimate, this money growth does not fuel inflationary pressures, since it is connected with the rise in corporate liquidity and households' refrainment from consumption in pandemic conditions. Apart from that, the link between money and inflation was generally weakened and the analyses indicate that this link mostly exists in the long, but not in the short run. In the coming period, money supply is expected to decline due to the payment of tax liabilities that were deferred during the pandemic owing to government measures and the expected rise in investment and consumption, but inflationary pressures will not build up on those grounds.

Chart IV.2.3 **Contributions to y-o-y corporate lending growth**
(in pp, excluding the exchange rate effect)



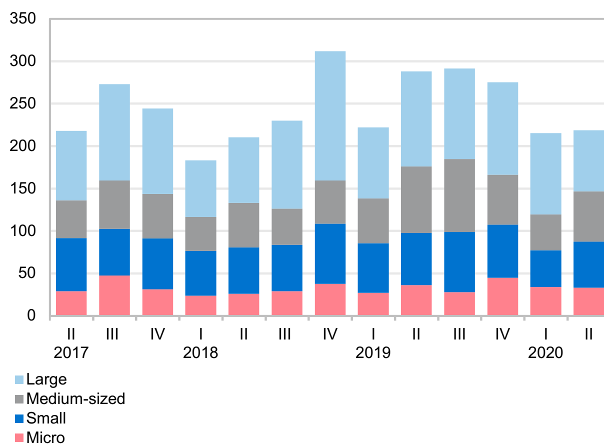
Source: NBS.

Loans

In 2020, **domestic lending** continued up at two-digit y-o-y growth rates, thanks to excellent loan disbursement in Q1, the effects of the April moratorium, and, as of May, a positive contribution also came from Guarantee Scheme loans. Total domestic loans rose 13.9% in y-o-y terms in June, keeping a favourable structure in terms of the contribution to economic growth.

Excluding the exchange rate effect, **corporate loans** increased by RSD 45.3 bn in Q2 and their y-o-y growth picked up from 14.5% in March to 15.9% in June. Observed by purpose, investment loans remained a dominant category of corporate loans, making up 44.4% in June, while their stock increased by RSD 13.0 bn in Q2. Next come current assets loans[12] whose share in total corporate loans has been rising in recent months owing to the growing need for liquid funds, reaching 40.7% in June. Corporates' loan balances increased in all sectors, particularly in construction, real estate and transport.

Chart IV.2.4 **Structure of new corporate loans, by enterprise size**
(in RSD bn)



Source: NBS.

The volume of newly approved corporate loans in Q2 equalled RSD 218.3 bn, where more than 50% of this amount was approved in June, thanks to the loans under the Guarantee Scheme. Relative to the same period in the year before, the volume contracted by 24.2%, or by

[11] Money supply M3 includes only resident funds. With non-resident funds included, at end-June dinar savings equalled RSD 85.5 bn and FX savings EUR 11.0 bn.

[12] Increased by RSD 32.5 bn in Q2.

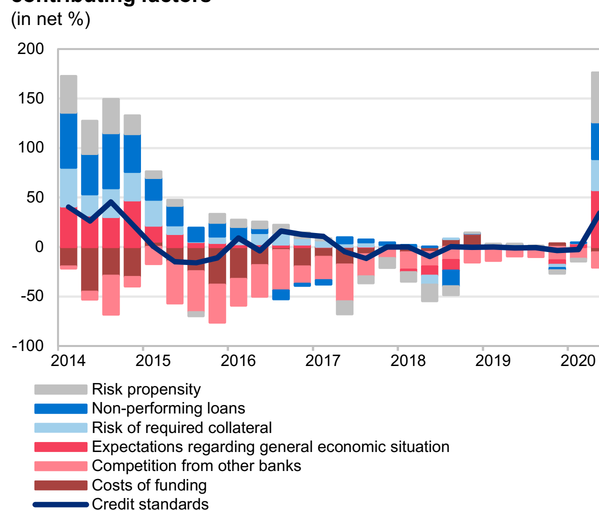
21.1% excluding the loans refinanced with the same bank. The bulk of new corporate loans in Q2 were current assets loans (RSD 130.5 bn), and 70% of these loans were approved to the market segment of micro, small and medium-sized enterprises. This market segment also absorbed 75% of new investment loans[13] in Q2.

In the course of Q2, excluding the exchange rate effect, **household loans** rose by RSD 50.7 bn, picking up to 12.6% y-o-y in June (from 9.7% in March), partly as a result of the moratorium on loan repayment, which was, according to the July decision of the NBS Executive Board, extended by two more months, starting from 1 August. In the structure of household loans, the greatest share is held by cash loans (44.2% in June) and housing loans (36.2% in June). Acting proactively to alleviate the consequences of the crisis and create conditions for further household consumption, the NBS passed new regulations in July aiming to facilitate the repayment of cash, consumer or other types of loans (except housing loans and current account overdrafts). Concretely, as of the effective date of these regulations, banks will be encouraged to offer to borrowers the refinancing or change in the maturity date of the last instalment of consumer, cash and other loans (other than housing loans and current account overdrafts) approved by 18 March 2020, for two more years compared to the repayment regime that is currently in place for these loans (assuming the repayment term of up to seven years during this year, up to six years during 2021, up to eight years for consumer loans approved for the purchase of motor vehicles regardless of the year). In addition, the NBS made the decision in June to reduce the minimum downpayment for the purchase of the first apartment to 10%, which should also alleviate the crisis burden.

In Q2, **the volume of new household loans** stood at RSD 75.0 bn, 47% of which were cash loans and 23% – housing loans. Relative to the same period in the year before, the volume of new household loans contracted by 52.6%, or by 40.7% excluding the effect of loans refinanced with the same bank.

The results of the **NBS bank lending survey from July**[14] show that banks, consistent with the expectations presented in the April survey, tightened the standards for corporate and household loans in Q2. Such movements are the consequence of the rising risk aversion in conditions of uncertainty caused by the coronavirus

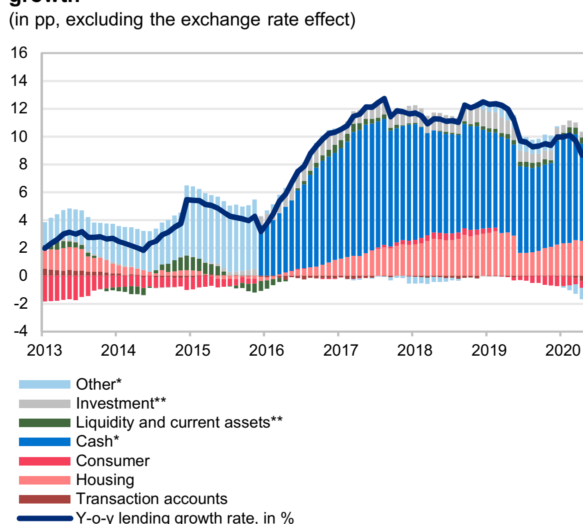
Chart IV.2.5 **Change in corporate credit standards and contributing factors**
(in net %)



Source: NBS.

Note: Growth indicates the tightening and decline indicates the easing of credit standards.

Chart IV.2.6 **Contributions to y-o-y household lending growth**
(in pp, excluding the exchange rate effect)



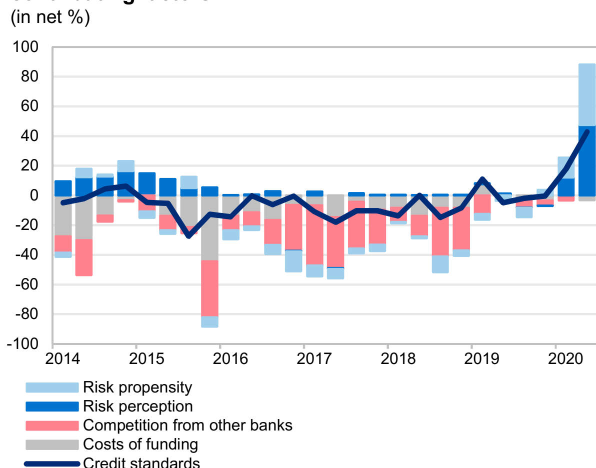
Source: NBS.

* Until December 2015, the contribution of cash loans is shown within the contribution of other loans.
** Loans extended to entrepreneurs.

[13] RSD 55.2 bn of investment loans were approved in Q2.

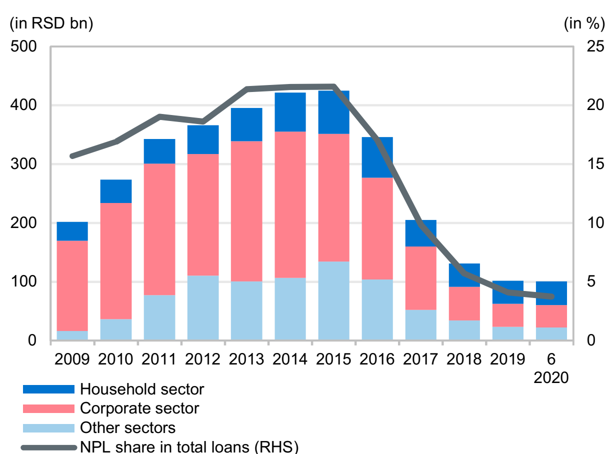
[14] The NBS implements the survey since the start of 2014.

Chart IV.2.7 **Change in household credit standards and contributing factors**
(in net %)



Source: NBS.
Note: Growth indicates the tightening and decline indicates the easing of credit standards.

Chart IV.2.8 **NPL share in total loans, gross principle**



Source: NBS.

pandemic. On the other hand, the competition in the sector and dinar sources of funding were recognised as the factors working towards standards easing, largely as a result of the NBS key policy rate cut. Banks reported an increased corporate loan demand in Q2, including current assets loans and loans for the refinancing of existing liabilities. At the same time, household loan demand contracted in the same period, which can be associated with the implemented containment measures.

The degree of dinarisation of corporate and household receivables, measured by the share of dinar in total receivables, increased in Q2 by 1.4 pp to 34.6% at end-June – the highest recorded level of dinarisation so far. The dinarisation of corporate receivables rose to 16.4% at end-Q2 (from 14.7% at end-Q1) due to almost twice higher growth of dinar compared to euro loans, which was also supported by the disbursement of dinar loans from the Guarantee Scheme. At the same time, the dinarisation of household receivables also went up, by 0.7 pp to 55.8% at end-Q2.

The gross **NPL ratio** continued down in Q2[15], to 3.7% in June, the lowest recorded level of this asset quality indicator. At the same time, the NPL ratios of corporate and household sectors declined in Q2 by 0.2 pp and 0.3 pp to 2.8%[16] and 3.8%[17] in June, respectively. NPL coverage remained high – allowances for impairment to total loans measured 91.6% of NPLs in June, while allowances for impairment to NPLs stood at 62.6% of NPLs.

According to the latest available data, at end-Q2 2020, the **capital adequacy ratio**[18] measured 22.7%, unchanged from end-Q1 and indicating high capitalisation and resilience of the banking sector (regulatory minimum 8.0%).

[15] Partly also due to moratorium effects.

[16] Includes companies and public enterprises. Looking only at companies, the share of NPLs in total loans came at 3.1% in June, down by 0.2 pp relative to end-Q1.

[17] Including entrepreneurs and private households, the share also fell by 0.3 pp to 3.8%.

[18] The regulatory Basel III framework is applied as of 30 June 2017.

Text box 2: Micro, small and medium-sized enterprises – disbursement of Guarantee Scheme loans and terms of financing

Given the growing corporate needs for liquid assets amid the coronavirus pandemic, the support of lending to economic activity and the globally heightened risk aversion fuelled by the pandemic, the Serbian Government adopted the Decree Establishing a Guarantee Scheme as a Measure of Support to the Economy to Mitigate the Consequences of the COVID-19 Disease Caused by the SARS-CoV-2 Virus.[1] The Decree aims to facilitate access to and terms of lending to the market segment comprising micro enterprises, small and medium-sized enterprises and entrepreneurs, which is more vulnerable to negative economic consequences of the coronavirus pandemic and is a significant generator of GDP growth and jobs.

The Guarantee Scheme enables banks to lend, with government guarantee, to micro enterprises, small and medium-sized enterprises and entrepreneurs up to EUR 2 bn for liquidity and current assets purchases, provided that such loans are disbursed no later than end-January 2021. The maximum guarantee amount at the level of the bank's insured portfolio is EUR 480 mn, while the maximum amount of an individual guarantee is calculated by multiplying the value of the bank's insured portfolio, coverage rate (80%) and maximum guarantee rate (30%). Also, in order to further boost economic activity, a condition has been prescribed that minimum 50% of loans under the Guarantee Scheme must be new loans, while maximum 50% may be used to refinance the existing liabilities. In order to ensure a level playing field for all banks in the market, it was decided that one half of the overall Guarantee Scheme amount (up to EUR 1 bn) should be awarded proportionally to the banks' market share (in the segment of micro, small and medium-sized enterprises and entrepreneurs). After reaching 90% utilisation of the maximum insured portfolio, the bank may apply for its increase, except that each individual application must be in the range from EUR 5 mn to EUR 25 mn. The loans may be approved

Table O.2.1 **Guarantee Scheme 2020**

Loan	– Liquidity and current assets loans intended for entrepreneurs, micro, small and medium-sized enterprises in accordance with the law governing accounting.
Structure of financing	– Banks provide the amount of up to EUR 2 bn, while the maximum amount guaranteed by the government is EUR 480 mn (maximum guarantee rate of 30% x coverage rate of 80%), – The amount of up to 50% of the Guarantee Scheme (for new loans) is allocated to banks proportionally to their share in the market segment of loans to entrepreneurs, micro, small and medium-sized enterprises on 29 February 2020.
Terms	– Maximum interest rate for dinar loans BELIBOR 1M + 2.5 pp, – Maximum interest rate for euro loans EURIBOR 3M + 3.0 pp, – Maximum maturity 36 months including 9 - 12 month grace period, – Minimum 50% of the total amount of loans under the Guarantee Scheme are new loans, – Maximum 50% of the total amount of loans under the Guarantee Scheme may be rolled over loans maturing after 29 February 2020, and not later than 31 January 2021.
Purpose	– Liquidity and current assets loans.
Maximum loan amount that the user is eligible for in all banks	Lower of the two amounts: – 25% of the realised income the loan user generated in 2019 according to the financial statements submitted to the Business Registers Agency for statistical purposes, – EUR 3,000,000 for loans approved in euros or the dinar equivalent of EUR 3 mn at the middle exchange rate of the NBS on the date of conclusion of the loan contract for loans approved in dinars.
Additional terms	– Loan approved not later than 31 December 2020 and disbursed not later than 31 January 2021, – Loan repayment in monthly annuities, – Loan collateral is the promissory note of the loan holder and majority loan holder (direct participation in ownership of minimum 25%), – Loan user must not pay out dividends nor repay loans to the founder in the first year after concluding the loan contract, – During the grace period, the loan user must not engage in early repayment of existing loans with the same purpose to any other bank which are not included in the insured portfolio.
Regulation	– Decree Establishing a Guarantee Scheme as a Measure of Support to the Economy to Mitigate the Consequences of the COVID-19 Disease Caused by the SARS-CoV-2 Virus (RS Official Gazette, No 57/20).

[1] RS Official Gazette, No 57/20.

in dinars or in euros, and the maximum interest rate is set at the level of one-month BELIBOR increased by 2.5 pp for dinar loans and three-month EURIBOR increased by 3.0 pp for euro loans.

Loans approved to the market segment of micro, small and medium-sized enterprises make up a larger share of total corporate loans, accounting for over 65% in June, with a stable rising trend, running at two-digit rates for more than a year – 12.5% y-o-y in June. Bearing in mind that the market segment of micro, small and medium-sized enterprises absorbed almost 65% of new liquidity and current assets loans in 2020, the Guarantee Scheme proved to be a significant support for the unhindered continuation of credit and economic activity in this market segment.

During May and June, the market segment of micro, small and medium-sized enterprises and entrepreneurs absorbed EUR 638.4 mn of liquidity and current assets loans within the Guarantee Scheme.[2] Given that 86.9% of approved loans are new, they are expected to give a positive impetus to economic activity going forward. Also, the currency structure of approved loans testifies to the increased corporate interest in dinar loans, because 56.4% of approved loans are in the domestic currency. This at the same time strengthens dinarisation and consequently the efficiency of monetary policy and financial stability. An additional incentive for a greater use of dinar loans is the NBS Executive Board's decision adopted at the extraordinary meeting in July, stipulating that the NBS will pay to banks which approve dinar loans under the Guarantee Scheme at a rate lower by at least 0.50 bp than the ceiling rate defined by the Decree the so-called remuneration rate (paid on required reserve allocations in dinars) 0.50 bp higher than the standard remuneration rate (currently equalling 0.1%). The amount subject to the higher remuneration interest rate is calculated as the average daily balance of dinar loans in the Guarantee Scheme, provided that each individual loan included in that balance is approved at the abovementioned lower interest rate.

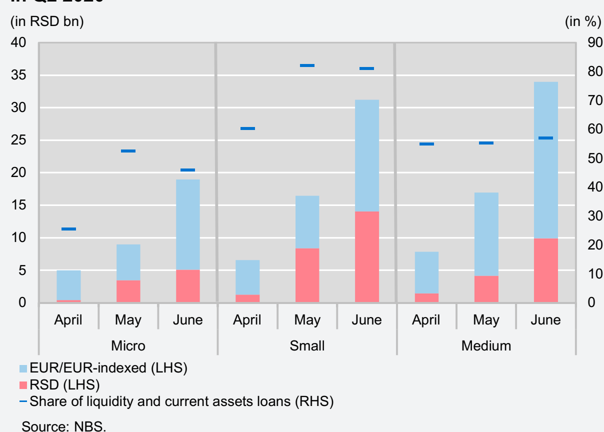
Chart O.2.1 **Interest rates on new loans to micro, small and medium-sized enterprises in Q2 2020**
(weighted average values, p.a., in %)

Source: NBS.

The balance of loans approved to micro, small and medium-sized enterprises in Q2 increased by RSD 27.9 bn and the bulk of this growth was generated in May and June (a total of RSD 46.8 bn), largely owing to the Guarantee Scheme loans. According to the preliminary data, almost one half of the total planned amount under the Guarantee Scheme was approved by end-July, which indicates that there was high demand for these loans and that the adopted measure was timely and adequate in terms of encouraging lending and speeding up economic recovery.

The terms of financing of micro, small and medium-sized enterprises and entrepreneurs remained favourable during Q2. Despite the expected increase according to the April lending survey, in conditions of growing risk aversion, interest rates on dinar loans to micro, small and medium-sized enterprises edged down, owing to NBS monetary policy easing and the favourable lending terms under the Guarantee Scheme. Interest rates on new dinar loans to micro enterprises dropped from 5.5% in March to 3.8% in June, led by the

Chart O.2.2 **New loans to micro, small and medium-sized enterprises in Q2 2020**



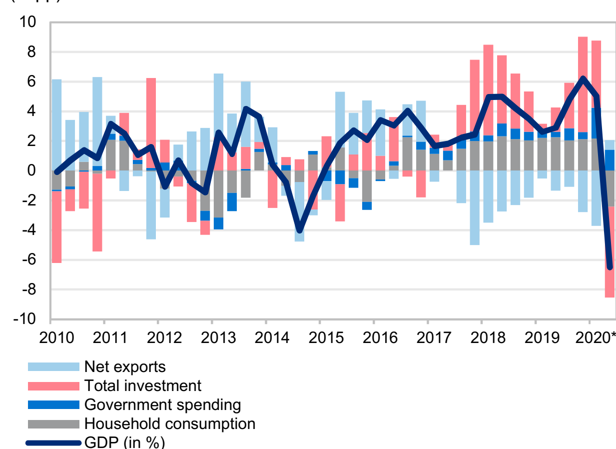
Source: NBS.

[2] Almost 90% of approved loans, i.e. EUR 558.5 mn were disbursed by 30 June 2020.

decline in interest rates on current assets loans of almost 2 pp. Similarly, under the influence of lower interest rates on current assets and investment loans, interest rates on loans to small enterprises lost 1.2 pp, falling to 3.5% in June, while interest rates on loans to medium-sized enterprises were lower by 0.7 pp, measuring 3.2% in June. As opposed to dinar interest rates, interest rates on new euro loans in the market segment of micro, small and medium-sized enterprises were mildly adjusted upward in Q2, measuring 3.5% for micro, 2.9% for small and 2.6% for medium-sized enterprises in June. Entrepreneurs also borrowed in dinars at lower rates (a decline from 7.2% in March to 3.9% in June), while interest rates on euro loans increased, exceeding the dinar rates.

Lending growth and favourable terms of financing help boost the disposable income of this most vital and most flexible part of the economy which, together with other economic measures, should contribute to the preservation of its production potential and jobs, and speed up post-crisis recovery.

Chart IV.3.1 **Contributions to y-o-y GDP growth rate – expenditure side**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate for Q2 2020.

3 Aggregate demand

Based on a preliminary estimate of the Statistical Office, Serbian GDP contracted by 6.5% y-o-y in Q2 2020, entirely as a consequence of falling domestic demand. The effects of the crisis manifested most strongly on investment and to a somewhat lesser extent on private consumption too, while government spending recorded a rise amid coronavirus-driven purchase of goods and services. As expected, the contribution of net exports was positive given that in addition to exports hit by weaker external demand, imports also contracted due to industry's smaller needs for intermediate goods, while weaker private consumption and lower investment weighed down on the import of consumer goods and equipment.

Domestic demand

Table IV.3.1 **Movement in key indicators and sources of household consumption**
(real y-o-y growth rates, in %)

	2019		2020	
	Q3	Q4	Q1	Q2
Household consumption	**3.0**	**3.1**	**3.2**	**-3.5** *
Indicators				
Retail trade	8.59	11.4	10.2	-0.7
Catering turnover	9.7	10.2	5.7	-93.3 **
Number of domestic tourists	7.1	10.5	-3.5	-65.4
Number of overnight stays of domestic tourists	5.5	13.6	1.5	-60.8
Consumer goods imports (BEC classification), nominal	15.9	8.0	9.2	-3.5
Sources				
Total wage bill, nominal	14.6	15.4	13.9	10.4 ***
Net remittances inflow, nominal	2.5	-3.4	-11.2	-31.3
Stock of loans intended for consumption, nominal	13.9	13.2	12.8	12.3

Sources: SORS and NBS calculation.
* NBS estimate.
** April (SORS estimate).
*** April–May.

The 3.5% y-o-y fall in **household consumption** in Q2 is largely attributable to the coronavirus pandemic and the declared state of emergency. Namely, during April most service activities were completely suspended, except for trade where real turnover dropped by 18.4% y-o-y. Gradual normalisation of economic flows began with the lifting of the emergency state in May. A full recovery was made by retail trade which already in May recorded a y-o-y rise in real turnover of 4.7%, followed by 11.5% in June. The effects of the crisis remained visible in the sector of tourism, with the number of overnight stays of domestic tourists declining in June by 17.2% y-o-y, and in Q2 as a whole by close to 61% y-o-y. As regards the sources of consumption, Q2 saw 10% y-o-y growth in the private sector wage bill (April–May), which can be put down mainly to the Government's measures of support aimed at keeping jobs by providing subsidies up to the amount of the minimum wage. The rise in the disposable income of households was also sustained by the NBS's introduction of a three-month moratorium on loan repayment, used by approximately 90% of borrowers. At the same time, new household lending was almost ground to a halt in April, only to pick up in May led by loans intended for consumption, which already in June reached their pre-crisis level. Remittances were also on the decline, which in times of crisis gathered pace from 11.2% y-o-y in Q1 to 31.3% in Q2, reflecting a sharp fall in economic activity in European countries and lesser workforce mobility. Another source of consumption in Q2 was the EUR 100 cash payment, applied for by over six million citizens.

The effects of lower private consumption were partly offset by the rise in **government spending** (8% y-o-y),

notably on account of the coronavirus-driven purchase of goods and services. Thus, total final consumption is estimated to have decreased in Q2 by 1.2% y-o-y, dragging GDP down by 1.0 pp.

Aggravated business conditions in Q2, as well as heightened uncertainty over the recovery of specific economic activities, brought about a **fall in** private sector **investment** estimated to have amounted to 9.9% y-o-y in Q2. This is confirmed by nearly all monthly frequency indicators available. Namely, the production of capital goods slumped by 25.4% y-o-y in Q2, while equipment imports dropped by 14.5% relative to the same period a year earlier. The number of issued construction permits also went down (31.1% y-o-y April–May), and so did the production and import of construction material (11.5% and 9.1% y-o-y, respectively). Reduced incomes and globally higher risk aversion took their toll on the sources of investment financing, as evidenced by the fall in net FDI inflow of 38.7% y-o-y in Q2, and by the 32% lower investment loan growth than in the same quarter of the year before.

As the implementation of government-financed transport and energy infrastructure projects continued during the pandemic, **government investment** is estimated to have edged up by around 2% relative to Q2 2019. As a result, total investment is estimated to have contracted in Q2 by 8% y-o-y, knocking 1.8 pp off Serbia's GDP.

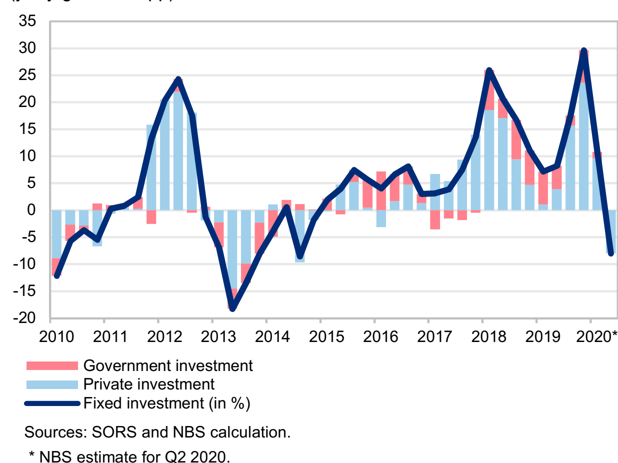
Disrupted supply chains have strained the procurement of intermediate goods and led to significant spending of inventories, which shook 4.3 pp off GDP in Q2.

At the quarterly level as well, total consumption stayed broadly unchanged, since the 2.7% s-a growth in government consumption, in our estimate, fully compensated for the 0.8% s-a drop in private consumption. On the other hand, fixed investment shrank by 13.8% s-a, chiefly on account of lower private investment, while an additional contribution to the fall in GDP came from the reduction in inventories.

Net external demand

The crisis caused by the coronavirus pandemic bore down strongly on external trade in Q2. Exports and imports of goods and services declined in real terms by 20.0% and 18.0% y-o-y, respectively. However, due to the greater share of imports relative to exports, the contribution of net exports to GDP movements in Q2 was positive, equalling 0.7 pp.

Chart IV.3.2 **Fixed investment**
(y-o-y growth, in pp)



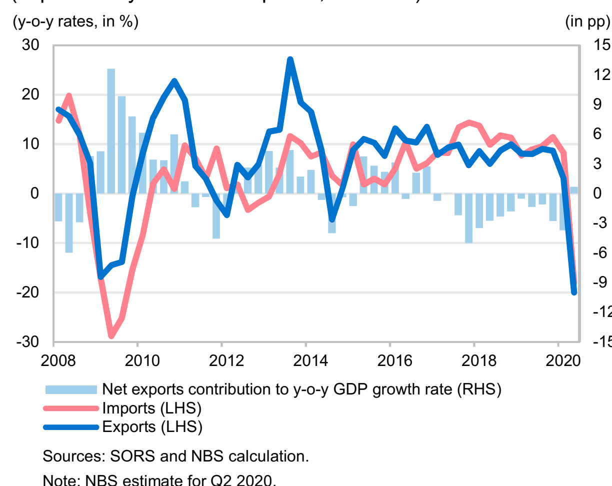
Sources: SORS and NBS calculation.
* NBS estimate for Q2 2020.

Table IV.3.2 **Investment indicators**

	2019		2020	
	Q3	Q4	Q1	Q2
Real y-o-y growth rates (in %)				
Fixed investment (national accounts)*	17.5	29.6	10.7	-8.0
Construction (national accounts)*	36.0	48.3	19.6	-3,5
Government investment	10.6	30.8	5.0	2.0
Number of construction permits issued	18.4	18.4	22.3	-31.1 **
Production of construction material	3.4	0.1	-3.1	-11.5
Value of works performed	45.1	61.8	24.4	-0.8
Imports of equipment, nominal	16.0	42.5	27.2	-14.5
Production of domestic machinery and equipment	-6.8	10.7	-0.5	-15.0
Finished product inventories in industry	-3.2	-3.8	-5.1	-0.8

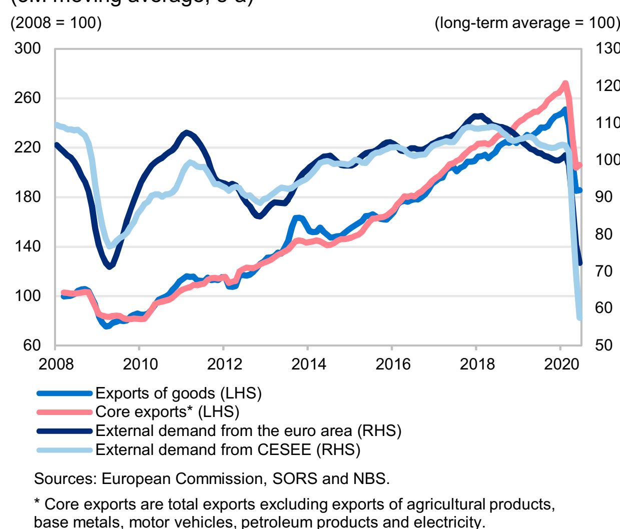
Sources: SORS and NBS calculation.
* NBS estimate for Q2 2019.
** April–May.

Chart IV.3.3 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



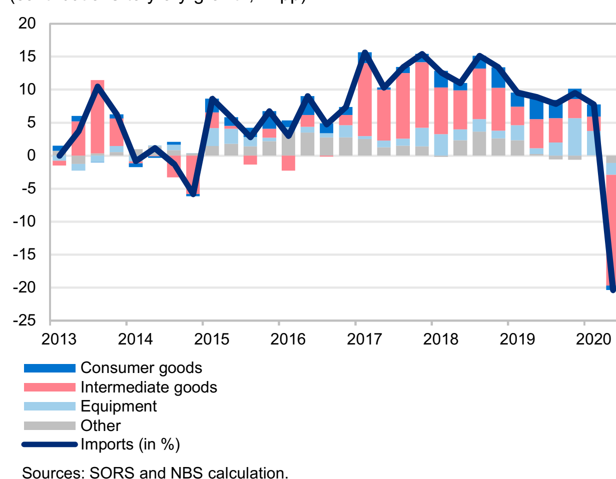
Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2020.

Chart IV.3.4 **Movement of indicators of external demand for Serbian exports**
(3M moving average, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart IV.3.5 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

According to the balance of payments data, commodity exports in euro terms decreased by 20.4% y-o-y in Q2 due to the health measures and a sharp fall in external demand induced by the coronavirus pandemic. The fall in exports is entirely attributable to manufacturing, whose exports slumped by 22.0% y-o-y in Q2, while those of agriculture recorded a rise in the face of the crisis (13.0% y-o-y). The negative effects of the crisis on exports, which began to unfold in March, were most pronounced in April. With the gradual relaxation of health measures and opening of economies, a recovery began in May, as confirmed also by the positive s-a growth rates registered in 16 out of 23 branches of manufacturing. When it comes to key export branches, the growth in exports of electrical equipment, rubber and plastic and automobiles, vehicle parts and accessories began in May and continued in June, when the exports of base metals and metal products also picked up.[19]

Slackening economic activity translated into a precipitous fall in commodity imports, whose amount in euro terms went down by 19.9% y-o-y in Q2. According to the EU classification, this was mostly due to the lower import of industrial inputs for export-oriented production (intermediate goods -19.5% y-o-y), capital goods (-27.0% y-o-y), as well as energy (-57.2% y-o-y), reflecting lesser industry needs and lower oil price. Working in the same direction, though to a significantly smaller degree, was the import of consumer goods. The same trends are indicated also by the classification of imports by broad economic categories (BEC). Namely, under BEC, the import fall was driven primarily by intermediate goods (-29.5% y-o-y), and to a lesser extent, by equipment (-14.5% y-o-y) and consumer goods (-3.5% y-o-y). Spurred by equipment and intermediate goods, imports began to recover in May and this trend continued in June.

The surplus on trade in services in Q2 was higher than in the same period a year earlier, as the fall in their imports (-24.6% y-o-y) was sharper than in their exports (-20.1% y-o-y). The largest negative contribution with both exports and imports of services stemmed from tourism (more pronounced with imports), followed by transport.

The commodity export-to-import ratio[20] stayed broadly unchanged from March, equalling 73.7% in June, or 83.5% services included.

[19] See Text box 3, p. 37.
[20] Measured by the 12-month moving average.

4 Economic activity

After 5% y-o-y growth in Q1, which was the strongest among European countries, economic activity dropped by 6.5% y-o-y in Q2 (10% s-a) due to the negative effects of the coronavirus pandemic, which brought demand down, supply chains to a standstill and caused the shutdown of economies. The crisis effects were the most striking in April. With the relaxation of containment measures here and globally, recovery started in May and continued into June.

A considerable fall in external demand, with aggravated transport communication and a temporary halt in global supply chains, as well as the announcement of the emergency state in April, caused lower utilisation of production capacities. Consequently, **industrial production** dropped by around 8% y-o-y in our estimate, with a 1.6 pp negative contribution to GDP.

The industrial contraction is indicated by the fall in the physical volume of production by 7.8% y-o-y in Q2, with manufacturing recording a somewhat sharper drop (8.3% y-o-y), while, on the other hand, the mining sector was hit by the crisis the least, as testified by the minimum adjustment of it output in Q2 (-1.4% y-o-y). In manufacturing, the automobile industry recorded the sharpest reduction in output, as did other export-oriented industries – the production of electrical equipment and consumer goods (furniture, clothing, leather products). The production of primary commodities also declined, except for petroleum and chemical products production which went up, due to the low base caused by the overhaul of oil and chemical plants (an increase by 24.3% and 13.5% y-o-y, respectively). On the other hand, the food industry recorded a considerably less pronounced fall than other industries (-1.6% y-o-y), while higher demand in the face of the pandemic drove the volume of the production of pharmaceuticals up by 15.0% y-o-y.

It is necessary to emphasise that industrial recovery started in May, when the fall decelerated to 9.4% y-o-y (from 16.7% y-o-y in April) and that the volume of industrial production went up by 2.6% y-o-y already in June, which is fully attributable to the increased volume of production in manufacturing by 4.1% y-o-y. Positive developments in manufacturing in June were widespread as 16 out of 24 industries recorded a y-o-y increase in the volume of production.

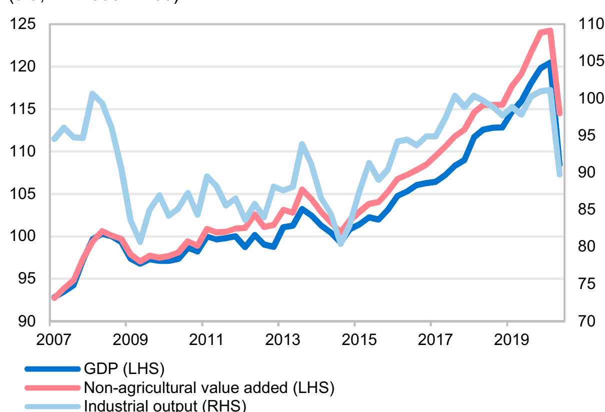
A smaller than expected fall in private consumption was the factor behind an almost complete recovery of **retail trade** which rose by 4.2% y-o-y already in May,

Table IV.4.1 **Contributions to y-o-y GDP growth**
(in pp)

	2019			2020	
	Q2	Q3	Q4	Q1	Q2*
GDP (in %, y-o-y)	**2.9**	**4.8**	**6.2**	**5.0**	**-6.5**
Agriculture	0.0	0.0	0.0	0.0	0.1
Industry	-0.5	0.4	0.7	1.0	-1.6
Construction	0.7	1.7	2.3	0.7	-0.1
Services	2.0	2.1	2.5	2.7	-1.2
Net taxes	0.5	0.5	0.5	0.7	-3.2

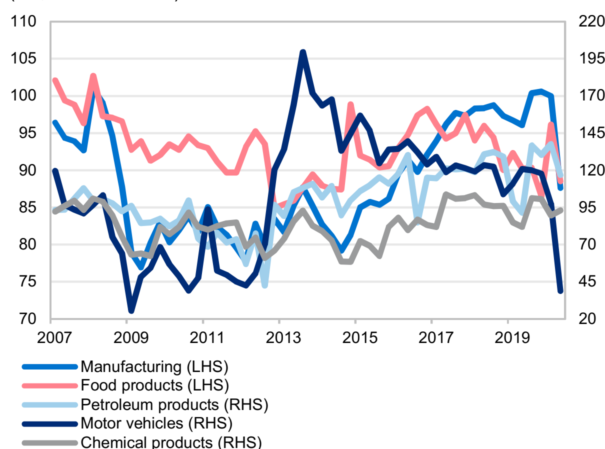
Sources: SORS and NBS calculation.
* NBS estimate.

Chart IV.4.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



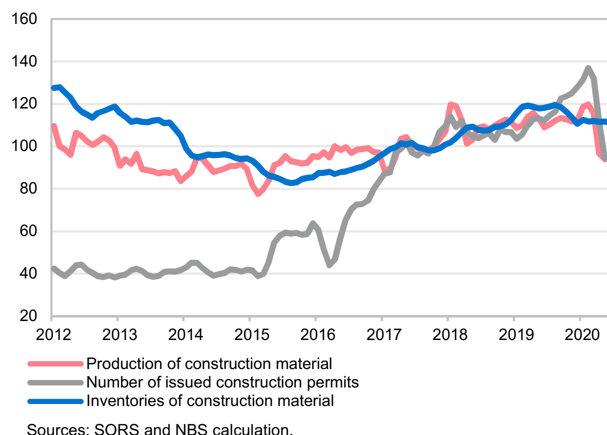
Sources: SORS and NBS calculation.

Chart IV.4.2 **Physical volume of production by branch of manufacturing**
(s-a, H1 2008 = 100)



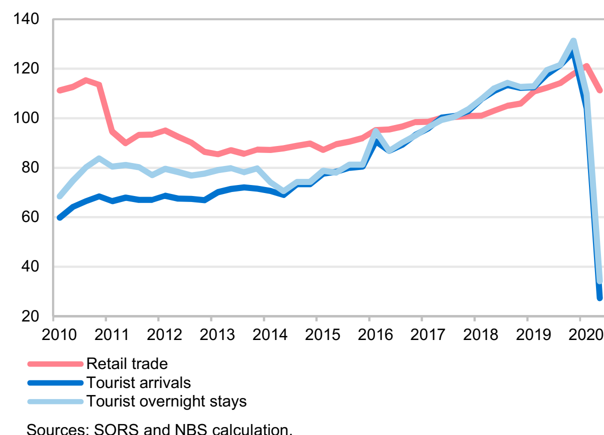
Sources: SORS and NBS calculation.

Chart IV.4.3 **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



Sources: SORS and NBS calculation.

Chart IV.4.4 **Service sector indicators**
(s-a, 2017 = 100)



Sources: SORS and NBS calculation.

accelerating to 11.5% y-o-y in June. Other services which were hit more by the state of emergency and containment measures: **tourism, catering and transport**, recorded a slower recovery as of May. Amid still present uncertainties caused by the pandemic, air transport has only partially recovered, while tourism turnover partially recovered in June after more than an 80% drop y-o-y in May. The latter recovery is attributable primarily to domestic tourist activity – the total number of overnight stays was cut by 43.3% y-o-y in June. With this in mind, we estimate that services collectively recorded a 2.2% fall y-o-y in Q2, with a 1.2 pp negative contribution to GDP.

Construction indicators show that the emergency caused by the pandemic dampened construction activity. The production of construction materials declined by 11.5% y-o-y in Q2, while the number of issued construction permits for the period April–May dropped by 31.1% y-o-y. Nevertheless, we estimate that the intense implementation of infrastructure projects mitigated the fall in the construction industry in Q2 (-2.0% y-o-y) relative to other industries, with a minimum negative contribution to GDP (0.1 pp).

Due to the adopted fiscal support measures, a negative contribution to GDP originated from **net taxes**.

According to our estimate, a single positive contribution (0.1 pp) in Q2 came from agriculture. Based on the first estimates of wheat output and data on areas sowed under corn and industrial plants, we anticipate that **agriculture** will grow by around 1% this year owing to the high base, i.e. above-average results recorded last year.

In quarterly terms, economic activity is estimated to have contracted by around 10% due to the downturn in all sectors except agriculture. This is better than our expectations in the last *Report*, given that manufacturing and retail trade recovered faster since May and construction had a less pronounced than projected fall.

Text box 3: Expected vs. actual macroeconomic developments in Q2

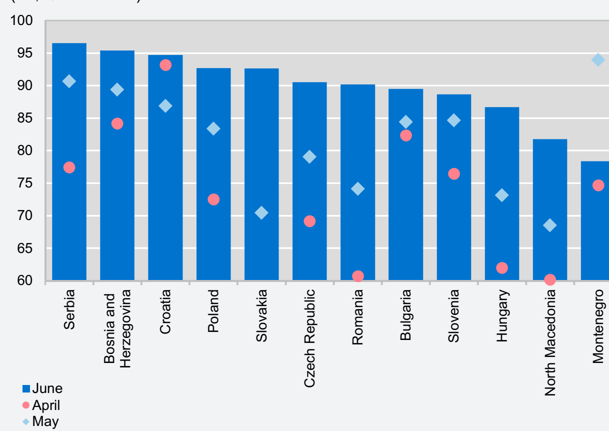
In the previous *Inflation Report* we suggested that the negative effects of the pandemic on the domestic economy would be felt mostly in April, with gradual recovery taking place over the coming months owing to the gradual relaxation of containment measures and the economic measures adopted by the NBS and the Government. As we highlighted at the time, according to our first estimates, economic activity in Q2 could contract by around 8% y-o-y or close to 11% s-a relative to Q1. A downturn was expected in almost all service sectors, accounting for over a half of the projected economic contraction y-o-y, mainly in the fields of transport, tourism and catering. A negative contribution was also expected from industrial and agricultural production given the assumption of an average agricultural season, and from construction, partly due to the last year's high base effect.

According to the first SORS estimate, the economic contraction in Q2 was smaller than we had projected – GDP fell by 6.5% y-o-y, or 10.0% s-a compared to Q1, reflecting better results in almost all production and service sectors. The agricultural season will almost certainly be better than the previous one, the downturn in construction minimal, and the reduction in industry and some service sectors smaller than projected.

In Q2, the physical volume of **industrial production** was under the strongest sway of manufacturing, which in April saw a sharp contraction over reduced production volumes caused by halts/suspensions in production chains, plummeting external demand and containment measures. These measures temporarily locked down the economies across the world, driving down demand. When the state of emergency was lifted in Serbia in early May, manufacturing recovered in that month, while an upturn in June further neutralised the negative effects of the pandemic-induced crisis. Moreover, industrial recovery in May and June was faster than initially expected.

It is noteworthy that almost all Central and Southeast European countries recorded similar dynamics of manufacturing – a decline in April and recovery in May and June. Still, the intensity of monthly changes was more favourable in Serbia than in most of these countries, as seen in the June output level, which indicates that Serbia witnessed the smallest contraction of manufacturing relative to Q1 (-3.5% s-a), while for other countries this figure ranged from 4.6% s-a in Bosnia and Herzegovina to over 20% s-a in Montenegro.

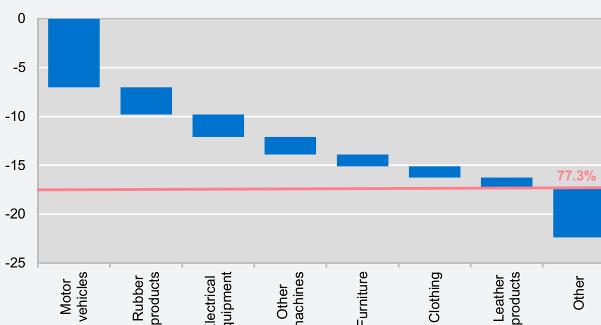
Chart O.3.1 **Change in the physical volume of manufacturing in Q2 2020**
(s-a, Q1 2020 = 100)



Source: Eurostat.

Compared to Q1, the physical volume of industrial production declined by 18.9% s-a in April, with more than a half of it compensated in May. In April, 20 of 24 manufacturing branches went downhill, but they also recovered in May. Seven export-oriented branches (production of motor vehicles and trailers, rubber products, machines, electrical equipment, furniture, clothes and leather products) generated over a half of the contraction in manufacturing in April and May. Shrinking external demand brought about a 23.3% s-a drop in manufacturing exports in Q2, with almost 80% due to the lower exports of the automobile industry, machines and equipment, and

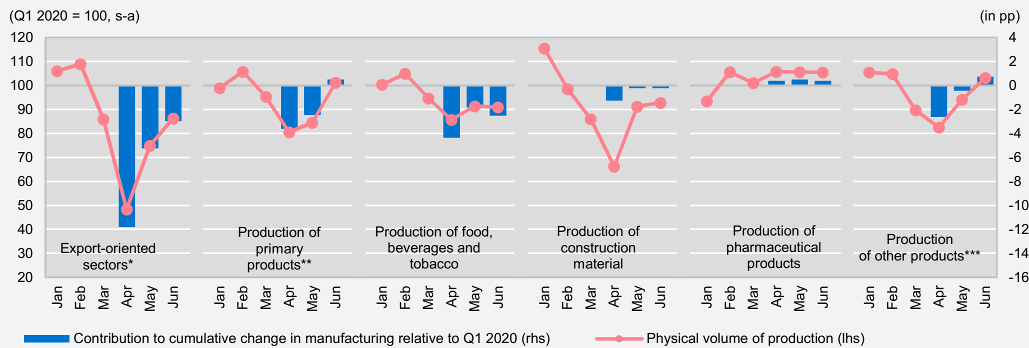
Chart O.3.2 **Contribution to the quarterly fall in manufacturing exports in Q2 2020**
(in pp)



Sources: SORS and NBS calculation.

consumer goods. Already in March, export-oriented branches saw a larger fall in the volume of production than other manufacturing branches. This gap deepened further in April, when the volume of production of export-oriented branches contracted by 43.6% s-a, mirroring a 76.3% s-a fall in motor vehicles production. Recovery began in May and continued into June, when production in export-oriented branches reached 86% of the average monthly production recorded in Q1.

Chart O.3.3 **Physical volume of manufacturing by sector in 2020**



Source: Eurostat.

* Manufacture of motor vehicles, machines and equipment, electrical equipment, furniture, rubber products, clothing and leather products.
** Manufacture of base metals, chemical products, petroleum products, textile, and wood processing.
*** Manufacture of paper, other transport equipment, computers, equipment, printing and reproduction of recorded media etc.

As external demand was dwindling, the production of primary products went down – base metals, chemical products, petroleum products, textile and wood processing. Though the April decline in the production of primary products was smaller than in the areas related to the automobile industry and the production of machines and electrical equipment, May saw sluggish recovery, which picked up in June. As a result, the physical volume of production of primary products exceeded the Q1 level by 1.2%.

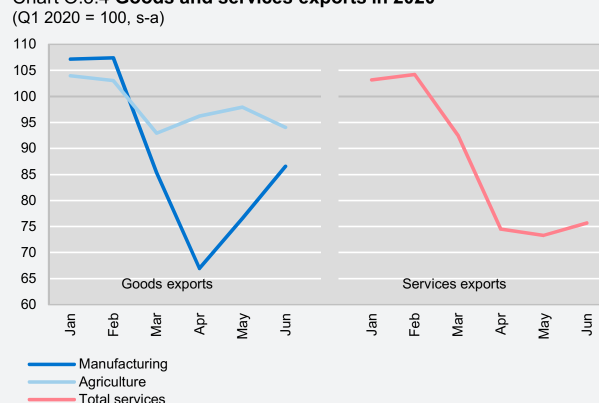
The April contraction in the food industry and production of beverages and tobacco was much smaller given the inelastic domestic demand for these products. After the emergency measures were lifted, the production of food products, beverages and tobacco recovered somewhat, though the June outturn was by 9% lower than the Q1 average. This can be associated with the difficulties to export goods, as exports of these products fell by 12.8% s-a in Q2.

Unlike other sectors, the production of pharmaceutical products increased by 4.7% s-a in April, led by rising demand for medical equipment. In May and June, the level of production remained broadly unchanged – a 5.7% s-a rise was recorded in quarterly terms, adding 0.4 pp to manufacturing growth.

Though works on infrastructure projects were not suspended during the state of emergency, the containment measures slowed down their implementation. The opening of new construction sites also slowed in April, as shown by a 38.4% s-a fall in the number of issued permits. All this drove down the production of construction material by 23% s-a. Still, the **recovery in construction** as of May, supported by a higher number of issued permits (14.0% s-a), fuelled a robust rise in the volume of production of construction material (37.8% s-a), which continued into June (1.7% s-a).

As emergency measures were lifted in early May, trade facilities re-opened, which, together with rising domestic demand – also powered by fiscal measures supporting businesses and households to mitigate the negative effects of the pandemic – enabled almost full recovery of **real trade turnover** already in May. The real growth of 30.1% s-a in May fully offset the

Chart O.3.4 **Goods and services exports in 2020**
(Q1 2020 = 100, s-a)

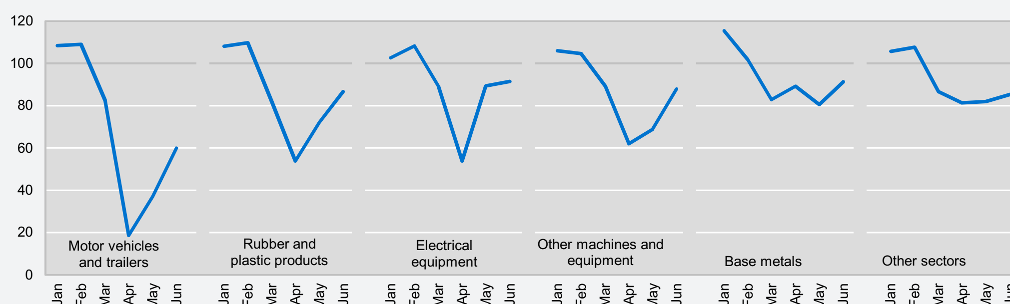


Sources: SORS and NBS calculation.

April drop (-23.6% s-a), exceeding our expectations. In June, real turnover edged up by additional 6.4% s-a, or 3.7% s-a relative to Q1.

Catering and tourism experienced a standstill in April, in line with our expectations. After the economy was opened and containment measures eased, activity picked up in May in these sectors as well.

Chart O.3.5 **Manufacturing exports in 2020**
(Q1 2020 = 100, s-a)



Sources: SORS and NBS calculation.

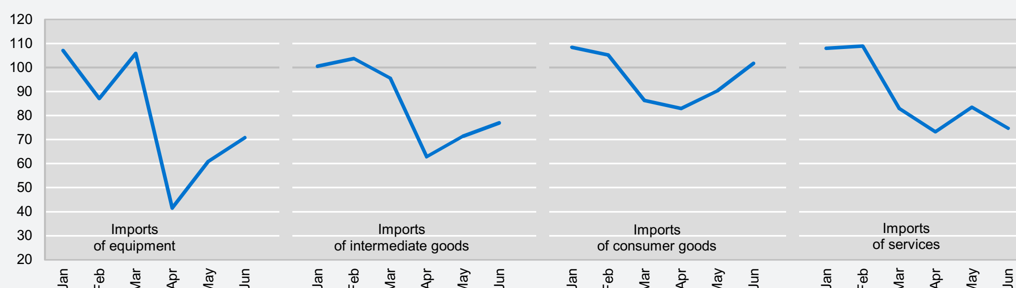
The coronavirus pandemic and containment measures bore down heavily on the **current account deficit**, which narrowed from EUR 977.3 mn in Q1 to EUR 371.0 mn in Q2 (down by almost 47% compared to Q2 2019) – the deficit on trade in goods and the primary income deficit declined, the balance of services improved somewhat, and small remittances inflows worked in the opposite direction. After March, when **trade in goods** suffered the first negative effects of the pandemic, goods exports and imports were hit the hardest in April, plunging by 19.7% and 28.5% s-a, respectively – as a consequence of containment measures and the lockdown. With the gradual opening of economies in May, foreign trade began to recover, but at a slower pace than production, meaning that domestic demand was recovering faster than external demand. Goods exports rose by 14.2% s-a in May, led by the recovering exports of manufacturing (14.4% s-a) and the majority of its key export areas (electrical equipment, the automobile cluster, rubber and plastic). Although exports picked up in 16 of 23 manufacturing branches, some important branches, such as the metal complex and the food and tobacco industry, continued to record weaker exports. The recovery of production pushed up imports in May (12.5% s-a), as suggested by the imports structure dominated primarily by equipment (46.8% s-a) and intermediate goods (13.6% s-a), and to a lesser extent by consumer goods (8.9% s-a). Trade in goods continued to recover in June – exports rose by 11.3% s-a. Manufacturing exports picked up (13.0% s-a) also thanks to metals and metal products, while the imports growth (10.4% s-a) remained driven mainly by intermediate goods, with a somewhat higher contribution of consumer goods.

Foreign **trade in services** was also hit hard by the pandemic. Exports recovered somewhat faster than imports, resulting in a slight improvement in trade in services. After growing in s-a terms only in tourist and ICT services in May, exports rose in June in other types of services as well. The weaker recovery of services imports is due primarily to the absence of tourist travels abroad. **Primary income** was up based on smaller FDI and portfolio investment expenditure. The **secondary income surplus** was reduced reflecting primarily lower remittances inflows, which was expected amid the global slowdown and reduced labour force mobility.

In Q2, capital inflows on the **financial account** (EUR 1.8 bn) rose by almost 30% y-o-y, reflecting the successful issue of seven-year eurobonds in May. Thanks to this eurobond issue, net capital inflows from portfolio investments came at EUR 1.65 bn in Q2. Although net FDI inflows declined y-o-y (EUR 665.1 mn in Q2 2020 vs. EUR 1.0 bn in Q2 2019), the difference concerns primarily reinvested earnings, which, as was expected, mainly did not materialise. The inflows of intercompany loans also dipped somewhat y-o-y, but were largely compensated by higher equity investments. It should also be borne in mind that data are compared with 2019, which saw record FDI inflows. Unlike Q2 2019, Q2 2020 saw net outflows on account of higher amounts of cash and deposits held by banks abroad (EUR 233.3 mn) and trade loans (EUR 567.0 mn).

The negative effects of the pandemic on the labour market in Q2 were largely mitigated by the adopted economic policy measures – formal employment and wages were preserved in most service sectors. According to data of the National

Chart O.3.6 **Goods and services imports in 2020**
(Q1 2020 = 100, s-a)



Sources: SORS and NBS calculation.

Employment Service, the number of **registered unemployed persons** was 525,987 in June 2020, up by around 13,000 from March. It would have probably been much higher had robust fiscal and monetary stimuli not been introduced. In the formal segment of the labour market, employment was not only preserved – it even increased, by 1.6% y-o-y.

According to the programme of measures adopted by the Government in late March and the Decree on Supplementary Budget for 2020, the **consolidated fiscal deficit** would be around 7% of GDP in 2020. The bulk of the planned support measures, which directly affect the budget of the Republic, was implemented already in Q2. This generated a consolidated fiscal deficit of RSD 311.5 bn in six months (with over 4/5 of the deficit relating to Q2).

In H1 2020, public revenue dropped by 7.4% in real, y-o-y terms, reflecting the economic contraction in Q2 and the adopted anti-crisis measures. The strongest effect on lower revenue compared to H1 2019 was exerted by deferred payments of advance profit tax in Q2 (RSD -28.3 bn), lower social insurance contributions (RSD -22.0 bn) and lower non-tax revenue (RSD -14.8 bn), while other categories either stagnated or rose marginally.

Public expenditure expanded by 23.3% in real, y-o-y terms, mainly due to the one-off payments to adult citizens (RSD 76.2 bn) and payments of minimum wage subsidies to businesses (RSD 69.7 bn). Goods and services purchases also rose somewhat (RSD 44.8 bn), as did wage expenses (RSD 30.1 bn) and capital expenditure (RSD 27.2 bn).

The funds to finance the deficit and pay regular obligations were ensured with the eurobond issue in the international financial market worth EUR 2 bn, and with dinar securities issues in the domestic market.

According to the Ministry of Finance's estimates, through direct assistance and temporary tax exemption of the corporate sector (including the third payment of the minimum wage in July and credit support provided through the Development Fund), the Government has so far injected somewhat more than EUR 2.3 bn to the corporate and household sectors.

In late July 2020, the Government adopted the second package of fiscal policy measures worth around RSD 66 bn, extending wage subsidies for SMEs by another two months. The deferral of the payment of tax on wages and social insurance contributions for all private enterprises was extended by another 30 days. The total support to corporates and households will thus amount to around 12.2% of GDP this year. As estimated by the Ministry of Finance, this will generate a general government fiscal deficit of around 8.2% of GDP this year. In our opinion, such one-off deficit is justified as, otherwise, the economic contraction could be much sharper this year, followed by reduced production capacities, a declining number of jobs and much slower recovery next year. Public debt would temporarily rise to around 60% of GDP this year, only to continue down next year.

To conclude, available economic indicators suggest that the negative effects of the pandemic on the economy in Q2 were weaker than we anticipated in May, owing to timely and robust monetary and fiscal policy measures. Also, the agricultural season will, by all odds, be better than average. GDP declined by 6.5% in Q2, less than the projected 8%. Though it is hard to estimate how the pandemic will play out – given the new global waves and uncertainties surrounding the recovery of the global and, thus, our economy – the undertaken economic measures and favourable medium-term macroeconomic prospects will sustain the recovery going forward.

5 Labour market developments

So far, the coronavirus pandemic has not significantly reflected on employment in Serbia, primarily owing to the comprehensive support package for domestic companies which helped preserve jobs in most sectors. However, the y-o-y pace of wages and employment growth, on the one hand, and the unemployment drop, on the other, slowed down in Q2 compared to the period before the pandemic.

Wages and labour productivity

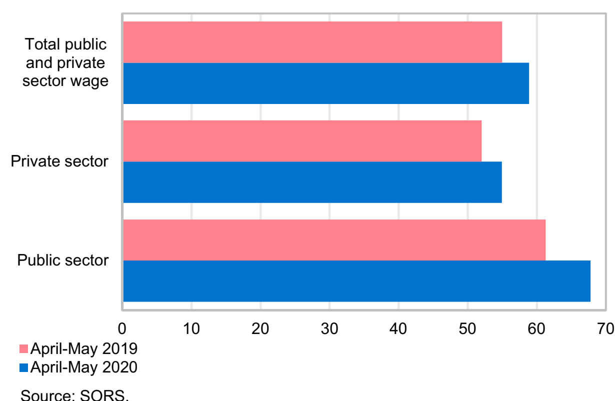
The average nominal net wage reached RSD 58,912 (i.e. EUR 501) **in April and May**, which is a 7.1% y-o-y rise, with a contribution coming from higher **private and public sector** wages (increase by 5.6% and 10.6% y-o-y, respectively). However, unlike the public sector, the private sector recorded a noticeable slowdown in y-o-y wage growth in April and May relative to early 2020 and 2019, caused by the pandemic. This is confirmed by a monthly fall in the average nominal net wage, first in April (-0.1% s-a), and then in May (-1.2% s-a). This decrease would have probably been even more pronounced but for the timely implementation of the programme of economic measures aimed at preserving an adequate level of employment and business activity, and hence wages. This was made possible on the back of provided fiscal room and generated reserves of the domestic corporates' profitability in the last five years.

Though at a slower pace than in the pre-pandemic period, a y-o-y rise in wages continued in April and May in **all economic sectors**. It averaged 8.9% in agriculture, 5.6% in services and 5.0% in industry. At the same time, the deceleration of y-o-y wage growth was felt the most in private sector activity – catering, transport, trade, and manufacturing branches, which were affected the most by containment measures. As opposed to that, April and May saw the y-o-y growth acceleration of the average wage in ICT (21.9%) and health and social protection (18.5%) dominantly on account of a rise in health workers' wages in April.

Total nominal net wage bill, which is a dominant source of consumer demand, increased by 10.4% y-o-y in April and May, with the private sector recording a 10.8% y-o-y rise, and public sector a 9.7% y-o-y rise.

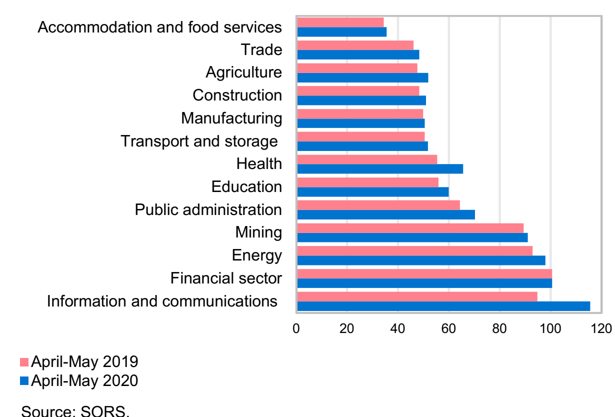
Relative to Q1, when **overall economic productivity** went up on account of robust GDP growth, a fall in productivity is estimated for Q2 because of containment measures.

Chart IV.5.1 **Average nominal net wage**
(in RSD thousand)



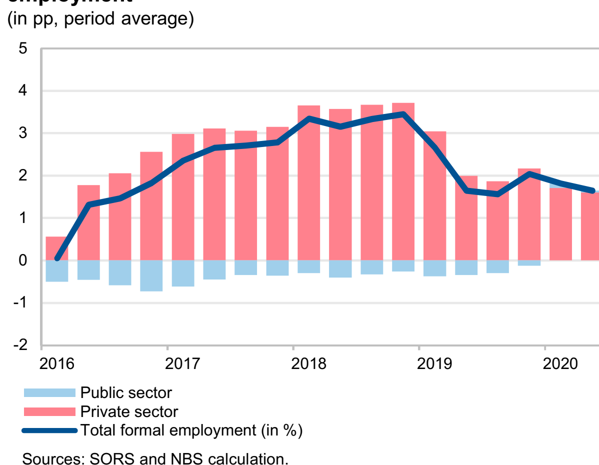
Source: SORS.

Chart IV.5.2 **Nominal net wage by economic sector**
(in RSD thousand)



Source: SORS.

Chart IV.5.3 **Structure of y-o-y growth in total formal employment**
(in pp, period average)



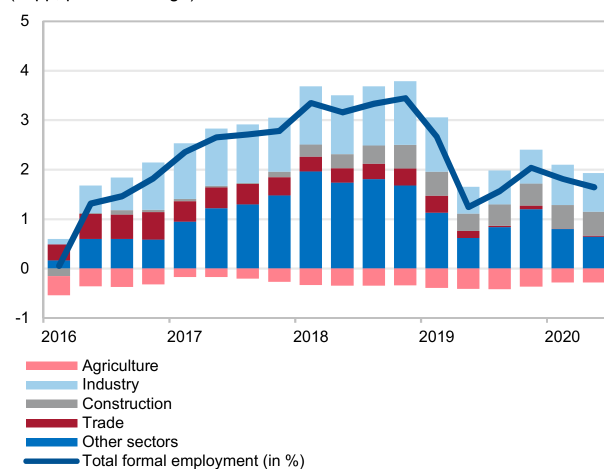
Sources: SORS and NBS calculation.

Table IV.5.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2019		2020	
	Q3	Q4	Q1	Q2
Total number of formally employed	1.6	2.0	1.8	1.6
Employed with legal persons	1.7	2.2	2.4	2.2
Entrepreneurs and their employees	3.0	3.4	1.0	1.1
Individual farmers	-8.6	-8.4	-7.4	-7.8
Unemployed	-9.5	-8.9	-9.1	-3.3
First-time job seekers	26.1	32.9	26.3	11.3
Used to be employed	-27.2	-29.4	-28.5	-14.8

Sources: SORS and NES.

Chart IV.5.4 **Contribution to y-o-y growth in total formal employment by economic sector**
(in pp, period average)



Sources: SORS and NBS calculation.

Employment

In spite of the pandemic, **formal employment** decelerated only negligibly in Q2, to 1.6% y-o-y (from 1.8% y-o-y in Q1), largely due to employment cuts among workers employed in non-standard arrangements[21] in the **private sector** and among individual farmers in the past year (by around 13 thousand). According to Statistical Office data obtained from the Central Registry of Mandatory Social Insurance, the y-o-y rise in employment among workers employed in standard arrangements in the private sector (by more than 47 thousand persons), which has made up more than 70% of formal employment for a while now, continued in this period. At the same time, the public sector also recorded somewhat higher employment in Q2 (by around one thousand, primarily in the health sector). The said indicates that for the time being a more significant impact of the pandemic on the labour market has been avoided, as also suggested by the Employment Expectations Indicator[22] for Serbia, which returned from 91.9 in April and 99.7 in May to 106.0 in June.

In Q2, the number of people employed by legal entities continued up, with the number of entrepreneurs and their employees also going up. By **sector**, the highest number of new recruits relative to the same period last year was recorded in manufacturing (by close to 16 thousand persons on average) and in most service activities (by around 22 thousand persons on average), giving the strongest impetus to economic growth. Agriculture recorded a drop in employment as did the energy and water supply sectors (by around two thousand persons aggregately), partly on account of control of employment in public fund users.[23]

In June the National Employment Service **registered** 525,987 **unemployed** persons, down by around 1.2 thousand persons relative to the previous year and by almost 216 thousand relative to end-2014 when labour market reforms were initiated. This shows the success of implemented reforms supported by active labour market

[21] Non-standard employment arrangements include mainly temporary and occasional work, while standard employment arrangements cover permanent or fixed-term employment contracts.

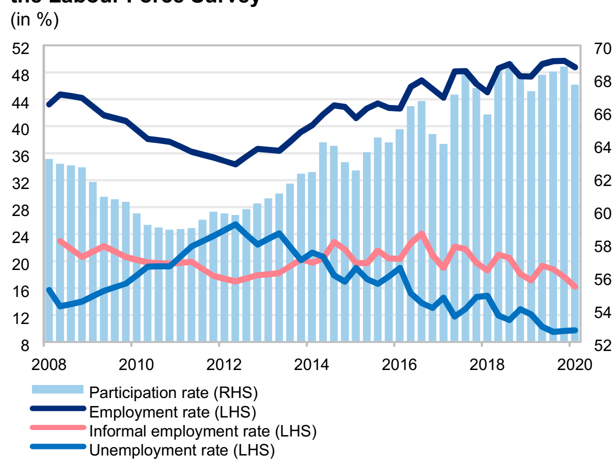
[22] The Employment Expectations Indicator is published by the European Commission based on the business survey. The index value higher than 100 (long-term average) indicates that employment plans are high, while the value below 100 indicates that employment plans are low.

[23] Pursuant to the Decree on the Procedure for Obtaining Consent for New Employment and Additional Engagement in Public Fund Users. Late in 2019 the Law Setting the Maximum Number of Employees in the Public Sector was no longer effective.

policies.[24] However, with the outbreak of the pandemic, May and June saw an increase in unemployment by around 13 thousand from March. Consequently, the speed of the unemployment cuts in y-o-y terms went down, from -9.8% in March to -0.2% in June. Accordingly, a milder y-o-y drop in unemployment was recorded in Q2, in almost all occupational groups, but most in those connected with manufacturing (by around 7 thousand persons on average) and trade, catering and tourism (by around 1.6 thousand persons on average), followed by occupations in construction, transport and agriculture.

Available results of the **Labour Force Survey** for Q1, covering both formal and informal labour market, indicated still favourable labour market trends before the pandemic. This referred primarily to the still relatively high participation rate of the working age population (15–64) of 67.6% and the 48.7% employment rate in Q1, which rose by 0.4 pp and 1.4 pp, respectively, relative to the same period in 2019. At the same time, the informal employment rate was lowered in Q1 to 16.2% – its lowest level since comparable data are available, proving that the number of persons working without a formal employment contract went down. Also, the unemployment rate was preserved at a one-digit level for two consecutive quarters (Q4 2019 and Q1 2020). It measured 9.7% (down by 2.4 pp from Q1 2019), while the long-term unemployment rate[25] was once again close to its historic low (5.5%).

Chart IV.5.5 **Labour market indicators according to the Labour Force Survey**
(in %)



Source: SORS.

6 International environment

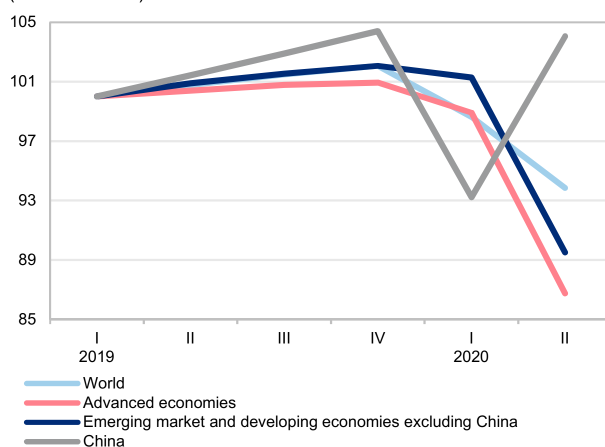
The whole world is currently faced with a health and economic crisis caused by the coronavirus pandemic which drove the global economy down in H1 2020, even more than previously projected. In the remainder of the year, concurrently with the easing of containment measures, the leading economies are expected to recover gradually, notably the euro area and the USA, whereas China has already struck an upward path in Q2. Yet, risks to global growth remain pronounced and skewed to the downside, as it is still not possible to grasp the full effects of the new crisis due to the virus continuing to spread in many countries across the globe.

[24] Active labour market policies and programmes encompass, inter alia: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market.

[25] The long-term unemployment rate is the percentage of persons who have been unemployed for one year and longer in the total active population.

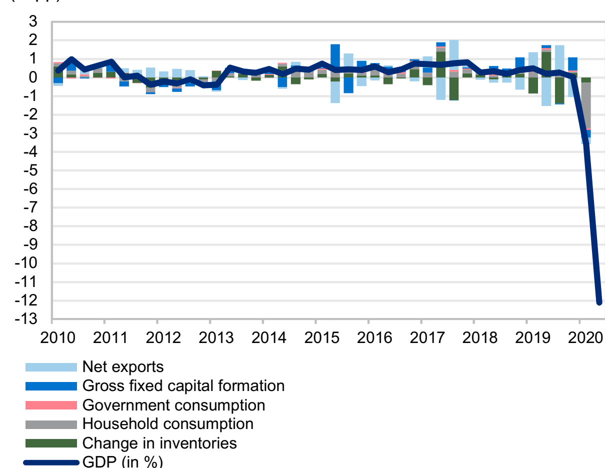
The fall in the economic activity would have been much sharper had it not been for strong reactions of monetary and fiscal authorities throughout the world, which calmed financial markets and increased investors' confidence, thus leading to improved financial conditions in both developed and developing countries. Monetary policy easing by leading central banks, as well as those in emerging countries, which are increasingly applying non-conventional measures as well, was possible in conditions of low inflationary pressures that resulted from the fall in aggregate demand and low energy prices. A mild acceleration of inflation which some countries saw in June is assessed as temporary.

Chart IV.6.1 **Quarterly GDP dynamics**
(Q1 2019 = 100)



Source: IMF WEO Update (June 2020).

Chart IV.6.2 **Contributions to s-a GDP growth rate of the euro area**
(in pp)



Source: Eurostat.

Economic activity

When the coronavirus pandemic broke out, the global economy faced an unprecedented crisis, and according to the current estimates of leading international organisations, its consequences will be harder than anticipated, and the recovery uncertain. Due to the **economic activity falling in H1 more than was projected**, in its June World Economic Outlook Update the IMF made significant downward revisions of its global growth projections in 2020 (by 1.9 pp to -4.9%), and forecast a slower economic recovery in 2021 relative to the projections in the April report. The bleaker prognoses are mostly based on subdued private consumption in the majority of countries as a consequence of the introduced containment measures and the rise in precautionary savings. In addition, corporate capital investments decreased amid heightened uncertainty, therefore Q2 is expected to see global activity continue down. A major deterioration in domestic demand was partly prevented by the economic support measures for the private sector, as indicated by the Global Composite PMI, which recovered slightly in June (47.7) relative to May (36.3) and April (26.5), while at the same time the production and services sectors saw a milder contraction in activity. Still, **risks to the global growth projection remain significant and skewed to the downside** not only because of the pandemic but also because of the renewed tensions between the USA and China, rattled relations between OPEC members and other oil exporters (OPEC+), and social unrest throughout the world.

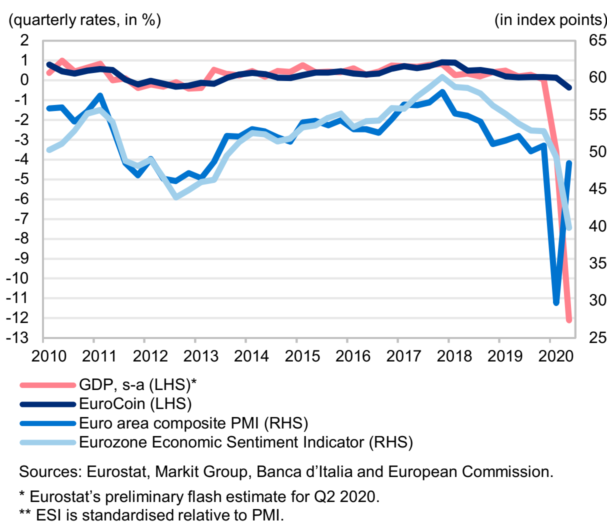
Due to the implementation of containment measures, **the euro area economy** recorded a fall of 3.6% s-a in Q1, mostly in terms of household consumption and fixed investments (with an aggregate contribution to GDP of -

3.2 pp). Similar movements can be seen in leading euro area economies[26] – in **Germany**, Q1 saw a 2.0% s-a fall in GDP, while in **Italy** GDP fell by 5.3% s-a, which means that both countries entered technical recession. In some sectors of euro area countries business activity lessened considerably and was even entirely suspended during April, only to recover gradually as of May. This is evident from the dynamics of leading economic activity indicators – Eurozone Composite PMI[27] increased to 48.5 in June (from 31.9 in May and 13.6 in April), and the Economic Sentiment Indicator[28] to 75.7 in June (from 67.5 in May and 64.8 in April), though they still suggest contracted economic activity. Eurostat's preliminary flash estimate is along the same lines: Q2 saw a sharp fall of -12.1% s-a in euro area GDP, dominantly due to the prolonged implementation of containment measures.

Assuming these measures are eased in the period ahead, in June the **ECB** assessed that **during H2 the euro area will see a gradual recovery**, supported by favourable financial conditions and an accommodative fiscal policy, as well as the renewed activity in Europe and the world, whose speed and scope still remain questionable amid the new global spread of the virus. Considering the depth of the crisis, the ECB made significant revisions in its June euro area growth projection for 2020, relative to March (by 9.5 pp, to -8.7%). Whether the projection materialises will depend on the duration of the pandemic and the efficiency of containment measures, the impact on supply and demand, and the success of economic policies in preserving jobs and wages. In this regard, the leading euro area economies introduced the so-called **short-time work schemes**, to prevent mass layoffs and increase the flexibility of the labour market. This helped the euro area unemployment rate edge up slightly – from 7.5% in April to 7.8% in June. The absence of a major negative impact of the pandemic on the labour market is also evident based on the euro area Employment Expectations Indicator,[29] which rose to 82.8 in June from 58.9 in April and 70.1 in May.

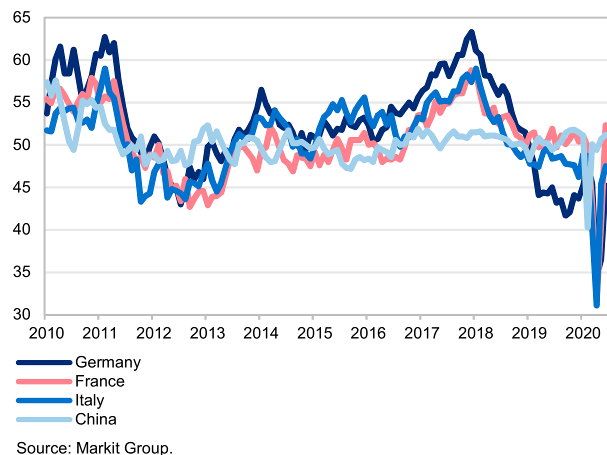
The US economy posted a -1.3% s-a fall in Q1, or -5.0% annualised, which is dominantly the consequence of the introduced social distancing measures that reflected mostly on household consumption and investment, with a negative contribution to GDP growth (-6.5 pp in

Chart IV.6.3 **Movements in GDP and economic activity indicators of the euro area**



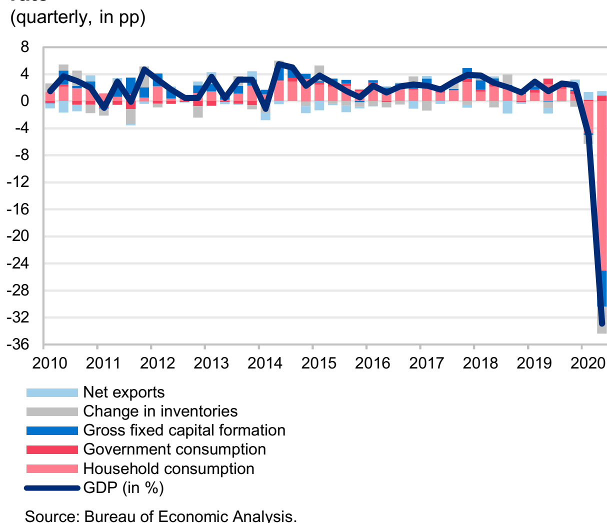
Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.
* Eurostat's preliminary flash estimate for Q2 2020.
** ESI is standardised relative to PMI.

Chart IV.6.4 **PMI Manufacturing for selected countries**
(in index points)



Source: Markit Group.

Chart IV.6.5 **Contributions to the annual US GDP growth rate**
(quarterly, in pp)



Source: Bureau of Economic Analysis.

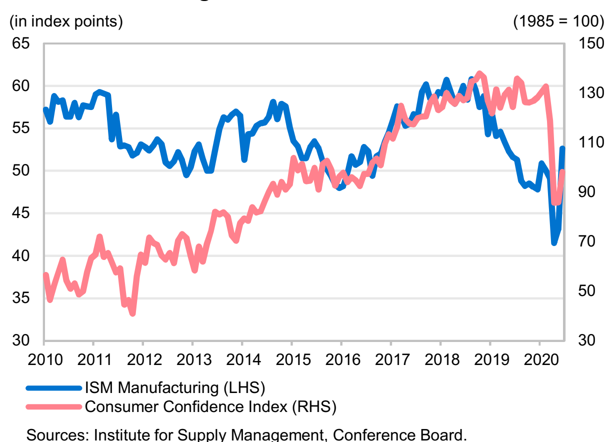
[26] Germany and Italy are Serbia's key foreign trade partners in the euro area.

[27] Index value above 50 points indicates expansion, and below 50 a decline in economic activity.

[28] Index value above 100 points indicates improvement, and below 100 worsening of economic expectations.

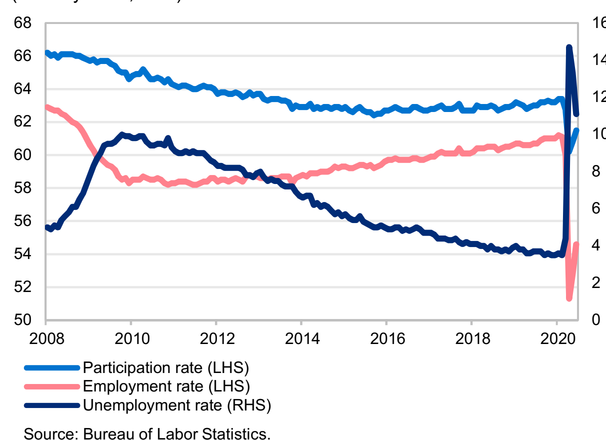
[29] The index has been designed to indicate long-term average with 100 points.

Chart IV.6.6 **Leading economic indicators in the USA**



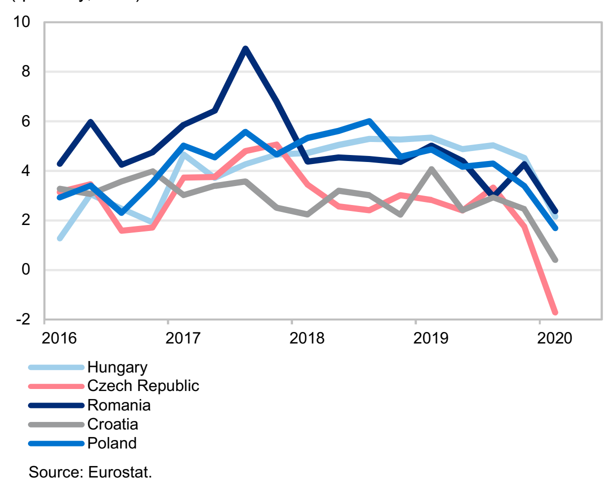
Sources: Institute for Supply Management, Conference Board.

Chart IV.6.7 **US labour market**



Source: Bureau of Labor Statistics.

Chart IV.6.8 **Y-o-y GDP growth rates in CESEE countries**



Source: Eurostat.

aggregate), while a positive contribution came from higher government consumption and net exports (1.5 pp in aggregate). Although indicators of production activity and consumer confidence perked up in June, they are still below pre-crisis levels, therefore the **Fed** assessed in June that **Q2 will see economic activity continue down** and unemployment up. According to preliminary data of the Bureau of Economic Analysis, US GDP posted a sharp fall of -9.5% s-a in Q2, or -32.9% annualised, as a consequence of stay-at-home measures and suspended business operations in March and April, which remained in force in the majority of states during May and June. To hedge against any lasting deterioration of economic conditions, the government adopted a comprehensive fiscal programme, with direct aid payments to households and corporates, parallel with monetary policy measures for supporting liquidity and lending. Based on this, the **Fed in its basic scenario forecast a gradual recovery of the US economy in H2**, though not to the full scope, therefore a 6.5% fall of GDP is expected at the year level.

After the US unemployment rate recorded the highest level since World War II – 14.7% in April, **May and June saw somewhat improved conditions in the labour market**, as attested by the fall in the number of submitted claims for compensation in the event of job loss and a smaller number of applications for various types of social welfare. In June, the unemployment rate (though still relatively high) declined to 11.1%, and the number of unemployed persons decreased by around 3.2 mn. Concurrently, the number of non-farm payrolls increased by around 4.8 mn, mostly in the services sector (catering, recreation, trade, business and professional services), and also in manufacturing, health and education.

Unlike the euro area, with which it has strong trade relations, the **Central and Southeast European region posted growth of 0.7% y-o-y in Q1**, owing to a positive contribution of final consumption (a total of 1.5 pp), in contrast to the negative contribution of net exports and investments (-0.8 pp). Most countries in the region, with the exception of the Czech Republic and Slovenia, recorded y-o-y GDP growth in Q1. In the forefront of these countries was **Serbia with the GDP growth of 5.0% y-o-y in Q1**. However, during Q2 economic activity plummeted across the region, reflecting on lower consumption, which was then followed by deterioration in the labour market and lower investments. The pace of the recovery in the remainder of the year will depend on the degree to which social distancing measures are loosened and on measures taken by economic policy makers based on the previously secured fiscal space.

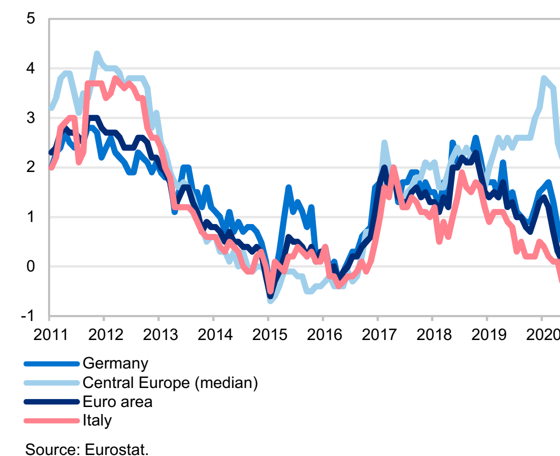
Favourable **economic developments in Russia** at the onset of the year (with estimated GDP growth of 1.6% y-o-y in Q1) were disrupted by the coronavirus pandemic. A drastic fall in the global prices of oil as of February, which is attributable to the slashed demand amid the pandemic, together with the inability of Russia and Saudi Arabia to reach an agreement on capping production, resulted in a significant decrease in the net oil export revenue, including Russia's. Therefore, relative to April, the IMF's June projection included an additional downward revision of Russia's growth (by 1.1 pp to -6.6% in 2020). On the other hand, the leading index of economic activity in Russia at end-Q2 (48.9) recorded the smallest fall since February amid favourable developments in the services and production sectors, and signs of recovery in consumption and investments in June. According to the Central Bank of Russia, the pace of Russia's economic recovery is conditioned by the force of the shock on the demand and supply side, secondary effects of the pandemic and long-term changes in consumer behaviour.

The Chinese economy bore the brunt of the crisis during Q1, as seen from its 6.8% y-o-y fall in GDP. During Q2, it took coordinated measures of fiscal and monetary policy which, according to the National Bureau of Statistics, helped achieve the GDP growth of 3.2% y-o-y, thus mitigating the economic fall in H1 to -1.6% y-o-y. Already in H1, the incipient economic recovery is indicating the return of leading activity indicators in the production and services sectors to pre-crisis levels in June – 51.2 and 58.4 respectively, and it is supported by a solid agricultural season and the rising profits in industry (11.5% y-o-y in June). Therefore, in June the IMF forecast growth of 1.0% for the Chinese economy in 2020, triggered by the extensive economic support to troubled corporates and households via a welfare programme and further development of medical and digital services.

Inflation movements

Slashed energy prices slowed down the **inflation in the euro area** to 0.3% in April and then to 0.1% in May, its lowest level since June 2016. The decelerated y-o-y food prices also acted towards slowing inflation down since May. Still, as global oil prices recovered, the negative contribution of energy prices to inflation was reduced, therefore in June it slightly picked up to 0.3% y-o-y, though it remained significantly below the inflation target of below, but close to 2%. Inflation excluding volatile components, i.e. the prices of food, energy, alcohol and

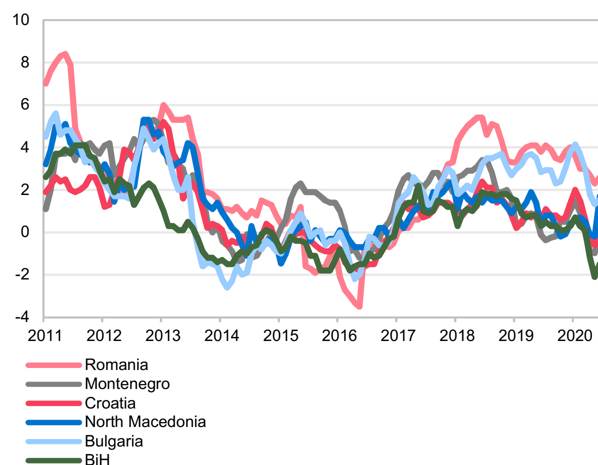
Chart IV.6.9 **HICP for selected countries**
(y-o-y rates, in %)



Source: Eurostat.

tobacco, continued to decelerate until end-Q2, from 0.9% y-o-y in April and May to 0.8% in June, in conditions of plummeting economic activity due to the pandemic. As for Serbia's key foreign trade partners, y-o-y inflation in **Germany**, measured by the Harmonised Index of Consumer Prices, mirrored the dynamics of the euro area – after slowing down to 0.5% in May, it rose mildly to 0.8% in June, due to the slower y-o-y fall in energy prices. On the other hand, after posting a y-o-y fall in prices in May (-0.3%), **Italy's** y-o-y inflation fell even deeper into the negative zone in June, to -0.4%.

Chart IV.6.10 **CPI for selected countries**
(p.a., in %)



Sources: Statistical offices of selected countries.

As in the euro area, inflation in the majority of observed **Central and Southeast European countries** slowed down in April and May, mostly due to the lower prices of those categories that were most impacted by coronavirus containment measures (petroleum products, services, etc.). In June, these countries saw an acceleration in inflation: in the Czech Republic inflation overshot the upper bound of the target tolerance band (3.3%), in Poland it came close to the upper bound (3.3%), while in Hungary (2.9%) and Romania (2.6%) it was close to the central midpoint. In addition to the rise in the prices of petroleum products, a contribution to this also came from the rise in the prices of some categories of services and products as economies gradually opened up and some producers and service providers sought to transfer the higher costs caused by the pandemic onto consumers. However, the June acceleration of inflation is assessed as temporary and there are currently no fears that inflation might pose a major problem in those countries going forward.

The majority of **Western Balkan** countries also recorded a slowdown in y-o-y inflation in April and May, and then its mild acceleration in June. Despite that, inflation in Montenegro (-0.2%) and Bosnia and Herzegovina (-1.5%) remained in the negative territory at end-Q2. A y-o-y fall in prices was also recorded in North Macedonia in April and May, which then posted a 1.7% y-o-y price hike in June. The rise in food prices led to a somewhat higher inflation in Albania as of March, when compared to other countries in the region, while their slower y-o-y growth in June curbed inflation growth to 1.8%.

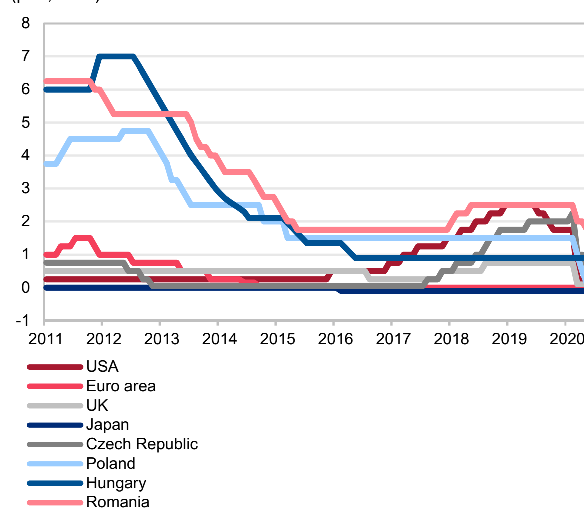
After falling in April, inflation in **Turkey** went back up as of May, reaching 12.6% y-o-y in June against the backdrop of a depreciating lira and the rising prices of food and energy. Higher food prices in April drove **Russia's** inflation up, but a subsequent slowdown in food price growth did not reflect on the fall in inflation (3.2% y-o-y in June), primarily owing to the last year's low base, while inflationary pressures remained low.

Measured by the personal consumption expenditures index, headline y-o-y inflation in the **USA** decelerated significantly during Q2, from 1.3% in March to 0.5% in April, remaining there in May as well, due to low aggregate demand and low energy prices, only to perk up mildly to 0.8% in June owing to a recovery in the prices of energy. Inflation excluding energy and food prices – as the Fed's preferred measure – declined from 1.7% in March to 0.9% in June, thus moving further from the 2% inflation target.

Monetary policy

Though it kept its main refinancing rates unchanged, during Q2 the **ECB** used other instruments to further ease its monetary policy with a view to providing support to the real economy and increasing the availability of loans to households and corporates in conditions of abated inflationary pressures due to the pandemic. The Pandemic Emergency Purchase Programme (PEPP), introduced in March, was expanded in the June meeting by an additional EUR 600 bn to EUR 1,350 bn, and its implementation extended – instead of end-2020 until at least end-June 2021, and in any case until the ECB estimates that the crisis caused by the pandemic has ended. The implementation of this programme will be flexible, which means that if the situation in the markets improves in the meantime, the amount of assets purchased under the PEPP can be lower than EUR 1,350 bn, and the programme can also be expanded if needed. The ECB will continue to reinvest the maturing principal payments from securities purchased under the PEPP at least until end-2022. Also, the ECB continued with net purchases under the asset purchase programme (APP) at a monthly pace of EUR 20 bn, and the additional asset purchases in the total amount of EUR 120 bn until end-2020. The auction of securing liquidity to banks via longer-term refinancing operations (TLTROs III), held in June, attracted a lot of attention, and the interest rate on these loans, for banks that meet certain conditions, can even be -1.0%. Banks can also make use of non-targeted pandemic emergency longer-term refinancing operations (PELTROs), which have been introduced to ensure a sufficient level of liquidity and further ease the financial conditions in the euro area during the pandemic. At end-June, it also announced the introduction of repo auctions to provide euro liquidity to central banks outside of the euro area, to be carried out until end-June 2021. Thus, in July, the ECB and the NBS set up a pre-emptive repo line to ensure additional euro liquidity to the domestic financial system should such a need arise amid disturbances in the market caused by the COVID-19 pandemic.

Chart IV.6.11 **Policy rates across selected countries**
(p.a., in %)



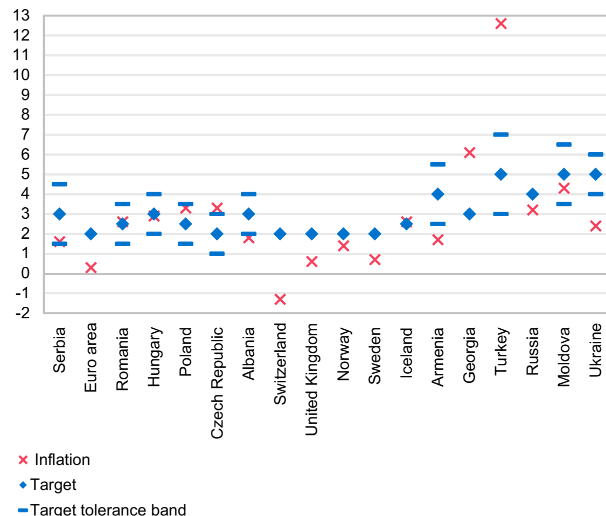
Sources: Central banks of selected countries.

Table IV.6.1 **Inflation, policy rates and inflation targets by country**
(in %)

Central banks	Inflation*	Inflation target	Policy rate**
Serbia	1.3	3.0 ± 1.5	1.50
Poland	4.6	2.5 ± 1.0	0.50
Czech Republic	3.4	2.0 ± 1.0	1.00
Hungary	3.9	3.0 ± 1.0	0.90
Romania	3.1	2.5 ± 1.0	2.00
Turkey	11.9	5.0 ± 2.0	8.75

Sources: Websites of central banks.
* CPI, y-o-y rates in June.
** End-July 2020.

Chart IV.6.12 **Inflation and target by country in June 2020**
(p.a., in %)



Sources: Eurostat and websites of central banks.

In June, the **Fed** kept its federal funds target range at 0–0.25% by a unanimous vote of FOMC members, which was in accordance with the expectations of the majority of analysts. In a press release following the meeting it reiterated that interest rates are expected to remain very low until there is confidence that the US economy is on the path of achieving maximum employment and price stability. Considering the potential negative effects on money market funds and the banking system, the federal funds rate is not expected to descend into the negative zone, and projections indicate it will remain at the current level during this and the following two years. The meeting also considered applying the Yield Curve Control in conditions of the effective lower bound of nominal interest rates, however, the introduction of this measure remains uncertain. Also, a decision was made to continue with net purchases of Treasury bonds and mortgage-backed securities at least in the same volume (USD 80 bn and USD 40 bn a month, respectively), as well as to carry out large repo operations in order to sustain the smooth functioning of markets and efficient monetary policy transmission. Additionally, at end-July it extended the implementation of temporary dollar swap lines with other central banks and temporary international repo transactions, introduced in March to ensure additional dollar liquidity, until 31 March 2021. The Fed does not expect that the 2% inflation target, measured by the personal consumption expenditures index excluding food and energy prices (core PCE), will be achieved by end-2022.

To maintain price stability and encourage economic growth, central banks in countries of the Central and East European region also continued with monetary policy accommodation during Q2. In April, the central bank of **Poland** launched an asset purchase programme in the secondary market and trimmed its key policy rate by another 50 bp, followed by 40 bp in May, to a record-low 0.1%. Analysts pointed out the appreciation of the Polish zloty as an important factor behind the decision on the rate cut. The **Romanian** central bank also embarked on a programme of government bond purchase in the secondary market in April, and in late May it again trimmed the policy rate, by 25 bp to 1.75%, where it remained in June. Though the inflation projection of the central bank of the **Czech Republic** indicated a key policy rate cut by 50 bp, it was trimmed by 75 bp in May, to 0.25% amid aggravated prospects for domestic economic activity, and it remained unchanged throughout June. In June, for the first time since May 2016, the central bank of **Hungary** reacted via the policy rate, trimming it by 15 bp and then by another 15 bp in July, to 0.6%.

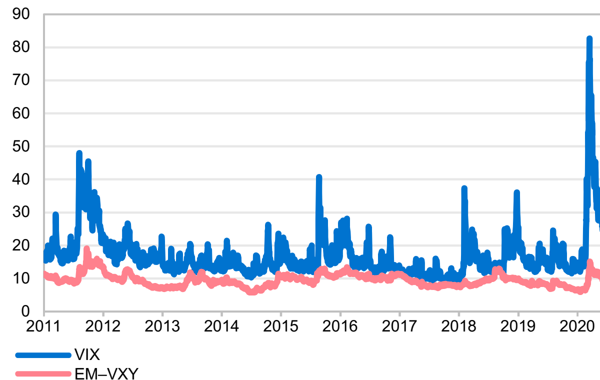
After cutting the key policy rate by 100 bp in April and another 50 bp in May, the central bank of **Turkey** kept its policy rate at 8.25% in June, against the backdrop of rising inflationary pressures and contrary to the expectations of analysts. By doing so, it paused the cycle of monetary policy easing, having cut the policy rate in the previous nine consecutive meetings by a total of 15.75 pp. The central bank of **Russia** also continued with key policy rate cuts during Q2, by 50 bp in April, then another 100 bp in June, and an additional 25 bp in July, bringing it to the lowest level on record in the inflation targeting regime (4.25%), i.e. since early 2014. The decision was made in conditions of rising disinflationary pressures on account of dampened domestic and external demand, though the possibility of its further cut is still not entirely off the table.

Financial and commodity markets

Volatility in global financial markets subsided considerably in Q2, mostly during April after leading central banks stabilised the financial system and helped calm the markets, aided by extensive government measures to mitigate the pandemic effects worldwide. In the period thereafter, investor sentiment was on the one hand impacted by the relaxation of social distancing measures, signs of recovery of the leading world economies and news on the progress in vaccine development, and on the other hand, by renewed trade and political tensions between the USA and China and fears over the potential second wave of the coronavirus pandemic. The implicit measure of **financial market volatility** (VIX) dropped by 23.1 pp in Q2 and by a further 6.0 pp in July, to 24.5%, while the volatility of currencies of emerging economies, measured by EM–VXY, declined by a total of 2.0 pp to 10.3% during Q2 and in July, but both measures remained above their end-2019 levels, given the expectation of an uncertain and gradual economic recovery.

The volatility of **yields on ten-year government securities** of advanced economies also decreased in Q2, so at quarter-end the yields on US Treasuries (0.7%) and German government bonds (-0.5%) remained almost unchanged relative to end-Q1, and hence also their spread. The upward pressure on yields stemmed from the gradual opening of economies and the data which signalled a gradual stabilisation in the labour market, while rising uncertainty as to the continuing spread of the coronavirus worked in the opposite direction, as this could lead to re-imposing of some restrictions and slow down the economic recovery. Apart from German bonds, negative yields at end-Q2, and somewhat lower than at

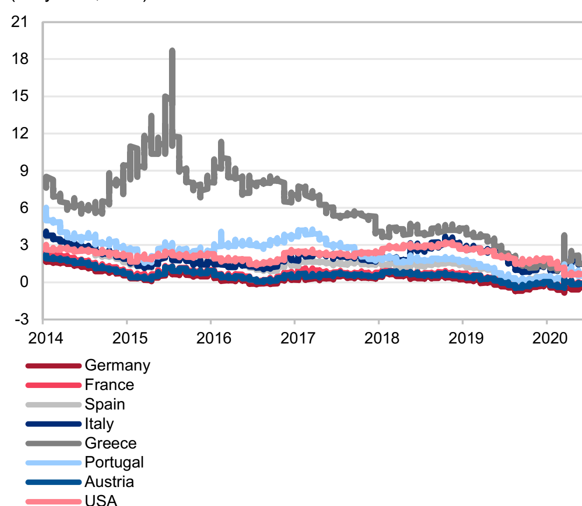
Chart IV.6.13 **Implied volatility of the global financial market***



Source: Bloomberg.

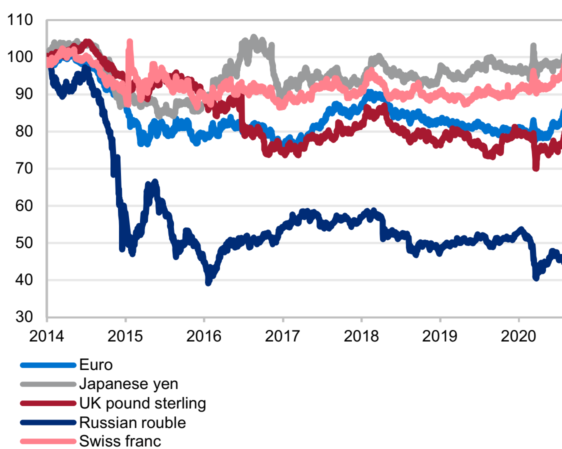
* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM–VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.6.14 **Yields on ten-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

Chart IV.6.15 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



Source: IMF.

* Growth indicates appreciation.

end-Q1, were also recorded by the ten-year French (-0.1%) and Austrian bonds (-0.2%). The yields on comparable bonds of countries in the euro area periphery declined by around 0.3 pp on average in Q2, supported by the agreement on the establishment of an EU-level fund for assistance to hardest hit member states. The yields of the countries observed declined further in July, by 0.1 pp on average.

During April and nearly until the end of May, the **USD/EUR exchange rate** oscillated around 1.09 dollars per euro. The dollar, which is considered a safe haven currency, was strengthening during the periods of rising risk aversion, prompted by the weaker readings of macroeconomic indicators of leading world economies, the continuing spread of the virus and the news about the tightening of relations between the USA and China. On the other hand, the signals of the epidemic stabilising in the hardest hit euro area economies and the measures taken to mitigate its effects worked toward the strengthening of the euro. The uncertainty regarding the position of the German constitutional court on the ECB violating the proportionality principle with the asset purchase programme worked toward the euro's weakening in early May, while late May saw the single currency regaining ground against the US dollar (1.11 dollars per euro). The euro's strongest rise against the dollar was recorded after the European Commission presented the details of the EU recovery plan (Next Generation EU) assuming assistance to the most vulnerable member states. During June the euro continued to appreciate (the average monthly exchange rate was 1.13 dollars per euro) amid hints of economic recovery in the leading economies, the ECB's decision to step up asset purchases within the PEEP, and Germany's decision to support the economy by an additional package worth EUR 130 bn. However, fears over the potential second wave of the pandemic and slower exit from recession of the leading world economies contained the euro's further rise, so at end-Q2 the euro was 2.2% stronger against the dollar than at end-Q1. Apart from the euro, also appreciating against the dollar in Q2 were the Japanese yen (0.9%), Swiss franc (1.6%) and Russian rouble (10.4%), while pound sterling weakened by 0.7%. In July, the observed currencies, with the exception of the Russian rouble, significantly strengthened against the dollar, on the back of heightened uncertainty as to the pace of the economic recovery in the USA, especially after the news of a significant fall in economic activity in Q2. In July, the euro appreciated against the dollar by 5.8% to 1.18 dollars per euro, receiving a further boost from the agreement between EU leaders on the EU budget for the next seven years (worth over EUR 1,800 bn),

including a package of assistance to the most vulnerable countries and sectors for recovery from the consequences of the coronavirus pandemic.

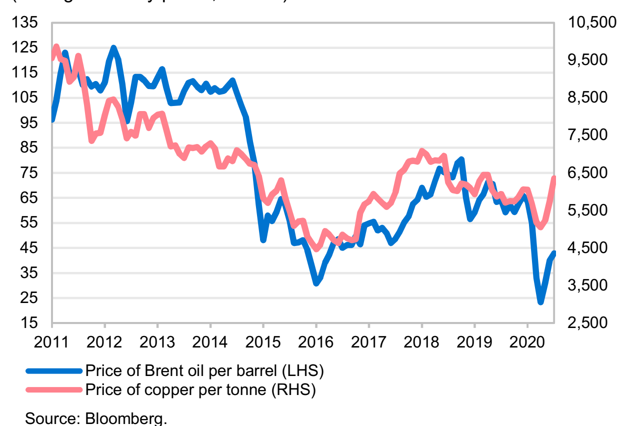
At end-July, Fitch changed the US long-term outlook from stable to negative, while affirming the AAA rating, primarily due to the rising public debt. On the other hand, S&P upgraded the EU rating outlook from stable to positive and affirmed its AA rating, citing as the key factor the adoption of a common recovery plan (Next Generation EU) and striking of the budget deal for the next seven years.

The **price of gold**, which is considered the safest asset, went up in Q2 (9.9%), supported by multiple factors: concerns over the pandemic, tensions between the USA and China, as well as huge liquidity injections by central banks worldwide. The rise continued in July, propped up additionally by the dollar's weakening, so that at month's end the price of gold reached its record high – USD 1,965 per ounce.

Oil price in the global market continued down until the second half of April, when it touched 17.3 dollars per barrel, with oil futures entering the negative territory for the first time in history, showing how much oil demand contracted due to the pandemic. In the ensuing period the price recovered, mainly owing to the reduction of OPEC members' output to the lowest level in almost 30 years, applied as of 1 May with a view to alleviating market saturation. Oil price was also driven up by the optimism that the demand might recover with the opening of economies. The price rise was also influenced by significantly stronger import demand from China during May, the rebound of global demand in June and sharper than expected depletion of US oil inventories. At end-Q2 the oil price measured USD 40.9 per barrel, by 90% higher than at end-Q1, but still much lower (by 37%) than the year before. July saw a mild rise in oil price, to USD 42.8 per barrel, partly also reflecting the data on reduced crude oil inventories in the USA.

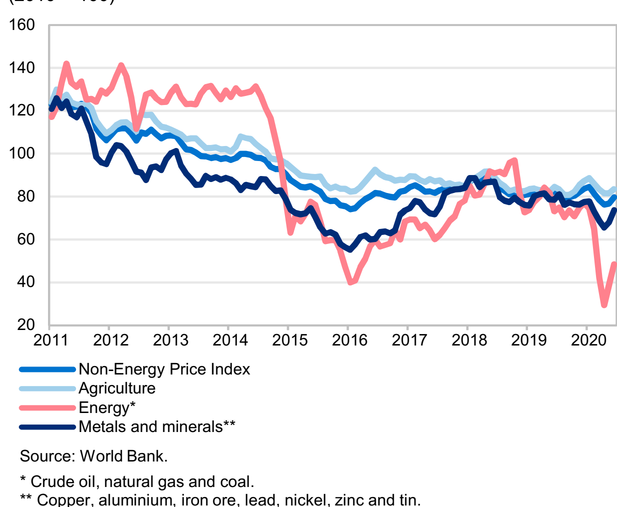
After the 11.3% decline in Q1, **prices of metals and minerals**, according to the World Bank primary commodity index, gained 7.2% in Q2, mainly due to the strong growth of industrial production in China, spurred by the Chinese government's measures for mitigating the pandemic effects. The greatest increase was recorded for the iron ore, by 16.1%, which however did not pass through to the price of steel. So the price of hot-rolled metal sheets, which are the main export product of the Smederevo Steel Plant, dropped by 11% in the Western European market in Q2.

Chart IV.6.16 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

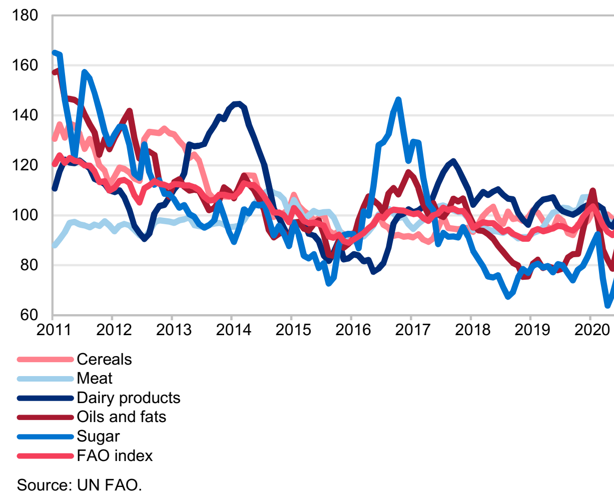
Chart IV.6.17 **Primary Commodity Prices Index**
(2010 = 100)



Source: World Bank.

* Crude oil, natural gas and coal.
** Copper, aluminium, iron ore, lead, nickel, zinc and tin.

Chart IV.6.18 **World Food Price Index**
(in real terms, 2014−2016 = 100)



Source: UN FAO.

The copper price rise (11.0%) reflected the higher Chinese demand and also the disturbances in the Chilean and Peruvian production caused by the coronavirus epidemic and the efforts to contain its spread. Also rising were tin (10.1%), nickel (7.4%), zinc (6.4%) and lead prices (0.6%), while the aluminium price, though also recovering in May and June, still remained somewhat lower at end-Q2 than at end-Q1 (by 2.6%).

Global food prices, measured by the **FAO index**, continued down in April and May, recovering slightly only in June, but still remaining 2.0% lower than at end-Q1. The sharpest fall was recorded for meat prices (4.3%), given that the rising demand in Eastern Asia following the relaxation of social distancing measures was insufficient to compensate for the lower imports of other regions, as well as due to the expansion of export capacities of the leading producers. Prices of dairy products edged down 3.3% in Q2, in conditions of lower demand and growing export capacities and inventories, while still mildly recovering in June, as Middle East and Eastern Asia demand expanded. In April, the sugar price touched its lowest level in 13 years, reflecting the rising supply, bearing in mind that, due to the fall in energy prices, sugar cane was redirected from biofuel to sugar production. The recovery of energy product prices in May and June worked in the opposite direction, which, together with the disruptions in sugar supply from Brazil, led to the recovery of sugar price, pushing it up 1.5% compared to end-Q1. After May saw them touching the lowest level in ten months, vegetable oil prices increased in June, gaining 1.4% in Q2. The rise in prices was driven primarily by the growing global demand for palm oil, due to the relaxation of social distancing measures in many countries, but also by concerns over potential halts in production due to the lack of labour force and its limited mobility. After the April increase, cereal prices headed down again for the rest of the quarter and at end-Q2 were 0.9% lower than at end-Q1. Wheat harvest in the Northern Hemisphere in June additionally affected the wheat price decline, as did the good production prospects in countries which are the main exporters, primarily in the Black Sea Region. On the other hand, after several months of decline, the corn price edged up in June, influenced by a partial rebound of demand and unfavourable weather conditions in the USA.

Text box 4: Impact of the pandemic on inflation

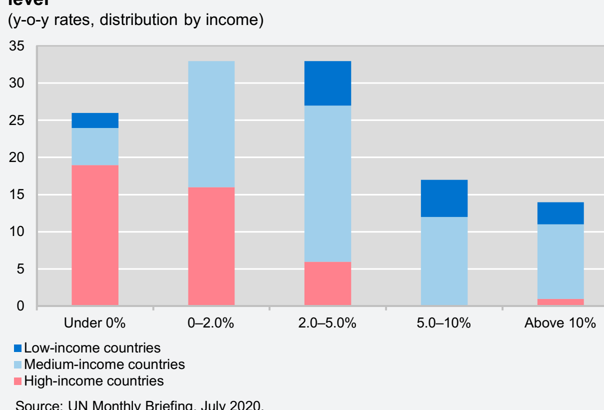
After the initial shock caused by the pandemic, an increasing number of countries have begun to gradually open up their economies, though still facing numerous unflagging uncertainties. Although the greatest attention has been paid to the pandemic's impact on economic activity, not less important is its influence on inflation trends. Before the current pandemic hit the global economy, inflation hovered at historically low levels both in advanced and emerging economies, so the question is raised of whether this trend will continue in the newly changed circumstances. The assessment of the pandemic's impact on inflation is aggravated by the fact that concurrent shocks hit domestic and external demand, production chains and economic activity, as well as business and consumer confidence, with central banks worldwide responding by significant monetary policy accommodation, by conventional and unconventional measures, coupled by generous fiscal programmes, unprecedented in modern history.

Another hindrance in the assessment of the pandemic's impact on inflation is the changed structure of consumption, which may trigger changes in relative prices. Demand for non-food products and "social consumption" (catering, tourist, transport and other services) contracted the most, while demand for the basic foodstuffs expanded. It is also harder to determine the inflation trend in the short run, as it is difficult to measure inflation in pandemic circumstances. Prices for certain products, primarily services, are not available, or at least not to the extent that would meet the criteria of adequate measurement, so statistical offices worldwide have been forced to replace them by the price imputation method.

In the first phase of the so-called lockdown, which in most countries lasted from March till May, the disinflationary trend accelerated globally. Measures implemented to protect the healthcare system and people's health induced a simultaneous shock on the supply (an upward pressure on prices), as well on the demand side (a downward pressure on prices). In this phase, limitations on the supply side, primarily disturbances in global supply chains, caused no major inflationary pressures. At the same time, a radical contraction in demand around the world triggered a collapse of global oil prices, while agricultural product and metal prices remained relatively stable.

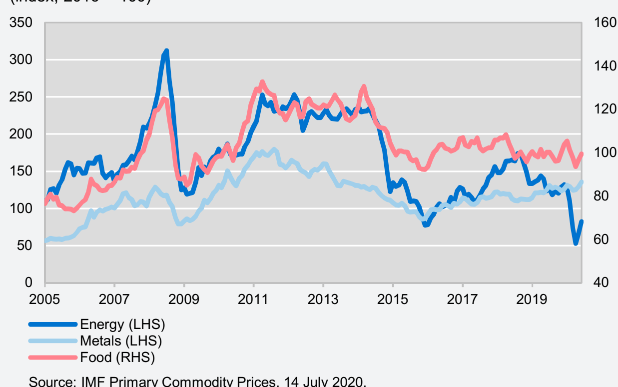
As a result, the majority of countries witnessed a slowdown in price growth and even a fall in prices. The exception are several countries which experienced high pre-pandemic inflation that continued up during the pandemic, largely due to the depreciation of the domestic currency. Based on the available data on inflation in 123 countries,[1] it can be seen that during the first two months of the pandemic, March and April, prices declined in 51 countries, while going up in 72 countries (of which in 57 countries by less than 2%). In April, y-o-y inflation was negative in 26 countries and positive in the rest, measuring 0–2% in 33 countries (including Serbia, with inflation of 0.6%), 2–5% in 33 countries, and above 5% in 31 countries. Such dynamics of consumer prices reflects both global factors and those specific for each country and the structure of consumption. The fall in prices can be observed in

Chart O.4.1 **Inflation rates in April 2020 across countries by income level**
(y-o-y rates, distribution by income)



Source: UN Monthly Briefing, July 2020.

Chart O.4.2 **Prices of selected products in the global market**
(index, 2016 = 100)



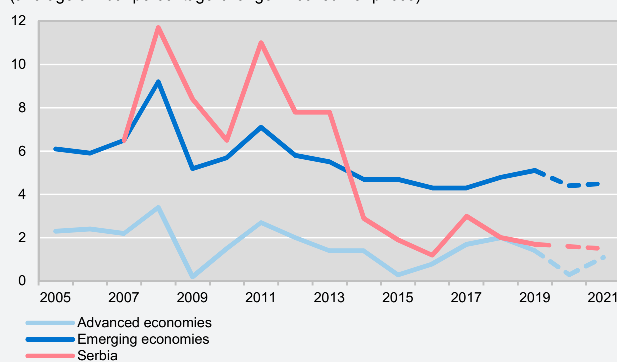
Source: IMF Primary Commodity Prices, 14 July 2020.

[1] Diverging inflation rates suggest new risks, July 2020, Monthly briefing, United Nations.

countries in which energy prices went down, coupled with relatively stable food prices. On the other hand, certain countries recorded an increase in food prices, despite the relatively stable movements of their counterparts in the global market. The main factors driving such growth are the lower supply of seasonal labour force and increased production and sale costs arising from additional health measures, which have been transferred to consumers. Inflation dynamics is also determined by the structure of consumption, which significantly varies by countries, mainly due to income levels. That is why the fall in global oil prices was more visible in inflation rates of high-income countries, which attach higher weight to energy in CPI than in low- and medium income countries, whose CPI is dominated by food items (as much as over 50% in many of those countries, compared to only 14% in the USA).

In the second phase of the so-called "new normal", currently prevailing in the majority of the world's countries, restrictive containment measures have been loosened, so the restrictions on the supply side somewhat lose in importance, albeit social distancing measures continue to weigh down on productivity, primarily in industry and the services sector. On the other hand, pandemic's negative effects on demand seem to still outweigh those on the supply side. Apart from the prohibition of larger gatherings, which hinders some activities, people refrain from spending and defer large purchases, such as automobiles and other durable consumer goods. Precautionary savings are also on the rise, driven by uncertainty as to the future course of the pandemic. The negative impact on overall demand stems also from the increasingly aggravating situation in the labour market. On the other hand, the majority of world's countries adopted generous monetary and fiscal stimuli, in order to mitigate the negative effects of the pandemic and ensure a fast recovery in post-pandemic period. The scope of these measures in the USA and the euro area is such that some analysts raised concerns about potential inflation hikes even above the central banks' targets, especially after the pandemic wears off. Still, according to the projections of central banks and leading international institutions, there is currently no reason to fear any significant problems with inflation in the coming period.

Chart O.4.3 **Inflation movements**
(average annual percentage change in consumer prices)



Sources: IMF World Economic Outlook Update (June 2020), SORS and NBS.

Accordingly, a somewhat sharper rise in June inflation in some countries, e.g. in Central and Southeast European countries (in some of them overshooting the central bank's target), is estimated as temporary and associated with the gradual opening of economies in the second phase of the pandemic and the fact that some producers and service providers managed to transfer to consumers the additional health costs imposed by the pandemic. It is estimated that the June inflation hike in these countries is not an upward turning point on the y-o-y inflation path and that such movements are temporary in nature. That inflationary pressures will remain low for a while is also indicated by the expected further monetary policy easing – the timing and extent of which will primarily depend on the pandemic course, the fiscal position of each individual country and movements in the FX market. The first policy rate increases in these countries are not expected before August 2021.

At the beginning of the second phase of the pandemic, it can be said that in the majority of countries inflation still remained low and below central banks' inflation targets. The euro area, our most important trade partner, saw an inflation hike in June, but merely to 0.3% from 0.1% in May, primarily due to the lower negative contribution of energy prices to inflation. In several euro area countries inflation rates entered into the negative territory (Italy, Spain, Ireland and Greece).

Consistent with the expectations from the May *Inflation Report,* **Serbia's inflation**, after hovering below the lower bound of the target tolerance band in April and May, returned within the target band, measuring 1.6% y-o-y in June. Inflation's return within the target band was mostly driven by the waning of the base effect in food prices and a somewhat lower negative contribution of petroleum product prices. A positive and somewhat higher contribution came from fruit prices, while the contribution of other food categories, as well as non-food products, was stable, indicating that the market remained fully supplied despite the aggravating conditions of pandemic. **Inflation is expected to remain low and stable**

going forward – moving around the lower bound of the target tolerance band by the end of this and the next year, after which it will, in line with the expected recovery of demand, start to gradually approach the target midpoint of 3%, though remaining below it in 2022.

In IMF's assessment,[2] the disinflationary pressure coming from the fall in aggregate demand, together with lower oil prices, more than compensated for the higher cost-push pressures induced by the shocks on the supply side. The IMF expects inflation to slow down this year, in advanced economies to 0.3% (from 1.4% in 2019), and in emerging economies to 4.4% (from 5.1%). In the coming year inflation is expected to increase somewhat in both groups of countries – to 1.1% in advanced and 4.5% in emerging economies. Relative to April, the IMF revised its projections downward, especially for 2020, due to the expected sluggish recovery of economic activity and lower energy prices. The IMF also expects that the leading central banks will continue to pursue accommodative monetary policy by end-2021.

The main underlying factors of inflation movements going forward are oil and food prices. Though rising since early May, the global **oil price** remains considerably lower than in the same period the year before, so the energy prices contribution to y-o-y inflation in many countries is expected to remain negative by the end of this year. Currently, the Brent oil price stands at around USD 43 per barrel, which is significantly below its 2019 price (by 33%). While its movements in the coming period are characterised by a high degree of uncertainty, the majority of central banks' and international institutions' projections assume it would remain widely unchanged by the end of this year. According to the IMF's projections, in 2020 the global oil price will decline by 41.1%, and the gradual recovery of global demand should spur its rise of 3.8% in 2021. **We gave a similar assumption in our current projection,** i.e. consistent with oil futures from end-July, **the global oil price will drop by 35.5% in this year, only to climb by 4.8% in 2021.**

Speaking of **food prices**, a question is raised as to whether the pandemic might induce their above-average growth, given the strong and non-elastic demand, on the one hand and additional health costs imposed on agriculture on the other. The opinions seem to be divided at the moment. As stated by FAO,[3] in early 2020 food prices in the international market went down. Agriculture is an energy-intensive sector, so the fall in energy prices spilled over to lower prices of agricultural products, via lower input costs. Apart from that, the global fall in energy prices leads to lower prices and contraction in the production of ethanol and biofuel, which triggered a fall in the demand for inputs used in their production and consequently drove down the prices of agricultural products such as corn, sugar and vegetable oil. Conversely, as agriculture and transport are labour-intensive sectors, the smaller labour supply influenced a rise in its price, caused by the limited labour force movements and the pandemic spread, softening the drop in food prices. In accordance with all this, the FAO concludes that the pandemic-induced crisis should not spill over into any sharper rise in food prices, given that the food production prospects are good, the supplies are high, trade less concentrated and the prices of production inputs and transport are relatively low. However, there is still danger from a potential localised food price hike in the case of potential disturbance in the supply chains due to the pandemic.

Speaking of the EU market, as stated in the June report of the European Commission,[4] with the alleviation of containment measures, there was a certain rise in food prices owing to the reopening of restaurants and better export possibilities, but the price rise should be limited by good prospects for the production of milk, sugar, meat, vegetable oil, wine and tomatoes (at the 2019 level or maybe even above it). Cereal crops in the EU are likely to decline relative to the last year's, while remaining above the five-year average. The European Commission expects any significant price growth to be limited also by the relatively low level of energy and fertiliser prices. Nevertheless, according to the Bundesbank estimate,[5] Germany, which is the largest euro area economy, expects to see food prices accelerate from 1.5% in 2019 to 3.5% in 2020, primarily due to the limited seasonal labour force supply and additional containment measures in production and sale, which put an upward pressure on costs. In the period thereafter, food prices in Germany are expected to slow down, to 2.0% by 2022, with the positive contribution coming from wage growth in conditions of expected economic rebound.

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[2] World Economic Outlook Update, IMF, June 2020.

[3] Food Outlook, FAO, June 2020.

[4] Short-term outlook for EU agricultural markets in 2020, European Commission, summer 2020.

[5] Monthly Report, Deutsche Bundesbank, June 2020.

Our latest projection does not forecast any major food price growth in Serbia in the coming period. Despite the pandemic challenges, our agricultural sector showed resilience and is expected to ensure full food supply in the market going forward as well. Apart from that, this season's estimated wheat output rose by 5.3% compared to the last year and judging by the status of crops and meteorological conditions, the prospects for autumn crops (corn, sunflower, soybean etc.) are better than the last year's (which boasted an above-average harvest). According to futures from the leading world exchanges, global food prices should rise slightly this and the following year. Consistent with that, the domestic prices of primary agricultural commodities, which mirror the global prices, should display similar movements and the food production costs will remain relatively low.

V Inflation projection

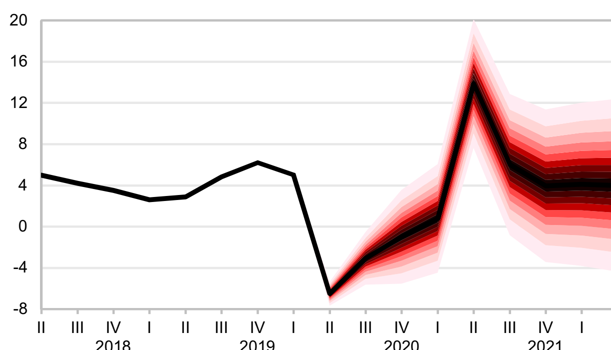
The economic recovery begun in May and June is expected to continue in the latter half of the year, supported by the taken and announced measures of the Government and the NBS, gradual rebound in external demand and moderation of containment measures. Despite the fact that the negative effects of the pandemic on domestic economic activity in Q2 were weaker than estimated, that additional measures supporting corporates and households were taken and that the outlook for this year's agricultural season has improved, we have kept our projection from May under which GDP will decline by 1.5% in real terms in 2020. In doing so, we have taken into account the renewed spread of the coronavirus globally which, according to relevant international institutions, will result in slower global recovery in the remainder of the year than estimated three months ago. On the expenditure side, domestic demand will be lower at year level, with a positive contribution coming from net exports as imports are expected to decrease more sharply than exports. In 2021, we expect to see accelerated recovery of around 6%, led by domestic demand and exports, and buttressed by the timely and adequate response of economic policy makers in Serbia and the maintained favourable medium-term outlook of the country, which will enable a return to a stable medium-term growth trajectory of around 4% p.a. Risks stemming from the international environment are judged to be tilted to the downside and relate in particular to the speed of recovery of the euro area, while those from the domestic environment are skewed to the upside as domestic demand may rally faster than anticipated.

Under the central August projection, y-o-y inflation is expected to move within the lower half of the target tolerance band, closer to the lower bound, until end-2021. Such inflation movements will be supported by relatively weak aggregate demand, subdued international inflation and global prices of primary agricultural commodities, while the effects of the fall in the global oil price will wane gradually. Thereafter, as the rise in economic activity and demand continues, supported by accommodative monetary and fiscal policy measures, inflation will edge up gradually towards the target midpoint of 3%, but remain below it even in 2022. Uncertainties surrounding the short-term inflation projection refer primarily to movement in fruit and vegetable prices, as well as the global price of oil and primary agricultural commodities. In the medium term, the key risks continue to stem from the international environment, and relate primarily to the speed of recovery of the euro area and capital flows to emerging economies. In part, the risks to the projection are also associated with the speed of recovery of domestic demand and movement in administered prices at home. On the whole, the risks to the inflation projection are judged to be symmetric.

GDP projection

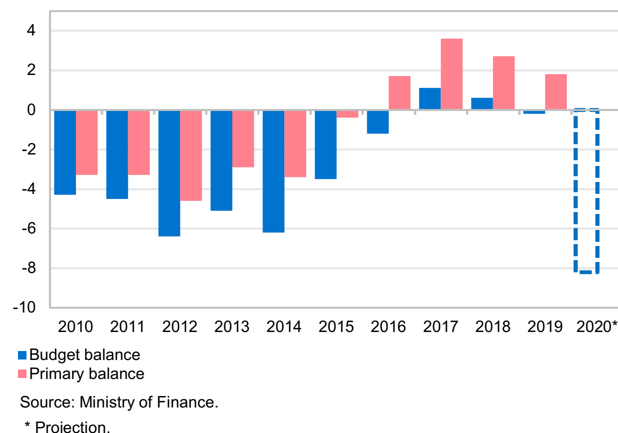
Like most other countries in the world, except China which was particularly affected by the pandemic in Q1, Serbia felt the effects of the pandemic in Q2 the most. The escalation of the crisis was quick and sudden, with the service sector hit particularly hard on account of the applied lockdown measures. Tourism, catering, trade and transport were affected most, as in the latter half of March shopping malls, catering and hotel facilities were closed, and air, city and intercity passenger transport suspended. The dip in external demand and halts in supply chains resulted in lower activity in industry in Q2. Still, **movements in available indicators signal that the negative effects of the pandemic were weaker than estimated in May**, to which timely and large-scale monetary and fiscal policy measures provided a key

Chart V.0.1 **GDP growth projection**
(y-o-y rates, in %)



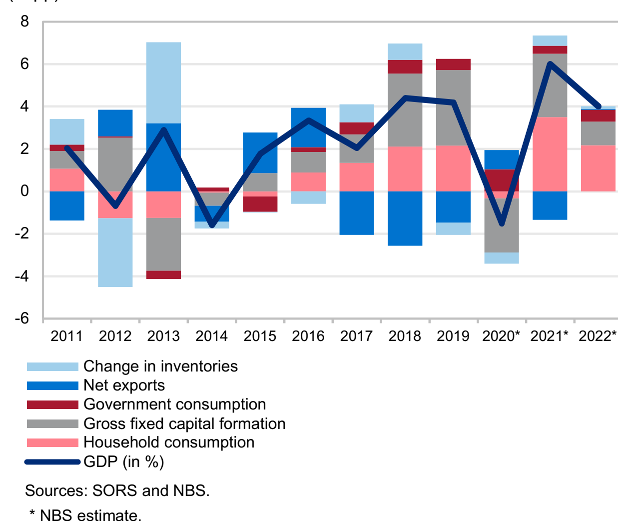
Source: NBS.

Chart V.0.2 **General government fiscal and primary budget balance**
(in % of GDP)



Source: Ministry of Finance.
* Projection.

Chart V.0.3 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

contribution. On the production side, from May onwards most production and service sectors saw a recovery which was faster than expected three months ago. Moreover, initial estimates on wheat production and areas sown by corn and industrial crops signal that this year's agricultural season is likely to be better than last year's, whereas in May we assumed it to move around its several years' average, that is to decline by around 4.0%, as last year's season was better than average. According to the SORS, economic activity contracted by 6.5% y-o-y in Q2, or by 10% s-a, compared to a quarter earlier, which is less than we previously expected (-8% y-o-y and -10.9% s-a). On the expenditure side, the decline in economic activity in Q2 was led by domestic demand, though household consumption probably declined less than anticipated. On the other hand, the contribution of net exports was positive, as we anticipated in May.

Assuming that the epidemiological situation does not call for further containment measures and fresh lockdown of economies globally and at home, the economic recovery begun in May and June ought to continue in the remainder of the year. The recovery will be supported by the taken and announced measures of the Government and the NBS, gradual rallying of external demand as economies open and containment measures are moderated, as well as by increased readiness to invest. The bulk of measures supporting corporates and households were implemented in Q2. In late July 2020, the second package of fiscal policy measures worth around RSD 66 bn was adopted, extending payment of subsidies for employee wages in SMEs by another two months. Also, the deferral of payment of payroll taxes and contributions for all private companies was extended by further 30 days. Thereby, total fiscal support will come to around 12.2% of GDP this year. According to the estimate of the Ministry of Finance, this will result in **a general government fiscal deficit** of around 8.2% of GDP, but such one-off deficit is, in our view, fully justified as otherwise the fall in economic activity this year would be much sharper, followed by a decrease in production capacities, including a fall in employment, and slower recovery in 2021. Though public debt would therefore temporarily climb to around 60% of GDP this year, it would return to the downward path from 2021 onwards.

The NBS's decision to allow a moratorium on loan and leasing debt repayment for another two months ought to support an increase in the disposable income of corporates and households. Government capital expenditure is also on the rise which, along with higher lending activity and favourable terms of financing, generates sources for new investment and contributes to their recovery going forward.

Despite a better agricultural season, additional economic measures and the fact that the negative effects of the pandemic on domestic economic activity in Q2 were weaker than expected, **we have kept our May projection that GDP will decline by 1.5% in real terms this year**, in view of the more adverse effect of factors from the international environment. Together with a maintained favourable medium-term outlook, the measures of the Government and the NBS will allow for a more than full recovery from the crisis next year, **with an economic growth rate of around 6%**, and a return to a stable and sustainable growth path of around 4% thereafter.

On the global plane, after the shock caused by the pandemic peaked in April, signals of economic recovery emerged in May, supported by the gradual opening of economies and accommodative fiscal and monetary policy measures of a large number of countries. Going forward, recovery is expected to continue, but economic activity is not likely to return to its pre-crisis level before 2022. Leading international institutions estimate that the effects of the pandemic-induced shock will be stronger than estimated three months ago, and that the renewed spreading of the virus will make recovery slower and less certain. As economic activity slumped in H1 more than previously projected, in June the IMF revised down the global growth forecast for 2020 by 1.9 pp to -4.9%, while expecting a slower recovery of 5.4% in 2021 as well (0.4 pp slower than in April). Growth of both advanced and emerging economies has been revised downwards. In addition, the risks to the projection are judged to be substantial and tilted to the downside.

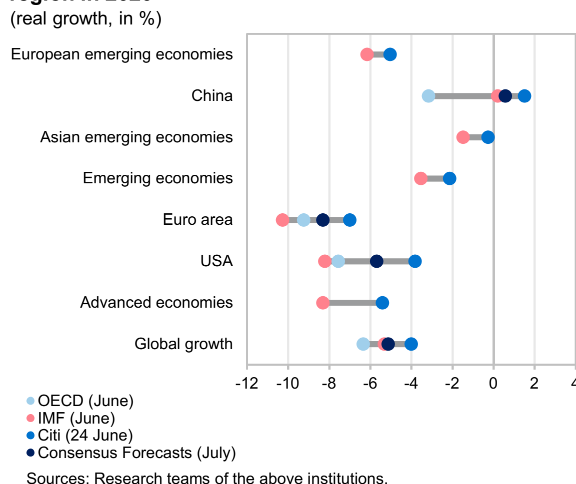
The **euro area**, our most important foreign trade partner, has been particularly affected by the pandemic due to its openness and deep integration into global supply chains. The key indicators of euro area economic activity in March and April slid to record lows, as did indicators of business and consumer confidence, and the countries that have been hit particularly hard are our most important foreign trade partners – Italy and Germany. Recovery began in May and, according to leading economic activity indicators, continued in both June and July, which signals that the undertaken fiscal and monetary policy measures have begun to produce positive effects. However, euro area growth outlook for this year has been revised down as the effects of the pandemic are assessed to be stronger than anticipated. In line with the Consensus Forecasts July projection, our new projection assumes that euro area economic activity will decline by around 8.0% this year, guided by subdued domestic demand, with investment hit particularly hard. Recovery is expected to ensue next year (growth of close to 6%), helped by additional

Table V.0.1 **Revision of IMF forecast of real GDP growth for 2020 and 2021**
(in %)

	2020		2021	
	Previous projection	New projection	Previous projection	New projection
World	-3.0	-4.9	5.8	5.4
Euro area	-7.5	-10.2	4.7	6.0
Germany	-7.0	-7.8	5.2	5.4
Italy	-9.1	-12.8	4.8	6.3
USA	-5.9	-8.0	4.7	4.5
Russia	-5.5	-6.6	3.5	4.1
China	1.2	1.0	9.2	8.2

Sources: IMF WEO (April 2020) and IMF WEO Update (June 2020).

Chart V.0.4 **Economic growth estimate by country and region in 2020**
(real growth, in %)



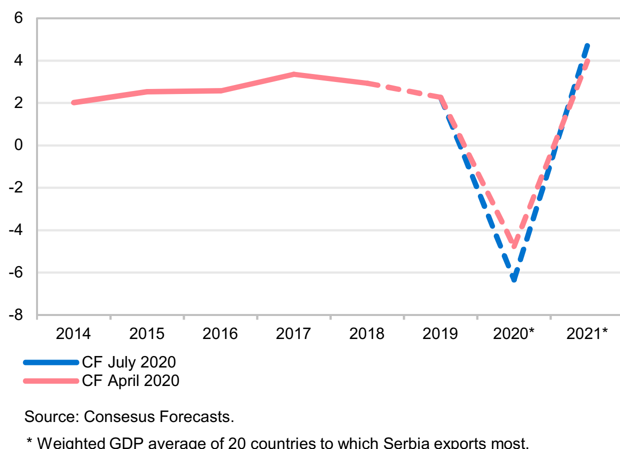
Sources: Research teams of the above institutions.

Table V.0.2 **Economic growth estimate by country**
(real growth, in %)

	April 2020		July 2020	
	2020	2021	2020	2021
Poland	-3.1	4.3	-4.2	4.3
Czech Republic	-6.1	5.3	-7.4	5.2
Hungary	-3.8	4.7	-5.0	4.2
Romania	-4.8	4.6	-5.7	4.9
Slovakia	-6.3	5.6	-7.9	6.3
Slovenia	-5.3	3.4	-7.8	4.7
Croatia	-6.7	4.0	-8.1	4.7
Bulgaria	-5.9	4.5	-5.7	4.5
Albania	-2.6	2.2	-6.7	5.2
Bosnia and Herzegovina	-5.9	3.9	-5.9	4.2
Macedonia	-3.1	4.3	-5.0	4.7
Serbia	**-2.0**	**4.2**	**-3.4**	**5.5**

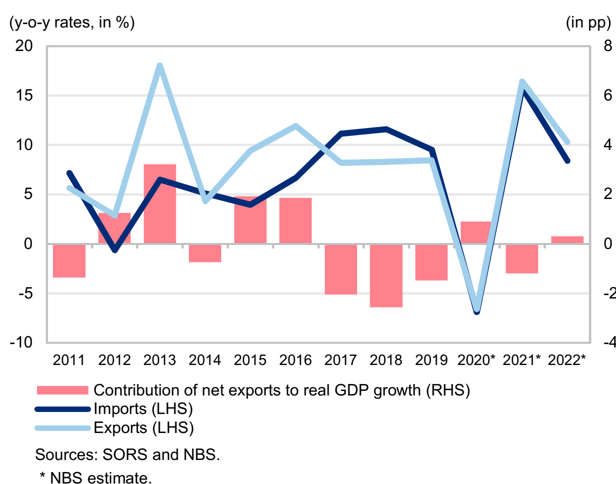
Source: Consensus Forcasts.

Chart V.0.5 **External demand indicator**
(in %)



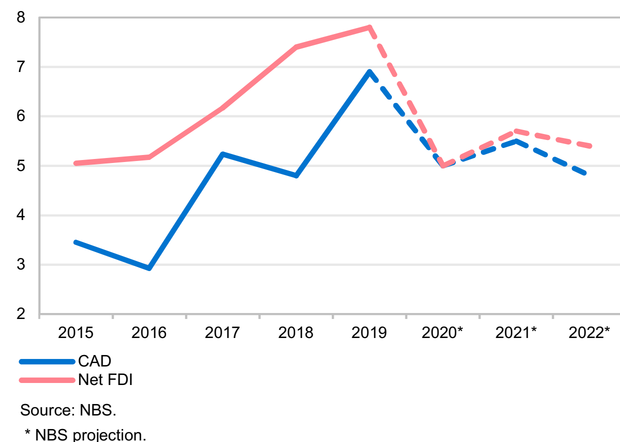
Source: Consesus Forecasts.
* Weighted GDP average of 20 countries to which Serbia exports most.

Chart V.0.6 **Real export and import growth**



Sources: SORS and NBS.
* NBS estimate.

Chart V.0.7 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.
* NBS projection.

unconventional measures of the ECB and large-scale fiscal programmes adopted by a number of states. Still, according to estimates, euro area GDP will not return to its pre-crisis level during 2021.

Compared to the May *Report*, the 2020 economic growth forecasts for most of **Serbia's other trade partners** have been revised down too, while the speed of recovery will depend primarily on the efficiency of measures aimed at containing the spread of the coronavirus and the available scope for using fiscal and monetary stimuli. It should also be noted that some of these countries where the pandemic-hit sectors, most notably tourism, account for a high share of GDP (e.g. Montenegro and Croatia) will see a sharp downturn in economic activity, but this will not reflect much on our exports. Also, it is important to highlight that, according to relevant international institutions (IMF, Consensus Forecasts), **Serbia will be one of the European countries to record the smallest decrease in economic activity this year, followed by a more than complete recovery from the pandemic next year**. This is supported by the country's sound macroeconomic position immediately before the pandemic, which created room for a powerful monetary and fiscal policy response, as well as by favourable medium-term prospects and the fact that the share of the sectors hit particularly hard by the pandemic (tourism, catering and transport) in GDP is low.

Serbia's exports declined **from March** onwards, due to a slackening in external demand, and are expected to fall by around 6.5% in real terms at year level. However, the broken supply chains, slump in domestic consumption and somewhat subdued FDI inflows amid weaker economic activity worldwide and global risk aversion, also led to a fall in real imports, which, according to our current estimates, will be higher and come to around 7% at year level. This should result in a **positive contribution of net exports to GDP this year (around 1 pp)**, though it will be lower than in the previous projection due to a sharper than expected slump in external demand. As imports of equipment and intermediate goods for industrial purposes go up with the continuation of the investment cycle, the contribution of net exports is expected to be negative in 2021. Subsequently, with the increase in export capacities and the rebound in external demand, the contribution of net exports is expected to be positive again.

Together with favourable terms of trade, including primarily the effects of a lower global oil price estimated at around USD 42 per barrel on average this year, the higher decline in imports than in exports in real terms will improve the foreign trade position and lead to a

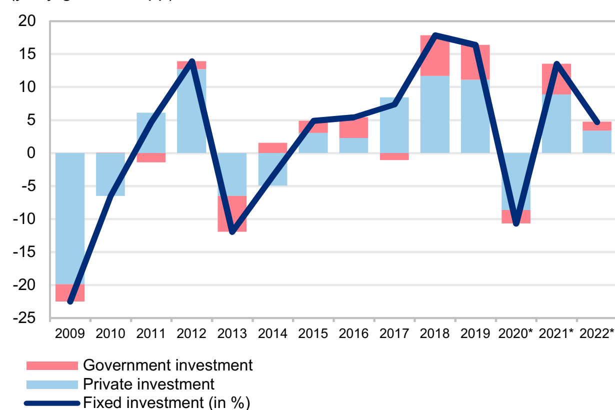
contraction of the share of the current account deficit in GDP to around 5% this year. Positive contribution to the narrowing of the current account deficit will also come from the lifting of the 100% tax on products delivered to Kosovo and Metohija, as well as lower expenses on account of primary income amid diminished corporate profitability due to the pandemic. The current account deficit will continue to **be fully covered by net FDI inflow**, which we assumed to be around EUR 2.3 bn this year, a conservative estimate given its performances in H1. Next year, we expect the share of the current account deficit in GDP to rise marginally amid implementation of investments deferred during the pandemic, while in the medium run, it is expected to subside slightly as export capacities go up and the global economy rallies, while remaining fully covered by FDI inflow of around 5% of GDP.

GDP dynamics will be determined primarily by **domestic demand** which, after this year's decline, will see an accelerated recovery next year, buttressed primarily by the continuation of the investment cycle and the rise in disposable income of corporates and households. Having in mind that the implemented coronavirus containment measures triggered a fall in consumption in Q2, and the expectation that households will, for some time to come, refrain from buying durable consumer goods and using services (such as travel and transport services), **private consumption** is expected to provide a negative contribution of 0.3 pp to GDP this year, which is less than what we expected in May. Thanks to the preservation of employment in the largest part of the economy and the implemented monetary and fiscal stimuli, it is expected to recover fully next year (contributing around 3.5 pp to GDP growth).

Fixed investment is estimated to provide a negative contribution of 2.6 pp to GDP amid global risk aversion, declining corporate sector profitability and the expected lower inflows from FDI, despite continued implementation of key infrastructure projects in Q2 as well. Still, investment is expected to rally in the remainder of the year, supported by a fall in country risk premium from May onwards and increased investor interest. A favourable macroeconomic outlook of the country, improved business environment, maintained favourable financial conditions and the planned investment projects of the government will, in our estimate, lead to investment growth and a contribution of around 3 pp to GDP growth in 2021.

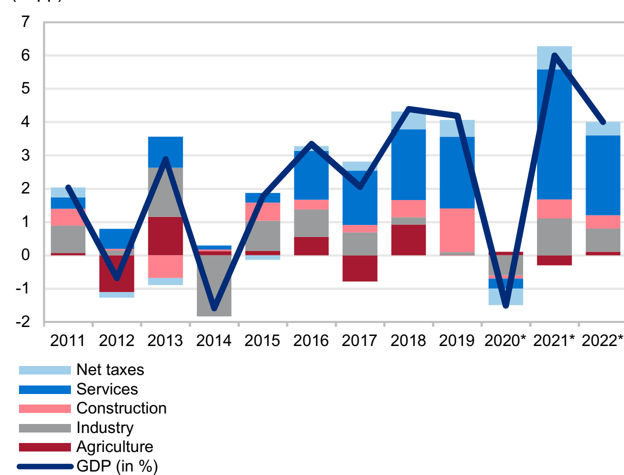
Of all components of domestic demand this year, the only one expected to provide a positive contribution is government spending due, among other things, to higher

Chart V.0.8 **Fixed investment**
(y-o-y growth, in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

Chart V.0.9 **Contributions to real GDP growth, production side**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

outlays for procurement of medical supplies, and growth will continue next year as well, though at a slower pace.

On the **production side,** activity is expected to contract this year in all production sectors, excluding agriculture, whereas the previous projection envisaged a fall in agriculture based on the assumption of an average agricultural season, as well as stagnation in the construction sector. As external demand slumped more than expected, the negative contribution of industry to GDP will be somewhat higher than we assumed in May, while faster recovery of trade since May and a smaller than expected decline in private consumption in Q2 will result in a less negative contribution of the service sector at year level. In our new projection, we assumed a mild negative contribution of construction. Next year, we expect growth and a more than complete recovery of activity in both service and production sectors. Manufacturing industry growth will be propped up by the activation of new and expansion of existing capacities on the supply side, and by the gradual acceleration of economic growth of our main foreign trade partners on the demand side. Stepped-up growth in activity is expected in service sectors as well, on account of continued positive trends in the labour market thanks to the undertaken economic policy measures and the expected rise in domestic demand. Positive contribution to GDP growth should also come from construction, given the ongoing and planned projects in the area of transport infrastructure (according to "Serbia 2025" project, over EUR 5 bn is planned to be invested in road infrastructure in the next five years), and favourable trends in the real estate market.

The risks to the GDP projection are mostly related to uncertainties regarding the **course and length of the pandemic globally**, and whether containment measures will continue to be relaxed or will have to be tightened. This will largely determine the **pace of the global economic recovery**. In our projection, we assumed that containment measures will not need to be tightened either globally or in Serbia. If, however, the epidemiological situation is not favourable and further containment measures are put in place, this could dampen global economic recovery.

Though Serbia lowered its exposure to disruptions in individual segments of external demand thanks to increased geographical and product diversification of its exports, the key risk from the international environment is still related to the **pace of growth in the euro area**. In addition to being our most important trade partner, the euro area also has an impact on the pace of **economic**

Table V.0.3 **Key risks to the GDP projection**

Risk	Possible channels of influence on inflation in Serbia	Estimate of the risk effect relative to the baseline scenario
International environment		
Uncertainty regarding the course of the pandemic and the effect on global economic growth	Slower global recovery would lead to a slackening of external demand, lower Serbian exports and slower growth in manufacturing.	↓
Pace of euro area's recovery from the pandemic	Slower euro area growth would lead to lower Serbian exports and a slower rise in manufacturing.	↓
Capital flows, relations of main currencies in the international financial market, monetary policies of leading central banks	Heightened uncertainty in the international financial market and the rise in risk aversion on account of slower global recovery would dampen the inflow of investment and increase the costs of borrowing. Accommodative monetary and fiscal policy measures of leading economies help reduce risk aversion and encourage investors' readiness to invest.	↕
Prices of primary commodities: – crude oil (Serbia is net importer) – grains (Serbia is net exporter) – base metals (Serbia is net exporter)	A rise/fall in oil prices would increase/decrease the disposable income and increase/decrease operating costs. A rise/fall in prices of base metals and grains would increase/decrease exports.	↕
Domestic environment		
Macroeconomic position of the country and structural reforms	Continuation of structural reforms and planned further systemic improvements of the business environment contribute to faster growth in investment and exports on the expenditure side, and of manufacturing and construction on the production side.	↑
Measures of the Government and the NBS to support corporates and households in the fight against the pandemic	Preservation of employment and higher disposable income moderate the negative effects of the pandemic on consumption and, by extension, on the activity of service sectors. Favourable terms of financing, the provided lending support and further growth in capital expenditure contribute to investment growth and, by extension, to a rise in manufacturing and construction.	↑
Agricultural season	Higher/smaller than expected growth in agricultural production contributes to a rise/fall in exports and manufacturing.	↕

Note: ↑ means a more favourable GDP outcome compared to the baseline scenario, ↓ means a less favourable outcome, and ↕ means that risks to the projection are symmetric relative to the baseline scenario.

growth in the countries of Central and Southeast Europe, with which Serbia is increasingly fostering strong economic ties. For our assumption of euro area growth, in the current projection we relied on the assessment of relevant international financial institutions, which on average expect euro area economic activity to shrink by around 8% and rally partly next year, judging the risks to the projection to be tilted to the downside in the conditions of a prolonged global economic recovery. Any sharper fall in economic activity in the euro area and the countries with which we have important trade ties would reflect on lower growth in Serbian exports and, by extension, weaker output in manufacturing.

As a small and open economy, Serbia is also under the sway of **capital flows and the relations of leading currencies in the international financial market**. Slower than expected global growth would add to the uncertainty in the international financial market and reflect negatively on business confidence and investment decisions, which would probably dent the inflow of capital into emerging economies, including Serbia. The **monetary policies of leading central banks** have been eased in the face of the pandemic, which led to a lowering

of risk aversion and enhanced readiness to invest in emerging economies. At the same time, central banks expressed their readiness to take further measures if needed to moderate any tightening of financial conditions.

To a degree, the risks to the GDP projection are also associated with **movements in prices of primary commodities, most notably the oil price which slumped significantly during the pandemic, while grains prices decreased less**, only to rally as signals of recovery emerged. Still, no major rise is expected in the period ahead, especially since global growth outlook has been revised down. As Serbia is a net importer of oil, any further decline in the oil price would spill over to higher disposable income and lower operating expenses, while its growth would have the opposite effect. When it comes to prices of base metals (iron and copper in particular) and grains, Serbia, as a net exporter, would not benefit from their fall.

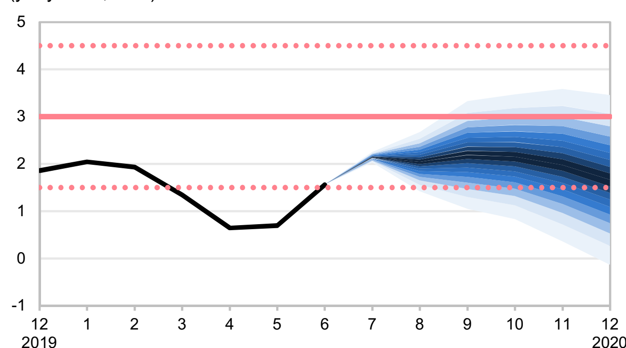
By contrast to factors from the international environment, based on which we judge the risks to the GDP projection for this year to be skewed to the downside, the risks associated with **domestic factors** are tilted to the upside. **The fall in consumption could be smaller than expected**, as in Q2 employment was preserved in the major part of the economy and additional measures were taken in the meantime by the Government and the NBS to ensure that no major layoffs happen in the coming months during the fight against the pandemic, while at the same time fuelling a rise in disposable income. **A smaller dip in investments is possible this year, as is their faster growth next year,** since low inflationary pressures, achieved macroeconomic stability and open fiscal space allow the NBS and the Government to take additional measures and activities to ease the position of corporates, without undermining price stability and the sustainability of public finances. Moreover, the continuation of structural reforms and the planned further systemic improvements of the business environment ought to contribute to faster growth in total factor productivity and, by extension, in the production potential. At the same time, the overperformance of capital government expenditure relative to the plan in the past two years indicates that government investment could also rise faster than anticipated in the period ahead, spurring **quicker than expected growth in construction**. As investments are mostly directed into tradable sectors, their stronger activation should also lead to faster export growth on the expenditure side, and a **rise in manufacturing** on the production side. To a smaller extent, the risk to the GDP projection is also associated

with movements in **agricultural production** which we now assume to rise moderately in 2020, given the first estimates of wheat crops and the state of autumn crops and meteorological conditions, and be average in the coming years. A better agricultural season will lead to stronger exports of primary and processed food products, especially given the fact that global food demand is not elastic and has not shrunk even during the pandemic.

Inflation projection

As in the case of GDP, in making our inflation projection we took into account that inflation movements in the period ahead will mostly depend on the success in controlling the pandemic globally, as well as on the pandemic's negative effects which are inflationary on the supply side and disinflationary on the demand side. After the initial stage of the pandemic (the so-called lockdown) which took place in March and April in most countries, gradual relaxation of containment measures ensued in May and June. This, coupled with stimulating monetary and fiscal policy measures, greatly helped moderate the negative effects of the pandemic on supply, but since its effects on demand are still present, no major inflationary pressures are expected in the coming period either. Also, though a gradual rebound in global economic activity began from Q3 onwards, it is estimated to be slower and inflation lower than expected three months ago. The key reasons for this include stronger effects of the initial shock of the pandemic than previously estimated and the fact that social distancing measures will, in all likelihood, remain in place in most countries until the pandemic is over. At the same time, pandemic containment measures in the coming period will not entail lockdown as in the initial stage, which means that they will not hamper recovery.

Chart V.0.10 **Short-term inflation projection**
(y-o-y rates, in %)

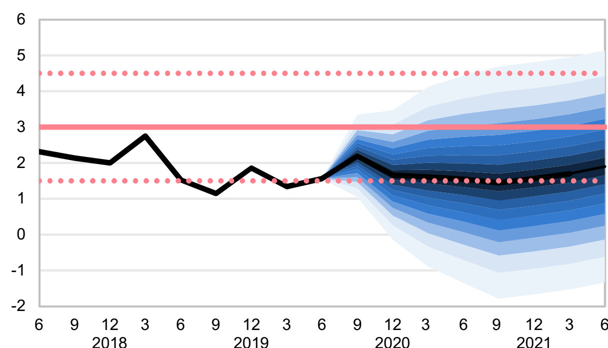


Source: NBS.

It is on this assumption that we have based our medium-term inflation projection – that the pandemic will be controlled by applying necessary epidemiological measures which are currently in place, without the need for their further tightening. Also, it is based on the positive effects of monetary and fiscal measures which alleviate the effects of the pandemic and encourage recovery in economic activity. Going forward, we expect economic growth at home which will not create any major inflationary pressures, but the speed of this recovery will greatly depend on the pace of rebound in the global economy, most notably the euro area, as our most important economic partner. Moreover, certain changes in relative prices are still possible, as supply and demand vary greatly across sectors due to the pandemic. As the slump in demand for catering, travel and transport

services was the most pronounced, they are expected to generate the weakest inflationary pressures. In view of the above, we estimate that in Serbia, as in most other countries, the effect of the pandemic in the medium run will result in inflation which will be lower than expected three months ago.

Chart V.0.11 **Inflation projection**
(y-o-y rates, in %)



Source: NBS.

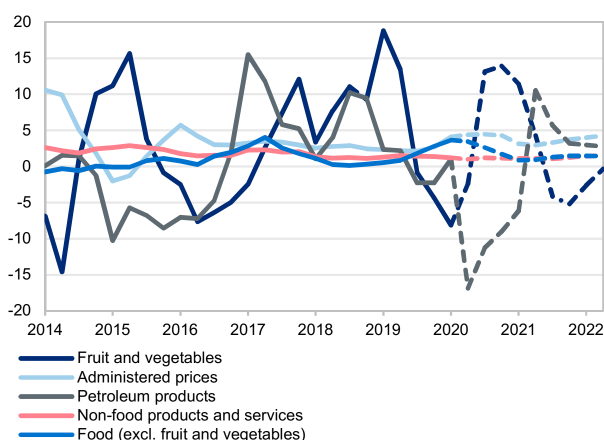
The fan chart depicts the probability of various inflation outcomes in the next eight quarters. The central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Each following shade includes 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected with probability of 90%. In other words, the probability that inflation in the next eight quarters would lie somewhere outside the band in the chart is 10%.

Medium-term inflation projection

Under the central August projection, y-o-y inflation will move within the lower half of the target tolerance band, closer to the lower bound, and, propped up by the expected further recovery in demand, gradually approach the target midpoint of 3% towards the end of the projection horizon. Such inflation movements will be supported by relatively weak aggregate demand, inflation in the international environment and global prices of primary agricultural commodities, while the effect of the global oil price slump will gradually wane. As economic activity strengthens and demand picks up, buttressed by accommodative monetary and fiscal policy measures, inflation will gradually move towards the target midpoint of 3% during 2022, but remain below it.

In terms of individual inflation components, the inflation profile will continue to be determined mainly by prices of fruit and vegetables and petroleum products. When it comes to prices of **fruit and vegetables**, the weather conditions, like in other European countries, were not favourable for fruit as it sustained great damage on account of a late frost. Things were similar with vegetables, which ripened later due to heavy rains. Also, the pandemic in all likelihood pushed up demand, most notably for fruit, resulting in somewhat higher fruit and vegetable prices than we expected three months ago. Given the substantial base effect for this category of food, which frequently deviates from typical movement in individual months, we expect it to provide a positive contribution to inflation until mid-2021, whereafter this contribution should turn negative.

Chart V.0.12 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

When it comes to **petroleum product prices**, their negative contribution to inflation is expected to subside gradually in the coming quarters and turn positive in Q2 2021, as the global oil price goes up after the drastic slump in the initial stage of the pandemic. Consistent with futures, in our new projection we assumed roughly 10% higher oil prices in 2020 and 2021 than in our previous projection. Such expectations on the basis of futures mostly rely on the agreement of OPEC+ countries on production caps and steps taken by most countries to normalise economic activity.

When it comes to **food prices (excluding fruit and vegetables)**, we expect no major upward pressures, as in the coming two years we anticipate moderate growth in prices of primary agricultural commodities which are important raw materials in processed food production (wheat, corn, soybean). The prices of domestic primary agricultural commodities, which are currently slightly above the neutral level, have not generated pressures on food price growth so far. Namely, in H2 2019 and H1 2020, food prices were on a rise, primarily due to disruptions in the global market caused by higher prices of pork. As this price increase drops out of the y-o-y inflation calculation, we expect this inflation component to slow down in the coming quarters. Food price growth is also likely to be contained by the fact that our agricultural season this year will in all likelihood be better than in 2019, which is also assumed in our projection, and means that, given somewhat more difficult export conditions, the supply of agricultural commodities in the domestic market could go up. In the medium run, we expect to see modest growth in food prices, guided primarily by a gradual rise in aggregate demand.

Weak aggregate demand and relatively low import costs and inflation abroad will contain the rise in **prices of non-food products and services**. As demand gradually rallies, these prices are expected to see moderate, though still relatively low, growth. We assumed that growth in administered prices will remain stable as so far, at around 4% per annum, until the end of the projection horizon.

Like our May inflation projection, the August projection was predominantly determined by the fact that **global supply and demand** were powerfully affected by the current pandemic, which has plunged the global economy this year in the sharpest recession since the Great Depression. Compared to the previous projection, the **global economic downturn is estimated to be stronger, as is its effect on lower inflation in the period ahead**. Though containment measures have been eased, the pandemic has affected the functioning of a significant part of the global economy and, on the one hand, pushed up production unit costs, thereby weakening the position of corporates, undermining business confidence and heightening risk aversion. In many countries, this has already caused a drastic fall in employment, wages and investment, and, by extension, demand. Weaker demand also reflects households' precautionary reluctance to spend and increased savings. Moreover, though the response of leading central banks greatly eased monetary conditions, and spilled over to a relaxation of financial conditions, there is still fear that banks' lending activity could be contained by a rise in bad receivables from corporates and households hit hardest by the crisis.

Table V.0.4 **Key projection assumptions**

	2020		2021		2022	
External assumptions	May	Aug	May	Aug	May	Aug
Euro area GDP growth	-5.0%	-8.1%	4.2%	5.9%	2.5%	3.3%
Euro area inflation (average)	0.7%	0.3%	1.0%	0.8%	1.5%	1.3%
EURIBOR 3M (December)	-0.4%	-0.5%	-0.4%	-0.5%	-0.4%	-0.5%
International prices of primary agricult. commodities (Q4 to Q4)*	2.6%	6.9%	7.9%	2.0%	2.8%	2.9%
Brent oil price per barrel (December, USD)	40	44	43	47	46	49
Internal assumptions						
Administered prices (Dec. to Dec.)	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%

* Composite index of soybean, wheat and corn prices.
Sources: NBS, ECB, Euronext, CBOT and Bloomberg.

Chart V.0.13 **Output gap projection**
(in % of potential output)

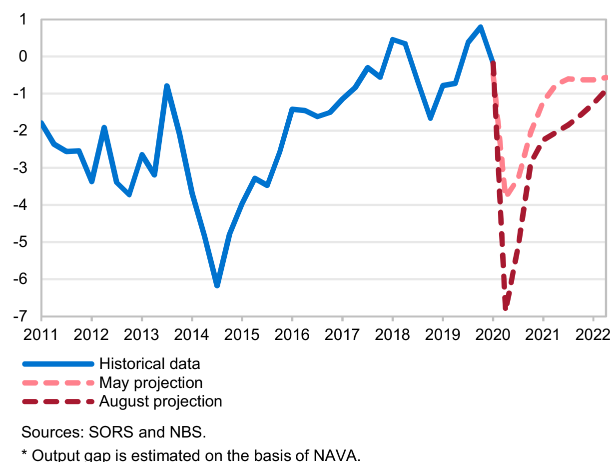


Chart V.0.14 **Expected 3M EURIBOR**
(p.a., in %)

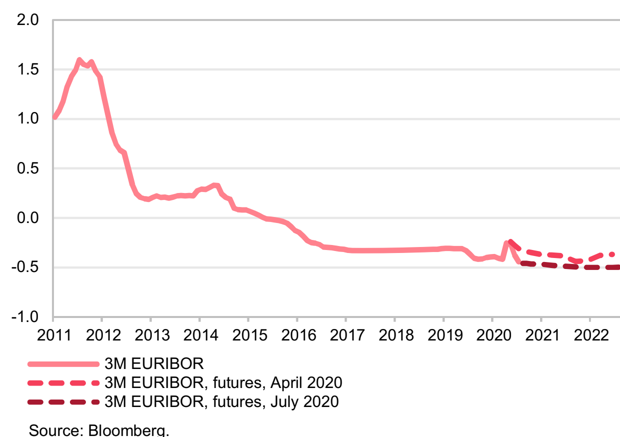
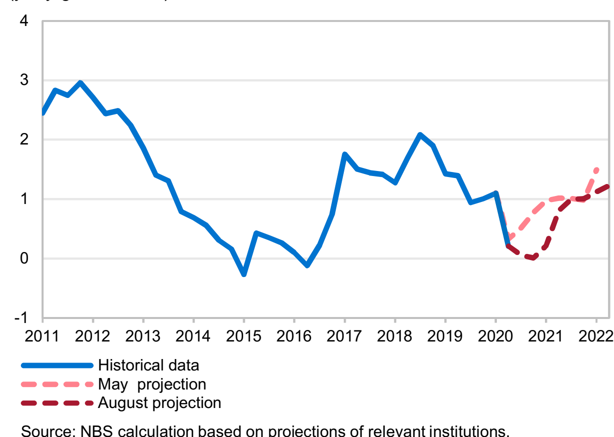


Chart V.0.15 **Assumption for euro area inflation**
(y-o-y growth, in %)



Economic growth of the euro area for this year has been adjusted to around -8% in our current projection, compared to -5% we assumed in our previous projection. This means that the euro area, as our most important trade partner, will be buying fewer products and services from Serbian companies this year, producing somewhat stronger disinflationary pressures than anticipated three months ago. Thanks to the expansionary measures taken by the ECB and the powerful fiscal stimulus packages taken by most member states and by the EU, euro area growth is expected to step up to close to 6% next year, pushing up demand for Serbian products and services.

At the time of making this projection, the dominant expectation is that the **negative effect of the pandemic in our country, as in other European countries, mostly played out during Q2, and that gradual recovery in economic activity and demand will ensue in Q3 this year**. The slump in external demand in Q2, and primarily the decline in euro area GDP, further deepened the negative output gap in our economy, signalling powerful disinflationary pressures from aggregate demand. It is estimated to come to around -3.5% in late 2020, contract to around -1.7% in 2021 as recovery in domestic demand accelerates and external demand goes gradually up, and close almost entirely in late 2022 (-0.3%).

The recovery of domestic demand is supported by the timely taken monetary and fiscal policy measures, which have contained the negative effects of the pandemic on economic activity, employment and wages in Q2 and spurred economic activity growth from Q3 onwards. Serbia faced this crisis in a much better macroeconomic position[30], which allowed the Serbian Government to **take powerful action in the form of fiscal measures** to support households and corporates in tackling the crisis caused by the pandemic and preserving the production potential. We expect that the acceleration of our economic growth next year will be led by the continuation of the investment cycle and higher disposable income of corporates and households.

In addition to the positive effect of the NBS's monetary policy easing on domestic demand, another positive impulse will come from lower interest rates on euro-indexed loans than expected three months ago. In the euro area, the **ECB** has taken unconventional monetary policy measures, including large-scale asset purchases, to substantially increase monetary policy accommodation in order to provide additional liquidity in new circumstances

[30] See Text box 1, p. 9.

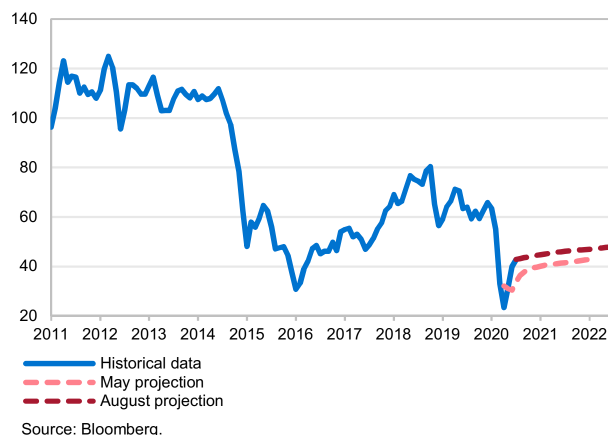
and ease financial conditions. Futures indicate that the three-month EURIBOR will be lower than expected three months ago and remain negative not only until the end of our projection horizon, but as far in 2026.

Despite highly accommodative monetary and fiscal measures taken by many countries of the world, **global inflation is expected to undershoot expectations**. Advanced economies' inflation was already low at the outbreak of the crisis, and some of them even experienced a fall in consumer prices in the initial stage of the pandemic. In any case, most advanced economies are not expected to meet their inflation targets in the next two years. With regard to the **euro area**, we have relied on the ECB's projection and expect inflation to be lower until the end of projection horizon than three months ago – it will slow to 0.3% in 2020 and pick up moderately to 0.8% in 2021 and 1.3% in 2022. In **most countries of the region**, which are also our important trade partners, inflation should be lower than previously expected, while inflation growth recorded by some of these economies in the past months is assessed as temporary and associated with the fact that some producers and service providers have passed on higher costs caused by the pandemic to consumers. Assuming lower inflation in the international environment, primarily in the euro area, relative to our prior projection, we expect **inflationary pressures from dinar-denominated import prices to be extremely weak** until the end of the projection horizon.

When it comes to import prices, the most significant are **global oil prices** which increased from early May, but remain significantly below their last year's level – by around 33% at the time of making this projection. Consistent with oil futures, in our new projection we assumed somewhat higher global oil prices: USD 44 per barrel in December 2020, and USD 47 per barrel in December 2021, compared with USD 40 per barrel and USD 43 per barrel, respectively, which we assumed in our previous projection. As global oil prices are still lower than last year, but have been revised upward, we expect the contribution of petroleum product prices to y-o-y inflation to remain negative, and diminish and turn positive in Q2 2021.

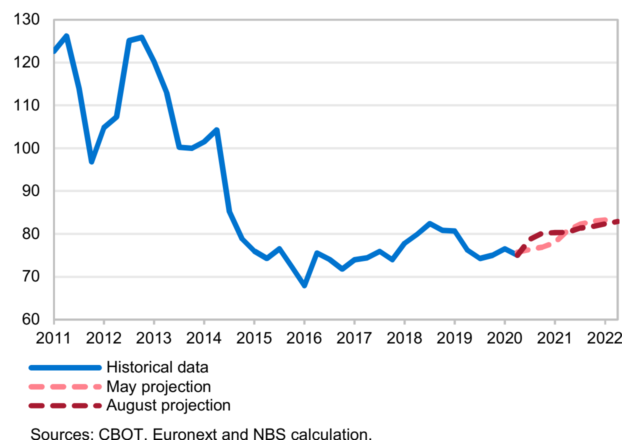
With regard to **global prices of primary agricultural commodities** relevant for us, our projection relies on futures data from Euronext Paris and the Chicago Board of Trade. Consistent with these data, we revised the assumption of growth in these prices up for 2020 (to 6.9% compared with 2.6% in our prior projection), and down for 2021 (to 2.0% compared with 7.9%). For this reason, **we also expect that prices of primary agricultural**

Chart V.0.16 **Assumption for Brent oil prices**
(USD/barrel)



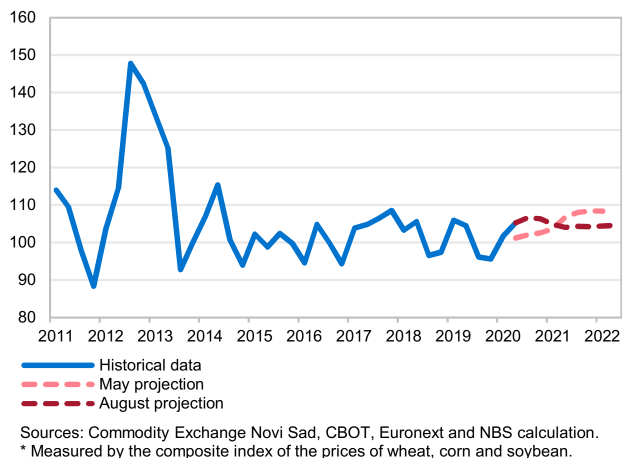
Source: Bloomberg.

Chart V.0.17 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: CBOT, Euronext and NBS calculation.

Chart V.0.18 **Assumption for domestic prices of primary agricultural commodities***
(Q4 2013 = 100)



Sources: Commodity Exchange Novi Sad, CBOT, Euronext and NBS calculation.
* Measured by the composite index of the prices of wheat, corn and soybean.

commodities in the domestic market[31], **which mirror movements in their global counterparts**, will display similar dynamics.

In the conditions of low and stable inflation for seven years in a row, anticipated low inflationary pressures and enhanced credibility of the NBS, we expect **inflation expectations to remain stable until the end of the projection horizon**.

Uncertainties surrounding the inflation projection in the short run are still mostly associated with movements in fruit and vegetable prices, as well as global prices of oil and primary agricultural commodities, as their dynamics is to a large extent mirrored by the prices of these products at home. In the medium run, the key risks to the projection are still associated with the international environment, and relate primarily to the speed of recovery of global trade and economic growth, most notably euro area growth, and capital flows to emerging economies. The risks to the projection also relate to the speed of recovery of domestic demand and movement in administered prices at home. On the whole, the risks to the inflation projection are judged to be symmetric.

When it comes to **fruit and vegetable prices**, movements in this inflation category are hardest to predict, as the output and their resultant price are largely influenced by weather conditions. In our current projection, we expect a y-o-y rise in prices of fruit and vegetables until mid-2021, and their decline thereafter. Still, as this is the most volatile inflation category, and shifts are possible in either direction, we judge the risks to the projection on this account to be symmetric.

The outlook for recovery of global trade and economic growth will largely determine movements in the international commodity market, notably **prices of oil and other primary commodities**. On the demand side, there are risks that global economic growth could be weaker than estimated, lowering the likelihood of rebound in demand for primary commodities and limiting recovery in their prices. Supply-side factors are specific for each primary commodity. Although market participants, according to futures, expect relatively low **global oil prices**, shifts in either direction are possible. In addition to the effects of the pandemic, there are also marked trade and geopolitical tensions, mostly between the US and China, which, on balance, undermine business confidence and the investment climate,

[31] Measured by the composite index of the prices of wheat, corn and soybean.

heightening uncertainty regarding global economic trends. Also uncertain are the effects of a gradual moderation of oil production caps of OPEC+ countries and the extent to which members will adhere to the agreement. Global oil prices will also impact prices of **primary agricultural commodities**, primarily through the costs of fuel in production, given that agriculture is an energy intensive sector. Also, energy prices impact demand for inputs in the production of ethanol and biofuels and, by extension, the prices of agricultural products such as corn, sugar and vegetable oil. The uncertainty regarding movement in global prices of primary agricultural commodities is additionally heightened by the pandemic, as the agricultural sector is labour intensive and the reduced supply of labour on account of labour movement restrictions and the spreading of the epidemic may induce price growth. Given the uncertainties surrounding global prices of oil and primary agricultural commodities, we estimate the risks to the projection on this account to be symmetric.

Uncertainty in the medium run is still mostly associated with movements in the international environment, most notably the **speed of recovery of global trade and economic growth, especially euro area growth, as this will determine the pace of recovery of our external demand and the level of import inflation**. Though economic recovery started with the relaxation of containment measures, the return to normal will be more difficult as many social distancing measures will remain in place to contain the spread of the virus. Like at the time of making the prior projection, we still do not know how long the pandemic will last and what its intensity will be. The longer it lasts, the weaker will be the position of corporates. In that case, risk aversion will probably be higher, investments lower, unemployment higher and households will refrain from spending out of precaution. Many countries are likely to see a much higher fiscal deficit and public debt, etc. On the other hand, it is positive that exceptional accommodative monetary policy measures were applied, as were large-scale fiscal packages in a large number of countries, which should spur recovery in economic activity. In view of the uncertainties surrounding movements in global trade and economic growth, most notably growth in the euro area, we estimate risks to the inflation projection to be tilted to the downside.

Though extremely large-scale monetary and fiscal measures of leading world economies helped alleviate the **uncertainty in the international financial market, it remains high, adding to uncertainty regarding capital**

Table V.0.5. **Key risks to the inflation projection**

Risk	Possible channels of influence on inflation in Serbia	Estimate of the risk effect relative to the baseline scenario
Short-term		
Fruit and vegetable prices (Serbia is net exporter)	Departures directly influence inflation and are possible in either direction, as this is the most volatile inflation component.	↕
Crude oil price in the global market (Serbia is net importer)	A fall/rise in the global oil price spills over to a fall/rise in petroleum product prices and thereby produces a disinflationary/inflationary effect. This fall/rise also has secondary effects, as it spills over to a decrease/increase in other prices, mostly through transport costs. Also, through a rise/fall in disposable income, it contributes to an increase/decrease in demand and may produce inflationary/disinflationary effects.	↕
Global prices of primary agricultural commodities (Serbia is net exporter)	Prices of primary agricultural commodities in the domestic market largely mirror the dynamics of their global counterparts. They increase/decrease in case of a rise/fall in their global counterparts, which thereby produce inflationary/disinflationary effects.	↕
Medium-term		
Pace of recovery of the euro area	– Slower recovery of the euro area leads to a slowdown in external demand growth, lower Serbian exports, higher supply in the domestic market and therefore produces disinflationary effects; – Slower recovery of the euro area leads to a slackening of inflation growth in the euro area and, in the conditions of a relatively stable exchange rate, creates disinflationary pressures at home on account of import prices; – Slower recovery of the euro area leads to higher expansiveness of the euro area monetary policy, resulting in lower interest rates on euro loans and, through growth in credit and disposable income, stronger demand and inflationary pressures.	↓
Uncertainty in the international financial market and capital flows to emerging economies	Higher/lower uncertainty in the international financial market leads to higher/lower risk aversion of investors and lower/higher capital flows to emerging economies, which results in depreciation/appreciation of the domestic currency and, by extension, a rise/fall in prices.	↕
Pace of recovery of domestic demand	Preservation of employment and higher disposable income moderate the negative effects of the pandemic on demand. Also, favourable terms of financing, the provided lending support and further growth in capital expenditure contribute to demand growth and, by extension, to inflationary pressures.	↑
Administered prices	Lower growth in administered prices leads to lower inflation.	↓

Note: ↑ means a more inflationary effect relative to the baseline scenario, ↓ means a more disinflationary effect, and ↕ means that risks to the projection are symmetric relative to the baseline scenario.

flows to emerging economies. Investors responded to the pandemic by reconsidering their portfolios and favouring investment in safe assets, which has led to shifts in global capital flows, fall in stock exchange indices, and rising prices of gold and sovereign securities of advanced economies. Emerging economies saw substantial capital outflows on account of portfolio investments in March. Thereafter, portfolio flows were more positive, which helped stabilize the foreign exchange markets of these countries. Going forward, uncertainty in the international financial market and, by extension, global capital flows, will largely be determined by the success in controlling the pandemic globally and the effects of the undertaken monetary and fiscal policy measures. With this in mind, we judge the risks to the inflation projection on this account to be symmetric.

The risks to the projection are also associated with the speed of recovery of **domestic demand**. The economic activity in Serbia saw a downturn in the latter half of March and in April reflecting not only lower external demand, but also more difficult business conditions in many sectors. Thereafter, **economic activity began to rally gradually, supported by timely monetary and fiscal policy measures**. The preservation of employment and the rise in disposable income helped alleviate the negative effects of the pandemic on demand. Also, favourable terms of financing, provided lending support and further growth in government capital expenditure led to a rise in demand. The coordination of monetary and fiscal policy measures will continue in the period ahead, helping moderate any further negative effects from the international environment and the consequences of the coronavirus spread on the domestic economy. As, in our view, it is more likely that domestic demand growth will outstrip our expectations in the period ahead, we estimate that the risks on this account are tilted to the upside.

Since, over the past few years, **administered price growth** at home was mostly slower than expected, we estimate that growth in these prices could be lower than anticipated in the coming period as well, so risks on this account are skewed to the downside.

Overall, **the risks to the inflation projection are judged to be symmetric until the end of the projection horizon**.

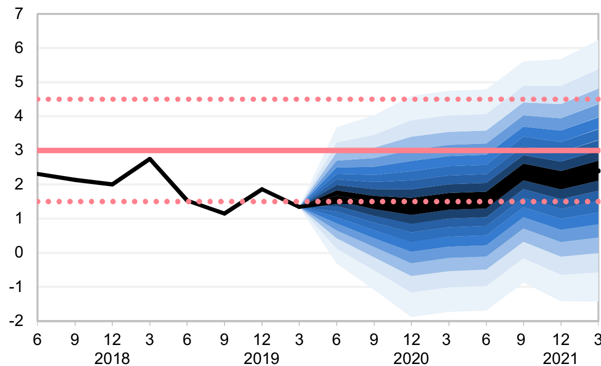
Monetary policy decisions in the coming period will depend on the assessment of the impact of past monetary policy easing on future inflation, but also on anticipated movements in key factors from the domestic and international environment and their influence on inflation, financial stability and the speed of economic recovery. The Executive Board emphasises that the NBS is ready to respond depending on any further effects of the pandemic at home and abroad.

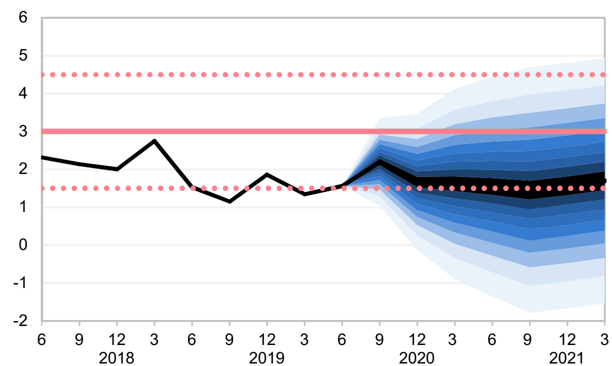
Comparison and outcome of inflation projections

Compared to the May projection, the new medium-term inflation projection is somewhat higher in the short term and lower in the medium term until the end of the projection horizon.

The key reason why the current inflation projection is somewhat higher relative to the previous one in the short term, primarily in Q3 this year, are higher than assumed **prices of fruit and vegetables** in the preceding months.

Chart V.0.19 **Current vs. previous inflation projection**





Source: NBS.

Also, in the period since our previous projection, **the global oil price** increased, as did expectations regarding its future movements. As the assumption on global oil price movement was revised up by around 10% in 2020 and 2021 consistent with the futures current at the time of making the projection, our **projection of petroleum product prices is somewhat higher than three months ago**.

However, since we estimate that the more disinflationary effect of aggregate demand and import inflation will outstrip the inflationary impact of oil prices in the medium term, inflation will move at a lower level until the end of the projection horizon than we expected in May.

The period since our previous projection was marked by strong direct and indirect effects of the pandemic on global economic developments, which has led to **a higher than expected deepening of the negative output gap in the euro area and, by extension, of the domestic output gap as well**, so disinflationary pressures on account of demand were stronger than in the previous projection.

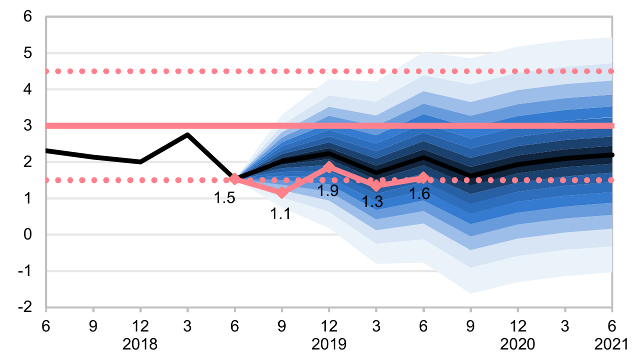
The current inflation projection is lower than the previous one also due to the anticipated **reduced cost-push pressures from import inflation**. Since our assumption of inflation in the international environment, most notably in the euro area, is lower than in May, we expect inflationary pressures from dinar-denominated import prices to be muted. Cost-push pressures should also be weaker on account of **lower prices of primary agricultural commodities**, which is another factor behind lower projected inflation than three months ago.

Outcome of the August 2019 inflation projection

In the past year, inflation was largely aligned with the projection made and published in the August 2019 *Inflation Report* (slightly below the projection midpoint), **which helps strengthen confidence in the NBS and anchor inflation expectations**.

In the observed period, a somewhat higher downward departure was recorded only in Q3 2019 due to a **notable decline in vegetable prices**, higher than typical for this time of the year, which we anticipated in our August 2019 projection. Vegetable prices decreased significantly due to a good agricultural season in 2019. In the remaining quarters of the August 2019 projection, inflation moved slightly below the midpoint, as the **fall in prices of petroleum products was sharper and the increase in prices of non-food products weaker** than we projected in August 2019. The drop in oil prices was mostly led by the global growth slowdown due to the pandemic, while a slower rise in **non-food product** prices was due to lower import costs. Somewhat higher than expected growth was recorded only by **prices of food products**, most notably meat, as demand from China went up and pork prices in the EU saw notable growth, but the effect of this departure was more than offset by the effects of the previous two inflation components.

Chart V.0.20 **Achievement of August 2019 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Q1 2020	Q2 2020
EXTERNAL LIQUIDITY INDICATORS (in %)																	
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.6	6.6	6.7	6.2	5.4	5.4	5.7	5.5	6.2
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.9	237.3	268.6	294.0	256.4	234.0	202.1	210.9	242.4	220.9	
FX reserves /GDP	22.1	34.8	30.5	22.9	32.6	31.7	34.0	32.4	30.7	27.9	29.1	27.8	25.4	26.3	29.1	28.1	30.1
Debt repayment/GDP	4.7	9.7	9.6	10.1	12.1	11.3	11.7	12.3	12.6	13.3	11.1	12.3	10.9	11.3	10.0	7.6	
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.2	25.9	22.2	22.9	19.5	15.1	
EXTERNAL SOLVENCY INDICATORS (in %)																	
External debt/GDP	56.2	55.2	55.1	58.8	68.6	74.5	68.1	76.1	70.4	72.4	73.5	72.1	65.1	62.2	61.9	62.1	
Short-term debt/GDP	12.5	13.1	12.2	14.1	14.8	16.6	11.3	13.7	11.4	9.5	11.3	11.9	12.6	12.5	12.0	12.7	
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	166.8	152.4	132.2	126.0	121.5	122.8	
FINANCIAL RISK EXPOSURE INDICATORS (in %)																	
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	250.2	207.3	176.2	168.0	174.1	165.3	147.1
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	196.6	185.0	171.4	194.1	175.7	171.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	67.1	73.0	74.7	78.0	65.1	75.3	78.0	84.5	87.1	91.8	96.2	100.7	106.3	108.3	111.9	112.8	93.1
MEMORANDUM: (in EUR million)																	
GDP [1]	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,855	45,912	11,025	10,886 [3]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,234	26,494	25,526	26,662	28,418	29,034	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,595	4,728	3,960	4,508	4,285	4,849	4,573	841	
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	10,205	9,962	11,262	13,378	13,115	13,956
Short-term debt [2]	951	968	1,044	1,832	1,852	1,758	612	455	196	99	303	672	844	1,401	1,929	2,395	
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,076	-3,160	-977	-371

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2019	2020
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan/March/ June/Dec	March/ Dec	Dec	Sept	Dec	May
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB-/negative				BB- /positive	BB /stable	BB /positive		BB+ /positive	BB+ /stable
Fitch	BB- /stable			BB- /negative		BB- /stable		BB-/negative		B+ /stable	B+ /positive	BB-/stable	BB /stable		BB+ /stable		
Moody's									B1 /stable			B1 /positive	Ba3 /stable		Ba3 /positive		

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during last 12 months.
Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.
Foreign exchange reserves/GDP (in %) - ratio of end-of-period foreign exchange reserves to GDP.
Debt repayment/GDP (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.
Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to exports of goods and services during period under review.
External debt/GDP − ratio of end-of-period outstanding debt to GDP.
Short-term debt/GDP − ratio of end-of-period short-term debt at remaining maturity to GDP.
External debt/exports (in %) − ratio of end-of-period outstanding debt to annual value of exports of goods and services.
Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-of-period.
(Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

[1] According to ESA 2010.

[2] At original maturity.

[3] NBS estimate

Notes:

1. The Statistical Office revised GDP data for the period 2005-2017, which led to a change in the share of macroeconomic indicators in GDP.

2. Data are subject to corrections in line with the official data sources.

3. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.

4. As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

5. In September 2010, the methodology of external debt statistics was changed – public sector external debt now includes liabilities under SDR allocation (EUR 479.2 mn) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 948.6 million, of which EUR 427.5 million relating to domestic banks and EUR 521.1 million to domestic enterprises).

6. Foreign debt repayment for 2019 does not include advance debt repayment of eurobonds.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Q1 2020	Q2 2020
Real GDP growth (in %)[1]	5.5	4.9	6.4	5.7	-2.7	0.7	2.0	-0.7	2.9	-1.6	1.8	3.3	2.0	4.4	4.2	5.0	-6.5[9]
Consumer prices (in %, relative to the same month a year earlier)[2]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	1.7	1.5	1.6	3.0	2.0	1.9	1.3	1.6
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	10,205	9,962	11,262	13,378	13,115	13,956
Exports (in EUR million)[3]	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	15,728	17,385	19,312	21,166	23,398	5,558	4,662
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	8.8	10.5	11.1	9.6	10.5	4.6	-20.3
Imports (in EUR million)[3]	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	18,643	19,597	22,343	25,257	27,966	6,875	5,469
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	3.0	5.1	14.0	13.0	10.7	7.7	-20.9
Current account balance[3]																	
(in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,234	-1,075	-2,051	-2,076	-3,160	-977	-371
as % of GDP	-8.0	-9.1	-17.3	-20.0	-6.3	-6.5	-10.3	-10.9	-5.8	-5.6	-3.5	-2.9	-5.2	-4.8	-6.9	-8.9	-3.4
Unemployment according to the Survey (in %)[6]	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2	17.7	15.3	13.5	12.7	10.4	9.7	
Wages (average for the period, in EUR)[7]	210.4	257.8	347.1	402.0	337.8	331.8	372.5	366.1	388.5	379.8	367.9	374.5	383.9	419.7	465.9	504.0	501.0
RS budget deficit / surplus (in % of GDP)[4]				-1.6	-3.0	-3.2	-3.8	-5.6	-4.9	-5.9	-2.7	-0.2	0.7	0.6	0.2	-3.6	-20.1
Consolidated fiscal result (in % of GDP)[4]	1.1	-1.4	-1.8	-2.5	-4.2	-4.3	-4.5	-6.4	-5.1	-6.2	-3.5	-1.2	1.1	0.6	-0.2	-4.1	-20.2
RS public debt, (central government, in % of GDP)[8]	47.6	33.9	27.9	26.8	30.9	39.5	42.8	52.9	56.0	66.2	70.0	67.8	57.9	53.7	52.0	51.9	57.3
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.85	111.29	107.50	100.28	105.28	106.57	106.76
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	99.46	111.25	117.14	99.12	103.39	104.92	106.68	104.63
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	120.73	123.12	121.34	118.27	117.85	117.57	117.58
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	120.96	121.63	123.47	118.47	118.19	117.59	117.50	117.58
MEMORANDUM:																	
GDP (in EUR million)[5]	22,276	25,906	31,551	35,701	32,486	31,546	35,432	33,679	36,427	35,467	35,716	36,723	39,183	42,855	45,912	11,025	10,886[10]

[1] At constant prices of previous year.

[2] Retail prices until 2006.

[3] Starting from 2007 data on balance of payments (current account, exports and imports of goods and services) are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to the break in the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

[4] Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5] According to ESA 2010.

[6] New methodology of Labour Force Survey since 2014.

[7] Until 2017, wages are shown according to the old methodology. Since 2017, wages are shown according to the new methodology and data are based on Tax Administration evidence. For conversion of wages from RSD to EUR, we used the average of the period RSD/EUR exchange rate. Data for Q2 2020 is average of two months.

[8] Data on the share of public debt in GDP were downloaded from the website of the Ministry of Finance.

[9] SORS flash estimate

[10] NBS estimate

Notes:

1. The Statistical Office revised GDP data for the period 2015-2017, which led to a change in the share of macroeconomic indicators in GDP.

2. Data are subject to corrections in line with official data sources.
3. Source for the data on unemployment: Labour Force Survey, Statistical Office.
4. Source for public debt: MoF.

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Executive Board meetings and changes in the key policy rate

2019

Date	Key policy rate (p.a, in %)	Change (in basis points)
10 January	3.00	0
7 February	3.00	0
7 March	3.00	0
9 April	3.00	0
9 May	3.00	0
6 June	3.00	0
11 July	2.75	-25
8 August	2.50	-25
12 September	2.50	0
10 October	2.50	0
7 November	2.25	-25
12 December	2.25	0

2020

Date	Key policy rate (p.a, in %)	Change (in basis points)
9 January	2.25	0
13 February	2.25	0
11 March	1.75	-50
9 April	1.50	-25
7 May	1.50	0
11 June	1.25	-25
9 July	1.25	0
13 August	1.25	0
10 September		
8 October		
12 November		
10 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 June 2020

At its meeting today, the NBS Executive Board voted to continue monetary policy easing and cut the key policy rate by 25 basis points to 1.25%.

In making such decision, the Executive Board had in mind that the scale of the global crisis caused by the spread of the coronavirus (Covid-19) calls for additional monetary policy support to the domestic economy, in order to mitigate the negative effects of the crisis and boost economic growth in the period ahead. The Board took into account the previously taken measures involving substantial monetary accommodation and fiscal stimuli, but also the fact that, thanks to a responsible conduct of economic policy, Serbia faced this crisis in a much better macroeconomic position than in the case of earlier crises. This has created scope for further monetary easing and provision of support to the economic recovery of the country.

The Board emphasises that the decision on further trimming of the key policy rate was taken in an environment of low and stable inflation which continued to slow in April to 0.6% y-o-y, consistent with NBS expectations. According to the Board's estimate, inflation is likely to move around the lower bound of the target tolerance band (3±1.5%) in the remainder of the year against the backdrop of dampened aggregate demand and lower import prices, including oil prices. Inflation is expected to gradually get closer to the midpoint in the medium run, on account of the recovery of demand supported by monetary and fiscal policy measures.

As the Covid-19 pandemic has pulled the global economy into an unprecedented recession and it is increasingly certain that it will open gradually, many central banks have adopted new measures to encourage faster recovery. Particularly important for us is the euro area recovery, which should be supported by the recent ECB measures aimed at providing liquidity and supporting favourable financing conditions. Coordinated monetary and fiscal policy measures in many countries across the world should contribute to more favourable financing conditions and encourage economic recovery in the coming period. The Board also had in mind that due to weaker global growth prospects, the prices of primary commodities in the global market, primarily of oil, will remain relatively low.

The Board particularly emphasised the fact that the effects of the pandemic on the Serbian economy will be significantly mitigated with the additional key policy rate cut, together with earlier adopted monetary and fiscal policy measures. It is almost certain that the strongest effects of the crisis were felt in Serbia in April, as was the case with most other European countries, while the months to come will experience recovery, supported by the undertaken measures. This will lead to GDP growth of at least 6% in 2021, without prejudice to price and financial stability.

As underscored by the Executive Board, the full coordination of monetary and fiscal policy measures will continue, which will help diminish potential further negative effects from the international environment. The NBS will continue to keep a close eye on global developments and their implications for the domestic economy and inflation, and will respond in a timely manner to preserve the achieved price and financial stability, and contribute to sustainable growth.

The next rate-setting meeting will be held on 9 July.

Press release from Executive Board meeting held on 9 July 2020

At its meeting today, the NBS Executive Board kept the key policy rate on hold, at 1.25%.

The decision was made in light of the expected effects of monetary policy measures undertaken to mitigate the impact of the COVID-19 pandemic. In an environment of high banking sector liquidity, the past key policy rate cuts – to the lowest levels in the inflation targeting regime, will continue to influence trends in the financial and real sectors and contribute to preserving the favourable terms of financing of businesses and households and to the increase in their disposable income. The Board also had in mind the expected effects of the robust fiscal package (around 11% of GDP), which ensured support to the private sector, in order to encourage the fastest possible recovery of our economy from the pandemic. The Board underscores the NBS is prepared to respond as potential new pandemic shocks emerge in the domestic and international environment.

As emphasised by the Board, the adoption of the stimulus measures was made possible thanks to low and stable inflation. In line with NBS expectations, inflation slowed since early 2020 – to 0.7% y-o-y in May, reflecting mainly the high base effect for vegetable prices and lower current petroleum product prices as global oil prices plummeted. Inflation is likely to move around the lower bound of the target tolerance band in the rest of the year, amid dented aggregate demand and lower import prices. It is expected to gradually approach the target in the medium run, owing to the recovery of demand, supported by monetary and fiscal policy measures.

The external environment continues to be plagued by uncertainty, notably with regard to the global recovery from the effects of the pandemic and developments in the international financial and commodity markets. Many central banks worldwide reacted by easing their monetary policies, taking conventional and unconventional measures, to mitigate the fallout from the crisis. The recovery of the euro area, Serbia's key trade and financial partner, should be encouraged by the ECB's measures geared at boosting liquidity and supporting favourable terms of financing. In keeping the key policy rate unchanged, the Executive Board was also guided by uncertainty in the commodity markets, above all the uncertain outlook for global primary commodity prices, notably the price of oil, which exhibited considerable volatility in recent months, and began rising as of May.

The Executive Board underlined the fact that Serbia faced this global crisis in a much better position than earlier crises, which enabled the adoption of monetary and fiscal measures that will significantly alleviate the effects of the crisis on the domestic economy. It is almost certain that the major negative effects of the pandemic in Serbia played out in April and that in the coming months we will see a recovery, encouraged by the measures taken, leading to the GDP growth of minimum 6% in 2021. This is also confirmed by the economic and external trade activity indicators for May, which point to a recovery relative to April, as well as by the leading indicators of economic expectations for June, for both Serbia and the euro area.

The Executive Board stressed that monetary and fiscal policy measures will remain fully coordinated, which will help moderate any potential further negative effects from the external environment. The NBS will continue to keep a close eye on global developments and their impact on the domestic economy and inflation, and will respond timely in order to preserve the achieved price and financial stability and contribute to the sustainable growth of our economy.

The next rate-setting meeting will be held on 13 August.

Press release from Executive Board meeting held on 13 August 2020

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged, at 1.25%.

The decision was made primarily in light of the achieved and expected effects of monetary policy measures taken to mitigate the fallout from the pandemic and to bolster economic growth. Dinar interest rates declined as a result of monetary policy easing, notably as a result of reducing the key policy rate by a whole percentage point relative to the pre-pandemic period. In an environment of high banking sector liquidity, which the NBS supported additionally through its monetary operations since the beginning of the crisis, the Executive Board expects that past monetary policy easing will continue to contribute to preserving favourable terms of financing for businesses and households and to the increase in their disposable incomes. The NBS's stimulating measures, which ensure to businesses more favourable terms of dinar financing within the government Guarantee Scheme, should also give impetus to the faster recovery of the Serbian economy. In making the above decision, the Board also had in mind the expected effects of the extensive fiscal package (over 12% of GDP in total), which provided robust support to the private sector in order to make the recovery of our economy from the pandemic as fast as possible.

The Board emphasises that it was possible to adopt such stimulus measures in the first place thanks to low and stable inflation. In line with NBS expectations, after running low in April and May, inflation returned within the target band in June, reaching 2.0% y-o-y in July. Such inflation profile was determined mainly by fruit and vegetable prices, whose high base effect waned with the onset of the new agricultural season, and petroleum product prices, which mirrored the dynamics of the global oil price, strengthening the disinflationary pressures until May and weakening them as of June. That there are no major inflationary pressures is further indicated by core inflation, which remained low and stable, despite a mild rise in July, measuring 1.7% y-o-y. Inflation expectations of the financial and corporate sectors also stayed anchored at a low level, showing market participants' confidence in price stability going forward. The Executive Board judges that in the coming months inflation is likely to continue moving in the lower half of the target band, closer to its lower bound, reflecting mainly dented aggregate demand and lower import prices. Inflation is expected to gradually

approach the target midpoint in the medium run, on the back of recovering demand, supported by monetary and fiscal policy measures.

The decision to keep the key policy rate on hold was also motivated by the developments in the international environment. Although the initial phase of the pandemic was followed by the gradual relaxation of containment measures and the nascent gradual economic recovery on a global scale, a high level of uncertainty persists in the international commodity and financial markets. The uncertainty primarily relates to the global course of the pandemic and the pace of recovery of the global economy going forward, but is also fuelled by the economic tensions between the USA and China. Particularly important for Serbia is the incipient recovery in the euro area, which will be further encouraged by the ECB's measures boosting liquidity and supporting favourable terms of financing. In keeping the key policy rate unchanged, the Executive Board also took into account uncertainties in the commodity markets, primarily as to the movement of prices of primary commodities, above all the oil price, which remains lower than the last year, in spite of the rising trend in place since May.

The Executive Board particularly underlines the fact that Serbia faced the crisis in a much more favourable position compared to the previous crises, which created room for the ongoing robust monetary and fiscal measures and for any future measures if the need arises, without jeopardising price and financial stability or the country's fiscal position. Consistent with the Board's expectations, the economic recovery of Serbia began in May, encouraged by the implemented monetary and fiscal policy measures, and it turned out faster than expected in the majority of production and service sectors. The Executive Board expects the recovery to continue in the period ahead, also supported by the gradual rebound in external demand, signalled by leading economic activity indicators for the euro area.

At today's meeting, the Executive Board adopted the August Inflation Report, to be published on 19 August. Apart from the new inflation and GDP projections, the Report also gives detailed explanations of monetary policy decisions and the underlying macroeconomic developments.

The next rate-setting meeting will be held on 10 September.

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