National Bank of Serbia

2010

February

INFLATION REPORT

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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 NBS prepares and publishes quarterly *Inflation Reports* as its main communication tool. The *Inflation Report* provides key economic facts and figures that shape the MPC'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 analysis of underlying macroeconomic developments. It also seeks to explain reasoning behind MPC's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this Report is inflation projection for at least four 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 task of the NBS.

The February *Inflation Report* was adopted by the NBS Monetary Policy Committee in its meeting of 22 February 2010.

Earlier issues of the *Inflation Report* are available on the NBS website (http://www.nbs.rs).

Monetary Policy Committee of the National Bank of Serbia:

Radovan Jelašić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

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I. Overview

In 2009, which is the first year of operating a fully fledged inflation targeting regime in Serbia, inflation moved within the target band, save in October and November when it fell below the lower bound of the target range.

The culmination of the global economic crisis marked the first year of operating a fully fledged IT regime in Serbia. Inflation moved within the target band throughout the year, save in October and November when it fell below the lower bound of the target range. The Q4 consumer price growth was low, especially growth in market-based prices, owing to low aggregate demand and decline in food prices resulting from good agricultural performance. Inflation retreated within the target range in December, and measured 6.6% at year-end.

Low aggregate demand will continue to be the key disinflationary factor.

Household spending plunged further in Q4 despite lessened decline in sources of household income. Government spending however went down primarily on account of the freeze on wages in state administration. The slower y-o-y decline in investment spending in Q4 is in large part attributable to its abrupt curtailment in late 2008. The impact of lower domestic demand on economic activity was only partly neutralised by the growth in exports. It is expected that the domestic demand will remain the key disinflationary factor given the expected continuation of the freeze on public sector wages, minor growth in real wages of the enterprise sector and a modest pick-up in lending activity.

In an environment of global economic crisis, the drop in GDP and the decline in employment in Serbia were moderate compared to those recorded by other countries.

Low domestic demand and limited capacity to expand exports were the main factors behind movements in GDP. Economic recovery is estimated to have slowed down in Q4. Continued deceleration of the y-o-y decline in real GDP however is in large part attributable to the precipitous drop in economic activity in late 2008.

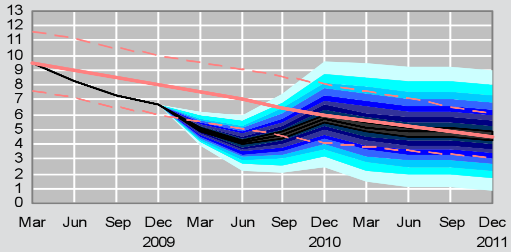
Monetary policy implemented in Q4 was more expansionary.

As announced in the previous Report, and in accordance with inflation projection and subsiding inflationary pressures, the NBS continued easing its monetary policy stance – after October and November downward revisions by 100 basis points each, the key policy rate was cut by another 50 basis points in December. Coupled with the depreciation of the dinar and slower growth in domestic relative to eurozone prices, this resulted in an increase in monetary policy expansiveness.

The weakening of the dinar in late 2009 and early 2010 is estimated to have been largely seasonally-induced.

After an extended period of almost no change in value, the dinar depreciated in late 2009 and early 2010. Such movements were caused by a seasonal increase in

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



enterprise demand for foreign exchange needed to settle foreign liabilities due, as well as by higher end-of-year foreign trade deficit and government spending. Though the national currency weakened in the period under review, the foreign exchange liquidity position of the banking sector remained comfortable. Net capital inflow from abroad was more than sufficient to cover the current account deficit (record low in 2009 - 5.7% of GDP), but did not fully reflect on the forex market as banks preferred to use ample foreign exchange liquidity to replenish their reserves.

Inflation is likely to move below the lower bound of the target tolerance band in H1 2010, and to retreat gradually to the target by end of year.

In the first three quarters of 2010, inflation will revolve around the lower bound of the target tolerance band, most probably undershooting it in the first half of the year. By-end 2010 and throughout 2011, inflation is expected to revolve around the target. Though the weakening of the dinar has generated some inflationary pressures over the past several months, with aggregate demand low and public sector wages and pensions frozen, a threat to price stability is insignificant.

Key risks to the projection are the exchange rate pass-through to inflation (short-term) and the speed of economic recovery (medium-term). Another source of medium-term risk are food prices, which explains why the projection band is mildly asymmetric to the upside from Q3 2010 onwards.

The key short-term risk to inflation projection is the exchange rate pass through to inflation against the backdrop of markedly low aggregate demand. In the medium run, the highest degree of uncertainty is associated with the pace of economic recovery that will in large part determine the strength of demand-side (dis)inflationary pressures. There is also a possibility of a significant increase in food prices amid gradual recovery of the global and domestic economies and the potentially weaker agricultural performance this year, which explains why the projection band from Q3 2010 onwards is mildly asymmetric to the upside.

The key policy rate is more likely to be lowered in the coming period than kept on hold.

Based on the current inflation projection and the underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (9.5%). However, the lowering of the key policy rate will be considerably slower than in the prior period. Should inflationary pressures prove stronger than anticipated, the process of monetary easing may be even halted for a while.

II. Monetary policy since the November *Report*

The degree of monetary policy expansiveness increased in Q4 as a result of further lowering of money market interest rates and opening of the depreciation gap of the real exchange rate.

In deciding on the level of the key policy rate in Q4 2009, the NBS Monetary Policy Committee was guided primarily by the aim of achieving the target inflation rate in the second half of 2010. It was clear already in September that monetary policy neither should nor would be able to respond to the expected temporary deviation from the target in October and November (caused by the lower-than-expected growth in food prices) and that inflation would retreat within the target band in December.

As announced in the previous *Report*, and in accordance with inflation projection and subsiding inflationary pressures, the NBS continued easing its monetary policy stance – after the October and November downward revisions by 100 basis points each, the key policy rate was cut by another 50 basis points in December (to 9.5%).

The MPC's decision to continue lowering the key policy rate despite a mild increase in inflation expectations, strengthening of depreciation pressures and adoption of the budget revision for 2009 was based primarily on the persistently strong disinflationary effects generated by domestic demand. With the announced freeze on public sector wages, very low real wage growth in the corporate sector and further year-on-year decline in retail trade turnover, domestic demand is expected to remain the key disinflationary factor in the coming period.

The MPC's decision was also underpinned by lower inflation growth, which is expected to reflect on (lower) year-on-year inflation in 2010 and increase the likelihood of undershooting the 2010 target.

In the last quarter of 2009, the NBS intervened twice in the foreign exchange market. Both interventions were geared at preventing excessive volatility of the exchange rate. The first intervention took place on 4 December because of banks' attempted arbitrage, and the second on 30 December amid a glut of dinar liquidity at the close of the year. In January 2010, in the midst of seasonally increased foreign exchange demand, the NBS intervened again few more times, but only in order to prevent excessive volatility of the exchange rate of the dinar and to ensure smooth operation of the forex market.

In addition, the NBS changed the currency proportions of required reserves for banks signatories to the Vienna Agreement by increasing the foreign currency component of reserves allocated under foreign currency reserve requirements from 70% to 80%.

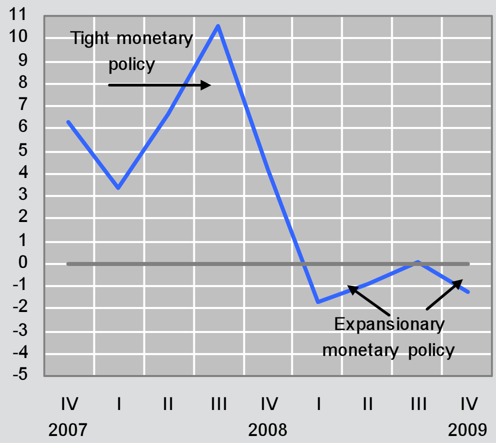
In the last three months of 2009 the MPC took no other measures for regulating bank liquidity or keeping inflation on target.

At the close of the year the MPC adopted the trajectory of inflation targets until 2012 consistent with the need to achieve medium-term price stability and anchor inflation expectations. Inflation targets for 2010 and 2011 were not changed from their previously determined levels. What was changed, however, is the way they are defined: they are no longer formulated in terms of bands, but rather as points with a tolerance band in order to enable a more effective communication with the general public (6±2% for 2010 and 4.5±1.5% for 2011).

The monetary policy stance is determined not only by the character of the decisions taken by the monetary authorities, but also by how market participants respond to them. Judging by the movements of the real MCI[1], monetary policy shifted away from the almost neutral stance in Q3, and resumed expansionary character in Q4.

Depreciation gap of the real exchange rate – one of the two MCI components – opened in Q4 as a result of 1.3% nominal depreciation of the dinar and slower growth in domestic relative to euro zone prices.

Chart II.0.1 **Monetary Conditions Index**

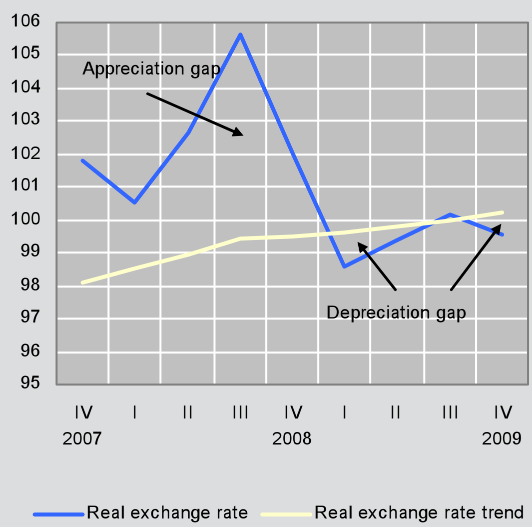


Monetary policy stance was expansionary.

The second MCI component – real interest rate on two-week BELIBOR – moved below the neutral level in Q4. Its trend declined amid further decline in the country risk premium and record low interest rates abroad. As the trend decline was sharper than the decline in the rate itself, the inflationary effects generated by the real interest rate were weaker than a quarter earlier. Further lowering of inflation expectations eased the decline in real interest rate despite the fact that interest rates in the interbank money market decreased.

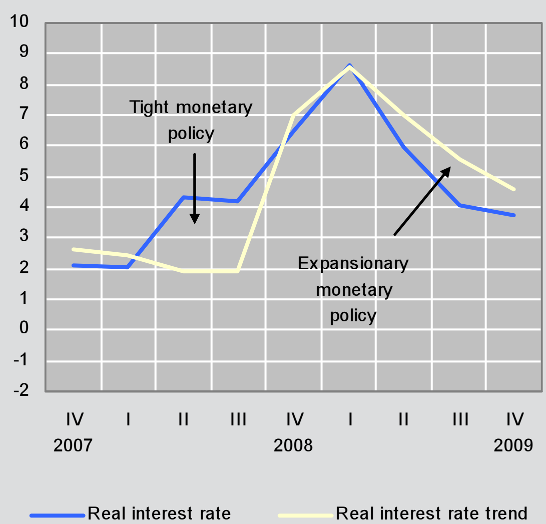
Based on the current inflation projection and its underlying risks, the key policy rate is more likely to be lowered in the coming period than kept on hold (9.5%). However, the pace of lowering of the key policy rate will be considerably slower than in the prior period, and if inflationary pressures prove stronger than anticipated, the process of monetary easing could even be halted for a while. According to the results of the February Reuters survey, the financial sector expects the key policy rate to equal 9.3% in April.

Chart II.0.2 **Real exchange rate and its trend**
(base index)



Depreciation gap of the real exchange rate opened in Q4.

Chart II.0.3 **Real interest rate and its trend**
(in %)



Real interest rate was running below the trend.

[1] Real Monetary Conditions Index.

III. Inflation developments

The NBS has achieved its objective defined by the Monetary Policy Programme for 2009. Inflation moved within the target band throughout the year save in October and November when it slid below the lower bound of the target. It was however higher in Q4 as a result of rising agricultural product prices, whilst market determined prices remained flat.

It is estimated that inflation in Q1 2010 will move below the lower bound of the tolerance band.

Inflation developments in Q4

Q4 inflation was much lower than expected mainly due to continued low aggregate demand.

Consumer price growth was markedly low in Q4 (0.4%) mainly on account of falling food prices and disinflationary effects of (low) aggregate demand. Consumer prices declined in October and December in response to falling food prices, whereas their November rise was caused by higher growth in agricultural product prices.

Q4 inflation stayed below the estimated level, mainly on account of lower than expected growth in agricultural product prices, a decline in processed food prices and slower regulated price growth as some of the announced price increases were put on hold.

Y-o-y consumer price growth in October and November was below the lower bound of the target, but retreated within the target band (6-10%) in December and reached 6.6% at the year-end.

The outturn for all three components of headline inflation, most notably agricultural product inflation, was lower than anticipated at the time of the November Report.

Q4 core inflation (0.2%) was however lower than in Q3. The last quarter saw a slowdown in monthly growth rates, leading to negative core inflation (–0.1%) in December for the first time in the year. This was largely accounted for by a 1.1% cut in processed food prices, prompted by low prices of primary agricultural products. This price correlation is best illustrated by the example of fresh meat and sunflower oil – the prices of these products fell the most owing to good maize and sunflower harvest yields (joint contribution to core inflation of –0.5 pp). Not counting in food prices, core inflation rose by 1.2%, which is slightly less than a quarter earlier. Despite depreciation pressures in Q4, the lowest core inflation outturn (food excluded) for the year as a whole was recorded in December. End-2009 core inflation reached 4.1% y-o-y.

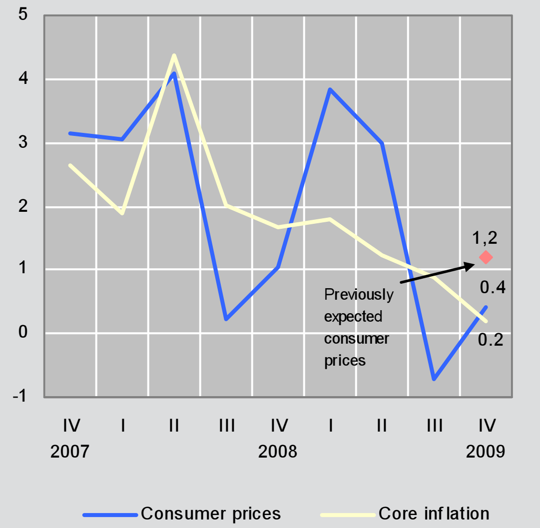
The 2009 quarterly regulated price growth slowed further, reaching 0.5% in Q4. Growth in petroleum product prices, although lower than expected, had a decisive influence on regulated price movements. By contrast, prices of medicaments, utilities and bread declined. Total regulated price growth in 2009 came to 15.5%, slightly above the agreed rate for this product group (13±2%).

Table III.0.1 **Price indicators**
(growth rates, in %)

	III 2009 / III 2008	VI 2009 / VI 2008	IX 2009 / IX 2008	XII 2009 / XII 2008
Consumer prices	9.4	8.3	7.3	6.6
Core inflation	10.2	6.9	5.7	4.1
Retail prices	9.9	9.8	9.5	10.4
Cost of living	9.1	7.8	7.1	6.6
Industrial producer prices	4.9	6.6	5.3	7.4
Agricultural producer prices	0.2	-9.4	-8.9	-4.8

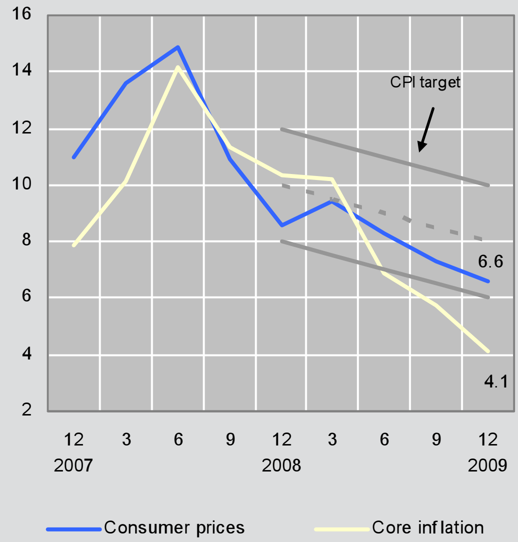
Most price indicators point to a lower y-o-y price growth at end-Q4 relative to the previous three quarters.

Chart III.0.1 **Price movements**
(quarterly growth, in %)



Q4 headline inflation rose while core inflation continued to decelerate. Growth in headline inflation was spurred by rising agricultural product prices.

Chart III.0.2 **Price movements**
(y-o-y growth, in %)



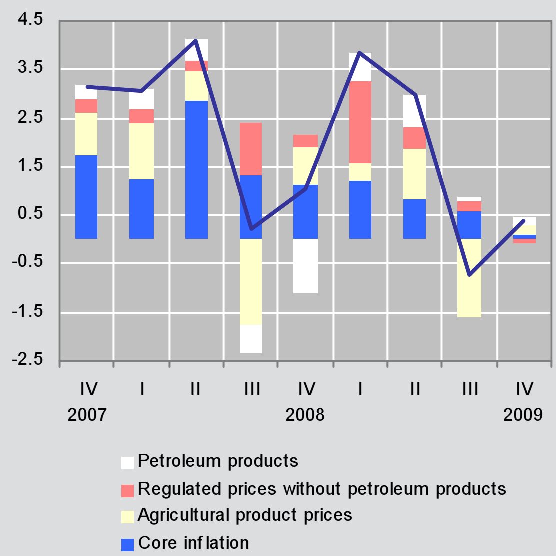
Y-o-y growth in headline and core inflation continued decelerating, while core inflation was much lower.

Table III.0.2 **Consumer price growth by component**
(by quarter, in %)

	2008	2009			
	Q4	Q1	Q2	Q3	Q4
Consumer prices	1.1	3.8	3.0	-0.7	0.4
Core inflation	1.7	1.8	1.2	0.9	0.2
Prices of agricultural products	11.4	4.7	13.1	-18.5	2.7
Regulated prices	-3.1	9.1	4.4	1.1	0.5
Electricity	0.0	0.0	0.0	0.0	0.0
Petroleum products	-24.2	16.9	17.9	2.3	3.5
Gas for households	55.6	-0.8	0.1	0.0	0.2
Utilities	4.5	12.8	3.1	6.0	1.0
Social welfare services	2.9	0.9	1.8	3.3	8.7
Transport services (regulated)	0.4	26.6	0.4	0.0	0.1
Postal and telecommunications services	0.7	10.1	0.0	1.9	0.0
Bread	-0.8	-0.7	-4.1	0.6	-2.8
Cigarettes	0.0	15.0	0.0	0.0	0.0
Medications	-3.2	10.1	10.3	-1.3	-2.7
Other	0.0	0.7	9.7	0.1	0.0

The sharpest rise in Q4 was recorded with prices of agricultural products, social security services and petroleum products.

Chart III.0.3 **Contribution to quarterly consumer price growth**
(in percentage points)



Contribution of all inflation components to overall consumer price growth was generally similar, whilst contribution of regulated prices (petroleum products excluded) turned negative.

Owing to the good harvest results and prolonged season, growth in agricultural product prices (2.7%) was much lower than expected (9.4%). In December y-o-y, agricultural product prices fell by 1.0%.

Total 2009 consumer price growth (6.6%) was driven in particular by rising regulated prices and core inflation (3.9 pp and 2.8 pp respectively), whilst agricultural product prices gave a negative contribution (–0.1 pp). As regards regulated prices, their total annual growth was fuelled mainly by prices of petroleum products, utilities and housing services, cigarettes and medicaments. Of total contribution of core inflation to y-o-y consumer price growth, 2.4 pp came from growth in prices of non-food products and services, whereas the contribution of processed food prices was a mere 0.4 pp.

Inflation expectations

One-year ahead inflation expectations eased from a quarter earlier, but remained higher compared to targeted inflation.

As indicated by the Strategic Marketing survey, one-year ahead inflation expectations of the majority of sectors edged down from end-Q3. Relative to November, inflation expectations of the financial and corporate sectors in December picked up to some extent.

However, following the announcement of low December inflation, expectations of the financial sector for January and February declined further both for the corporate and trade union sectors, while those of households remained unchanged from September 2009.

According to the Reuters survey, inflation expectations of the financial sector continued declining over the September-January period, but rose in February.

As indicated by the Strategic Marketing survey, one-year ahead expectations of the financial sector are on the upper bound of the tolerance band (7.8%), while the Reuters survey places these expectations above the target (6.8%).

Expectations for Q1 2010

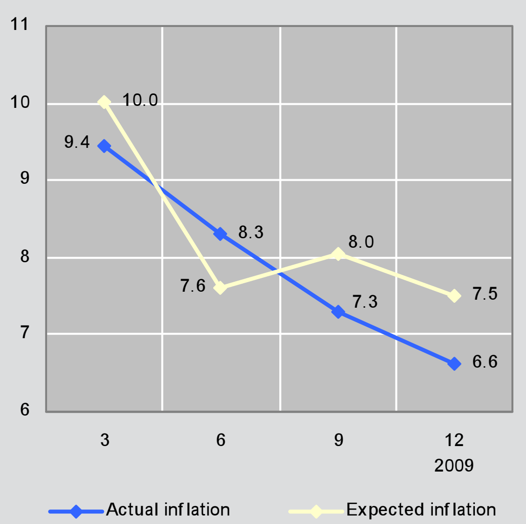
Q1 inflation will probably move below the lower bound of the target tolerance band.

Q1 inflation is expected to move below the lower bound of the target, reaching around 5% y-o-y at end-March (March target being 7.5±2%). Consumer price growth will come to around 2.2% mainly in response to the rise in regulated prices (contribution of 1.6 pp). Agricultural product and market-determined prices are likely to give equal contribution to headline inflation.

Q1 core inflation will probably increase from a quarter earlier. Disinflationary effects of food prices are expected to persist as well. On the other hand, a rise in import prices, prompted by depreciation of the dinar, will exert inflationary pressures, although no significant price hikes are to be expected against the backdrop of low demand.

The rise in regulated prices in Q1 is expected at around 6%, most notably in respect of cigarettes, electricity, utilities and housing services and petroleum products. Cigarette and petroleum product prices will be raised in line with the regular annual adjustment for inflation of excise tax rates on these products, while petroleum product prices will be further raised in line with movements in world prices of crude oil. Housing and utilities prices are likely to go up on the back of higher heating prices.

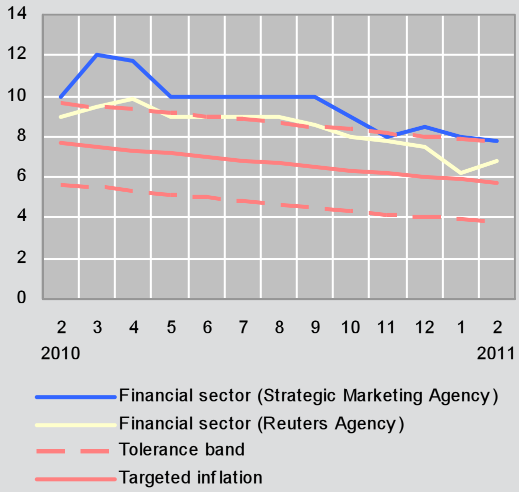
Chart III.0.4 **Expected* and actual inflation**
(y-o-y growth, in %)



*NBS expectations.

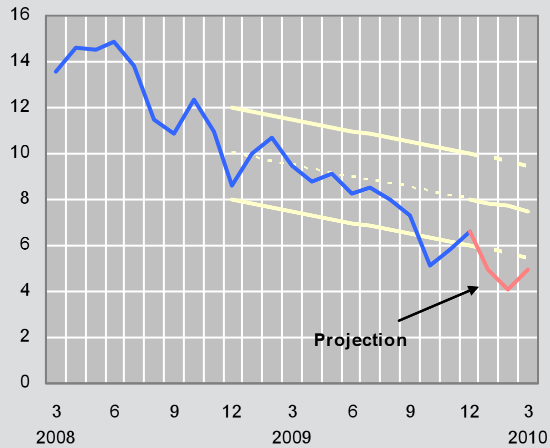
Q4 inflation was lower than expected due to lower agricultural product price growth.

Chart III.0.5 **One-year ahead expected and targeted inflation**
(in %)



One-year ahead inflation expectations of all sectors are on the decline.

Chart III.0.6 **Short-term inflation projection**
(y-o-y growth, in %)



Y-o-y inflation is likely to fall in Q1 and revolve below the lower bound of the target.

Table III.0.3 **Major revisions of regulated prices expected in Q1**

	Growth rate (in %)	Contribution to retail price growth (p.p.)
Electricity	11.5	0.7
Cigarettes	12.2	0.5
Utilities and housing services	5.3	0.2
Petroleum products	2.8	0.1

Regulated price growth is expected to be much higher than in a quarter earlier.

Growth in agricultural product prices is estimated to display a customary seasonal dynamics.

Except for the exchange rate, other factors of inflation continue to produce disinflationary effects. Low demand, public wage and pension freeze and declining inflation expectations are likely to contribute to price stabilisation in the coming period.

The degree to which producers and traders will be able to pass through the effect of depreciation to end-consumers against the backdrop of weak demand remains the key uncertainty in the short run.

A year into fully-fledged inflation targeting – the NBS's objective for 2009 achieved

Many central banks adopted inflation targeting as a pragmatic response to the failure of other monetary policy regimes. Acceptance of the concept that permanently high inflation rates lead to lower economic growth and higher unemployment supported the introduction of the regime and marked a move away from monetary policy as a tool for short-term demand management (or fine tuning) to a focus on the medium-term goal of price stability, which lies at the heart of inflation targeting. Although gradually introduced into practice from 2006, it was only in 2009 that fully-fledged inflation targeting became the National Bank of Serbia's official monetary policy strategy.

One year being too short a period for assessment of the new monetary strategy, the first results are rather encouraging especially in light of the intensification of the global financial crisis in 2009. Inflation moved within the target band throughout the year, save in October and November when it slid below the lower bound of the target. Inflation retreated within the target range in December and measured 6.6% at year-end. Furthermore, a drop in GDP and employment, in the midst of the crisis, was more moderate when compared to other countries (most notably those with fixed exchange rate pegs). The advantage of an inflation targeting regime in such adverse conditions has proved to be its inherent flexibility, i.e. a central bank's ability to combine elements of both "rules" and "discretion" in monetary policy. Inflation targeting is a framework rather than a rigid set of rules for monetary policy, its essential elements being: (a) a numerical target for inflation in the medium term and (b) discretion in responding to economic shocks in the short term, i.e. the question of the need for reacting to shocks and the speed at which a central bank will bring inflation back to target.

Having contributed to the achievement of the inflation target and a relatively moderate decline in GDP in 2009, the new monetary strategy of the National Bank of Serbia helped anchor inflation expectations at a lower level. The effects of monetary policy decisions on expectations of the financial, corporate and household sectors have become the very focus of the National Bank's consideration. Albeit still high and above the target, inflation expectations of all sectors declined in 2009 by around 2 percentage points. Aware of the importance of inflation expectations for monetary policy and the fact that their reduction is a process that depends on credibility, the National Bank continues to insist on its clear-cut mandate and independence which are, in an inflation targeting regime, enshrined in the central bank law. Furthermore, inflation targeting improves transparency and communication with the public, contributing to more effective anchoring of inflation expectations.

The new monetary policy strategy of the National Bank of Serbia provides for the institutional demarcation of inflation-control functions between the National Bank and the Government. The efforts of the Government are thus more streamlined to the achievement of inflation targets. There is no disputing that the achievement of inflation targets entails accountable fiscal policy and adherence to the planned regulated price growth. Market-determined prices fall under the remit of the National Bank, unlike regulated prices that are directly or indirectly set by the Government. In order to react pre-emptively and warn of any deviations from the target, the National Bank has kept and will continue to keep a watchful eye on fiscal policy and regulated price movements. The planned regulated price growth for 2009 was accomplished – it came to 15.5%, only slightly above the target (13%±2 pp).

The advantages of an inflation targeting regime also include a floating exchange rate which is consistent with inflation targeting and represents a self-correcting mechanism that efficiently absorbs shocks. Moreover, inflation targeting contributes to a reduction in the exchange rate passthrough, better understanding of the monetary policy transmission mechanism, development of a clear analytical basis and the forecasting process, all of these elements being indispensable in the monetary policy decision-making process.

IV. Inflation determinants

1. Money market developments

Interest rates

A reduction in the key policy rate prompted a fall in all money market interest rates. Lower bank interest spreads at the end of the period resulted from a sharper cut in lending relative to deposit rates.

A reduction in the key policy rate in Q4 prompted a fall in all money market interest rates.

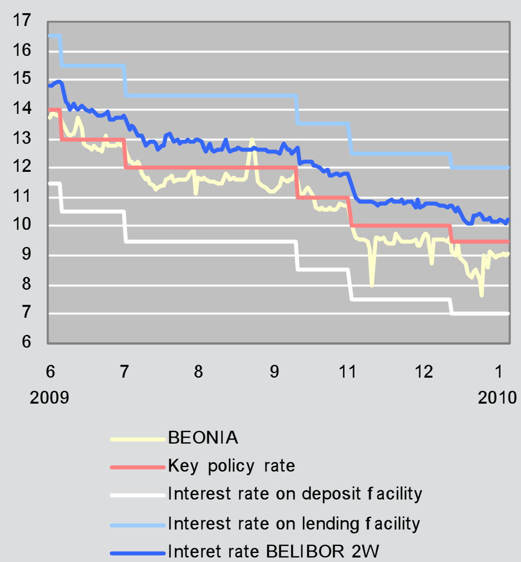
The BELIBOR rate declined almost evenly for all maturities, averaging in December between 10.5% for overnight and 11.2% for six-month maturity. The downward trend in BELIBOR continued into January.

BEONIA, the interest rate on overnight interbank loans also declined in Q4 and came to 9.5% p.a. in December. A sharper cut in BEONIA relative to the decline in the key policy rate was induced by an increase in bank liquidity. The average daily turnover, down by 12.5% from Q3, reached RSD 5.9 billion in Q4.

A reduction in BEONIA was particularly pronounced in the first half of January, which can be ascribed to a surge in transaction deposits with some banks resulting from employee compensation payments from the Privatisation Register. The average value of BEONIA was 8.7% p.a. in January.

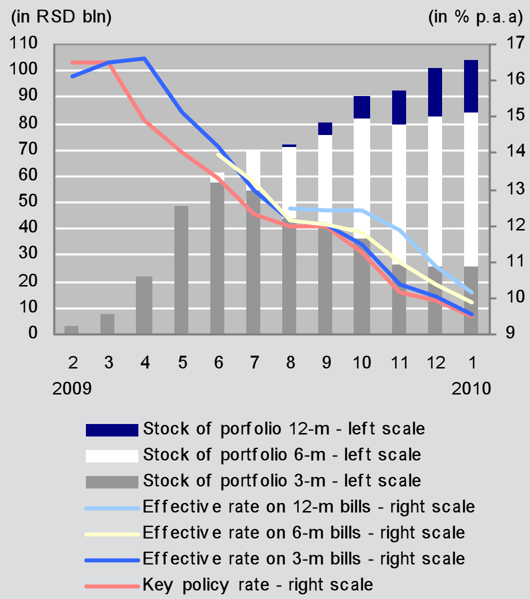
High correlation between interest rates on safe securities was also evident in Q4[2]. Interest rates of T-bills

Chart IV.1.1 **Interest rate movements**
(daily data, p.a, in %)



Ample bank liquidity in Q4 impacted on a steeper decline in BEONIA than in the key policy rate.

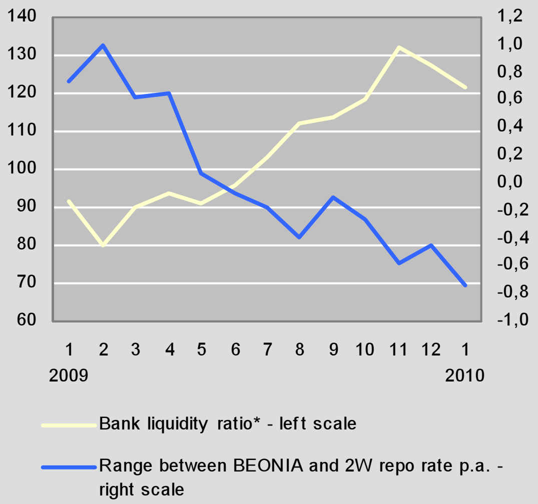
Chart IV.1.2 **Effective rates on T-bills and stock of portfolio**



A cut in the effective rate on T-bills did not impact on the stock of portfolio.

Chart IV.1.3 **Bank liquidity and range between BEONIA and the key policy rate**

(in RSD bln)

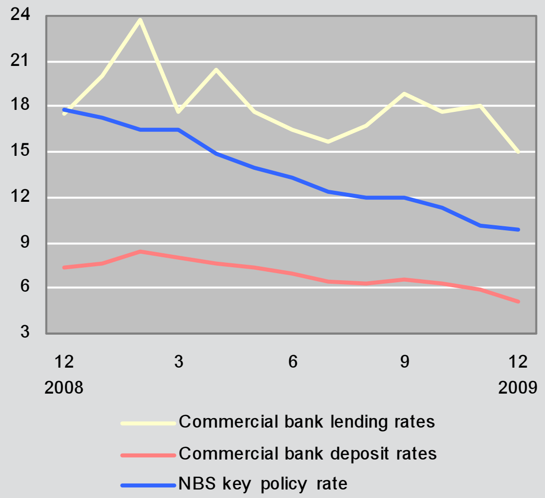


* Bank liquidity is calculated as a ratio of bank average liquid assets (free reserves, repo stock with the NBS and net purchase of T-bills in the current month) and transaction deposits.

BEONIA declined more sharply than the key policy rate.

Chart IV.1.4 **NBS key policy rate and commercial bank interest rates***

(weighted average, p.a, in %)



* Lending interest rates refer both to foreign currency-indexed and dinar loans.

Lower bank interest spreads at end-2009 resulted from a sharper cut in lending relative to deposit rates.

increasingly converged to the key policy rate – at the most recent January auctions, the effective interest rate on three-month T-bills fell to the level of the key policy rate, while deviations of the effective rate on six-month and one-year bills from the key policy rate equalled at most 18 and 59 basis points respectively. Much lower rates of return on government bills did not however diminish their attractiveness. At all auctions since 16 September stocks of T-bills were sold out in full. Still, in January the composition of buyers shifted in favour of banks.

The Government's decision to limit the issue of bills to RSD 5 billion per week (the issue of three- and six-month bills came to RSD 2 billion each, while one-year bills came to RSD 1 billion) influenced movements in effective interest rates. Ample bank liquidity and a limited possibility to invest in T-bills suggest that movements in the effective interest rate in the coming period will be driven mainly by movements in the key policy rate.

According to the preliminary auctions schedule, until end-2010, the Government will engage in the weekly issue of bills in the nominal value of RSD 5 billion (RSD 260 billion for the whole year). As no significant reduction in risk premium on corporate and household loans is expected, banks will probably continue to invest sizeable funds in safe securities.

Following their rise during the Savings Week, bank deposit rates declined in December to 5.1% on average. Namely, more expensive sources of domestic finance in early Q4 induced an increase in the level of lending rates in October and November. In December however the weighted average interest rates on corporate and household loans declined by almost 300 basis points, which can be attributed to the level of approved subsidised loans, as well as to a decline in current account overdrafts. Such movements in interest rates led to a decline in interest spread that came to 10% at end-December.

[2] In 2009, the weighted average interest rate on T-bills and repo operations (February-December 2009) equalled 12.92% and 12.36% p.a. respectively.

Monetary aggregates

Demand for money was up throughout the year, most notably in Q4, which is indicative of moderate economic recovery.

Following a decline over two previous quarters, reserve money went up in Q4 by 10.9% in real terms. Throughout the quarter, reserve money creation was effected against foreign exchange transactions and the withdrawal through the dinar channel.

In addition to regular inflows, NBS foreign exchange reserves were boosted by IPA funds (EU 50 million) and funds that the Government received from domestic banks for budget deficit financing purposes (EUR 89.4 million). These funds, together with the SDR allocation received in Q3 (EUR 424.6 million), were converted into dinars and in their major part kept in Government accounts with the NBS. This helped neutralise the effect of reserve money creation via the foreign exchange channel. However, the Government spent a sizeable amount of these funds over the last three days of December, thereby boosting the banking sector's liquidity and exerting additional pressure on the exchange rate of the dinar.

Regardless of the two cuts in the key policy rate, investment in repo securities remained attractive. Spurred by changes in currency proportions of required reserves, the repo stock rose by RSD 25.4 billion in October and November. December however saw a decline in investments in repo securities (by RSD 33.7 billion) on account of banks' higher end-of-year demand for liquidity. Banks kept the majority of assets so released in their gyro-accounts.

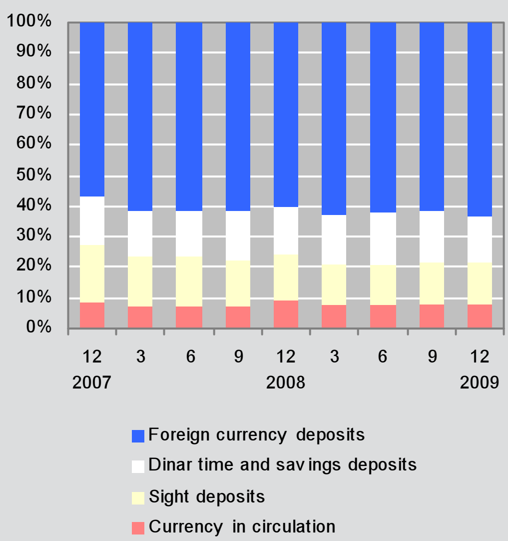
Monetary aggregates rose in Q4. Relative to Q3, M3 rose by 10.7% (10.3% in real terms), mainly in response to growth in foreign currency deposits (8.9 pp). A significantly lower contribution came from currency in circulation and demand deposits (1.4 and 1.2 pp), whereas the decline in dinar term deposits was negligible.

Monetary aggregates grew in y-o-y terms as well. Relative to end-2008, M3 and M2 rose in real terms by 13.7% and 3.6% respectively, while M1 recorded a positive growth of 0.5% for the first time in quite a while.

Bank lending activity provided the strongest impetus to M3 growth (4.8 pp). The Government's contribution was negative – the effect of sale of T-bills and borrowing with domestic banks (2.7 pp) was counterweighted by the retention of government dinar assets in accounts with the NBS (–3.6pp).

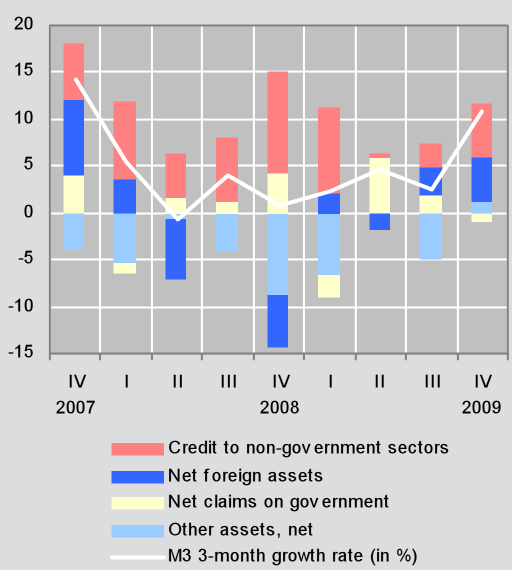
The growth in foreign currency savings of households had the strongest impact on rising foreign currency deposits with banks (over 90%). In November, the Savings Month,

Chart IV.1.5 **M3 Composition**



Share of foreign currency deposits in M3 was further supported by rising foreign currency household savings in Q4.

Chart IV.1.6 **Contribution to M3 growth**
(in percentage points)



Bank lending activity gave the greatest contribution to M3 growth.

household foreign currency savings reached their September 2008 levels, only to rise to EUR 6 billion by the year-end.

The disbursement of privatisation-related employee compensations had an impact on the maturity structure of deposits – term deposits (of financial institutions) declined and balances on current accounts of households went up. Though historically enterprises tend to keep substantial balances in their current accounts at the year-end, this year however they placed their excess funds in savings accounts.

Reserve money supply has been on the decline since early January 2010. Most of the dinar liquidity was withdrawn via IFEM interventions and open market operations. The decline in currency in circulation and current account balances induced a decline in M1 and M2, whereas M3 remained unchanged from end-2009 due to a rise in foreign currency deposits.

Bank lending

Lending activity picked up in line with moderate economic recovery in H2. Net repayment of foreign debt by enterprises continued.

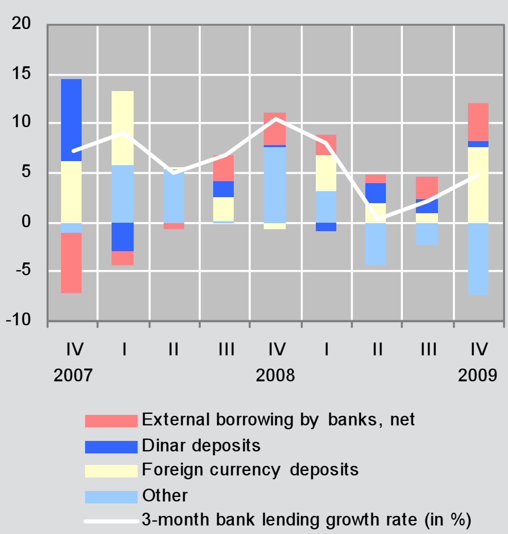
A pick-up in lending activity from Q3 continued into Q4 – the real growth in corporate and household lending reached 1.8% and 2.5% respectively.

A y-o-y slump in lending also came to an end amid emerging signs of economic recovery. The recovery in lending activity in Q4 was in line with slower economic downturn in Q3 as cyclical economic movements precede cyclical movements in lending activity.

Bank lending was funded in large part from domestic sources, most notably with foreign currency deposits (contribution of 7.7 pp), and to a lesser extent by foreign borrowing. Foreign currency deposits rose by around EUR 704.3 million in Q4, fuelled by a rise in foreign currency household savings (EUR 669.3 million). Banks stepped up their foreign borrowing relative to Q3 (EUR 396.8 million) but it seems likely that the majority of the newly borrowed funds were placed in accounts with the NBS to cover the increased foreign currency component of required reserves.

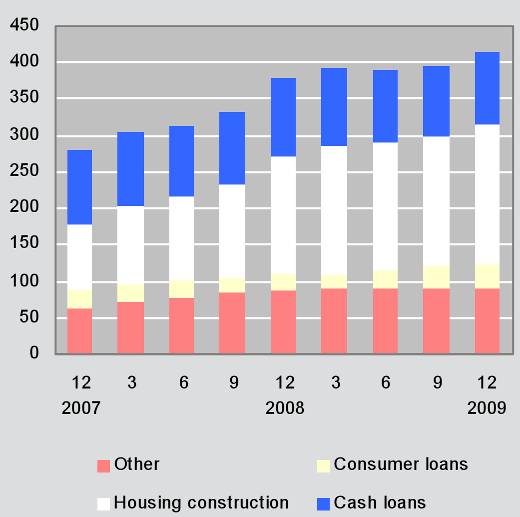
Bank lending to the corporate sector intensified in the course of Q4. However, as a portion of old receivables was written-off in December, the results show a lower than the actual level of growth in loans extended to enterprises. The real growth in lending to the enterprise sector (excluding the effect of depreciation) came to

Chart IV.1.7 **Contribution to bank lending growth**
(in percentage points)



Banks financed lending activity mainly from collected foreign currency savings.

Chart IV.1.8 **Composition of loans extended to households**
(in RSD bln)



The strongest growth was recorded with housing loans, while current account and credit card overdrafts declined.

around RSD 18.5 billion. Liquidity loans remained dominant in the newly approved loans. Much weaker prevalence of loans for capital investments indicates that the maintenance of current liquidity remains the key concern in enterprise operations.

As in previous period, enterprises continued reducing their foreign liabilities – their net debt repayment came to EUR 53 million (around RSD 5 billion).

Household loans were up by RSD 19.6 billion, of which the real loan growth was RSD 10 billion. As the share of foreign currency-clause indexed loans in total loans is quite significant (78%), as much as RSD 9.6 billion relate to the effect of dinar depreciation. The launch of government-subsidised housing loans resulted in the sharpest rise in housing loans relative to loans for other purposes, while contracted household spending triggered a decline in current account and credit card overdrafts.

In Q4, banks extended EUR 215.6 million (around RSD 20.4 billion) in government-subsidised loans, which points to a somewhat weaker activity in the subsidised segment of the market. This was due to the fact that funds earmarked for interest subsidisation of the most sought-after liquidity loans were spent already by mid-October. However, the extension of these loans continued into November and December from funds earmarked for other types of loans. The first disbursements of subsidised housing loans in October contributed EUR 13 million to credit growth (of total EUR 38 million approved). In 2010, banks will continue to extend both investment and subsidised loans, although under simplified and somewhat changed conditions to further encourage lending in dinars.

The share of NPLs in total loans stabilised at around 10% from August 2009, only to fall to 8.6% in December. The December contraction was due mainly to enterprise rescheduling of a portion of NPLs.

2. Movements in the foreign exchange market and the exchange rate

The dinar weakened against the euro in Q4 and trading volumes in the interbank foreign exchange market remained low. In December however the NBS intervened in the IFEM for the first time in nine months.

Remaining practically stable throughout Q2 and Q3, the dinar lost 1.3% on average in Q4. The weakening was most manifest in December (around 3% by end-period). During the quarter under review, the exchange rate moved between 92.9 and 96.6 dinars for one euro.

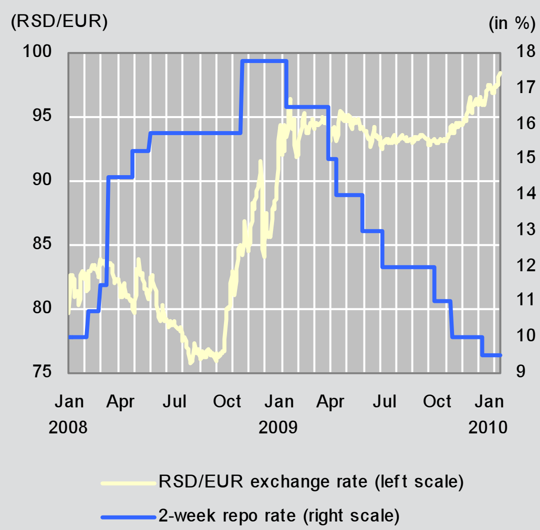
The above movements were caused by a seasonal increase in enterprise demand for foreign exchange needed to settle foreign liabilities due and by higher end-of-year foreign trade deficit. Further, Q4 witnessed a cut in the key policy rate (by 250 bp) and an increase in the foreign currency component of reserves allocated under foreign currency reserve requirements (from 70:30 to 80:20) for banks signatories to the Vienna Initiative. Dinar's depreciation was further fuelled by spending of budget reserve funds over the last few days of December (SDR allocation and IPA funds).

Though the national currency weakened in the period under review, the foreign exchange liquidity position of the banking sector was rather comfortable – banks continued borrowing abroad (mainly short-term) and purchasing sizeable amounts of foreign cash from exchange dealers. At the same time, an increase was recorded in foreign exchange household savings (in November – the Savings Month, they rose by almost EUR 0.5 billion).

Along with weakening of the nominal effective exchange rate of the dinar (3.3% end of period) and a slower growth in domestic relative to foreign prices, Q4 saw a real effective depreciation of the dinar by 3.4% (3.2% against the euro and 4.3% vis-à-vis the dollar).

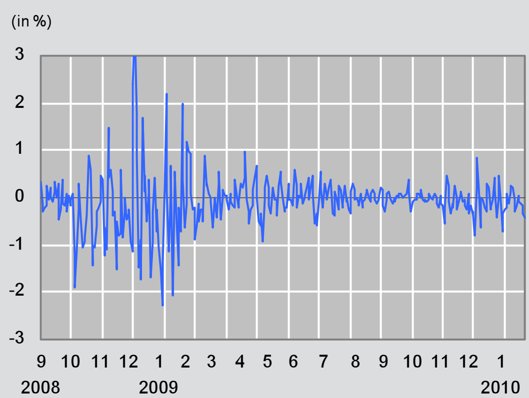
Albeit up from Q3, IFEM trading volumes remained markedly low – the average daily turnover was around EUR 30 million. In December, the NBS intervened twice, selling to banks EUR 100.5 million. It first intervened on

Chart IV.2.1 **Movements in RSD/EUR exchange rate and 2W repo rate**



Dinar's depreciation in Q4 was prompted by seasonal factors and further cuts in the key policy rate.

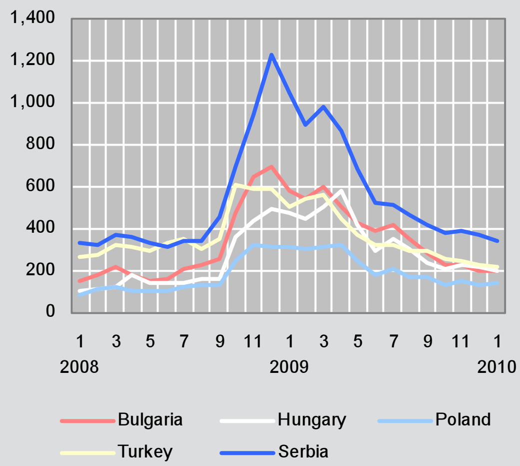
Chart IV.2.2 **Daily changes in RSD/EUR exchange rate***



* Negative rates indicate depreciation and positive rates appreciation of the dinar.

Daily volatility of the dinar vis-à-vis the euro was more pronounced.

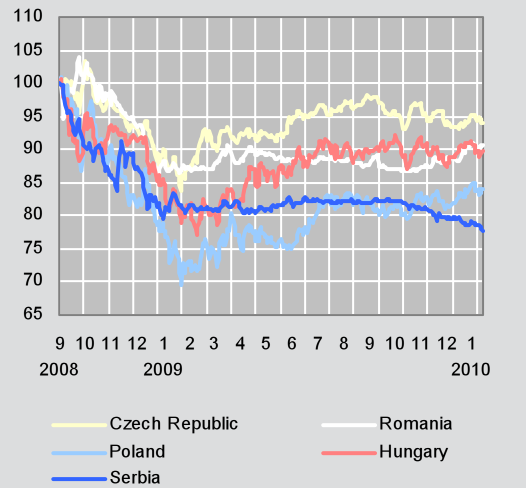
Chart IV.2.3 **Risk premium indicator – EMBI by country**
(monthly averages, in basis points)



Source: JP Morgan.

In Q4, a drop in risk premium in all countries observed slowed down.

Chart IV.2.4 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



The Polish zloty was the only currency that strengthened in Q4 (end of period).

4 December to prevent excessive volatility from the temporary mismatch between foreign exchange supply and demand and a sharp rise in bank quotations. On 30 December, the NBS continued its policy of intervening only to pre-empt disturbances resulting from a hike in bank dinar liquidity following adoption of the 2009 budget revision and increased budget payouts over the last three days of December.

Depreciation pressures continued into 2010, driven primarily by increased demand of bank clients for foreign currency. In order to preclude excessive fluctuations of the dinar and enable smooth operation of the foreign exchange market, the NBS intervened on several occasions in the course of January 2010 with EUR 245.5 million in total.

Neither in January nor in Q4 did banks show much interest in foreign exchange swap auctions introduced in May 2009 by the NBS as an additional measure of support to the country's financial stability.

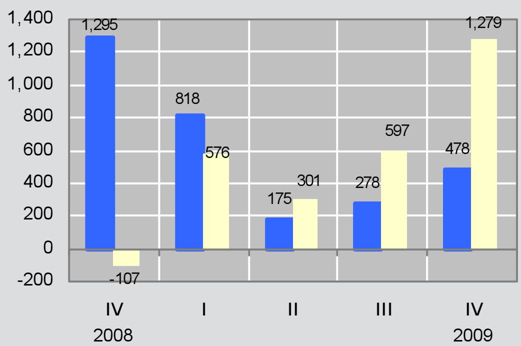
Risk premium, measured by EMBI, continued down, although at a slower pace than in Q3 as the index value returned to its pre-crisis level. The decline in the EMBI – from around 380 to around 330 index points since end-September, is likely to contribute to the alleviation of pressures on the domestic currency. At the same time, a slowdown in EMBI decline is evident in other transition countries as well. Since the second half of January, all countries saw an increase in risk premium.

As indicated by the January Strategic Marketing survey, one-year ahead inflation expectations of the financial sector place dinar's depreciation at around 6% (RSD/EUR 103.1 in January 2010). According to the February Reuters survey, the financial sector expects a 98.7 EUR/RSD exchange rate at end-March (depreciation of 1.4% relative to January).

Foreign capital inflow

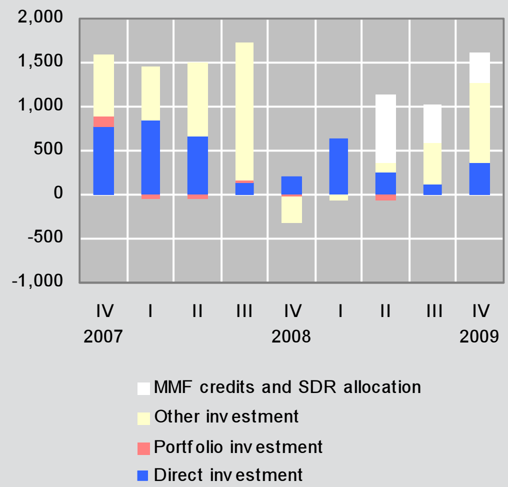
Net inflow on the capital and financial accounts in Q4 was more than sufficient to cover the seasonally wider current account deficit and ensure adequate level of foreign exchange liquidity.

Chart IV.2.5 **Current account deficit and net capital inflow**
(in EUR million)



Seasonally wider current account deficit was covered by much stronger capital inflows.

Chart IV.2.6 **Financial account structure**
(in EUR million)



A higher net capital inflow in Q4 was largely driven by inflows from financial loans.

The principal source of capital inflow in Q4 was external borrowing by banks of EUR 549 million (of which EUR 409 million short-term). The volume of restored foreign currency savings with the banking sector (following the withdrawal at end-2008) is estimated at EUR 560 million.

The bulk of the net FDI inflow of EUR 361 million was recorded in December on account of investments into "Fiat automobili Srbija", US Steel and mobile telephony.

A significant source of the financial account inflow was the disbursement of the second loan tranche under the current Stand-By Arrangement with the IMF (EUR 349 million).

On the other hand, net repayment of debts by enterprises continued, albeit at a slower pace than a quarter earlier, and amounted to EUR 53 million net.

Although net inflows on the financial account were more than sufficient to cover the current account deficit, a majority of capital inflows exerted no impact on the foreign exchange market, most notably inflows from short-term borrowing by banks, disbursement of the IMF loan and the portion of household savings that ended up in required reserves accounts with the NBS. At the same time, foreign exchange reserves of the NBS rose by EUR 1 billion, and ample foreign exchange liquidity enabled banks to replenish their reserves by EUR 307 million.

In January 2010, net repayment of debts by enterprises continued, while banks engaged in repayment of short-term loans taken in the prior period. Furthermore, a moderate inflow was recorded with foreign direct and portfolio investments, resulting in stronger depreciation pressures.

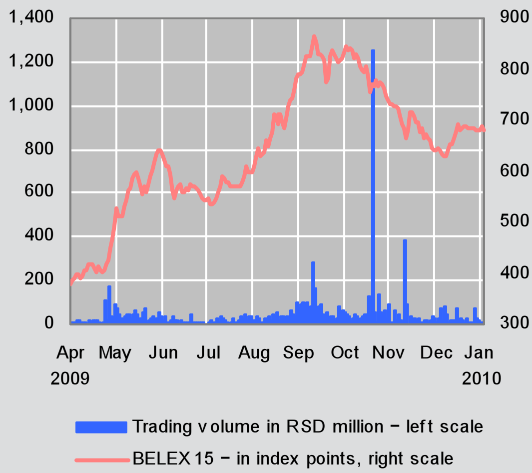
3. Capital market developments

The upward trend in both BSE indices ended in Q4, while the registered rise in trading volumes resulted from two individual transactions rather than from the increase in liquidity.

Both indices of the Belgrade Stock Exchange displayed negative movements in the last quarter of 2009 – BELEX 15 lost 19.6% and BELEX line 15.3%.

As the recovery of the global financial markets in Q3 was slower than anticipated, optimism deflated in Q4 and the value of trading at the BSE was lower than expected. As a result, following unreasonably strong growth in the

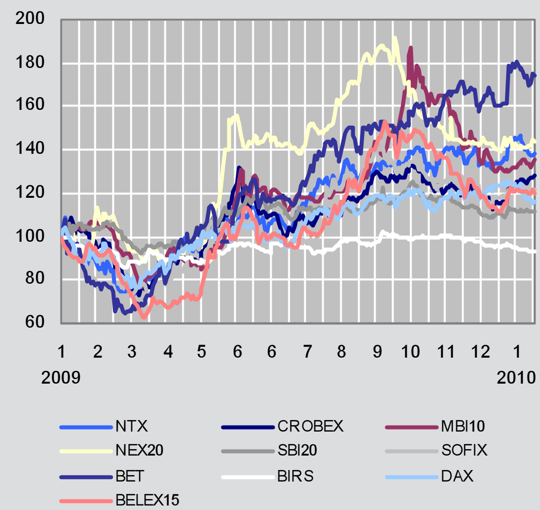
Chart IV.3.1 **Belex 15**



Source: BSE.

BELEX15 recorded a significant decline in Q4. The increase in total trading volumes was not a result of improved liquidity of the capital market.

Chart IV.3.2 **Stock exchange indices across the region**
(in index points, normalised, 31. 12. 2008 = 100)



All stock exchanges indices in the region, save the Bucharest Stock Exchange Index (BET) declined.

prior period, the prices of shares headed down. The decline in the value of shares was also occasioned by the announced re-introduction of the capital gains tax in 2010, as well as by the lower than seasonally expected growth in the value of shares in the closing months of the year.

Falling indices dragged the market capitalisation of the BSE down by RSD 32.4 billion to RSD 932.3 billion at year-end. In January 2010, market capitalisation plunged by additional RSD 57.6 billion due to the delisting of the shares of companies undergoing bankruptcy or liquidation proceedings.

According to official BSE data, the volume of trading in shares totalled RSD 23.2 billion, with the foreign investors' net share on the sale side equalling RSD 15.9 billion. Excluding block trade in the shares of Apatinska pivara[3], foreign investors' net share on the purchase side equalled RSD 475 million, and total volume of trading - RSD 6.9 billion. The rise in trading volumes relative to the previous quarter may also be put down to trading that took place on 4 November when RSD 1.2 billion worth of shares of AIK banka were purchased.

All stock exchanges in the region, save the Bucharest Stock Exchange (BET climbed 6.8%), underperformed in the last quarter. The steepest decline in the value of indices relative to the previous quarter was recorded in the Montenegrin stock exchanges – NEX 20 lost 21.7%, while MOSTE index shed 32.6%.

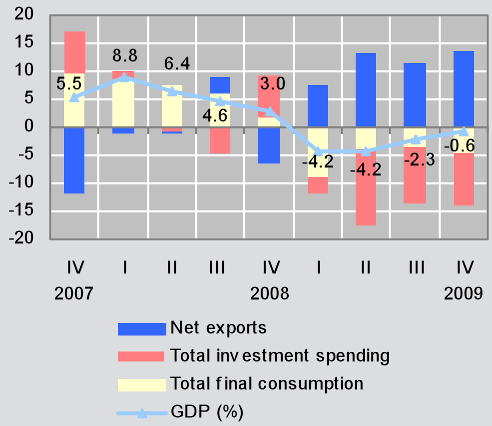
The volume of trading in frozen foreign currency savings bonds fell by 40% from Q3 to RSD 0.8 billion in Q4. Of this amount, the largest share (23%) was accounted for by the A2015 bond series. Average rate of return ranged from 5.03% for A2016 series to 5.63% for A2010 series.

4. Aggregate demand

A softer y-o-y decline in GDP in Q4 resulted from a decelerated decline in all GDP components except in total final consumption which recorded a further slump. Such movements were accompanied by slower contraction in domestic demand.

[3] Block trade in the shares of Apatinska pivara is classified in the category of sales to domestic legal entities, even though the end buyer was "CVC Capital Investment" – a foreign legal entity.

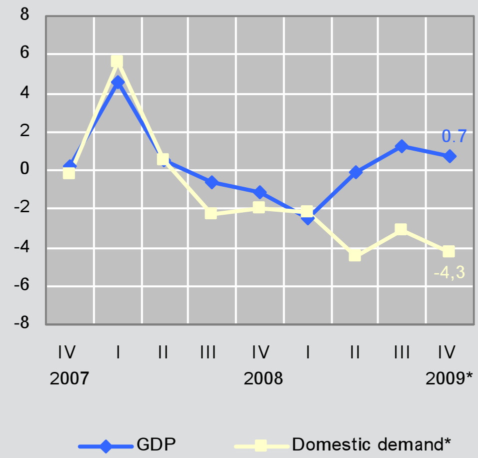
Chart IV.4.1 **Contribution to y-o-y GDP growth***
(in percentage points)



* NBS estimate.

Q4 is likely to see a more moderate y-o-y decline in GDP due to a slower decline in total investment spending and net exports.

Chart IV.4.2 **Growth in GDP and domestic demand**
(seasonally adjusted quarterly growth rates)



* NBS estimate.

A moderate GDP growth in Q4 was prompted by rising exports of goods and services.

A y-o-y decline in domestic demand in Q4 is estimated at 9.9%, contributing 14 pp to a fall in GDP. Of all components of domestic demand the sharpest drop was recorded for total investment spending (contribution of –9.3 pp) in response to a downturn in gross capital and government investment spending. The effect of dented domestic demand on GDP was only partly compensated by sharper exports, resulting in a positive contribution of net exports to y-o-y GDP growth (13.4 pp).

According to seasonally-adjusted data, domestic demand fell by 4.3% q-o-q (contribution of –5.4 pp). However, by contrast to y-o-y data, seasonally-adjusted household spending shows a smaller and investment spending a stronger decline relative to a quarter earlier. The decline in government spending was due to a real decline in current expenditure on goods and services and the lower wage bill (on account of the state administration pay freeze), while social transfers remained flat. Foreign trade deficit contracted by 24.4%, feeding through to the positive contribution of net exports to GDP growth of 6.1 pp.

The strongest contribution to economic growth in 2010 is expected from investment spending (2.4 pp), while a decline in total final consumption is likely to be smaller than in 2009 (contribution of –1.5 pp). According to our expectations, 2010 is likely to see a faster rise in exports than in imports (6% vs. 2.5% y-o-y), contributing 0.6 pp to the growth of the economy.

Domestic demand

Indicators of household spending

Despite a slower decline in domestic demand in Q4, a y-o-y drop in household spending accelerated, as indicated by further y-o-y contraction in retail trade and household income.

A decline in domestic demand slowed despite accelerated y-o-y contraction in household spending. In real terms, overall household income (wages, pensions and social transfers) fell by 4.6% relative to Q4 2008, mainly due to the real drop in wages. Pensions and social transfers remained almost unchanged.

A decline in household income was only partly compensated by the net inflow of remittances that recorded a real 2.1% y-o-y growth in Q4. In addition, the volume of exchange dealers' net purchases of foreign currency from households remained broadly the same.

Bank lending activity was on a gradual recovery path in Q4 as well. Within the composition of lending, the strongest growth was recorded with housing loans. At the same time, current account and credit card overdrafts declined.

The Savings Week that was extended throughout November was well received among households, exerting a significant impact on a hike in savings in Q4, thereby helping reduce the volume of funds earmarked for spending.

Household spending[4] is estimated to have contracted by additional 4.5% y-o-y in Q4. Seasonally-adjusted data point to a slower decline relative to Q3 (1.3%).

In real terms, retail trade slumped further, reaching 15.5% y-o-y. Such a contraction in retail trade was driven by channelling household demand to green markets.

The decline in household spending in 2009 is estimated at 4.3% and is expected to decline further in 2010 although at a more moderate rate.

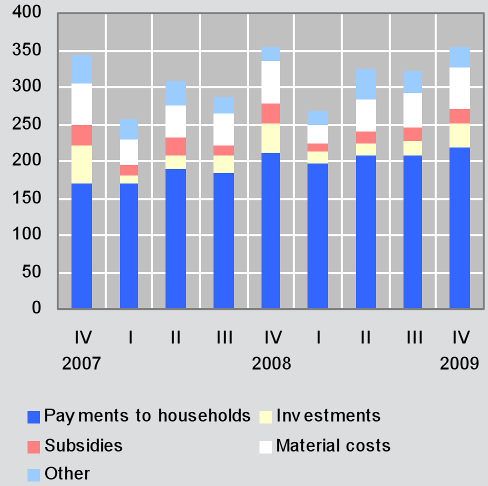
Public spending

Government spending eased y-o-y, partly on account of high expenditure in the same period a year earlier.

Government spending, calculated based on outlays for the purchase of goods and services and household payments declined by 2.8% in real y-o-y terms.

Total expenditure (y-o-y) was on a decline in real terms, which however was not prompted by excessive economising in 2009 but by inordinate spending by end-2008.

Chart IV.4.3 **Composition of public expenditure**
(in RSD bln)



Source: Recalculated based on Ministry of Finance data.

Investements were on a seasonal increase despite predominance of current expenditure.

In y-o-y terms, public debt repayment was the only spending item witnessing a substantial increase (25.7% nominally) mainly due to the weakening of the dinar. Namely, RSD 12.7 billion were repaid in 2009 relative to RSD 7.7 billion in 2008 (up by 65.9%). The freeze on public sector wages and pensions eventually brought about the real y-o-y decline in outlays to households. However, the dominance of current over capital consumption remained unchanged from 2008.

The actual outlays were financed from a solid revenue inflow in Q4. A moderate y-o-y real growth was registered with revenue from excise taxation (26.5%), followed by non-tax and capital revenue (much tapped during 2009), as well as VAT receipts as the most important revenue category (1.5%). The composition of the revenue side of the budget remained broadly unchanged although total revenue was up by 9.1% in real terms. This could be a signal that economic recovery in place since H2 2009 is not of a temporary character.

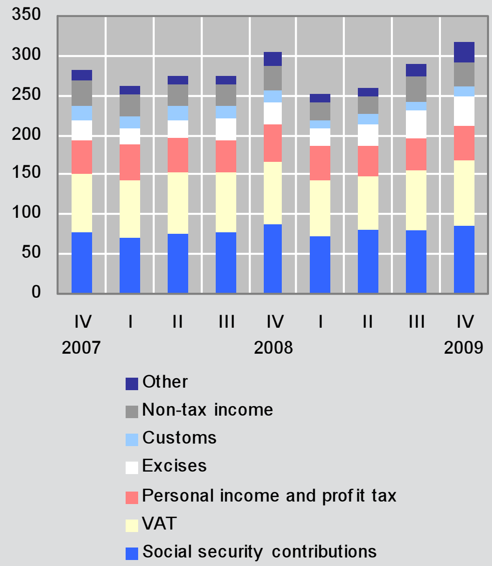
[4] Including not-for profit organisations catering for households.

The effect on demand of the RSD 40 billion budget deficit (calculated by the IMF methodology) was RSD 5.6 billion only. This disproportion is due to the budget deficit financing from domestic sources. Namely, following a RSD 63.5 billion issue in Q4, the stock of T-bills increased to RSD 93.5 billion in December, which accounted for the Government decision to focus on domestic sources in the 2009 budget financing.

Late in the year, however, the Government also engaged in substantial borrowing abroad (RSD 44.3 billion), but these funds will in their major part be used to finance deficit in 2010 (hence putting pressure on demand). Owing to the low levels of pre-crisis indebtedness (26.1% of GDP at end-2008), public sector debt poses no threat to the country's macroeconomic stability for the time being (despite the rather unsettling speed of borrowing – 8.7%[5] of GDP in 2009).

The year 2010 is likely to see a similar budget deficit although with a somewhat stronger effect on demand due to greater reliance on foreign borrowing. Q1 however is likely to record a moderate seasonal surplus in public finance. Government current spending will probably continue to record negative growth rates (expected decline of 6%), which would create leeway for a 20% increase in capital investment outlays.

Chart IV.4.4 **Composition of public revenue**
(in RSD bln)



Source: Recalculated based on Ministry of Finance data.

The share of income and profit tax declined in crisis conditions, while excises, non-tax and other revenue were on a regulated rise.

[5] To gain a real insight into growth in indebtedness, the growth rate is calculated including Kosovo and Metohija's debt (EUR 381.2 million), written off in August 2009, into the stock of public debt. We have also taken note of the IMF's SDR allocation (EUR 424.6 million) made in December and not recorded in public debt as at 31 December 2009.

Table IV.4.1 **Consolidated public expenditure**
(by quarter, in RSD billion)

	2008				2009				Indices	Indices, real
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q4 2009 / Q4 2008	Q4 2009 / Q4 2008
I. Consolidated revenues and grants	263.58	273.39	275.21	303.32	252.85	258.87	286.03	315.23	103.93	98.15
o/w grants	0.16	0.52	0.30	0.32	0.19	0.45	0.87	5.23	1,625.63	1,535.35
II. Consolidated expenditures and debt repayment	262.43	312.29	289.31	356.71	268.69	331.48	379.22	398.76	111.79	105.58
Outlays to households:	171.5	188.3	184.6	210.1	198.6	207.5	207.5	218.0	103.76	98.00
Net wages	63.9	71.3	68.6	78.9	70.1	72.8	72.3	78.1	99.00	93.50
Social transfers	107.6	117.0	116.0	131.2	128.5	134.7	135.2	139.9	106.63	100.70
Pension benefits	84.8	91.7	93.8	105.6	106.0	108.9	109.9	111.6	105.68	99.82
Social benefits	19.1	20.7	17.3	20.5	18.1	21.1	19.5	21.8	106.41	100.50
Other transfers to households	3.6	4.6	4.9	5.2	4.4	4.7	5.7	6.6	126.70	119.67
Subsidies	13.3	22.2	13.9	28.3	11.0	14.7	18.7	18.6	65.73	62.08
Material expenses	34.3	43.0	42.5	56.6	26.3	44.6	44.6	55.7	98.48	93.01
Investment	10.6	21.1	24.2	40.8	14.0	17.9	20.2	34.1	83.56	78.92
Interest expenses	5.3	2.5	4.8	3.3	5.6	4.4	6.6	4.6	141.94	134.05
Debt repayment	11.3	18.2	9.2	5.6	6.2	27.8	63.7	48.8	875.25	826.64
Frozen foreign currency savings repayment	0.5	12.7	3.6	1.2	0.4	16.4	4.1	1.1	93.36	88.17
Pensioners debt repayment	5.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.00	0.00
Other internal debt repayment	4.4	3.5	2.8	2.8	2.0	7.5	56.4	45.7	1,627.35	1,536.98
Foreign debt repayment	1.3	2.0	2.8	1.5	3.8	3.8	3.2	1.9	125.67	118.70
Other*	16.1	17.0	10.1	12.0	7.1	14.6	17.9	18.9	156.93	148.22
III. Consolidated revenues without grants	263.41	272.87	274.91	303.00	252.66	258.42	285.16	310.00	102.31	96.63
IV. Consolidated expenditures (excluding foreign debt repayments, pre payments and FFCD repayments)	256.26	294.12	280.12	351.17	262.51	303.69	315.51	350.01	99.67	94.13
Fiscal balance - IMF methodology (III - IV)	7.15	-21.24	-5.21	-48.17	-9.85	-45.27	-30.35	-40.01	83.06	78.45
GDP	604.77	684.38	713.91	747.94	637.51	713.12	752.85	787.09	105.23	99.39
Fiscal balance - IMF methodology in % of GDP	1.18	-3.10	-0.73	-6.44	-1.55	-6.35	-4.03	-5.08	78.93	74.55

* Item Other includes: other transfers, net purchase of financial assets and other current expenses.

Source: Calculation based on RS Ministry of Finance data.

Fiscal policy and deficit financing in 2010

The budget of the Republic of Serbia adopted for 2010 envisages a RSD 107 billion deficit, which will probably result in a consolidated deficit (not planned explicitly pursuant to the current Law on the Budget System) of around RSD 120 billion or 4% of GDP.

The share of budget deficit financed from external sources will be much larger than a year earlier. Around 47.1% is to be financed from foreign credits and grants, and the remaining portion of the deficit and maturing debts by issuing bonds. Whether these bonds will be issued in the domestic or in foreign markets is yet to be determined. In any case, this means that the monetary effect of fiscal policy will be much more expansionary than a year earlier.

Table 1

Financing of Republic of Serbia's budget

(in RSD bln)

	2009	2010
T-bills (net)	92,755.7	26,418.2
Foreign borrowing	44,737.7	45,600.0
Borrowing with banks	9,926.8	33,250.0
Bonds		47,500.0
Grants	5,955.6	4,750.0
Privatisation	14,191.9	
Funds not spent in the previous years	0.0	21,733.5
Domestic debt repayment (apart from T-bills)	22,108.3	-54,208.8
Foreign debt repayment	12,748.0	-18,042.9
TOTAL	132,711.4	107,000.0

Table 2

Deficit, debt and capital expenditure projections for EU member states, 2010

(in % of GDP for 2010)

	Deficit	Debt	Capital expenditure		Deficit	Debt	Capital expenditure
Austria	5.5	73.9	3.4	Germany	5.0	76.7	3.2
Belgium	5.8	101.2	3.0	Netherlands	6.1	65.6	4.4
Bulgaria	1.2	16.2	7.0	Poland	7.5	57.0	7.3
Greece	6.6	124.9	4.5	Portugal	8.0	84.6	3.6
Denmark	4.8	35.3	3.8	Romania	6.8	27.4	7.1
Estonia	3.2	10.9	7.8	Slovakia	6.0	39.2	4.5
Ireland	14.7	82.9	5.9	Slovenia	7.0	42.8	6.0
Italy	5.3	116.7	3.9	UK	12.9	80.3	3.6
Cyprus	5.7	58.6	4.1	Finland	4.5	47.4	3.1
Latvia	12.3	48.6	5.0	France	8.2	82.5	4.3
Lithuania	9.2	40.7	6.0	Czech Republic	5.5	40.6	7.3
Luxemburg	4.2	16.4	5.8	Sweden	3.3	43.6	3.6
Hungary	4.2	79.8	4.0	Spain	10.1	66.3	4.9
Malta	4.4	70.9	4.0	Serbia	4.0	35.9	3.5

Source: European Commission and NBS estimates.

The budget for 2010 is primarily socially-oriented, with a focus on current rather than capital expenditure. Capital expenditure is planned at the level of only 4.3% of total expenditure, meaning that we can expect capital expenditure to reach around 3.5%[1] of GDP at a consolidated level. To understand how small this share is, all we need to do is compare it with the relevant figures across the EU (Table 2).

Coupled with low capital expenditure, high borrowing for budget deficit financing could become problematic from the aspect of public debt sustainability. As the confidence in the long-run sustainability of fiscal policy declines, investors will demand increasingly higher compensation for the perceived risk. Thus, the question is not only whether Serbia will be able to service its debt in the future, but also whether it will be able to access new funding. Although the Serbian economy is not alone in this (with 32.7% debt to GDP ratio in 2009, Serbia ranks among moderately indebted European countries), it seems that the window of opportunity for cutting public expenditure (especially its current component) is slowly closing, while the question of debt sustainability is becoming an increasingly hot topic.

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[1] This amount is underestimated to an extent due to methodological reasons. Namely, it does not include a portion of the purchase of goods and services which may be considered capital expenditure. However, according to our estimates, even inclusive of this item, capital expenditure would not exceed 4% of GDP.

Investment spending

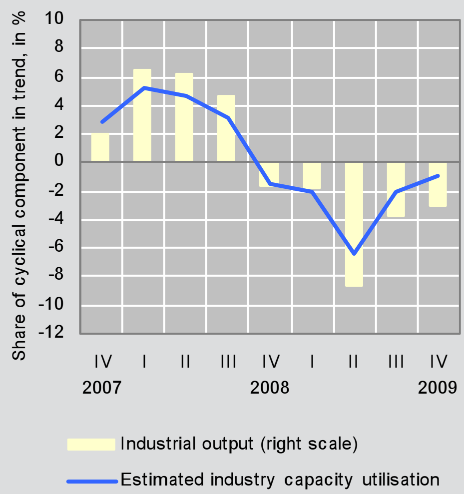
According to the majority of indicators available, y-o-y decline in investment spending slowed down in Q4 2009, while production and exports of intermediate goods even recorded growth.

Q4 2009 saw a slowdown in the y-o-y fall in investment spending largely as a result of its abrupt cutback in late 2008. In seasonally-adjusted terms, the accelerated decline in investment spending from the previous quarter is the key factor behind slower economic growth.

According to our estimates, the decline in capital investment eased somewhat from the previous quarter (22.9% y-o-y). The downturn continued in construction industry (19.7% y-o-y), supported by the slump in the value of construction works completed (29.3%). The capital investment decline slowing was occasioned primarily by a decrease in the volume of imports of capital goods (17.1% y-o-y). The decline in enterprises' capital investment slackened (25.5% y-o-y) owing to a mild recovery in lending activity. Government capital expenditure, as the main indicator of government investment spending, also recorded a softer decline (17.6% y-o-y). Note however that Q4 is the period when capital expenditure is executed at a faster pace, which is exactly what the budget revision for 2009 has provided for.

Softer decline was also registered for the production of capital goods (12.9% y-o-y) and investment in current assets. The production and stocks of intermediate goods even recorded y-o-y growth in Q4. In addition, y-o-y decrease in exports of intermediate goods eased, as well the decline in their imports.

Chart IV.4.5 **Industry capacity utilisation**
(seasonally-adjusted data)



Estimated industry capacity utilisation recorded better performances in Q4.

Industrial capacity utilisation was slightly higher in Q4 than a quarter earlier as signalled by the cyclical component of labour productivity in industry.

Despite some improvement in export demand, it is investment spending that is expected to play the key role in the recovery of our economy in 2010.

Table IV.4.2 **Investment indicators**
(growth rates in %)

	Q4 2008 / Q4 2007	Q1 2009 / Q1 2008	Q2 2009 / Q2 2008	Q3 2009 / Q3 2008	Q4 2009 / Q4 2008
Real indicators					
Physical volume of industrial production of capital goods	-7.3	-29.8	-22.3	-22.1	-12.9
Physical volume of industrial production of intermediate goods	-12.8	-34.7	-34.2	-18.6	3.3
Construction	-1.1	-14.0	-16.6	-18.5	-19.7 *
Imports of intermediate goods**	-11.8	-30.4	-30.6	-25.6	-10.5
Exports of intermediate goods**	-27.9	-48.2	-52.7	-49.3	-9.7
Stocks of intermediate goods	-0.3	0.0	-4.2	-5.3	3.4
Imports of capital goods**	-17.6	-28.8	-34.3	-27.8	-17.1
Exports of capital goods**	6.1	-19.0	-22.8	-37.2	-24.7
Stocks of capital goods	-8.7	-17.7	-20.5	-17.8	-10.5
Government investment spending**	-27.1	25.9	-19.6	-20.3	-17.6
		2009			
Financial indicators	Q4	Q1	Q2	Q3	Q4
Medium- and long-term external borrowing by enterprises (net) in EUR billion	379.0	-160.2	-226.0	-114.0	-35.4
Short-term credits to entreprises in RSD billion	19.8	55.9	2.2	8.7	-1.3
Long-term credits to households in RSD billion	45.7	12.8	-5.6	4.1	21.0
Long-term credits to enterprises in RSD billion	39.7	18.6	3.4	10.6	34.7

* NBS estimate.

** Imports are deflated by the index of industrial producer prices in Germany; exports are deflated by export prices; government investment spending is deflated by the index of industrial producer prices.

Net external demand

Y-o-y decline in net external demand slowed down in Q4 2009 relative to the previous quarter. The slackening of the decline was more pronounced in exports than in imports. Quarterly rates of imported inflation from the beginning of the year suggest that its downward trend ended in Q4.

The recession that hit most countries in 2009, including Serbia, has weighed down heavily on the global trade. Serbia's current account deficit dipped to its record low in 2009 – 5.7% of GDP. Amid lower domestic consumption and investment, the value of imports fell by 21.5% y-o-y in real terms in Q4 2009. At the same time, exports decreased by 8.2% y-o-y, reflecting weak external demand. Relative to Q3, the y-o-y decline in real foreign trade lost pace, especially on the export side. This has in part reduced the contribution of net exports to y-o-y GDP growth, which nonetheless remains relatively high.

As the value of imports in euro terms continued down at a faster pace than the value of exports, the foreign trade deficit contracted by 29.6% y-o-y.

The decline in the value of imports in euro terms slackened from 33.2% in Q3 to 18.6% y-o-y in Q4 2009. The steepest drop was recorded for energy imports (-28.2% y-o-y), which is consistent with the contraction of industrial economic activity and lower volume of road transport resulting from the y-o-y increase in oil prices. A sharp decrease was recorded for the imports of capital goods (-22.2% y-o-y) due to reduced volume of capital investment. The decline in imports of other groups of products was more moderate.

The value of exports and imports declined primarily as a result of their reduced volumes, but also as a result of lower export and import prices.

The estimate[6] is that import prices were higher in Q4 than in Q3, while their y-o-y decline measured around 8.4%[7] . In the first two months of Q4, the decline in dollar import prices averaged 6.1%, while the exchange rate of the dinar against the dollar strengthened by 2.4%.

Measured in terms of the value added, only import prices of high value added manufactured goods went up, while those of manufactured and nonmanufactured goods decreased relative to Q3.

Though lower than a quarter earlier, most SITC[8] sections registered a decline in import prices in Q4. The steepest decline was recorded for import prices of crude materials (except fuels) and mineral fuels and lubricants. By contrast, the strongest growth was registered for import prices of beverages and tobacco and miscellaneous manufactured articles.

Although imported inflation rose in Q4 relative to Q3, at annual level it measured 0.0%[9]. The reversal in its trend in Q4 resulted from the 1.6% appreciation of the nominal effective exchange rate of the dinar (annualised)[10] and 1.7% price growth in the EU and USA (per annum average)[11].

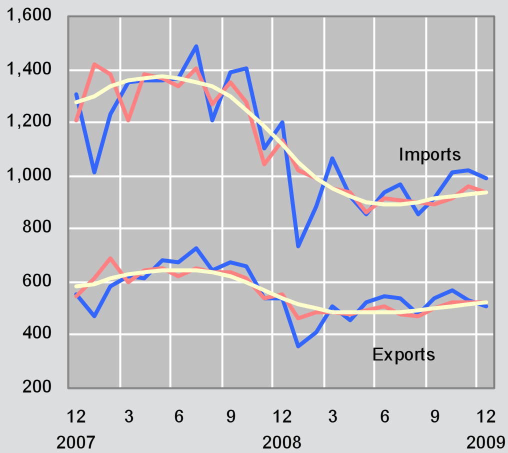
The rise in imported inflation, however, had no major effect on core inflation, which turned out lower than in Q3 (annualised).

No major volatility was recorded in Ural oil prices in Q4 2009 (USD 67–79 pb). In early Q4 oil prices stood at USD 67 pb. They, however, climbed nearly 10% in October as a result of increased demand from fast growing economies (India and China) and investor expectations of a speedy global rebound. Oil prices remained relatively high in the second half of October and throughout November 2009. As the hopes of a quick global recovery dissipated, in early December oil prices recorded a short-lived, and yet considerable, decline of around 10%. However, they took off again by the end of the month and in early January 2010 on the back of increased demand (cold weather), reduction in US oil inventories and tensions between Russia and Belarus.

The price of gold, as the ultimate safe haven, continued rising in Q4 2009, surpassing USD 1,200 per troy ounce in early December. As the investor risk aversion slightly eased by the end of the year, the price of gold retreated below USD 1,100 per troy ounce.

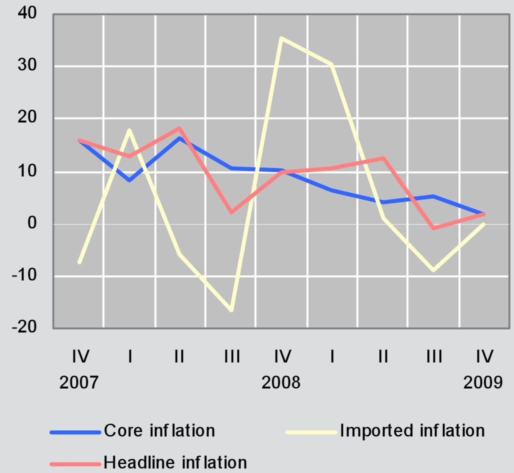
[6] Based on data for October and November.
[7] Imported inflation was estimated based on the index of average import prices at the current USD exchange rate. The unit value index was adjusted by the change in the exchange rate during the period under review.
[8] Standard International Trade Classification.
[9] Annualised ratio of averages for two consecutive quarters.
[10] EUR 80%, USD 20%.
[11] Weighted average inflation figures for the EU and USA (80:20) are used in the calculation of world inflation.

Chart IV.4.6 **Exports and imports**
(in EUR mln)



Trade deficit increased somewhat from Q3 in response to a sharper growth in imports than exports.

Chart IV.4.7 **Domestic and imported inflation**
(average quarterly growth rates p.a.)



Source: NBS and Eurostat.

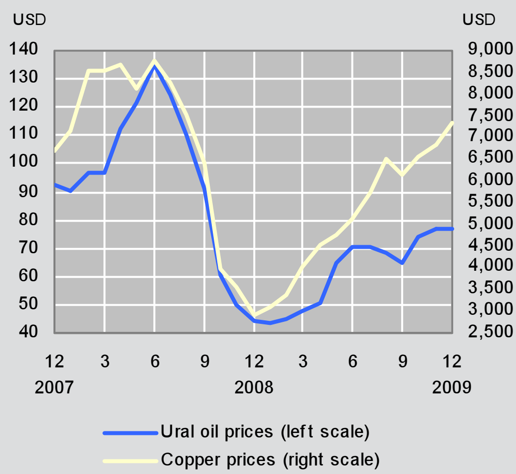
Quarterly rates of imported inflation from the beginning of the year suggest that its downward trend ended in Q4.

The prices of other important commodities also continued rising. The price of copper rose 20% in Q4 relative to Q3, reaching at year-end USD 7,350 per tonne on the London Metal Exchange. As in a quarter earlier, copper price growth was driven by buoyant demand from China, the world's largest importer of this non-ferrous metal, and by investor purchases prompted by expectations of a fast global recovery. Copper prices are expected to stabilise in the coming period.

The decline in Serbian exports slowed down (from -24.6% in Q3 to -6.7% in Q4) primarily owing to incipient recovery of the global economy. The exports of intermediate goods rebounded, most notably exports of iron and steel which posted y-o-y growth for the first time since the beginning of the year. The recovery in exports is supported by the rising international prices of crude commodities, and this trend is likely to continue if the global economic recovery persists.

In 2010, the volume of exports and imports is anticipated to increase by 6% and 2.5% y-o-y, respectively, and the current account deficit to measure around 8% of GDP.

Chart IV.4.8 **Oil and copper price movements**



Source: *Bloomberg.*

Oil prices displayed no major volatility in Q4 despite a moderate upward trend. At the same time, copper prices were on a continuous upward path.

As the world economy will be recovering at a sluggish pace, no major increase in demand for oil should be expected in the near future. A significant impediment to oil price growth in Q1 2010 will be the strengthening of the US dollar. Oil prices are therefore expected to more or less stay within a range recorded in the previous quarter, i.e. USD 70–80 pb.

Given the strong depreciation pressures and price growth in the EU, imported inflation is expected to continue rising in Q1 2010.

5. Economic activity

Economic recovery is estimated to have slowed in Q4, which however is not corroborated by further deceleration in y-o-y decline in real GDP, triggered in its major part by the sudden economic downturn by end-2008. Though slightly less pronounced, output gap remains markedly negative.

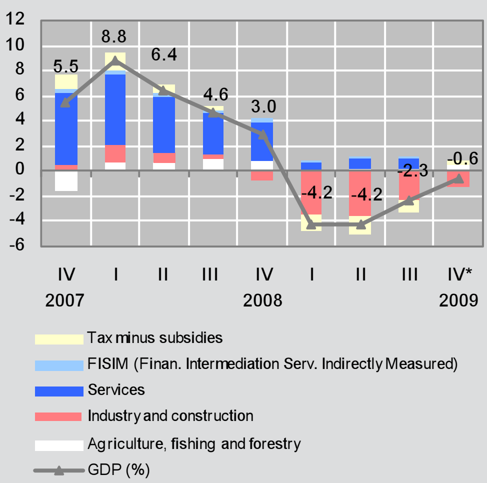
Available data on y-o-y real GDP growth suggest a continued economic recovery in Q4 2009. However, deceleration in the decline in real GDP from 2.3% in Q3 to 0.6% in Q4 was triggered in its major part by the sudden economic downturn by end-2008. This, coupled with a lower seasonally-adjusted quarterly growth rate (0.7%[12]) relative to Q3, points to a slowdown in economic recovery. Weak domestic demand and limited capacity to expand exports were the main factors behind movements in GDP.

In Q4, industrial output followed a much slower downward path in y-o-y terms (3.8%), while seasonally-adjusted data signal a q-o-q deceleration in industrial output and to a lesser extent in manufacturing.

Inventories of finished goods were scaled back by 3.6% y-o-y in December, mainly on account of declining inventories of durable consumer goods (29% y-o-y). Inventories of capital goods fell by 4.2% y-o-y.

Construction is estimated to have fallen by 19.7% y-o-y, which is confirmed by the decline in production of non-metal minerals in Q4 (down by 23.1% y-o-y). Government investment spending (17.6% y-o-y) shows the same tendency.

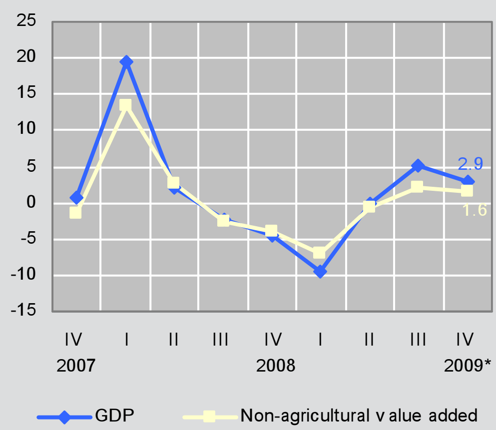
Chart IV.5.1 **Contribution to y-o-y GDP growth**
(in percentage points)



* Estimate of NBS.

Y-o-y decline in GDP is expected to ease in Q4.

Chart IV.5.2 **Growth in economic activity indicators**
(seasonally adjusted quarterly growth rates, annualised)

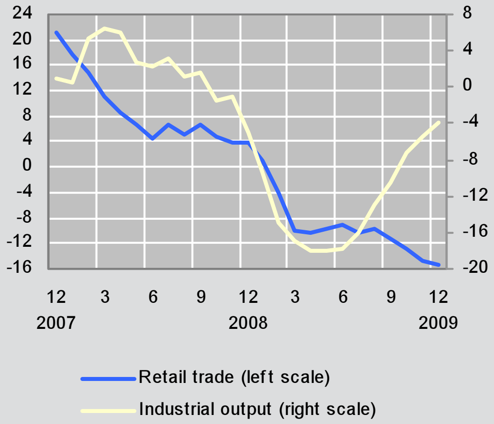


* NBS estimate.

Milder growth in NAVA and GDP in Q4 resulted from a more moderate increase in industrial output.

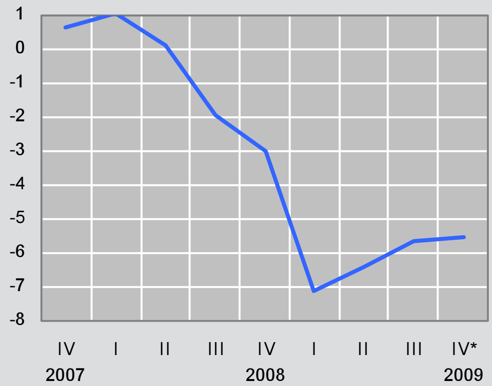
[12] The Serbian Statistical Office seasonally adjusts branch statistics data, using them for quarterly GDP calculations, whereas the NBS seasonally adjusts total GDP data.

Chart IV.5.3 **Quarterly moving averages of industrial output and retail trade**
(y-o-y, in %)



Y-o-y decline in retail trade continued, while industrial output is showing signs of recovery.

Chart IV.5.4 **Output gap**
(percentual deviation from the trend)



* NBS estimate.

Notwithstanding a mild improvement in Q4, output gap remains markedly negative.

Retail trade declined by 15.7% y-o-y in December. On a seasonally adjusted quarterly annualised basis, trade stagnated in Q4.

Based on the Serbian Statistical Office data on expected agricultural yield in 2009, Q4 is likely to see a 4.2% y-o-y growth in agricultural activity.

According to budget revenue data, revenue from taxation (minus subsidies) is likely to show an increase in Q4 by 1.8% y-o-y, matching the slowdown in y-o-y decline in GVA.

Measured by NAVA, growth in economic activity remains significantly below its long-term tendency.

Economic crisis and potential output levels

One of the key challenges facing monetary policy makers in times of economic crisis is determining the extent to which the downturn reflects weakness of demand as opposed to the decline (or slack) in the economy's supply capacity. Assessing the potential output of an economy is important not only for estimating the demand-side disinflationary pressures (output gap[1]), which are vital in monetary policy decision-making, but also for evaluating the outlook for economic growth in the period to come.

To decompose economic activity into potential output and output gap, the NBS uses the multivariate Kalman filter, which estimates the said parameters along with the real exchange rate and real interest rate gaps. We have assumed a break in potential output at the onset of the global economic crisis, which resulted in the slowing of potential output growth from 6.5% p.a. in Q3 2008 to 0% in Q1 2009. Hence, we have ascribed a large share of the economic downturn to the drop in potential output, while at the same time reducing the estimated impact of demand-side disinflationary pressures.

The slack in the economy's supply capacity came about as a result of several factors, most notably lower investment in production capacities, strained financing of current production activities and unfavourable developments in the labour market.

The most important factor is the drop in corporate and government investment spending, which triggered a marked slowdown, if not a decline, in the economy's production capacity. Much of the fall in investment reflects companies' concerns over demand prospects. Heightened uncertainty about the outlook for aggregate demand may induce some companies to delay their investment projects or abandon them altogether.

Overall investment spending in Serbia is estimated to have declined by 26% in 2009. Capital investment, as the key determinant of economic growth, fell by 29%, while capital budget expenditure, as an indicator of government investment spending, decreased by 21%. Add to this the fall in imports of capital goods measuring around 35% and it becomes clear that growth in the production capacity of the Serbian economy had slowed down significantly in 2009.

Factors alleviating the negative effects of a cutback in investment should also be taken into account. In conditions of lower production activity, there is less wear and tear of the capital goods (machinery), which expands their life span and reduces the need for investment in new production capacities. Further, it is possible that faced with the falling prices of their products, some companies may decide to focus their investment efforts on more productive activities and substitute imported goods with those domestically produced, which to a measure also eases the negative effect of investment cuts.

The weakening of the economy's supply capacity is also spurred by the diminished liquidity of companies and impaired financing of current production. Among the main causes of illiquidity are difficulties in the collection of receivables. It takes only one company in a chain to stop settling its obligations for the so-called "illiquidity spiral" to form. This largely hinders the supply potential of otherwise "healthy" companies, which is why many of them find it difficult to meet even the current (reduced) level of demand.

[1] Output gap is the difference between actual and potential output (trend). It is serves as an indicator of demand.

Illiquidity is also due to the constrained supply of bank credits. Mounting credit risk exposure and the share of NPLs brought about a change in the commercial bank thinking. Rather than high profits, the security of investment comes first for most banks nowadays. Such a shift in preferences on the part of banks has acted to discontinue the large foreign credit inflows that used to power economic growth.

Tighter credit conditions restrain access to the much needed capital and put downward pressure on output and use of existing production capacity. The most affected in this context are small and medium-sized enterprises lacking adequate assets for loan collateral. Thus, the financial system becomes less efficient in the allocation of capital as it constrains risky and more productive investment projects that are typically proposed by SMEs.

Though credit crunch did not affect Serbia as hard as some other countries (real corporate credit growth measured around 13% in 2009), many companies are finding it difficult to obtain credits to finance current production activities. Their access to credit is further constrained by the low levels of liquidity in the economy and the rising number of companies whose accounts are blocked.

The supply potential of the economy is also affected by developments in the labour market. Job seekers are discouraged by long-term trends in unemployment (normally occurring in periods of crisis) and find it difficult to maintain their skills let alone acquire new ones which the market demands. On the other hand, faced with diminished labour demand, people are prepared to work longer hours, which lessens the negative effects on the supply potential of the economy[2].

It follows from the above that Serbia can hardly be expected to restore its pre-crisis GDP growth rates as soon as it emerges from the recession. It is true, though, that the entry of a single large foreign investor in a relatively small market such as ours could make all the difference and orchestrate a significant step forward. If Fiat, for instance, follows through on the announced production of 200 thousand cars per year from mid-2011 onwards, and assuming (optimistically) that 80% of the components are produced domestically, another 2 percentage points could be added to potential output growth in both 2011 and 2012. As overly optimistic as it may appear, this scenario is used to illustrate how important large investments are for the supply capacity of the Serbian economy and for getting out of the crisis as soon as possible.

[1] This factor was also discussed in the Bank of England’s November Inflation Report, and, in our opinion, applies to Serbia as well.

6. Labour market developments

Wages

Q4 wages stagnated in nominal and declined slightly in real terms. Due to a further recovery in industrial output, unit labour costs in the industrial sector continued down, albeit at a slower rate than a quarter earlier.

Q4 wages remained almost unchanged mainly due to a freeze on public sector wages. In seasonally-adjusted terms, nominal wages remained flat, whereas a drop in real wages was negligible (0.2%).[13] A y-o-y rise in nominal wages slowed from a quarter earlier, while a decline in real wages accelerated.

The average net wage in Q4 came to EUR 352, up by 3.4% from the previous quarter, mainly on account of a strong seasonal increase in nominal wages in December.

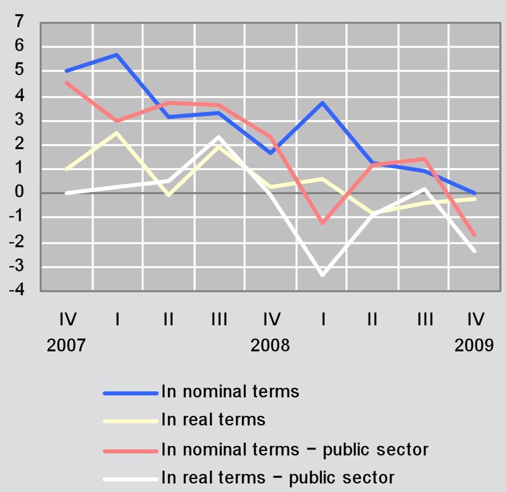
In terms of original series of data, the majority of sectors witnessed wage growth in response to a sharp December rise. The highest nominal wage growth was recorded in finance and real estate sectors, followed by manufacturing and trade, whereas a decline was registered in the construction and hotels and restaurants sectors.

Public sector wages rose by 4.4% nominally (3.9% in real terms), mainly on account of a rise in December wages, whilst seasonally-adjusted data signal a drop in both real and nominal terms (1.7%).

According to seasonally-adjusted data, a slower growth in gross real wages in the industrial sector relative to industrial output resulted in a more moderate q-o-q decline in unit labour costs. A drop in unit labour costs in manufacturing was somewhat above the average for the total industry owing to an upturn in manufacturing output prompted by a reduction in staff numbers.

In light of the Government's repeated announcements that public sector wages will not be raised, neither inflationary pressures nor growth in household spending on that account are likely in the coming period.

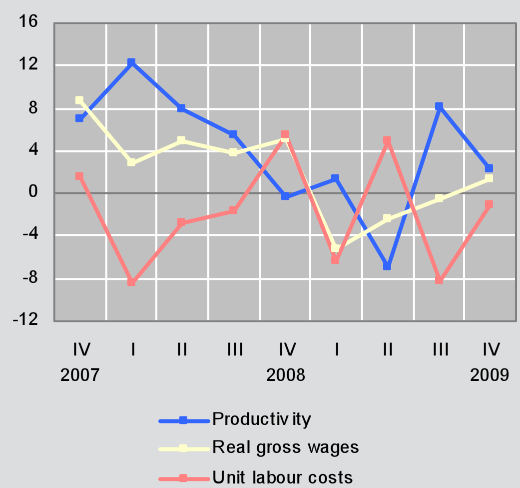
Chart IV.6.1 **Average net wages - total and the public sector**
(seasonally-adjusted data, quarterly growth, in %)



* Growth in total nominal and real wages in 2009 is calculated based on the new methodology.

In nominal terms, total wages rose somewhat and public sector wages declined.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in the industry**
(seasonally-adjusted data, quarterly growth, in %)



A decline in unit labour costs in the industry decelerated from Q3 due to a slower growth in productivity and gross real wages.

[13] Data for 2007 are adjusted to include the effects of changes in the wage calculation methodology that came into force in early 2008.

Employment

Further deterioration in all labour market indicators points to the continuing effects of the crisis.

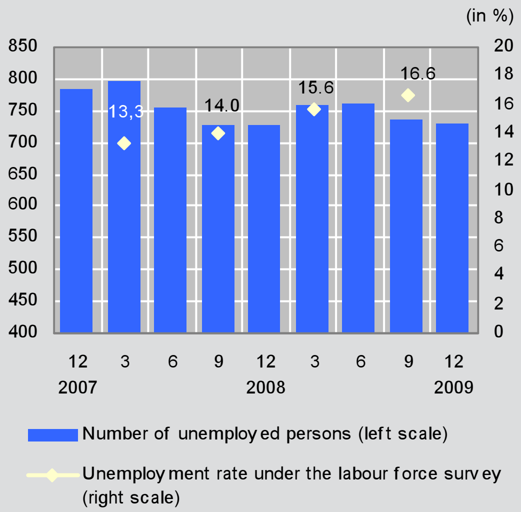
The spillover effects of the global economic crisis are increasingly transmitted to the labour market. According to the labour force survey conducted by the Statistical Office, a decline in formal employment was recorded for both legal and natural persons (entrepreneurs), the latter accounting for the major portion of the decline (ca. 15,000). As in the previous period, a fall in entrepreneurs' employment was not solely due to the economic crisis but to the updating of the Health Insurance Fund records as well.

A breakdown by sector shows that the fall in employment with legal entities was the steepest in manufacturing (ca. 4,000) and trade (ca. 3,500). As expected in light of the current recession, not a single sector registered a rise in employment, apart from the public sector that saw an upswing in response to a rise in the number of educational staff (ca. 2,000). Moreover, the announced staff cuts in the state administration will not have a major bearing on total public sector employment as the state administration makes up only 13.5% of the total public sector employment.

Contrary to negative economic developments, in the May–November period the National Employment Service registered a downward trend in unemployment, which however ended in December. Such movements were mainly due to tightened unemployment eligibility criteria of the National Employment Service.[14] A fall in unemployment was further supported by apprentice employment schemes and public works programmes that are likely to be implemented in 2010 as well.

The number of unemployed persons registered with the National Employment Service has been rising since December. In January 2010, for instance, unemployment reached around 751,100, up by 2.9% from a month before and by 4.8% from October when the global economic crisis started to intensify.

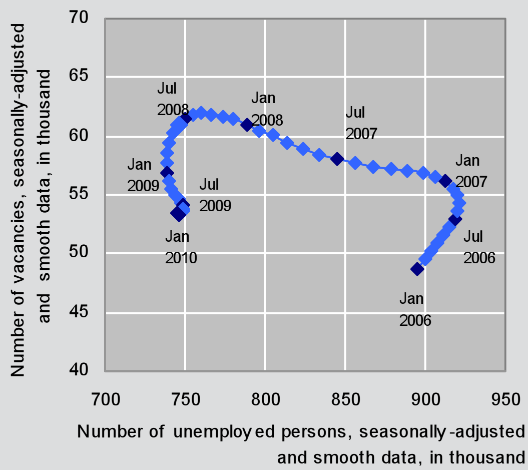
Chart IV.6.3 **Unemployment**
(in thousand)



Source: National Employment Service and Serbian Bureau of Statistics.

The unemployment rate continued up. A drop in the number of unemployed was driven largely by stricter registration criteria and not by positive labour market developments.

Chart IV.6.4 **Beveridge curve***



* Data on vacancies are inadequate as employers are not obliged to record their employment needs with the National Employment Service. Data on new employment contracts are used instead.

A decline in employment slowed, while growth in unemployment was not pronounced due to stricter unemployment registration criteria.

[14] Tightened unemployment eligibility criteria mean that a person is deleted from unemployment records for declining a job offer or refusing to attend a course or training, etc, or failing to timely contact the employment counselor.

Impact of the recession on the labour market is also reflected in the October 2009 labour force survey encompassing both formal and informal employment as well as employment in the agricultural sector. The crisis triggered a simultaneous decline in formal and informal employment rates, cut by 0.8 and 1.6 percentage points respectively from April to October. This shows that the crisis, as expected, weighed down most heavily on the more vulnerable strata of society, most notably those with less secure employment and those working in the black market.

Judging by the October survey, the jobless rate (16.6%) is still rising albeit at a slower pace. It upped by 1 percentage point from April and 2.6 percentage points from October 2008. At the same time, in terms of the duration of unemployment[15], there have been no major changes relative to the previous survey – the share of short-term in total unemployment equals 34.5%, less by 1 percentage point from April. This indicates that the strongest effect of the global downturn – evident from October 2008 to April 2009 when the share of short-term unemployment rose by as much as 6.2 percentage points (from 29.2% to 35.5%) – is way behind us.

Such movements are also confirmed by the Beveridge curve. The recession triggered a precipitous fall in the number of new employment contracts, which moderated in H2. A shift of the Beveridge curve towards the lower-right end of the chart, i.e. the inverse ratio of new employment contracts to the number of unemployed did not come to the fore mainly due to tightened unemployment eligibility criteria of the National Employment Service.

7. International environment

The world economy is recovering from the crisis, but its incipient growth remains fragile. Major advanced economies will continue to implement expansionary monetary policy, while at the same time phasing out the stimulus packages.

There is a broad consensus among economic analysts that the global recovery is off to a stronger start than anticipated earlier. Nevertheless, the International Monetary Fund and the World Bank underline that the current economic growth is fragile and still dependent on fiscal and monetary stimuli, most notably in advanced countries. Their governments are advised to continue with the stimulus programmes until consumer demand and employment have risen to a level not requiring further fiscal incentives. The IMF even warns of a relapse in the advanced economies if they end their stimulus programmes prematurely. Other potential risks to the global economic growth lie in rising unemployment (10% in both the USA and EU), higher investor risk propensity and unchanged structure of the financial system though the system itself has suffered a major damage.

Growth is proceeding unevenly around the world. Emerging economies, most notably India and China, are leading the global recovery, though the United States and West European countries are recovering at a pace faster than expected. The growth could slow down in the second half of 2010 with the waning of the effects of government stimulus measures. The difference between GDP growth rates of the USA and eurozone spread in the last quarter of 2009. Although Germany, the largest eurozone economy, emerged from recession earlier than the USA, in Q4 2009 it posted negligible economic growth (0.1%) relative to a quarter earlier. This is by no means good news for Serbian exporters. Other foreign trade partners of Serbia are not set for any major growth in 2010 either, but the overall situation will improve relative to 2009 and an increase in exports to those countries remains possible.

The difference in dynamics of economic growth across different regions is not without consequences. Faster recovery of emerging market economies could push the prices of raw materials up, while stronger growth of the US economy relative to that of the eurozone is already taking its toll on the euro. From November 2009 to date, the dollar has gained 6% and will possibly strengthen further in line with the abovementioned movements in economic activity. Still, the question remains as to how long such divergent economic

[15] In terms of duration, there are two types of unemployment: short-term (less than one year) and long-term (more than a year).

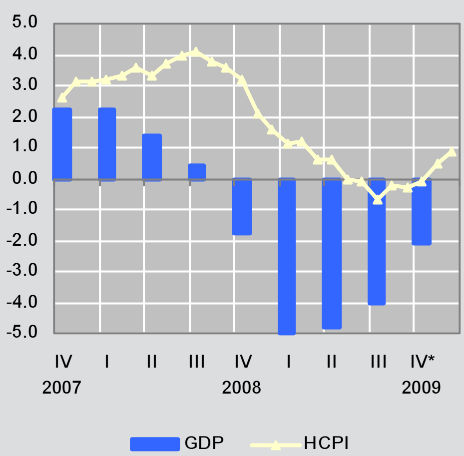
growth rates will persist and how far reaching the effect of government stimulus actually is.

Central banks of advanced countries will continue to implement expansionary monetary policies throughout 2010. The only certain change to take place is the termination of unconventional measures of liquidity support by the ECB and quantitative easing by the Fed. With financial markets partly stabilised and economic growth revived, these measures will be abolished by mid-2010 at the latest. In an environment of fragile recovery and huge amount of unused production capacities in advanced economies, there is no danger of an inflation surge. Hence the ECB and Fed are likely to keep their policy rates unchanged throughout the first half of 2010.

Central banks of some transition countries have completed the cycle of policy rate cuts. Countries such as Poland, Turkey and the Czech Republic are likely to see no change in their policy rates over the next several months. However, as the economic growth strengthens and inflation goes up, the central banks of these countries will probably respond by raising their policy rates. Further lowering of policy rates will take place in transition economies still showing no signs of recovery (Romania, Hungary, Russia).

In addition to stronger economic growth in the USA than in the eurozone, the euro is suffering pressures from fiscal woes of some eurozone members (Greece, but also Spain, Italy and Ireland) and their deteriorating outlook or lowered credit ratings. Investors are increasingly concerned about the sustainability of fiscal policy of the eurozone burdened by high budget deficits and public debt in member countries. Some economists argue that the euro is overvalued against the dollar and that its

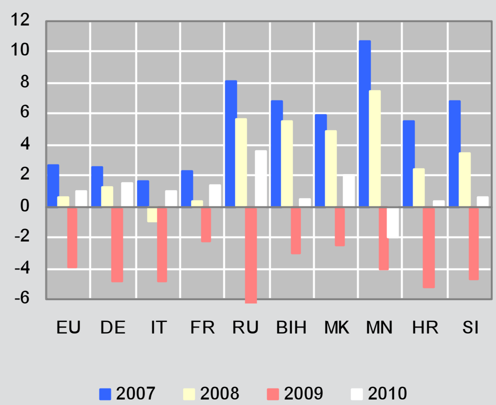
Chart IV.7.1 **Euro zone GDP and inflation**
(y-o-y growth rates)



* Estimate.
Source: EUROSTAT.

Following deflationary trends in Q2 and Q3, inflation picked up in Q4 2009. Y-o-y fall in GDP slowed down.

Chart IV.7.2 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Source: IMF, WEO, October 2009, Update January 2010.

Mild economic recovery, begun in H2 2009, will continue in 2010.

current value in the forex market does not reflect the eurozone's economic fundamentals. Despite their promises, eurozone members can hardly be expected to restore fiscal discipline and bring the relevant parameters in line with the Maastricht criteria limits any time soon.

Halted decline in economic activity and signs of a mild recovery in Serbia's key foreign trade partners give us grounds to believe that export demand will improve to some extent, reflecting positively on the overall domestic economic activity.

The current fiscal crisis in Greece should not have any effect on the financial stability of Serbia. As all other banks with majority foreign ownership operating in Serbia, banks with majority Greek ownership are not branches, but subsidiaries of their parent institutions. Furthermore, the results of stress testing implemented in October 2009 as part of the Financial Sector Support Programme (FSSP) and updated in January 2010 have shown that the Serbian banking system is highly capitalised and resilient to macroeconomic shocks. Banks with majority Greek ownership account for 16.25% of total banking sector assets and all of their performance indicators are high above the regulatory minimums.

V. Inflation projection

In the first three quarters of 2010 inflation will revolve around the lower bound of the target tolerance band, most probably undershooting it in the first half of the year. Inflation is expected to retreat to the target by end-2010 and revolve around it throughout 2011. Despite some inflationary pressures from the weaker dinar over the past several months, price stability will be maintained in the environment of low aggregate demand and a freeze on public sector wages and pensions, which will probably pave the way for further lowering of the key policy rate.

The medium-term inflation projection aims to show expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. This projection presumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Background information

Inflation continued slowing down in Q4 2009, ending the year slightly above the lower bound of the target tolerance band. All inflation components were on the decline: agricultural product prices recorded lower than seasonally expected growth, regulated prices stagnated, while core inflation fell close to zero amid a decrease in industrial food prices.

After minor regulated price revisions in H2 2009, the government announced in early 2010 some major changes relating to prices of electricity, heating, etc. What's more, petroleum products and cigarettes prices have risen already in January as a result of higher excise duties. All of the above price revisions however had already been taken into calculation and will not jeopardise the achievement of the target.

The weakening of the dinar in late 2009 and early 2010 is estimated to have been largely seasonally-induced. Still, to a degree, it reflected on the rise in import prices, putting some pressure on inflation. To the extent that higher import prices do not feed through immediately into

Table V.0.1 **Projection assumptions for 2010 and 2011**

	2010	2011
External assumptions		
EU inflation (Dec to Dec)*	1.3%	1.4%
ECB policy rate (year-end)*	1.25%	2.0%
Euro area GDP growth*	1.4%	1.6%
Ural oil price per barrel (year-end, USD)	80	88
Internal assumptions		
GDP growth	1.5%	3.0%
Regulated prices excl. petroleum products (Dec to Dec)	9.7%	8.0%
Prices of agricultural products (Dec to Dec)	10.0%	8.0%
Trends		
Appreciation trend of the real exchange rate (average)	2.5%	2.9%
Real interest rate trend (average)	4.2%	4.0%

* Source: *Consensus Forecast.*

higher domestic prices, net importers' profit margins will decline (the depreciation gap will widen), which could produce inflationary effects in the medium run.

On the other hand, low aggregate demand, sustained by the freeze on public sector wages and pensions, will continue to be the key disinflationary factor in the medium term. Output gap, as the demand-side measure, contracted slightly in Q4, but remains markedly negative.

The National Bank of Serbia continued lowering the key policy rate in Q4 (from 12% to 9.5%). As a result, real two-week interest rate in the interbank market moved below the neutral level, which together with the opening of the depreciation gap conditioned a mildly expansionary monetary policy.

Projection assumptions

The current projection is based on the assumption that the growth in regulated prices in 2010 and 2011 will be within the planned ranges of 9±2% and 7±2%, respectively. After rising in March, electricity prices are not expected to go up again in the rest of the year.

As the agricultural product prices are currently very low, they are expected to grow faster than other prices over the next two years.

The risk premium should be on a moderate decline in the coming period. Together with the appreciation trend of the real exchange rate which is expected to increase with the waning of the recession, this should induce a decline in the real interest rate trend.

In terms of external factors, the projection assumes a mild economic recovery and higher inflation in the eurozone in the coming two years, which would create conditions for the ECB to raise its policy rate. International oil prices are expected to grow at a moderate pace.

Inflation projection

In the first three quarters of 2010, inflation will revolve around the lower bound of the target tolerance band, most probably undershooting it in the first half of the year. By-end 2010 and throughout 2011, inflation is expected to revolve around the target.

Consumer price growth is expected to step up in Q1 2010 primarily as a result of the announced increase in regulated prices, which remained flat throughout H2 2009. Inflationary pressures will also be generated by higher import prices stemming from the weaker dinar, but considering that the demand is low, this is not likely to reflect on domestic prices to any major extent. On the other hand, processed food prices are expected to continue declining in Q1, but probably at a somewhat slower pace than in the prior period.

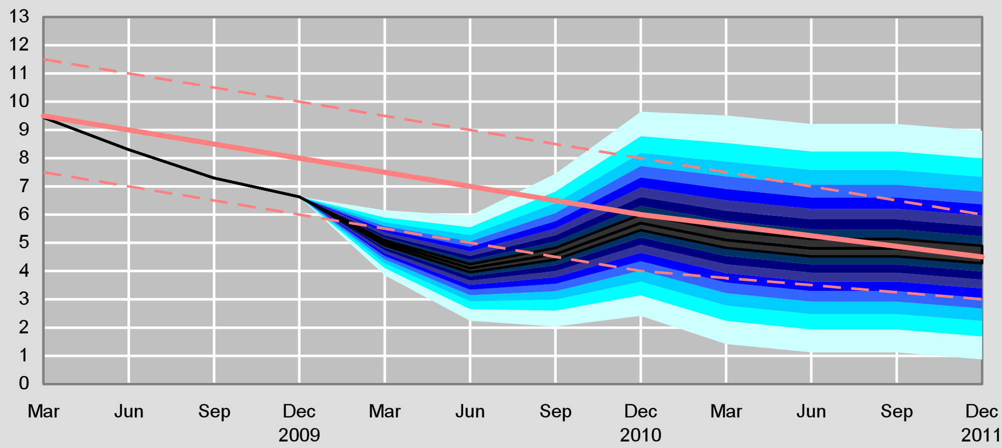
Though the above factors will trigger a rise in monthly inflation rates in early months of 2010, they will be significantly lower than in the same period a year earlier, causing year-on-year inflation rates to slip below the lower bound of the target tolerance band.

Disinflationary pressures generated by food prices are expected to lessen from Q2 onwards. The effects from the fall in processed food prices, occasioned by good harvest, will soon wane, especially in view of the recent rise in prices of their inputs (wheat, corn, livestock feed, sunflower). Besides, as the prices of primary agricultural products are currently very low, it is likely that they will rise faster during 2010.

In addition to short-term pressure on inflation, the weakening of the dinar will induce (to the extent it does not immediately feed through into price growth) the opening of depreciation gap, i.e. a decrease in the profit margins of net importers. In the medium run, these enterprises will compensate for the loss in their profit margins either by raising prices of their products once the conditions are created (i.e. increased demand), or by not lowering them proportionately to the strengthening of the dinar in case such strengthening takes place some time in the future. Still, with the improvement of competitiveness of our economy it will be possible to neutralize such increases in profit margins.

On the other hand, no major growth in prices is likely in the current environment of low demand. Output gap, as the demand-side measure, is still markedly negative. Though wide depreciation gap and recovery of the global economy will lead to its gradual closing, strong demand-side disinflationary pressures are likely to prevail again in 2010. They will be largely underpinned by the freeze on public sector wages (until end-2010) and pensions (until April 2011).

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



In the first three quarters of 2010 inflation will revolve around the lower bound of the target tolerance band, most probably undershooting it in the first half of the year. Inflation is expected to retreat to the target by end-2010 and revolve around it throughout 2011.

The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart 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%.

These two medium-term factors working in the opposite directions (depreciation gap and negative output gap) will be critical in keeping inflation on target in the medium run.

Movements in the year-on-year inflation rates in the course of 2010 will also be largely determined by the base, i.e. monthly inflation rates from the same period a year earlier[16]. Thus, the high base will cause a decline in year-on-year inflation rates in the first half of the year – with inflation most probably undershooting the lower bound of the target tolerance band in this period – while the low base will cause a rise in year-on-year inflation rates in the second half of the year. By end-2010 and throughout 2011, inflation is expected to revolve around the target.

The current projection is consistent with moderate lowering of the key policy rate over the coming period.

Risks to the projection

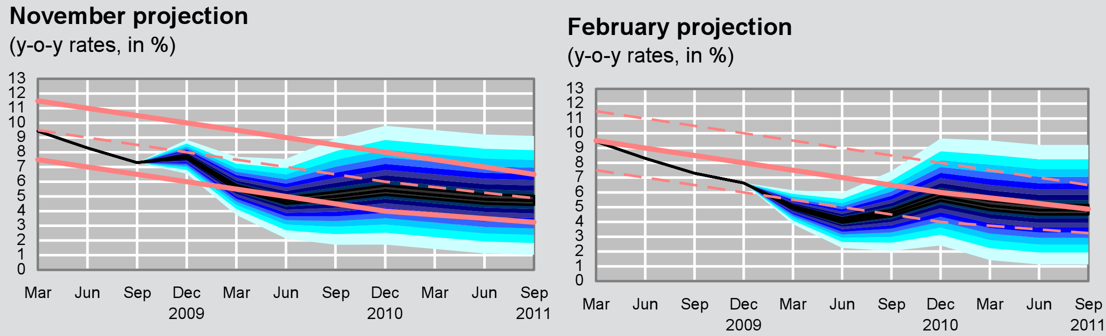
The key short-term risk to inflation projection is the exchange rate pass through to inflation against the backdrop of low demand. As a result of the weaker dinar, import prices recorded a moderate increase over the past several months. However, as the demand continues to be low, the extent to which producers and traders will be able to pass through their increased costs to end consumers remains highly uncertain. In this context, deviation from the projection is possible in each direction.

In the medium run, the highest degree of uncertainty is associated with the pace of economic recovery that will in large part determine the strength of demand-side (dis)inflationary pressures. Our projection is based on the 1.5% economic growth this year, which may turn out to be higher in the event of a stronger growth in the eurozone. A faster economic rebound would lessen the demand-side disinflationary pressures, while a slower recovery would lead to their strengthening (relative to those assumed by the projection), which would produce implications not only in terms of inflation movements, but also in terms of the monetary policy outlook.

Food prices are another medium-term risk. They are currently low owing to good harvest yields and dampened

[16] Year-on-year inflation in a month is on the decline if the monthly inflation rate for that particular month is lower than the corresponding rate in the same month a year earlier.

Chart V.0.2 **Current v. previous projection**



Inflation projection for the first three quarters of 2010 is slightly lower than the one published in the November Report, while projection for the remaining period is somewhat higher. The projection bands are more or less the same.

demand. There is, however, a possibility of a reversal in their trend amid gradual recovery of the global and domestic economies and potentially weaker agricultural performance this year. For this reason, from Q3 2010 onwards, the projection band is mildly asymmetric to the upside.

Comparison with the previous projection

Inflation projection for the first three quarters of 2010 is somewhat lower, while projection for the remaining period is somewhat higher than the one published in the November *Report*.

Compared to the previous projection, the current one envisages stronger inflationary pressures from the depreciation of the dinar. On the other hand, consumer price growth, which turned out lower in Q4 than anticipated in November, feeds through directly into lower year-on-year inflation rates until Q3 2010 assumed by the current projection (the so-called base effect).

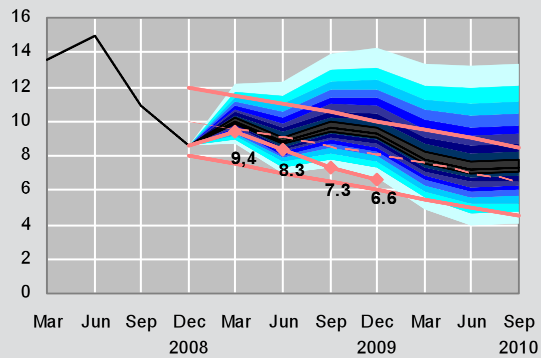
It is only from end-2010 onwards that the effects of the weaker dinar are expected to outweigh the base effect, thereby making the current projection higher than the previous one.

The current projection assumes slower lowering of the key policy rate, reflecting slightly stronger medium-term inflationary pressures from the depreciation gap.

In 2009, inflation moved within the band projected in February that year, except in December when the projected range was undershot by 0.1 percentage point. Throughout the forecast period, inflation outturns were below the central projection rates.

Departure from the central projection was particularly pronounced in the second half of the year when agricultural product prices recorded a much sharper than seasonally expected drop, precipitating a decline in industrial food prices as well. Apart from this, the exchange rate stabilised faster than anticipated a year ago,

Chart V.0.3. **Inflation outturn v. February 2009 projection**
(y-o-y rates, in %)



Inflation moved within the band projected in February for most of 2009, except in December when the projected range was undershot by 0.1 percentage point.

for which reason the resulting inflationary pressures were weaker than forecast.

Outlook for the key policy rate

Based on the current inflation projection and the underlying risk factors, the NBS Monetary Policy Committee judges that the key policy rate is more likely to be lowered in the coming period than kept on hold (9.5%). It is important to note, however, that the lowering of the key policy rate will be considerably slower than in the prior period. Furthermore, should inflationary pressures stemming from the weaker dinar, faster-than-expected recovery of aggregate demand, growth in food prices or some other factors prove stronger than anticipated, the process of monetary easing may even be halted for a while.

Conditioned on the projection assumptions described above and in light of low demand and a freeze on public sector wages and pensions, the MPC judges that there is scope for further monetary easing.

The National Bank of Serbia will continue to monitor movements in the relevant inflation factors and will act promptly in order to keep inflation within the target tolerance band.

Table A
Indicators of Serbia's external position

	2001	2002	2003	2004	2005	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
EXTERNAL LIQUIDITY INDICATORS (in %)												
Forex reserves/imports of goods and services (in months)	3.2	4.1	4.7	3.9	6.2	9.0	7.4	5.5	7.6	8.4	8.6	9.0
Forex reserves/short-term debt	114.0	223.5	336.3	425.0	385.9	717.3	729.8	336.4	412.6	516.4	486.0	464.5
Forex reserves /GDP	10.3	13.6	16.3	16.3	24.2	38.4	32.6	24.2	24.4	27.4	30.5	34.5
Debt repayment/GDP	0.8	1.4	2.0	3.9	4.6	7.0	9.8	10.5	10.0	12.4	10.2	10.5
Debt repayment/exports of goods and services	3.8	7.0	9.0	16.5	17.7	23.5	33.9	34.8	36.4	44.1	37.1	38.7
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	98.3	67.2	62.3	54.3	64.2	63.3	60.2	64.5	64.5	66.9	69.7	74.1
Short-term debt/GDP	9.1	6.1	4.8	3.8	6.3	5.3	4.5	7.2	5.9	5.3	6.3	7.4
External debt/exports of goods and services	463.9	344.8	281.6	232.3	245.1	214.2	204.8	214.7	221.9	236.0	252.7	269.0
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	300.3	366.2	372.4	383.4	393.3
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	140.6	160.9	177.1	193.3	190.3
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	60.3	59.4	63.6	73.2	73.4	80.4	82.1	83.4	76.2	71.8	68.3	69.7
MEMORANDUM:									(in EUR million)			
GDP (in EUR million)	12,821	16,034	17,416	19,075	20,358	23,521	29,543	33,779	6,788	7,574	8,075	8,330
External debt	12,609	10,768	10,857	10,355	13,064	14,884	17,789	21,800	21,445	21,687	21,784	22,787
External debt servicing	102	218	348	736	945	1,635	2,885	3,531	676	941	824	874
Central bank foreign exchange reserves	1,325	2,186	2,840	3,117	4,935	9,025	9,641	8,160	8,113	8,885	9,523	10,602
Short-term debt	1,163	978	844	733	1,279	1,258	1,321	2,426	1,966	1,721	1,960	2,282
Current account balance	282	-671	-1,347	-2,620	-1,778	-2,356	-4,615	-6,089	-818	-175	-278	-472
				Nov 2004	July 2005	Feb 2006	June 2007	March 2008				Dec 2009
CREDIT RATING				Standard & Poor's: B+	Standard & Poor's and Fitch: BB-	Standard & Poor's: BB-/positive; Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's and Fitch: BB-/negative				Standard & Poor's и Fitch: BB-/stable

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of foreign exchange reserves at end-period to average monthly imports of goods and services.

Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to short-term debt at end-period.
Foreign exchange reserves/GDP (in %) - ratio of foreign exchange reserves at end-period to GDP.
Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review.
Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services during period under review.
Debt/GDP (in %) - ratio of outstanding debt at end-period to GDP.
Debt/exports (in %) - ratio of outstanding debt at end-period to annual value of exports of goods and services.
Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-period.
(Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

Notes:

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

2. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology which apply to all IMF member countries. We have therefore adjusted the financial risk exposure indicator.

3. Trade with Montenegro is registered within relevant transactions as of 2003.
4. Foreign debt repayment does not include early debt repayment
5. GDP for 2008 and 2009 as estimated by the National Bank of Serbia.
6. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
Real GDP growth (in %)	5.6	3.9	2.4	8.3	5.6	5.2	6.9	5.5	-4.2	-4.2	-2.3	-0.6[1]
Consumer prices (in %, relative to the same month a year earlier)[2]	40.7	14.8	7.8	13.7	17.7	6.6	11.0	8.6	9.4	8.3	7.3	6.6
Core inflation (in %, relative to the same month a year earlier)[2]	20.5	4.4	6.1	11.0	14.5	5.9	7.9	10.3	10.2	6.9	5.7	4.1
NBS foreign exchange reserves (in EUR million)	1,325.1	2,186.0	2,839.5	3,117.3	4,935.1	9,024.8	9,640.7	8,160.4	8,113	8,885	9,523	10,602
Exports (in EUR million)[3]	2,693	3,125	3,847	4,475	5,330	6,949	8,686	10,152	1,859	2,135	2,219	2,266
- growth rate in % compared to a year earlier	20.7	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-21.2	-18.2	-20.2	-5.8
Imports (in EUR million)[3]	-5,023	-6,387	-7,206	-9,543	-9,613	-11,971	-15,578	-17,956	-3,201	-3,186	-3,312	-3,538
- growth rate in % compared to a year earlier	32.3	27.2	12.8	32.4	0.7	24.5	30.1	15.3	-22.5	-31.7	-30.8	-17.6
Current account balance[4]												
(in EUR million)	282	-671	-1,347	-2,620	-1,778	-2,356	-4,615	-6,089	-818	-175	-278	-472
as % of GDP	2.2	-4.2	-7.7	-13.7	-8.7	-10.0	-15.6	-18.0	-12.0	-2.3	-3.4	-5.7
Unemployment according to the Survey (in %)[5]	12.2	13.3	14.6	18.5	20.8	20.9	18.1	14.0	/	15.6	/	16.6
Wages (average for the period, in EUR)	89.9	151.7	176.7	194.4	210.4	260	347	403	321	338	341	352
RS budget deficit/surplus (in % of GDP)[6]	-0.2	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.8	-1.4	-5.9	-2.5	-3.3
Consolidated fiscal result (in % of GDP)												
- Ministry of Finance methodology	0.0	-1.8	-2.1	1.1	1.2	-1.1	-1.4	-2.2	-1.9	-6.6	-4.1	-5.1
- IMF methodology	-0.5	-2.6	-2.7	0.7	0.7	-2.0	-2.1	-2.5	-1.5	-6.4	-4.0	-5.1
RS public debt (external + internal, in % of GDP)[6]	97.6	76.4	69.9	55.4	48.0	39.6	30.6	26.0	27.1	29.4	32.0	32.0
RSD/USD exchange rate (average, in the period)	66.68	64.46	57.56	58.39	66.70	67.10	58.44	55.76	72.12	69.09	65.24	63.96
RSD/USD exchange rate (end of period)	67.67	58.98	54.64	57.94	72.22	59.98	53.73	62.90	71.59	66.25	63.60	66.73
RSD/EUR exchange rate (average, in the period)	59.78	60.68	65.05	72.57	82.92	84.16	79.98	81.44	93.93	94.15	93.24	94.50
RSD/EUR exchange rate (end of period)	59.71	61.52	68.31	78.89	85.50	79.00	79.24	88.60	94.78	93.44	93.01	95.89
Memorandum												
GDP (in EUR million)[7]	12,821	16,034	17,416	19,075	20,358	23,521	29,543	33,779	6,788	7,574	8,075	8,330

1) NBS estimate.
2) Retail prices until 2006.
3) Trade with Montenegro is registered within relevant transactions as of 2003.
4) In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
5) Source: Labour Force Survey, Statistical Office.
6) Source: RS Ministry of Finance Bulletin.
7) GDP in 2008 - NBS estimate.
Note: Data are subject to corrections in line with the official data sources.

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Sources of data: the National Bank of Serbia and Serbian Statistical Office, unless stated otherwise.

MPC Meetings and Changes in the Key Policy Rate

MPC Meetings and Changes in the Key Policy Rate in 2009

Date	Key policy rate (p.a., in %)	Change (in basis points)
22 January	16,5	-125
29 January	16,5	0
12 February	16,5	0
2 March	16,5	0
20 March	16,5	0
6 April	15	-150
22 April	14	-100
5 May	14	0
22 May	14	0
8 June	13	-100
25 June	13	0
10 July	12	-100
10 August	12	0
4 September	12	0
23 September	12	0
8 October	11	-100
28 October	11	0
5 November	10	-100
13 November	10	0
14 December	10	0
29 December	9,5	-50

MPC Meetings and Changes in the Key Policy Rate in 2010

Date	Key policy rate (p.a., in %)	Change (in basis points)
MPC meetings held		
12 January	9.5	0
21 January	9.5	0
4 February	9.5	0
MPC meetings		
22 February		
5 March		
19 March		
6 April		
20 April		
6 May		
20 May		
4 June		
22 June		
6 July		
20 July		
5 August		
19 August		
7 September		
21 September		
7 October		
21 October		
5 November		
19 November		
7 December		
21 December		

Press releases from NBS Monetary Policy Committee meetings

Press release from the MPC meeting held on 13 November 2009

Following discussion of current economic developments, the NBS Monetary Policy Committee decided to maintain the key policy rate at 10 percent.

In its meeting today, the MPC also adopted the November 2009 Inflation Report and amendments to the Decision on Special Facilities Supporting the Country's Financial Stability.

Pursuant to these amendments, effective as of 18 November, banks may allocate in dinars 20% of foreign exchange required reserves calculated in euros instead of the currently applicable 25%.

The amendments are geared at improving the dinar items of the banking sector balance sheet as banks are expected to allocate around EUR 153.4 million in required reserves and to withdraw in return around RSD 14.5 billion of additional dinar liquidity.

The next MPC meeting will take place on 4 December.

Press release from the MPC meeting held on 14 December 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided today to keep the key policy rate unchanged at 10 percent. The MPC assessed that the current monetary policy environment is conducive to the achievement of the inflation target set for the year.

The Monetary Policy Programme for 2010, adopted in the MPC's meeting today, establishes the achievement of inflation target as the primary objective of monetary policy. By achieving the inflation target, the National Bank of Serbia will contribute to the stability of the financial system and sustainable economic growth.

The National Bank of Serbia will implement monetary policy in 2010 based on the Memorandum of the National Bank of Serbia on Inflation Targeting as a Monetary Strategy, adopted by the MPC on 22 December 2008, and the Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012, adopted in today's meeting. These Memorandums envisage the achievement of inflation targets by using the key policy rate as the main monetary policy instrument.

In 2010, monetary policy will aim to lower the 8%±2 percentage point inflation in the beginning of the year to 6%±2 percentage points by the end of the year. Inflation targets are set for each month of the year, meaning that the achievement of inflation target is watched continuously, not only at a particular point in time, which contributes to the accountability and credibility of monetary authorities and helps anchor inflation expectations.

The National Bank of Serbia will strive to achieve the inflation target by adjusting the level of its key monetary instrument – the interest rate applied in the conduct of two-week repo operations. The rate will be changed in a sustainable, consistent and predictable manner in line with economic developments and inflation projections. Other monetary policy instruments, including reserve requirements and interventions in the foreign exchange market, will play a supporting role.

The National Bank of Serbia will continue pursuing a managed floating exchange rate regime and will intervene in the foreign exchange market only to limit excessive daily oscillations in the dinar exchange rate and contain threats to financial and price stability. It will, however, intervene in the foreign exchange market with more leeway owing to the high level of foreign exchange reserves.

The Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012 envisages a gradual reduction in inflation targets over several years ahead, which reflects the MPC's commitment to achieving medium-term price stability and contributes to stabilisation of inflation expectations.

The next MPC meeting is scheduled to take place on 29 December 2009.

Press release from the MPC meeting held on 29 December 2009

After reviewing current economic developments, the NBS Monetary Policy Committee decided to trim the key policy rate by half a percentage point. As of today, the key policy rate equals 9.5 percent.

Governor Jelašić will explain the rationale behind this decision in a press conference later in the day.

The next MPC meeting is scheduled to take place on 12 January 2010.

Press release from the MPC meeting held on 12 January 2010

After reviewing current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 9.5 percent.

The next MPC meeting is scheduled for 21 January 2010.

Press release from the MPC meeting held on 21 January 2010

After reviewing current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 9.5 percent.

The next MPC meeting is scheduled for 4 February 2010.

Press release from the MPC meeting held on 4 February 2010

After reviewing current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 9.5 percent.

The next MPC meeting is scheduled for 22 February 2010.