National Bank of Serbia

February 2011

INFLATION REPORT

February 2011

INFLATION REPORT

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

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

www.nbs.rs
Number of copies: 55
ISSN 1820-9394

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 Executive Board's decisions[1] 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 the reasoning behind the Executive Board's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this *Report* 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 Executive Board in its meeting of 10 February 2011.

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

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

[1] In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No. 44/2010), the Executive Board has assumed all powers of the Monetary Policy Committee.

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
sa – seasonally-adjusted
SDR – Special Drawing Rights
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Y-o-y inflation moved above the target tolerance band in Q4 2010.

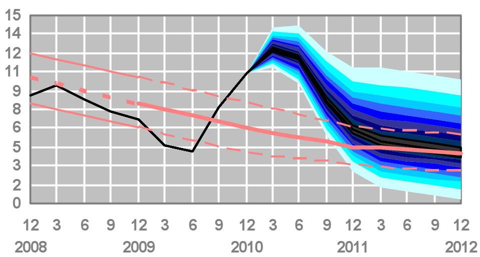
Y-o-y inflation exceeded the upper bound of the target tolerance band in October 2010 for the first time since January 2009 when the National Bank of Serbia switched to headline inflation targeting. Consumer price growth continued in the following two months, settling at 10.3% at year-end (6±2% target).

Consumer price growth in Q4 was driven by the increasingly pronounced cost push pressures.

Inflationary pressures in Q4 stemmed mostly from high production costs of processed food, reflecting the increase in agricultural product prices this summer (in the country and abroad), as well as from the past depreciation of the dinar and heightened inflation expectations.

Economic activity declined in Q4 due to falling domestic demand and a poor agricultural season.

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



Following strong growth in Q3, economic activity subsided in Q4 in response to falling domestic demand and poor agricultural performance. Net exports, on the other hand, provided a positive contribution to GDP growth owing to dinar's depreciation, the rise in international prices of Serbia's key export products, and the recovery in foreign demand. The widening of the negative output gap in Q4 indicates that low domestic demand will remain an important disinflationary factor. As the drop in economic activity in Q4 is believed to be temporary, the recovery is expected to resume in the quarter to follow.

The NBS continued implementing restrictive monetary policy measures.

To contain inflationary pressures in Q4 and early 2011, the NBS continued implementing restrictive monetary policy measures. It raised the key policy rate from 9.5% to 12%, and adopted a new decision on reserve requirements envisaging a lower release of liquidity into the banking system than the earlier decision.

Monetary policy measures and the expected stabilisation of food prices will be instrumental in reducing inflation in H2 2011 and bringing it closer to the 4.5±1.5% target set for the year-end.

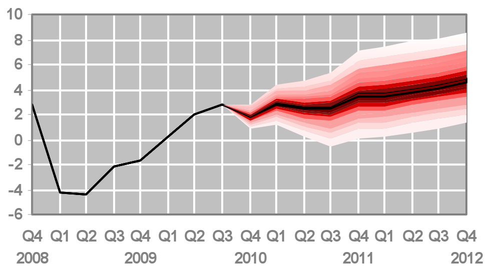
The cost push pressure on food prices and a hefty rise in regulated prices will keep inflation elevated in H1 2011 despite low demand and current appreciation of the dinar. Inflation is expected to decline in H2 2011 and early 2012 on the back of anticipated relative drop in food prices and low aggregate demand. After overshooting the target tolerance band for most of 2011, inflation is expected to retreat close to its upper bound at the end of the year, and to move within the target band in 2012.

The key risks to inflation projection are uncertainties regarding movements in public sector wages, regulated prices, food prices, the risk premium and inflation expectations.

The risks to the outlook for inflation are tilted to the upside due to the possibly faster growth in public sector wages, regulated prices and primary agricultural product prices.

Economic recovery is expected to gather pace.

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



In 2011 and 2012, economic activity is expected to grow at a faster pace than last year. Domestic demand, notably higher capital investment, will provide a somewhat stronger contribution to GDP growth than in the prior period, while the contribution of net exports will decline as imports go up reflecting the recovery in domestic demand and economic activity.

The key policy rate is more likely to be raised or kept on hold rather than revised down.

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the key policy rate is more likely to be raised or kept on hold rather than revised down.

II. Monetary policy since the November *Report*

Under the impact of both of its components – the exchange rate and the interest rate, the real Monetary Conditions Index for Q4 showed a decrease in monetary policy expansiveness for the first time in a year.

Consistent with inflation projection and in anticipation of stronger inflationary pressures, the NBS Executive Board raised the key policy rate in Q4 by 250 bp, from 9.0% to 11.5%, and further to 12.0% in January. Monetary policy stance will become less expansionary in the coming period also on account of the new decision on reserve requirements even though it does not imply liquidity withdrawal from the banking system, but a lower release of liquidity than envisaged by the earlier decision. Actions in the direction of tighter monetary conditions are in line with expectations stated in the November *Report*.

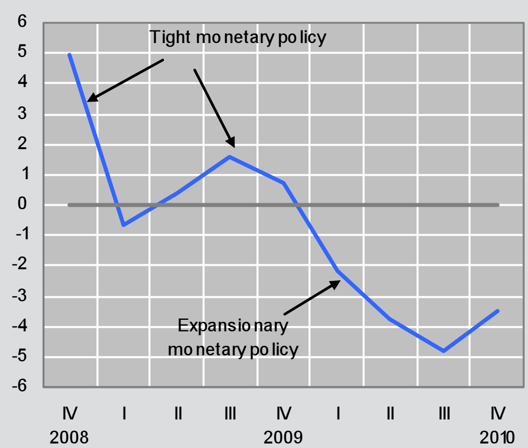
The Executive Board decided to raise the key policy rate in view of the need to quell inflationary pressures stirred by the growth in regulated, food and international oil prices, as well as by the rising inflation expectations and past depreciation of the dinar. The Executive Board's decision was also based on the assessment that low aggregate demand would continue to produce disinflationary effects, particularly in view of the lower than announced growth in pensions and public sector wages.

Y-o-y inflation exceeded the upper bound of the target tolerance band in October, settling at 10.3% at end-2010 (6±2% target). Monetary policy measures and the expected stabilisation of food prices will be instrumental in reducing inflation in H2 2011 and bringing it closer to the 4.5±1.5% target set for the year-end.

As indicated by the real Monetary Conditions Index, the degree of monetary policy expansiveness subsided in Q4 as a result of a shift in monetary policy stance since mid-2010 and the upward revision of the key policy rate. The MCI trend reversal in Q4, pointing to a less expansionary monetary policy than a quarter earlier, was brought about by both of its components – the *real exchange rate* whose depreciation gap narrowed and the *real interest rate* that came close to neutral level (trend).

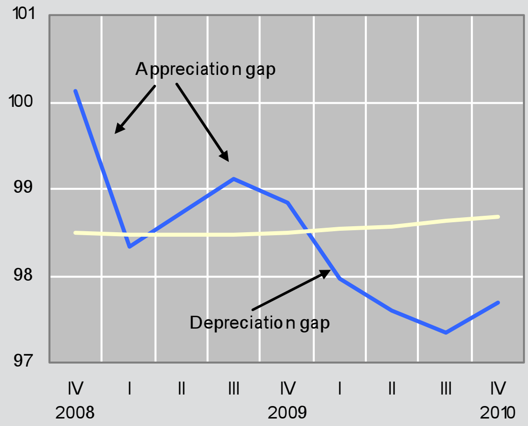
The depreciation gap of the real exchange rate narrowed down as the difference between domestic and foreign inflation exceeded the average nominal depreciation of the dinar (1.3%).

Chart II.0.1 **Monetary Conditions Index**



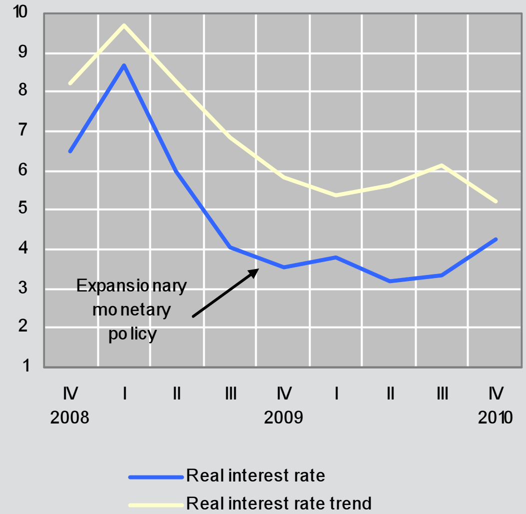
The degree of monetary policy expansiveness decreased in Q4 following a year of constant increase.

Chart II.0.2 **Real exchange rate and its trend**
(base index, IV 2007 = 100)



Depreciation gap of the real exchange rate narrowed down in Q4 from a quarter earlier.

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



Real interest rate came close to its neutral level (trend) in Q4.

A substantial increase in the key policy rate in Q4 powered the rise in the real two-week BELIBOR rate. At the same time, the trend of the real two-week BELIBOR rate declined, chiefly in response to lower risk premium and continuing fall in real money market rates abroad. Thus, real BELIBOR came close to neutral level (trend).

III. Inflation developments

Y-o-y inflation trended above the upper bound of the target tolerance band throughout Q4 in response to growth in primary agricultural product prices, depreciation of the dinar and elevated inflation expectations.

According to estimates, y-o-y inflation will continue up in Q1 2011 and will move above the upper limit of the target tolerance band.

Inflation developments in Q4

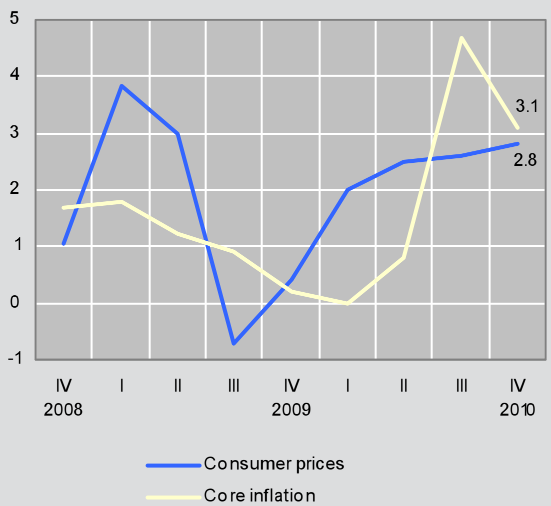
Consumer price growth was driven by rising cost pressures on producers.

In October 2010, for the first time since the NBS began to target headline CPI inflation, y-o-y inflation overshot the upper bound of the target tolerance band. The growth persisted over the next two months and reached 10.3% by end of the year (vs. 6±2% target).

Soaring prices of primary commodities in the world market (mainly cereals and metals), past depreciation of the dinar and elevated inflation expectations were the key determinants of high consumer price growth in Q4 (2.8%).

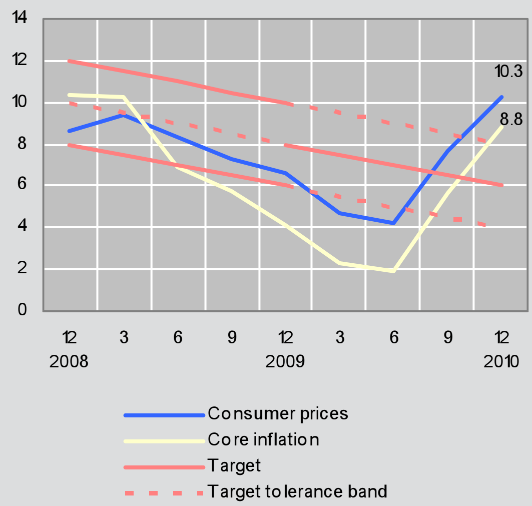
Despite deceleration, **core inflation** (measured by market-determined prices) remained high (3.1%) in Q4. Growth in processed food prices reached 3.6% (vs. 7.8% in Q3) reflecting a hike in primary agricultural product

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



Headline inflation in Q4 was slightly lower than in Q3, while core inflation recorded smaller, though relatively high growth.

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



In Q4, y-o-y inflation trended above the upper bound of the target tolerance band, while growth in core inflation accelerated.

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

	III 2010 / III 2009	VI 2010 / VI 2009	IX 2010 / IX 2009	XII 2010 / XII 2009
Consumer prices	4.7	4.2	7.7	10.3
Core inflation	2.3	1.9	5.7	8.8
Retail prices	7.4	6.4	8.7	11.5
Cost of living	4.4	3.7	7.2	10.4
Industrial producer prices	11.7	11.3	14.0	16.2
Agricultural producer prices	-7.3	-3.3	22.8	29,8*

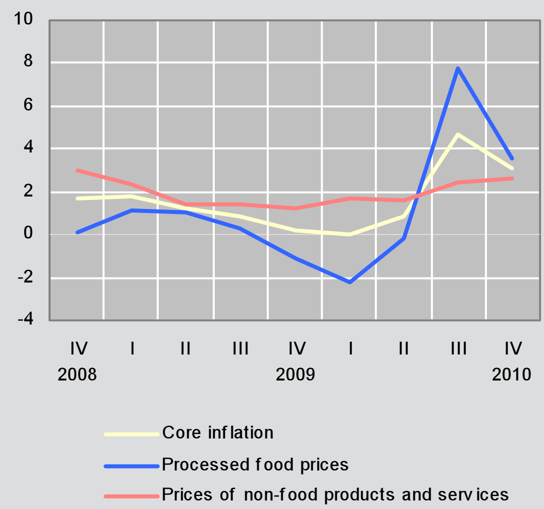
* November on November.

prices. A 2.6% rise in prices of non-food products (included in core inflation measure) was fuelled by past increases in import prices. Non-food core inflation rose to its record high of 1.2% in October. In the course of November and December, non-food core inflation subsided with the gradual weakening of effects of past depreciation of the dinar. The waning depreciation pressures in Q4 are likely to stabilise growth in non-food core inflation in the coming period. Y-o-y core inflation came to 8.8% by the year-end.

Regulated prices went up 1.7% in Q4. The strongest push came from utility prices sparked by rising heating prices (0.3 pp). Other contributing factors were elevated medicament and petroleum product prices. Regulated prices headed up to 12.0% y-o-y by end-2010 and exceeded the annual target of 9±2%.

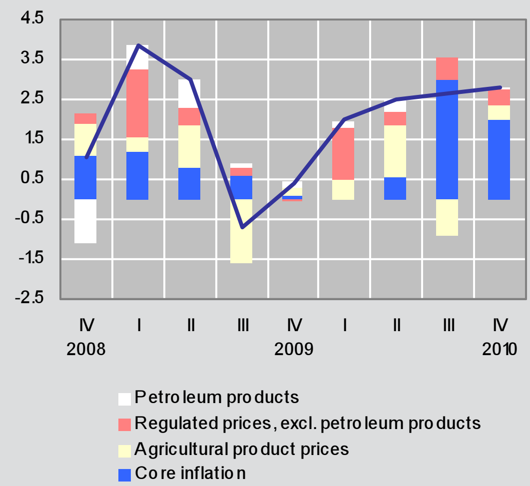
Agricultural product prices recorded lower than seasonally expected growth (4.3%) owing to favourable weather conditions. Nonetheless, at 17.4%, the rise in retail agricultural product prices in 2010 was exceptionally high.

Chart III.0.3 **Core inflation by component**
(quarterly growth, in %)



Deceleration in core inflation in Q4 was a result of slower growth in prices of processed food products.

Chart III.0.4 **Contribution to quarterly consumer price growth**
(in percentage points)



Growth in core inflation was the main determinant of consumer price growth in Q4, though its contribution was weaker than in Q3.

Inflation expectations

Following a moderate rise in Q4, inflation expectations stabilised in January and February 2011.

Propelled by strong consumer price growth and the announced price increases, inflation expectations rose in Q4. Their rise, however, was somewhat moderated by the upward revision of the key policy rate.

After moving around 7.4% in October and November, according to **Medium Gallup** surveys, one-year ahead inflation expectations of the financial sector spiked in December to about 8.7%. Higher inflation expectations were also recorded for businesses and trade unions, while the customarily high expectations of households showed no further increase.

The results of a **Bloomberg** survey carried out in Q4 point to a rise in one-year ahead inflation expectations – from 6.3% reported in September to 7.2% reported in December.

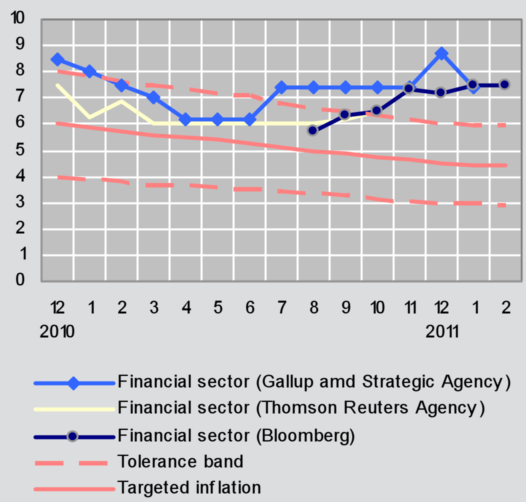
Overall, inflation expectations for the next twelve months exceed the upper bound of the target tolerance band.

While the Bloomberg survey carried out in January shows continued upward trend in inflation expectations (7.5%), driven mostly by the ever-growing number of price hikes announced for early 2011 (prices of cigarettes, processed food, electricity, petroleum products, transport services, etc.), the survey conducted in February reveals stabilisation of inflation expectations at 7.5%.

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

	2009	2010			
	Q4	Q1	Q2	Q3	Q4
Consumer prices	0.4	2.0	2.5	2.6	2.8
Core inflation	0.2	0.0	0.8	4.7	3.1
Agricultural product prices	2.7	7.0	17.0	-10.1	4.3
Regulated prices	0.5	5.5	2.3	1.9	1.7
Electricity	0.0	11.5	0.0	0.0	0.0
Petroleum products	3.5	3.0	6.8	0.8	1.3
Gas for households	0.2	0.0	0.0	0.0	0.0
Utility-housing services	1.0	4.2	1.3	5.9	9.9
Social welfare services	8.7	3.7	0.3	0.0	2.5
Transport services (regulated)	0.1	2.3	0.2	1.7	0.1
Postal and telecommunications services	0.0	0.0	0.5	0.0	0.0
Bread of wheat flour T-850	-2.8	-0.8	0.2	3.8	3.9
Cigarettes	0.0	10.2	0.0	5.6	0.0
Medications	-2.7	0.2	5.0	1.8	3.0
Other	0.0	0.6	12.6	0.8	0.2

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



Financial sector inflation expectations edged up in Q4 and are trending above the upper bound of the target tolerance band for end-2011.

At the same time, the January Gallup survey suggests that the financial sector has revised its one-year ahead inflation expectations down to their pre-December level of 7.4%.

The yield curve in the primary market of government securities points to a decline in inflation expectations. Namely, the level and slope of the yield curve decreased in December and January, signalling expectations of a decline in interest rates in the period ahead.

Inflation outlook for Q1

Inflation will move above the upper limit of the target tolerance band throughout Q1. Growth in regulated and food prices will be the key determinant of monthly inflation rates.

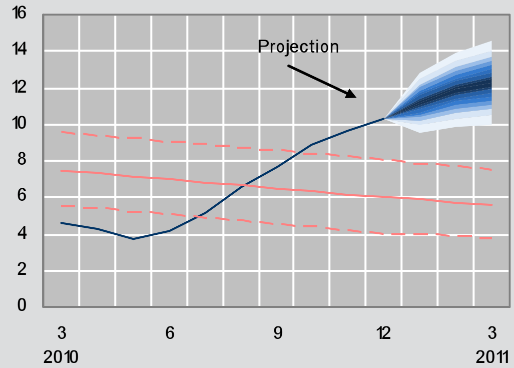
The key determinant of consumer price growth in Q1 will be the seasonally robust regulated price growth. A strong boost to headline inflation will also come from food prices and, to a lesser extent, from past depreciation of the dinar.

Rising further, y-o-y inflation rates will move above the upper bound of the target tolerance band in Q1, also reflecting weak consumer price growth from Q1 2010.

Q1 is likely to witness a slowdown in quarterly core inflation, partly on account of seasonal factors. According to our estimates, food prices, included in core inflation, are likely to give much stronger contribution to headline inflation than non-food product prices. The expected high growth in food prices stems from cost pressures facing producers. On the other hand, growth in non-food inflation will probably decelerate on account of waning effects of past depreciation, current appreciation of the dinar and a reduction in EU import duties on some product categories.

The seasonal growth in prices of fruits and vegetables in Q1 could be slowed by the reduction in EU import duties on some agricultural product groups.

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



Q1 inflation will move above the upper bound of the target tolerance band.

Q1 inflation will be pushed primarily by regulated price growth. An increase has been announced for prices of electricity (which, if realised, will strike the heaviest blow on inflation), cigarettes (on the back of rising excises), and natural gas, as well as utility and transport services. The announced, but so far only partly effected increase in prices of medicaments is likely to follow through as well.

Early Q1 saw a rise in petroleum product prices, propped up by higher excises on motor fuels. Estimates show that almost half of headline inflation in Q1 will be generated by the government (through rising excises and approved regulated price growth).

The key risk to inflation projection relates to the dynamics of regulated price growth (primarily as regards the scale and timing of the increase in electricity prices). Another strong risk are movements in food prices given the uncertainties as to the pass-over of higher production cost to end-consumers. Further, due to domestic market liberalisation, movements in petroleum product prices may prove to be less predictable.

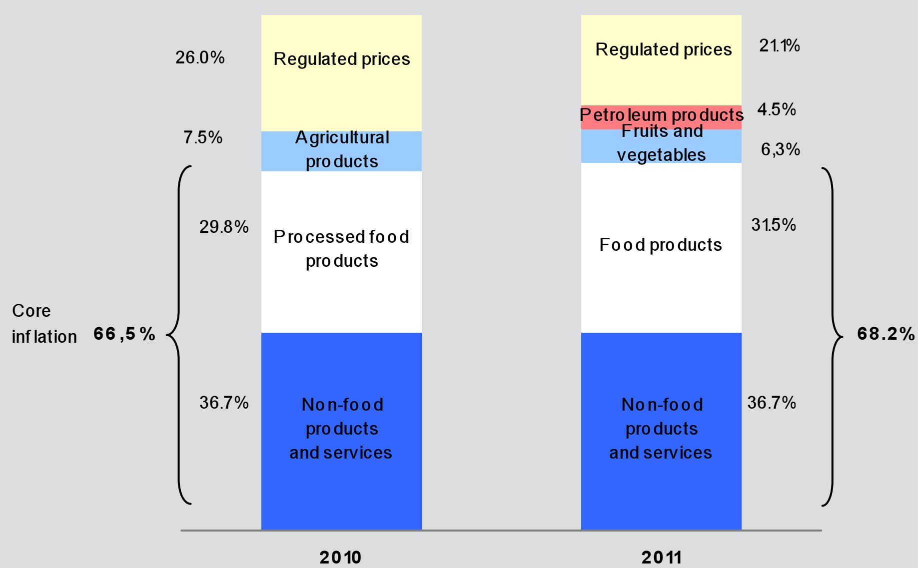
Box 1: New decomposition of the Consumer Price Index

As the prices of petroleum products and bread made from flour type T-850 have been liberalised, i.e. as the effectiveness of decrees regulating their growth ceased, the National Bank of Serbia engaged in the decomposition of the Consumer Price Index (CPI).

Until end-2010, all items within CPI were classified into three basic groups, i.e. inflation components: products and services at market-determined prices (core inflation), agricultural products (fresh fruits and vegetables, eggs and fish) and products and services under direct or indirect government regulation (regulated prices).

With the exclusion of petroleum products (now constituting a separate group) and bread made from flour type T-850 (now transferred to core inflation), the share of regulated prices in CPI fell to 21.1% in 2011. On the other hand, the group “agricultural products” was decomposed by transferring eggs and fish into food products within core inflation. Thus, the share of food products increased from 29.8% to 31.5%, and the share of core inflation from 66.5% to 68.2%.

Chart O 1.1 **CPI decomposition in 2010 and 2011**



Previously within core inflation, canned fruits and vegetables were added to fresh fruits and vegetables (the remaining items within the agricultural product group) to form the *fruits and vegetables* group. The share of this group, which is considered to be the most volatile inflation component, is now lower and equals 6.3%. One of the reasons for establishing a new group was also to clear up any doubts composition-wise, given that the term “agricultural products” was often associated with primary agricultural products such as wheat, corn, sunflower, etc.

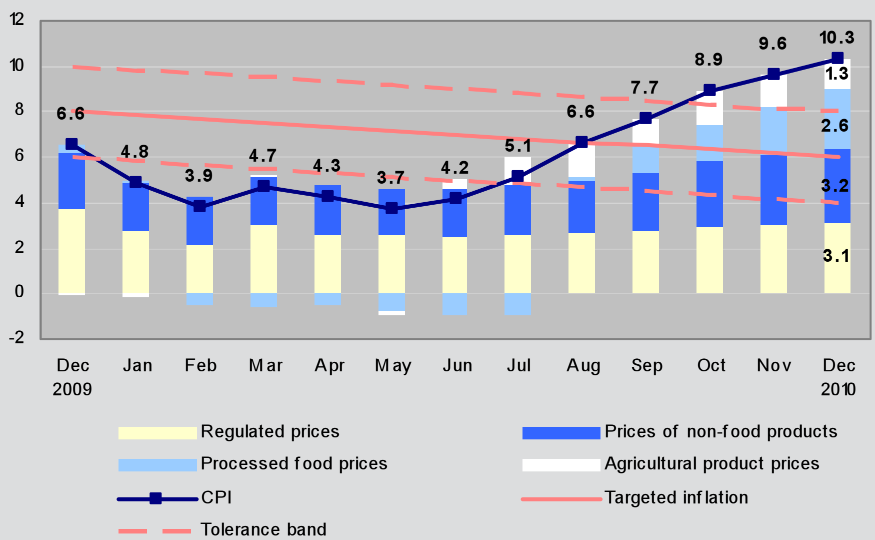
As set out above, petroleum product prices are no longer classified in the group of regulated prices. However, given their significant volatility, as well as the possibility of the government’s indirect impact through excise duties and VAT, the prices of petroleum products cannot be regarded as fully market-determined and classified as a core inflation item. Instead, they form a separate group of products, or better to say, they now represent the fourth component of the Consumer Price Index.

Box 2: Contribution of CPI components to their y-o-y growth

The substantial growth in food prices (agricultural and processed food products) was the main generator of elevated inflationary pressures in H2 2010. Given their marked volatility and a significant share in CPI (c. 38%), prices of food and non-alcoholic beverages exerted a strong impact on headline inflation, notably in H2 2010. To present the scale of impact of some CPI components on y-o-y inflation in 2010, we assessed their contributions.

Products and services whose prices are included in CPI calculation are classified into four groups: 1) processed food products within core inflation, 2) non-food products and services within core inflation, 3) agricultural products (fresh fruits and vegetables, fish and eggs) and 4) products and services whose prices are regulated (under government control). The chart below shows the relative impact of each of these groups of prices on y-o-y inflation in 2010.

Chart O 2.1 **Contribution of CPI components to y-o-y inflation**
(in pp)



The contribution of regulated price growth was significant but relatively stable (2–3 pp). Though rather constant throughout H1 2010, the prices of non-food products and services included in core inflation gathered pace in H2.

Unlike these two CPI components, food prices saw a reversal in contributions, first in regard to agricultural products (in June) and then in relation to processed food prices (in August). The 6.1 pp growth in inflation (from 4.2% to 10.3% y-o-y) in H2 2010 was driven mainly by rising prices of food and non-alcoholic beverages (4.5 pp). The sources of growth (and volatility) of food prices were manifold – unfavourable weather conditions, rising prices of primary agricultural products in the world market, a hike in prices of raw materials for the production of processed food, high customs protection, the government's inadequate agrarian policy and past depreciation of the dinar.

IV. Inflation determinants

1. Money market trends

Interest rates

Money market interest rates mirrored the rise in the key policy rate in Q4. Growth in deposit rates was particularly pronounced after the "Savings Week", while at a quarterly level, lending rates picked up slightly.

Banking sector liquidity improved in Q4 in response to a reduction in dinar required reserves, banks' waning interest in repos and the seasonal, end-of-year growth in excess reserves. These trends gave the strongest boost to the overnight interbank rate. BEONIA gained 1.9 pp on average, while the key policy rate rose 2.3 pp. At the same time, up by 7.5% on Q3, average daily trading reached RSD 8.6 bln in Q4.

Other rates in the interbank money market largely mirrored the key policy rate hikes. The only exception were 3- and 6-month BELIBOR rates that rose in December less than the key policy rate. It was, however, already in January that they overshot the average of other money market rates, giving rise to a substantial spread between longest- and shortest-maturity rates by end-January.

A hefty rise in effective rates on T-bills continued into Q4. A hike in up to 6-month rates may be correlated with the large issue of short-term bills coming up to almost 80% of total bills issued. Despite the shorter maturity of bills, investor interest remained subdued until end-2010, as shown by the fact that investor demand overshot government supply at only 2 of 27 auctions held in Q4. The end-of-period yield curve had an inverse slope reflecting the 15% effective rate on six-month bills sold at the extraordinary auction on the last of day of December. The level of 12-, 18- and 24-month effective rates was 14.6%, 14.4% and 14.9% respectively.

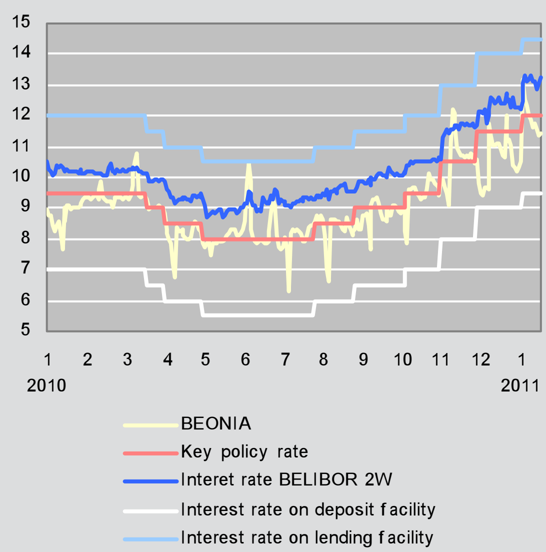
Close to the year-end, the government issued for the first time euro-indexed 6-month T-bills. As demand at that auction by far exceeded supply (RSD 21 bln), all bills were sold out at the 5.25% rate p.a.

In January, effective rates on T-bills declined both for 6-month (by 50 bp) and 24-month maturity (by 30 bp). Demand also rose strongly, particularly of foreign investors at longer-maturity auctions. Such positive trends signal restored investor trust.

An issue of 53-week T-bills worth EUR 200 mln is announced for early February and will be open to foreign investors. The first euro-denominated domestic bond issue (EUR 200 mln) has also been scheduled for February. The maturity of these bonds is 15 years and the coupon rate 5.85% with a semi-annual payment schedule.

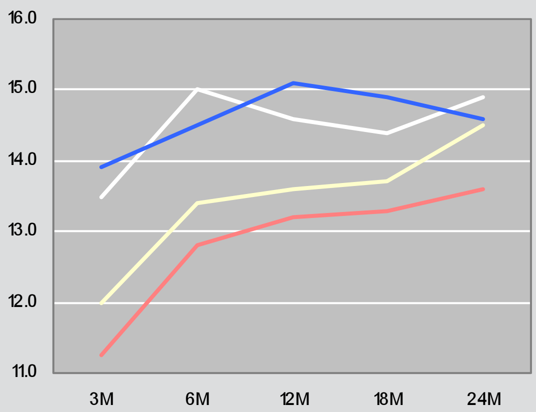
Secondary market securities trading reached RSD 1.9 bln in Q4, down by almost RSD 6 bln on Q3. At end-2010,

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



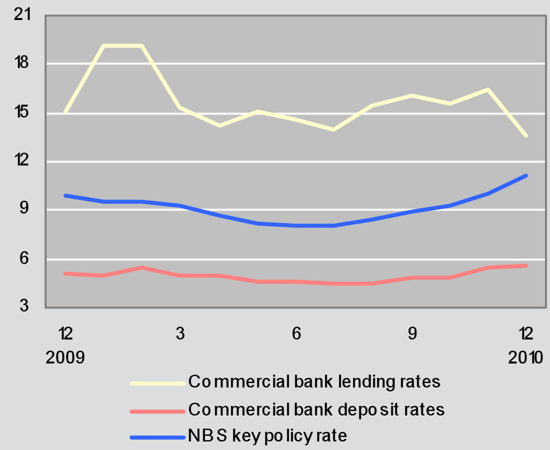
Due to improved banking sector liquidity, BEONIA trended below the key policy rate.

Chart IV.1.2 **Yield curve in the primary market of government securities**
(p.a, %)



Shorter-maturity effective rates recorded higher growth in quarterly terms. Greater demand by end-January 2011 prompted a fall in effective rates.

Chart IV.1.3 **NBS key policy rate and commercial bank interest rates***
(weighted average, p.a, in %)



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

The narrowing of interest spread in December is due to a reduction in lending interest rates and a rise in deposit rates charged by banks on corporate and household sectors.

the return to maturity ranged between 12.7% for one-year and 13.6% for six-month maturity.

Following a rebound in early Q4, lending rates fell sharply in December in response to a step-up in subsidised lending relative to December 2009. Growth in deposit rates in Q4 was largely due to the implementation of incentives offered by banks during the November "Savings Week". Such growth was maintained in December, prompting a fall in interest spread by the year-end. At the quarterly level, down by 0.7 pp on Q3, the average interest spread came at 9.9%.

Monetary aggregates

M1 and M2 experienced a real drop and M3 minimum real growth.

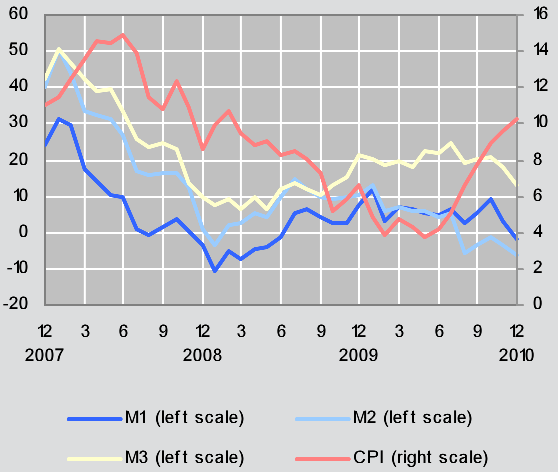
As reserve money declined through the foreign exchange channel by 1.4% in real terms, dinar transactions prompted the issue of reserve money.

Within the foreign exchange channel, most liquidity was withdrawn via interventions in the IFEM (EUR 322 mln net), while monetisation of EUR 250 mln in loans extended by domestic banks to close the budget deficit acted in the opposite direction. Partial drawdown under the IMF loan facility, EU grant and EIB loan added to a EUR 126 mln increase in total NBS FX reserves in Q4, in excess of EUR 10 bln at year-end. Net FX reserves (calculated at the programme exchange rate) came at EUR 4,940 mln, exceeding the threshold set by the IMF programme by EUR 940 mln.

A reduction in bank investment in repo securities (repo stock plummeted by RSD 17.6 bln) was the key generator of dinar liquidity in Q4. Though current on its regular and extraordinary dues (one-time aid to pensioners and other expenses envisaged under the budget revision), the government ended the year with rising balances in accounts with the NBS, which dampened the growth in reserve money.

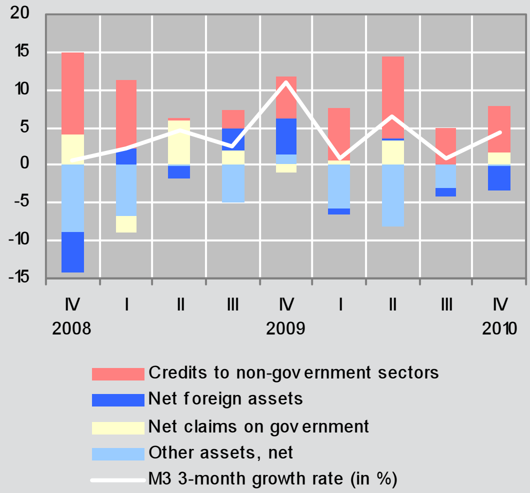
In real terms, M1 and M3 gained 1.5% and 1.4% in Q4 respectively, while M2 lost 1.0%. In the course of 2010,

Chart IV.1.4 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Money supply rose at a slower pace than prices, but remains below a long-term trend.

Chart IV.1.5 **Contribution to M3 growth**
(in p.p.)



Bank lending to the private sector was the main contributor to M3 growth.

money supply rose at a slower pace than prices, inducing by the year-end a real drop of 11.1% and 14.9% y-o-y in M1 and M2. At the same time, M3 was up 2.4% y-o-y in real terms, remaining below its long-term trend.

Following their customary practice at year-end, enterprises maintained higher balances in their gyro accounts. Balances in their savings accounts rose as well. Further, in accordance with the new Bankruptcy Law, a portion of funds of enterprises undergoing bankruptcy was allocated to special accounts.[2] Due to the settlement of liabilities by end-2010, balances in accounts of local government units decreased. Higher household FX savings were the main factor behind rising FX deposits in Q4. In November alone – the month of the "Savings Week", household FX savings deposits rocketed up by EUR 391 mln. To encourage saving in dinars, the NBS offered a reduction in dinar reserve requirements. Nonetheless, dinar household savings recorded no major increase and FX savings prevailed as the favourite option among Serbian citizens.

Table IV.1.1 **Monetary aggregates**
(real y-o-y growth rates, %)

	2010				Share in M3 Sep 2010 (%)
	March	June	Sep	Dec	
M3	14.6	17.2	11.5	2.4	100.0
FX deposits	22.0	27.6	25.1	12.2	69.9
M2	2.0	0.1	-10.3	-14.9	30.1
Time and savings dinar deposits	1.7	-0.8	-20.1	-20.3	11.5
M1	2.3	0.7	-2.4	-11.1	18.6
Demand deposits	0.7	-1.1	-4.1	-10.1	11.9
Currency in circulation	5.0	4.0	0.7	-12.9	6.7

Relative to a quarter earlier, monetary multiplier stayed unchanged as reserve money and dinar deposits increased proportionally.

[2] The number of businesses having their accounts blocked was cut by around 5100 in Q4 mainly due to the implementation of the new Bankruptcy Law. This and the Law on Out-of-Court Corporate Debt Restructuring will contribute to the consolidation of a segment of the Serbian economy.

The velocity of money remained broadly comparable to Q3 levels. Throughout 2010, the velocity of money moved above the 2009 values, confirming the incipient recovery of economic activity.

Bank lending to non-governmental sectors (mostly to the corporate sector) continued to provide the strongest impetus to M3 growth (5.9% pp). Growth in net government borrowing, both via FX borrowing from domestic banks and the issue of T-bills pushed M3 up by 1.8 pp. The NFA negative contribution (-3.3 pp) was prompted by a reduction in banks' NFA, i.e. an increase in their foreign liabilities.

In the course of January 2011, all monetary aggregates recorded a seasonal decline. A reduction in transaction deposits and currency in circulation, driven by contracted activity of businesses typical of the start of a year, dragged down on total dinar money supply (M2).

Bank lending

Banks stepped up their lending in the last quarter of 2010, particularly to the corporate sector at the close of the year.

Reflecting the uptick in corporate lending, real growth in total lending came at 4.8% in Q4, which is 1.9 pp more than a quarter earlier. Q-o-q, corporate lending rose 6.5% in real terms, while household lending gained 1.6%. In nominal terms, total bank lending increased by RSD 79.7 bln, or RSD 78.1 bln valuation changes excluded. Y-o-y data also point to a faster pace of lending – relative to end-2009, total lending increased by a real 16.2%.

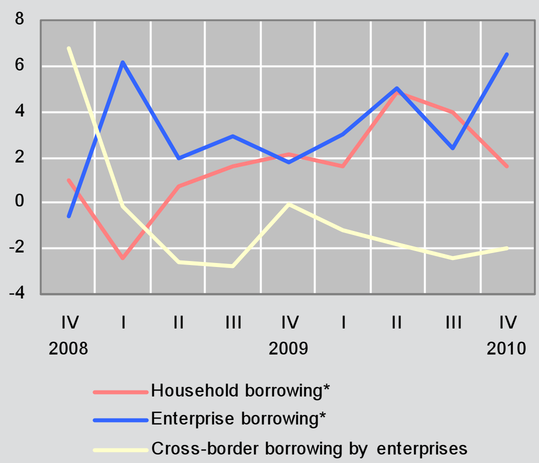
Banks financed their lending activity in Q4 from both domestic and foreign sources. In terms of domestic sources of funding, the largest contribution to quarterly growth in lending came from the growth in savings (3.0 pp), more specifically growth in household FX deposits, which gathered momentum in November in response to attractive rates traditionally offered by banks to mark the Savings Week. Besides, banks reduced their holdings with the NBS (1.2 pp contribution), mainly at the expense of investment in repos. The rise in net foreign borrowing contributed 2.7 pp to overall lending activity. In Q4, banks borrowed EUR 652 mln, mostly short term, while their net receivables from abroad increased by EUR 232 mln.

At the same time, corporate lending rose nominally by RSD 62.7 bln, or RSD 65.7 bln valuation changes excluded. Investment loans stepped up from Q3, but nevertheless remained second to liquidity loans, which shows that maintaining liquidity continues to be one of the main difficulties for the Serbian economy.

Loans were extended mostly to enterprises in the sector of industry, construction, trade and transport. An encouraging piece of information is that the share of loans approved to property development enterprises is on the rise, which could contribute to the recovery of activity in the construction industry.

Enterprises continued reducing their foreign financial debt (by EUR 259.1 mln in Q4). Net trade loans also declined by EUR 182.4 mln.

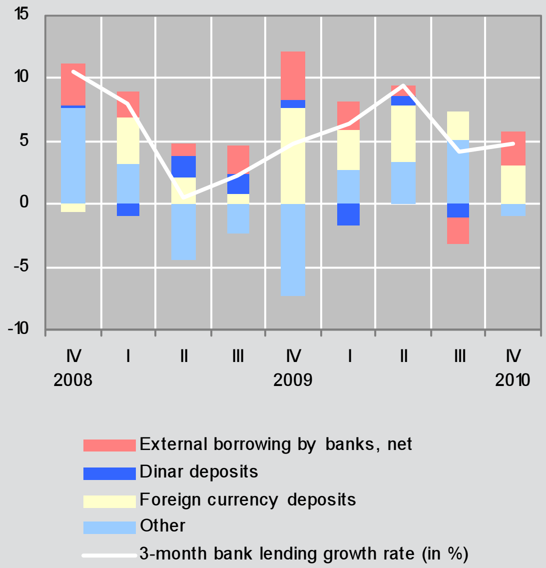
Chart IV.1.6 **Bank real loan receivables and cross-border borrowing**
(quarterly growth rates in %)



* Deflated by inflation, excluding the effects of valuation changes.

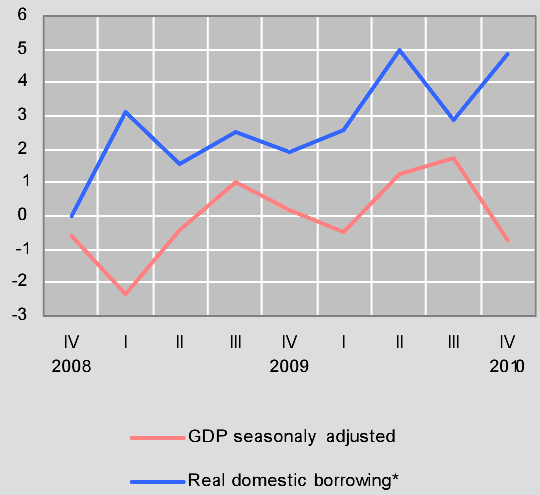
The corporate sector stepped up its domestic borrowing and reduced its liabilities under cross-border loans. Growth in household lending slowed in Q4.

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



FX deposits and net external borrowing were the main source of finance for bank lending activity.

Chart IV.1.8 **Bank real loan receivables and GDP**
(quaterly growth rates in %)



** Deflated by inflation, excluding the effect of valuation changes.*

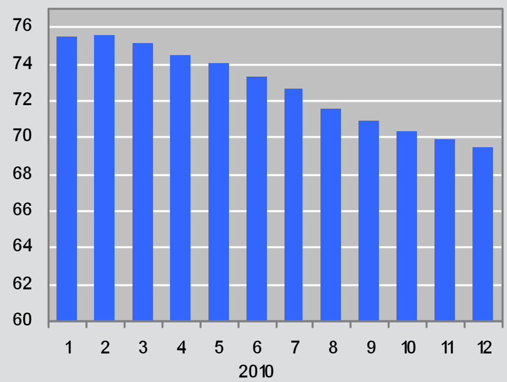
By contrast to economic activity, lending accelerated.

Household lending eased from a quarter earlier, rising by RSD 13.0 bln in nominal terms or RSD 8.3 bln valuation changes excluded.[3] Growth in housing loans proceeded, while the use of consumer and cash loans and current account overdrafts decreased, impacting on household consumption.

The volume of subsidised loans approved (around RSD 43 bln) contracted from the previous quarter and would have been even smaller had it not been for the supplementary budget which envisaged additional funds for these purposes. The loans in greatest demand were those for liquidity and investment purposes. Approval of cash loans was discontinued in November. The impact of the subsidised loan programme on the domestic lending activity, measured as the share of subsidised loans in total new lending, declined from the previous quarter to 10.5% in December.

The programme of loan subsidies for enterprises and households will continue in 2011, earmarking however a lower amount for liquidity loans than in 2010 and a higher amount for consumer and investment lending.

Chart IV.1.9 **Share of indexed and FX receivables in total bank receivables from households and enterprises**
(in %)



The share of FX and FX-indexed receivables in total receivables declined by almost 6 pp over the year.

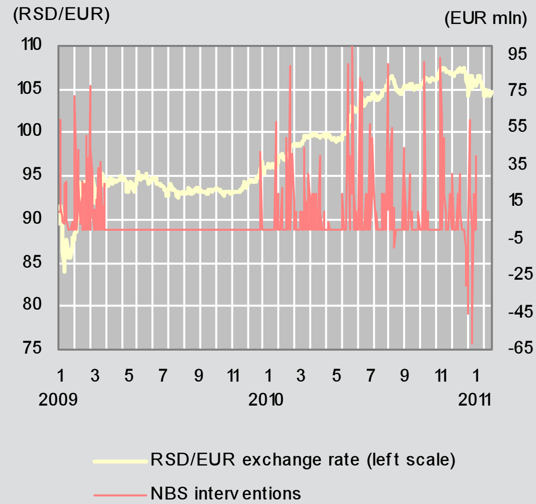
[3] Such growth is attributable primarily to substantial appreciation of the Swiss franc in Q4, considering that 22% of household loans are Swiss franc-indexed or -denominated.

Table IV.1.2 **Subsidised loans in 2010**

	Q1	Q2	Q3	Q4
Government Programme of Measures to Ease the Effects of the Global Financial Crisis				
	(in RSD bln)			
Loans approved	**25,6**	**65,6**	**56,3**	**37,6**
Liquidity	22,4	44,6	34,9	22,7
Investment	0,4	5,0	9,0	9,8
Consumer	2,8	4,1	0,6	1,7
Dinar cash	-	11,9	11,8	3,4
Subsidised housing loans				
	3,3	**3,2**	**3,7**	**3**
Subsidised loans for agricultural producers				
	-	**3,1**	**2,6**	**2,4**

Source: Ministry of Economy and Regional Development, National Mortgage Insurance Corporation and Ministry of Agriculture, Forestry and Water Management.

Chart IV.2.1 **Movements in RSD/EUR exchange rate and NBS FX interventions**



The NBS intervened in the IFEM in Q4 by both buying and selling foreign exchange.

Dinarisation strategy produced evident results in 2010 – the share of FX-denominated and -indexed loans in total lending shrank by nearly 6 pp, amounting to 69.5% in December.

Q4 witnessed an improvement in the household and corporate debt servicing capacity as the gross NPL ratio fell 0.7 pp to 17.2% at the close of the year (10.0% net NPL ratio).

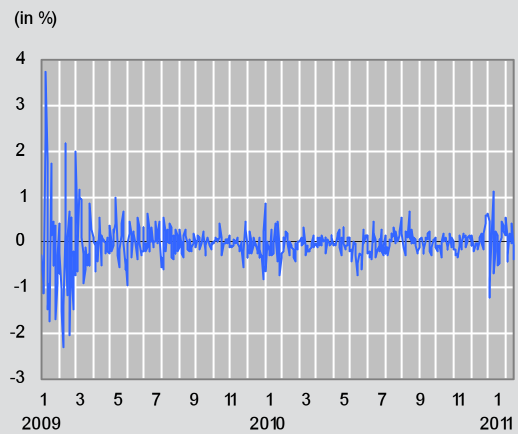
2. Movements in the foreign exchange market and the dinar exchange rate

The dinar lost 1.3% on average against the euro in the last quarter of 2010. The NBS intervened in the foreign exchange market by both buying and selling foreign exchange.

Relative to a quarter earlier, the dinar depreciated 1.3% on average against the euro, while the exchange rate ranged from 104.3 to 107.5 RSD/EUR.

Depreciation pressures gathered particular traction in late October, reflecting increased corporate demand for foreign exchange (typical for the end of the month) and low FX supply. However, as the supply improved amid greater inflows from remittances and non-residents, these pressures moderated in November and the exchange rate stabilised. The current strengthening of the dinar can be

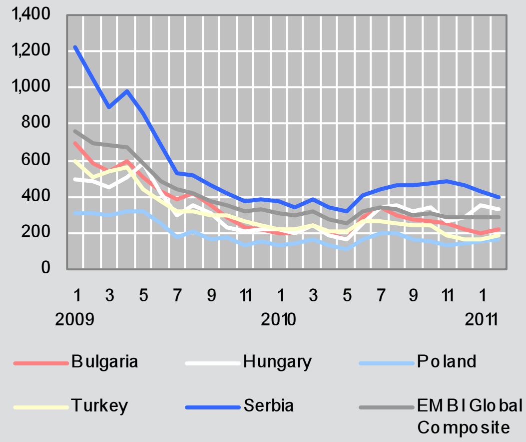
Chart IV.2.2 **Daily changes in RSD/EUR exchange rate***



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

Daily volatility of the exchange rate of the dinar heightened at the close of the year.

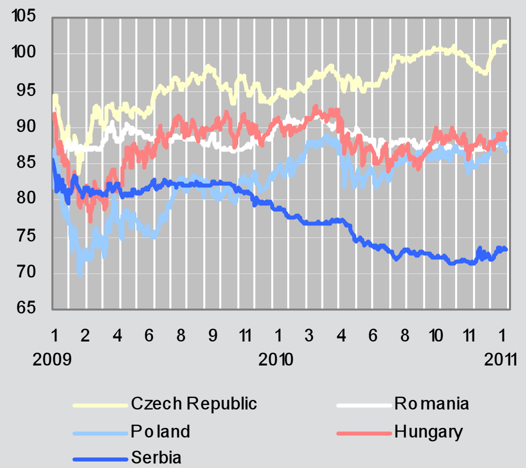
Chart IV.2.3 **Risk premium indicator – EMBI by country**
(monthly averages, in basis points)



Source: JP Morgan.

By contrast to most countries observed, Serbia witnessed a decrease in its risk premium in Q4. The decrease continued in January. Nonetheless, Serbia's risk premium remains above the risk premia of other countries observed.

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



Apart from the Serbian, the Romanian currency also weakened against the euro in Q4 relative to Q3. All national currencies observed strengthened against the euro in January.

put down to several factors – increase in the key policy rate, an upgrade in the outlook of the country's credit rating, the fall in risk premium, and new reserve requirement policy. To ease excessive daily volatility of the exchange rate, the NBS intervened also by buying foreign exchange from banks on several occasions.

The volume of NBS net sales in the Interbank Foreign Exchange Market fell significantly from the previous three quarters, down to EUR 321.5 mln (EUR 548.0 mln sold and EUR 226.5 mln bought). Trading volumes (NBS excluded) increased on Q3, owing to buoyant interbank trading in the second half of December (occasioned largely by the auction of euro-indexed treasury bills). In Q4 overall, daily interbank trading volumes averaged around EUR 60 mln, while in December they were in the region of EUR 106 mln.

The country risk premium, measured by EMBI *(Emerging Markets Bond Index)*, recorded a decrease in Q4. The decrease began in November, the month in which Fitch upgraded Serbia's credit rating outlook from negative to stable. At end-December, EMBI subsided to 418 bp. Of other transition countries observed, only Bulgaria and Turkey recorded a sharper decrease.

As the dollar continued weakening against the euro in Q4[4], the dinar's slide against the dollar (registered in the previous three quarters) came to a halt. As a result, the dinar gained around 3.8% on average vis-à-vis the dollar in Q4. With a negligible weakening in the nominal effective exchange rate of the dinar[5] (0.2%) and a faster growth in domestic relative to foreign prices, Q4 saw a 2.5% real effective appreciation of the dinar (1.2% against the euro and 7.3% against the dollar).

As indicated by the February Bloomberg survey, the financial sector expects the exchange rate to be stable throughout February and March. According to the January *Consensus forecast*, on the other hand, after weakening in February, the dinar is expected to be steady until the end of April.

[4] Average USD/EUR exchange rate in Q4 relative to average exchange rate in Q3.

[5] Weights used: 0.8 for the euro and 0.2 for the dollar.

Box 3: Credit rating in times of crisis – Serbia and neighbouring countries

In November 2010, Fitch Ratings upgraded the outlook on Serbia's credit rating (BB-) from negative to stable that the country enjoyed before the escalation of the global financial crisis. Positive assessments of economic and balance of payment trends, as well as public finance consolidation measures contributed to the country's diminished exposure to FX risk, while the IMF's arrangement guarantees external financing, reads the Fitch statement. This upgrade is all the more favourable as most neighbouring countries have faced cuts in their credit ratings and outlooks since the start of the crisis (Table 0.3.1). The sharpest cuts were made in the case of Greece (by five grades), Romania and Hungary (two grades each) and Bulgaria (one grade). Croatia's rating was kept unchanged, though its outlook was lowered from stable to negative due to its negative fiscal performances and a high level of external debt, which is why Croatia faces the risk of a further downgrade. Macedonia's rating was also kept unchanged, but its outlook was cut from positive to stable.

Table O 3.1 **Credit rating of Serbia and selected neighbouring countries**

	Fitch Ratings			*Standard&Poor's*		
	Level 15. 9. 2008 (outlook)	Last review	Level 31.1.2011 (outlook)	Level 15. 9. 2008 (outlook)	Last review	Level 31.1.2011 (outlook)
Albania	-	-	-	-	-	B+ (stable)
B&H	-	-	-	-	-	B+ (stable)
Bulgaria	BBB (negative)	30. 4. 2009, from BBB- (stable)	BBB- (negative)	BBB+ (stable)	1. 12. 2009, from BBB (negative)	BBB (stable)
Greece	A (positive)	14. 1. 2011, from BBB- (negative)	BB+ (negative)	A (positive)	27. 4. 2010. BBB+ (negative)	BB+ (negative)
Hungary	BBB+ (stable)	23. 12 .2010, from BBB (negative)	BBB- (negative)	BBB+ (negative)	23. 7. 2010, BBB- (stable)	BBB- (negative)
Macedonia	BB+ (positive)	27. 10. 2010, from BB+ (negative)	BB+ (stable)	BB+ (positive)	21. 9. 2009. from BB (negative)	BB (stable)
Romania	BBB (negative)	2. 2. 2010, from BB+ (negative)	BB+ (stable)	BBB- (negative)	9. 3. 2010, from BB+ (negative)	BB+ (stable)
Serbia	BB- (stable)	11. 11. 2010, from BB- (negative)	BB- (stable)	BB- (stable)	1. 12. 2009, from BB- (negative)	BB- (stable)
Croatia	BBB- (stable)	21. 5. 2009, from BBB- (stable)	BBB- (negative)	BBB (stable)	21. 12. 2010, from BBB (negative)	BBB- (negative)
Montenegro	-	-	-	BB+ (negative)	31. 3. 2010, from BB+ (negative)	BB (negative)

Source: Fitch Ratings, Standard&Poor's.

The Standard&Poor's has confirmed Serbia's relatively satisfactory position as all other countries in the region have witnessed downgrades from the pre-crisis period. Greece was once again subject to the sharpest cut (by five grades), followed by Hungary (2 grades), while other countries, save Serbia (including Albania and Bosnia and Herzegovina that were recently issued their first sovereign credit ratings), were notched down by one grade.

More favourable movements in Serbia's credit rating during the crisis, notably the November upward revision of the country's outlook (BB-, from negative to stable) made by Fitch, resulted in better performance of the country's credit risk indicator (measured by EMBI). In Q4 2010 and January 2011, EMBI for Serbia declined more sharply (99 bp) than for Bulgaria (20 bp) and Croatia (12 bp), while picking up for Hungary (17 bp). As a result, Serbia's risk premium came closer to that of other countries in the region, while its EMBI, however, remains elevated.

Foreign capital inflow

By contrast to the first three quarters of the year, in Q4 net capital inflow was somewhat higher than the current account deficit, which reflected on movements in the IFEM.

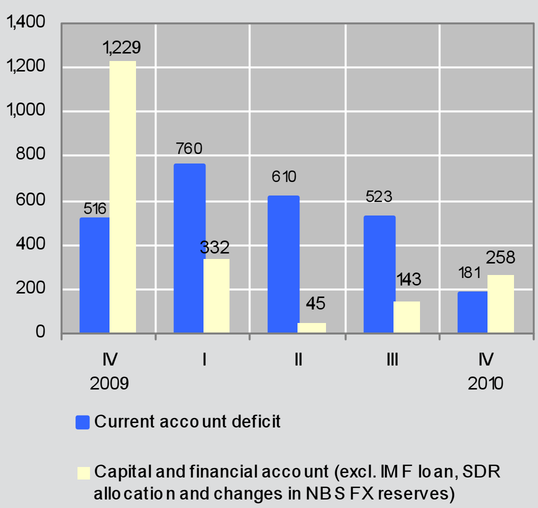
Though remaining subdued, net capital inflow turned out higher in Q4 than in the previous two quarters. As the current account deficit was relatively low thanks to increased remittances, capital inflow was sufficient for its financing, as well as for giving a boost to NBS foreign exchange reserves. This eased the mismatch between demand and supply in the IFEM and reflected on movements in the exchange rate of the dinar.

The most significant item on the financial account was foreign direct investment that rose from EUR 175.5 mln in Q3 to EUR 265 mln in Q4. Most investment flowed into manufacturing industry, financial sector, real estate and wholesale trade. At the same time, a net outflow of EUR 24 mln was recorded for portfolio investment.

Foreign exchange also flowed in through the Stand-By Arrangement with the IMF. Around 15% of the amount available under the sixth tranche was drawn in December, strengthening the NBS foreign exchange reserves by EUR 54.5 mln[6].

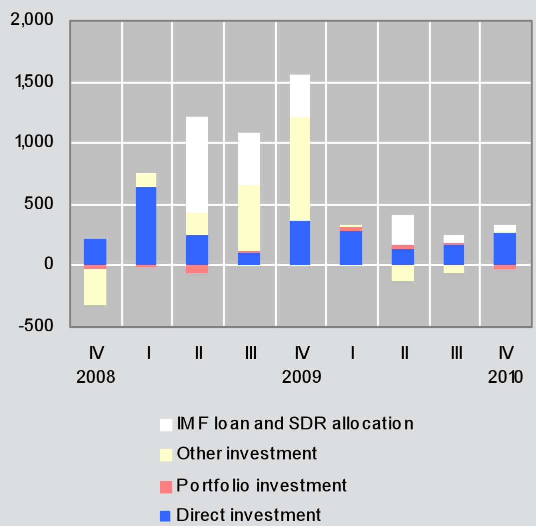
In Q4 banks borrowed abroad EUR 630 mln net, mostly short term. Of this amount, EUR 600 mln was borrowed in December alone. At the same time, bank holdings on accounts abroad increased by around EUR 217 mln. Net foreign debt repayment by the corporate sector was higher than in Q3, amounting to EUR 260 mln.

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



Capital inflow covered the rather low current account deficit in Q4.

Chart IV.2.6 **Structure of the financial account**
(in EUR mln)



Q4 saw a somewhat higher net capital inflow than Q3.

[6] In view of Serbia's broadly comfortable reserve position and the need to minimise the costs of the credit arrangement with the IMF, the authorities decided not to draw the tranches in the full amount approved.

3. Capital market trends

The fourth quarter saw substantial growth in trading in the domestic capital market, reinforced by a pick-up in stock exchange indices. Higher returns on RS bonds weighed down on market capitalisation of the Belgrade Stock Exchange.

Both indices of the Belgrade Stock Exchange (BSE) edged up in Q4. BELEX 15, the index of the most liquid shares, touched 651.8 points by the period-end, up by 5% on Q3. BELEXline, the benchmark index, reached 1282.7 by the year-end, up by 4.6% over the period observed. In January, the most liquid shares on the BSE rebounded vigorously, pushing up BELEX 15 and BELEXline by 12.8% and 8.4% respectively.

Increasing by 120% relative to Q3, total trading reached RSD 9.2 bln mainly due to domestic investor activity (RSD 6.4 bln vs. RSD 2.8 bln in Q3). Participation of foreign investors also increased (RSD 2.9 bln vs. RSD 1.4 bln in Q3).

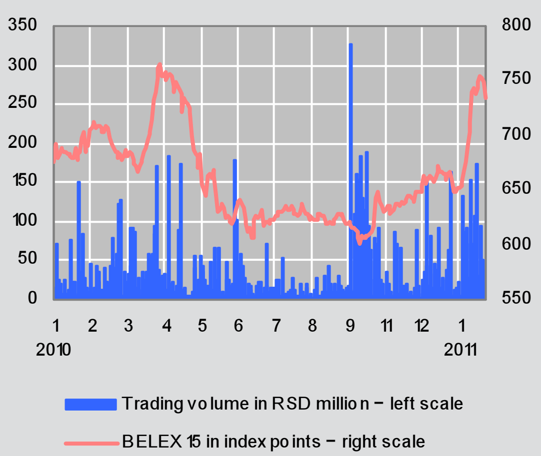
Shares accounted for RSD 7.6 bln of total trading assets, almost half of which were shares of two companies (AIK banka: RSD 2.1 bln and the Serbian Oil Industry: RSD 1.5 bln). Foreign investors focused mainly on stock purchases and accounted for RSD 1.6 bln of total purchases.

Total trading in RS bonds bounced back to RSD 1.7 bln in Q4. Still, December saw much less interest of investors, notably the foreign ones whose share in total bond trading amounted to not more than 0.8% (7.6% at the quarterly level), which reflected in reduced total bond turnover in December. These trends can be correlated with rates of return in the primary market of government securities[7].

On 31 December, the BSE market capitalisation arrived at RSD 933.5 bln (30.4% of GDP). Being under a stronger impact of plummeting bonds than a rise in shares, market capitalisation shrank by RSD 0.8 bln in Q4.

Regional stock exchanges recorded positive changes in benchmark indices, apart from Sofia and Budapest where SOFIX and BUX fell by 6.3% and 8.2% respectively.

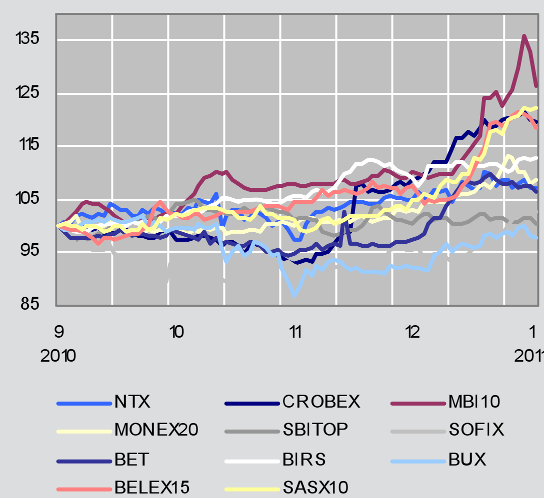
Chart IV.3.1 **Belex 15**



Source: BSE.

BELEX 15 has been rising since October, its hike particularly pronounced in January 2011.

Chart IV.3.2 **Stock exchange indices across the region**
(in index points, normalised, 30. 9. 2010 = 100)



Q4 growth in regional stock exchange indices was confirmed in early 2011.

[7] The average rate of return on bonds ranged in December between 4.3% for A-2016 series and 4.7% for May-2011 series, while the return on euro-indexed T-bills equalled 5.25%.

4. Aggregate demand

While foreign demand edged up in Q4, domestic demand weakened reflecting falling investment and government spending.

Seasonally-adjusted, the last quarter of 2010 saw a 1.3% decline in domestic demand and a 5.2% rise in net exports.

In terms of impact on GDP outturn, the decline in domestic demand (-1.5 pp) outweighed the positive impact of increased net exports (+0.8 pp). The most significant contributions to the decline in domestic demand came from lower investment (-1.0 pp) and government spending (-0.4 pp).

Overall in 2010, domestic demand stagnated (contributing -0.1 pp to GDP growth) primarily due to low domestic consumption (-1.2 pp). On the other hand, net foreign demand provided a positive contribution to GDP growth (1.8 pp).

Domestic demand

Household spending

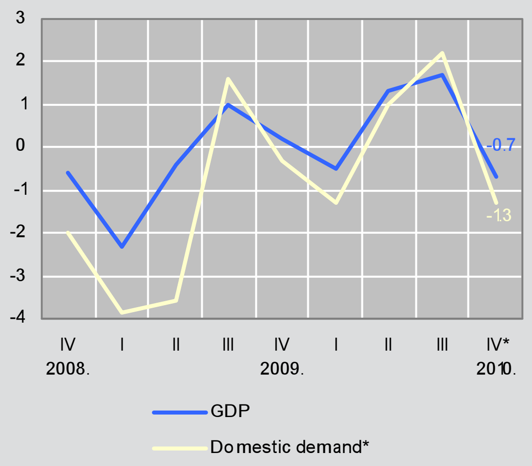
Household spending softened from a quarter earlier. This is also confirmed by the drop in retail trade turnover.

Household spending is estimated to have weakened in Q4 (by 0.2% sa), providing to GDP growth a negative contribution of 0.1 pp.

Real household income, as the main source of spending, continued down: real income (wages, pensions and social transfers) fell 2.8% sa relative to Q3. Such movements are chiefly due to the drop in real wages, which provided the greatest negative contribution to the drop in overall sources of spending.

Foreign exchange inflow from remittances increased, particularly in November. However, given the concurrent increase in savings, real net inflow from

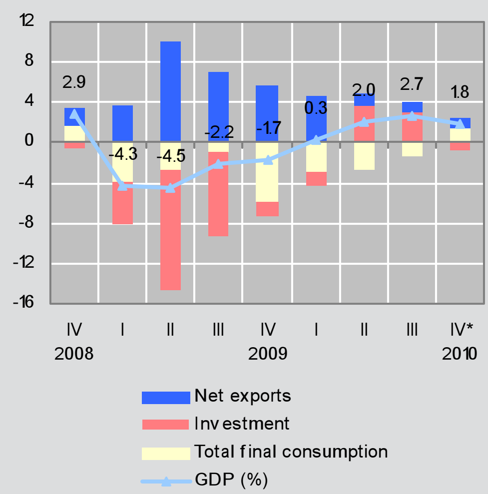
Chart IV.4.1 **Growth in GDP and domestic demand**
(seasonally-adjusted , quarterly growth , in %)



* NBS estimate.

GDP declined in Q 4 due to a drop in domestic demand triggered by falling investment and government spending.

Chart IV.4.2 **Contribution to y-o-y GDP growth**
(in percentage points)



*NBS estimate.

Slower GDP growth in Q4 is attributable primarily to the drop in investment activity.

remittances is estimated not to have had a significant impact on household spending in Q4.

Q-o-q, growth in household savings accelerated primarily as a result of attractive saving terms offered by banks during the Savings Week and extended over the entire month of November.

Consumer loans, as well as other household loans for consumption financing, slowed down in Q4.

Following recovery in the previous two quarters, retail trade turnover, the most important indicator of household spending, fell 1.9% sa in Q4. Turnover in the hotels and restaurants industry, as another indicator of household spending, recorded a moderate decline sa. The number of overnight stays also edged down.

In y-o-y terms, however, for the first time in two years, household spending recorded in Q4 an increase of 2.2%, contributing 1.5 pp to GDP growth. Such movements are attributable primarily to last year's low base, i.e. sharp drop in household spending in late 2009, but also to somewhat slower real growth in household savings.

The y-o-y increase in household spending is further corroborated by the rise in retail trade turnover and a high number of overnight stays, notably of domestic tourists.

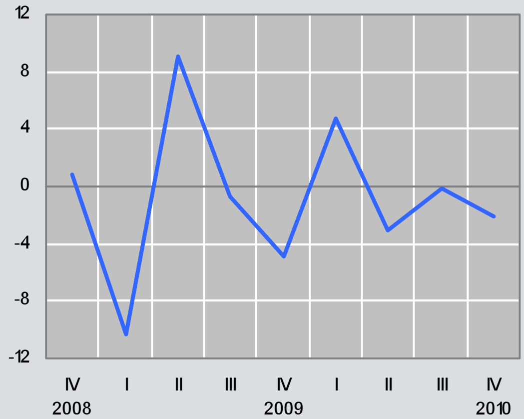
Overall in 2010, the drop in household spending is estimated at 1.6%, and its negative contribution to GDP growth at 1.2 pp. This is consistent with expectations of a much softer decline in household spending outturn in 2010 than in 2009, stated in the previous issues of Inflation Report, and confirmed by the movements in household spending indicators – a much softer decline in retail trade and hotels industry turnover relative to the previous year.

Government spending

In Q4, government spending fell both y-o-y and q-o-q. In 2010 as a whole, it declined 0.3% in real terms.

Data on government outlays for the purchase of goods and services and payment of public sector wages in Q4 point to a cut in government spending by 0.5% y-o-y in real terms.

Chart IV.4.3 **Public spending**
(seasonally-adjusted data, quarterly growth, in %)



Q4 saw a drop in public spending, mainly because of lower labour costs in the public sector.

Seasonally-adjusted, government spending fell 2.1% from the previous quarter.

The 0.3% real decline in government spending in 2010 as a whole came about as no surprise given the freeze on public sector wages in place until January 2011.

Investment activity

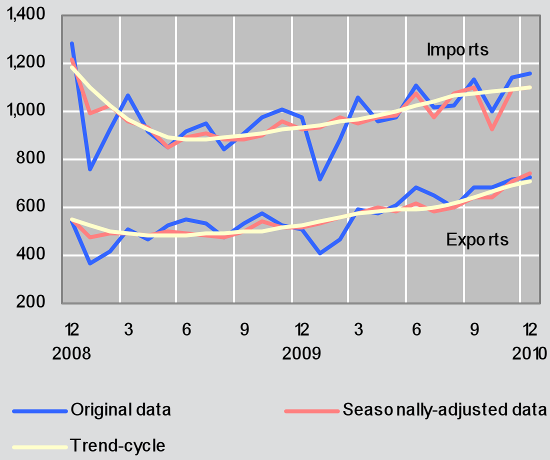
Capital investment is estimated to have edged down in Q4 from a quarter earlier.

The drop in capital investment in Q4 is signalled by the slowing imports and growing exports in conditions of stagnant domestic production of capital goods. Gross capital investment contributed -0.1 pp to GDP growth.

Based on the volume of new capital expenditure, government investment activity fell 1.7% q-o-q sa. Assuming government investment dynamics mirror that of capital expenditure, private investment stagnated.

Investment activity declined as a result of a smaller real increase in stocks.

Chart IV.4.4 **Exports and imports**
(in EUR mln)



The trade deficit contracted relative to Q3 as a result of faster growth in exports.

Net external demand

Outpacing imports in Q4, exports exerted a positive impact on overall economic activity.

Seasonally-adjusted, exports outpaced imports in Q4, resulting in a 0.8 pp contribution of net exports to GDP growth.

Foreign trade exerted a positive impact on GDP movements in y-o-y terms too (1.0 pp contribution) as exports continued growing at a faster pace than imports (33% compared to 12% y-o-y). The key export items were agricultural products (corn, apples) and processed food, base metals (iron, steel and non-ferrous metals), electrical machinery and chemical products. On the side of imports, growth was driven mainly by intermediate goods, which signals favourable economic expectations.

Exports shot past their pre-crisis level for the first time in Q4. In December 2010, they were 16% higher sa than the average January-September 2008 level, while

Table IV.4.1 **Investment indicators**

	2005-2008 (average)	2010			
		I	II	III	IV
Real indicators *(seasonally-adjusted, quarterly, growth, in %)*					
Construction	2.2	-0.7	-3.4	-1.2	1.5 *
Industrial production of capital goods (physical volume)	-6.5	-2.2	-6.1	-5.9	-0.1
Exports of capital goods**	29.3	-4.5	9.9	-8.3	14.8
Imports of capital goods**	11.2	-8.3	8.2	15.1	-3.1
Stocks of capital goods	-1.6	5.8	2.5	-6.9	-9.7
Industrial production of intermediate goods (physical volume)	3.9	-5.1	6.7	0.8	-2.5
Exports of intermediate goods**	17.6	6.5	5.9	1.6	12.6
Imports of intermediate goods**	15.4	0.2	12.0	12.5	4.4
Stocks of intermediate goods	0.5	0.0	-2.8	-0.8	-3.8
Government investment**	16.2	-17.7	-3.3	19.5	-1.7
Financial indicators					
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	528.8	-141.0	-270.0	-150.0	-233.0
Short-term credits to entreprises (in RSD bln)	54.7	32.5	39.4	19.7	36.4
Long-term credits to enterprises (in RSD bln)	51.8	16.1	35.8	12.3	26.1
Long-term credits to households (in RSD bln)	70.4	23.9	43.8	22.8	13.6

* NBS estimate.
** Imports are deflated by the index of producer prices of manufactured products in Germany; Exports are deflated by export producer prices of capital goods; Government investment spending is deflated by the index of producer prices of manufactured products.

imports remained 23% below the corresponding average. Robust growth in exports is in part due to past depreciation of the dinar, but also to the rise in food prices and international prices of base metals. As CEFTA members (our second most important trade partner that we are running a trade surplus with) are poised for further recovery in 2011, the prospects for Serbian exports remain bright.

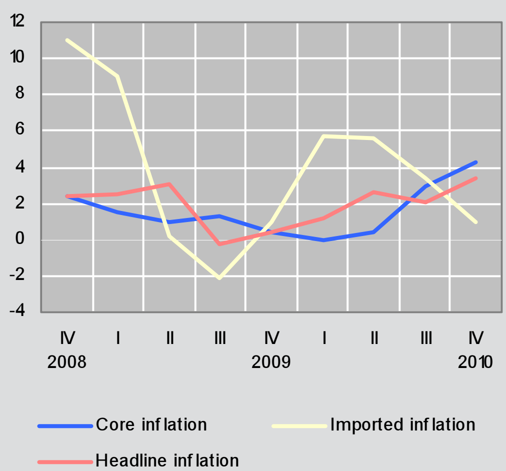
Reflecting movements described above, foreign trade deficit narrowed in Q4 by 13% from the same period a year earlier.

Imported inflation[8] declined for the third month in a row, settling at annualised 1.0%[9] in Q4. The slowdown in imported inflation came primarily in response to lower depreciation of the nominal effective exchange rate of the dinar (down from 3.4% in Q3 to 0.2% per annum average in Q4). At the same time, prices in the EU and the United States rose by 0.7% on average. The slack in imported inflation had no major effect on headline and core inflation (which moved in the opposite direction).[10]

Oil prices revolved around USD 80 per barrel in Q4. It was only in December that they recorded a stronger rise, exceeding USD 90, due to extremely cold weather and higher than expected demand that triggered a decline in US oil inventories. Oil prices surged also in response to a stronger than anticipated global economic growth and improvement in its outlook. According to the International Energy Agency, the demand for oil will be higher in 2011 than last year. Oil prices are expected to soar above USD 100, which could threaten the global recovery.

The price of copper, the most significant non-ferrous metal in terms of Serbian exports, recorded a hefty rise in Q4. Spiralling up by 16% from end-November, it touched the record high of nearly USD 10,000 per tonne at end-December 2010 (only to cross it in early February). The main reasons behind this staggering growth are the global economic recovery and, in particular, buoyant demand from emerging Asia and Europe.

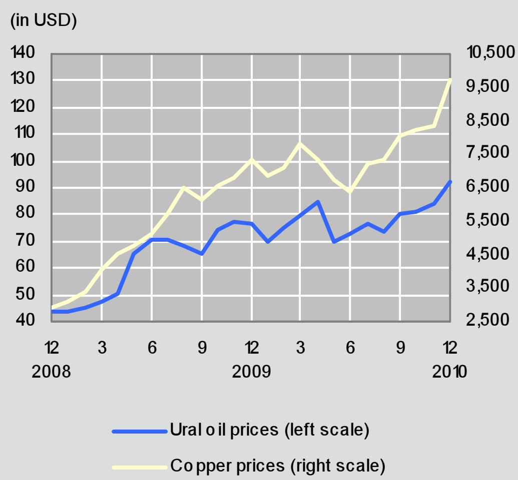
Chart IV.4.5 **Domestic and imported inflation**
(quarterly growth rates, in %)



Source: NBS and Eurostat.

The growth in imported inflation softened due to lower nominal effective depreciation of the dinar, but also due to the drop in EU and US prices.

Chart IV.4.6 **Oil and copper price movements**



Source: Bloomberg.

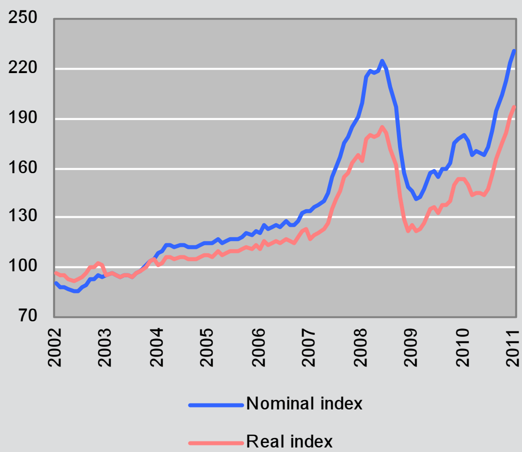
Oil prices rose throughout Q4, but most sharply in December. Copper prices exibited similar trend, marking however an even heftier rise in December.

[8] Imported inflation is a result of change in the nominal effective exchange rate of the dinar (weights: 0.8 for the euro and 0.2 for the dollar) and prices in the eurozone and the United States (weights 0.8 : 0.2).

[9] Ratio of averages for two consecutive quarters.

[10] Ratio of averages for two consecutive quarters.

Chart IV.4.7 **Index of global food prices**
(2002 - 2004 = 100)



Source: FAO, UN.

World food prices have been on a steep rise since June 2010.

As indicated by the Food Price Index of the UN Food and Agriculture Organisation, food prices rose to new highs in December.[11] The strongest rise was recorded for sugar prices, which soared to their 30-year maximum, followed by prices of meat and sugar beet. Prices of rice were relatively stable, while those of wheat spiralled up amid unfavourable weather conditions. The situation went even worse when the largest grain producers (Russia and Ukraine) introduced restrictions on exports. The weakening of the dollar also played a role.

5. Economic activity

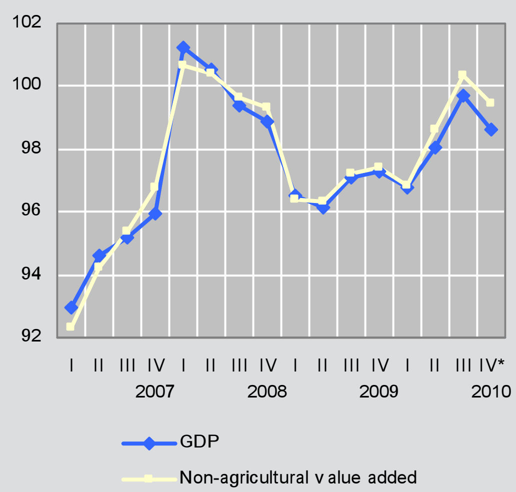
Following manifest growth in Q3, economic activity is estimated to have contracted in Q4 and negative output gap to have widened. Recovery is expected to continue in the coming quarter.

GDP growth of 1.7% sa (2.7% y-o-y) in Q3 was much higher than estimated in the November Inflation Report. Accelerated economic growth was driven mainly by improved agricultural performance, i.e. a more moderate decline in agricultural output. A positive contribution to economic growth came from robust trade, expanding activity in the sectors of transport, warehousing and communications, as well as in manufacturing. NAVA gained 1.7% sa (3.3% y-o-y), coming close to its pre-crisis levels.

However, following a rebound in Q3, GDP and NAVA are estimated to have fallen by 0.7% and 0.4% sa in Q4 respectively. In y-o-y terms, growth in GDP and NAVA in Q4 are projected to have slowed to 1.8% and 2.5% respectively.

A q-o-q drop in estimated GDP was driven mainly by slackening industrial output (contribution: -0.6 pp) and a cutback in agricultural output and trading volumes (0.1 pp each). Y-o-y, a slowdown in GDP growth was prompted by falling agricultural output (-0.3 pp), construction (-0.1 pp)

Chart IV.5.1 **Economic activity indicators**
(seasonally-adjusted data, 2008= 100)



* NBS estimate.

Q4 saw a fall in GDP mainly due to contraction in manufacturing.

[11] *FAO Food Price Index* is calculated since January 1990. It includes prices of most primary commodities such as: wheat, corn, rice, sugar beet dairy products, sugar and meat.

and industrial output (-0.2 pp) that plunged anew after two successive quarters of recovery.

Industrial output faltered due to a scale-back in manufacturing, as well as production and distribution of electricity, gas and water.

Within manufacturing, a decline was recorded with the production of food and beverages, chemicals and chemical products, coke and petroleum products. The production of food and beverages ebbed in response to a hike in prices of raw materials (mainly due to a weaker agricultural year) and producers' limited capacity to pass over the cost of the increase to end-consumers in an environment of low domestic demand. The overhaul of the Pančevo refinery, launched in mid-October, prompted a collapse in the production of the Oil Industry of Serbia in the same month. The completion of the overhaul by end-November propped up production which, however, stayed at a markedly low level until the year-end. In y-o-y terms, the production of motor vehicles declined as the programme of subsidised domestic car loans was brought to an end.

Industrial output lost pace not only in response to a decline in manufacturing, but also due to a drop in the production of electricity in above-average temperature conditions in November.

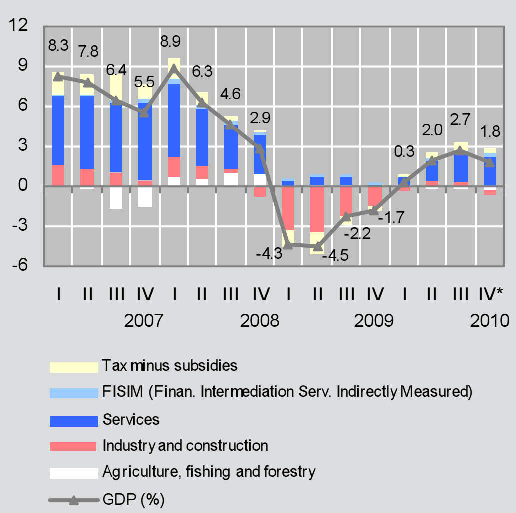
The economic downturn in Q4 was caused by a drop in agricultural output (1.2% sa), giving a negative contribution (0.1 pp) to GDP growth. A decline was recorded chiefly in regard to the production of vegetable crops, fruit and wine growing, with robust growth recorded in the production of cereals (corn) and industrial crops (soy, sugar beet).

Falling trade volumes (0.6 sa) provided further negative contribution to GDP growth. A monthly decline was particularly pronounced in October retail trade. The trend of recovery established in previous two quarters was thus effectively halted at the level well below the pre-crisis figure. A reduction in retail trade in Q4 reflected a further real drop in wages and consumer and cash loans. Y-o-y, however, trade volumes are estimated to have picked up by 7.1% in Q4.

In contrast to a rise recorded over the previous two quarters, the hotels and restaurants sector suffered a decline relative to Q3 (contribution to GDP growth: -0.1 pp), as evidenced by a turnover slip in the catering industry and a lower number of overnight stays by tourists. A y-o-y rise in this sector is estimated at 4.9%.

The slack in the construction sector, in place for almost three years, was discontinued in Q4. Construction is

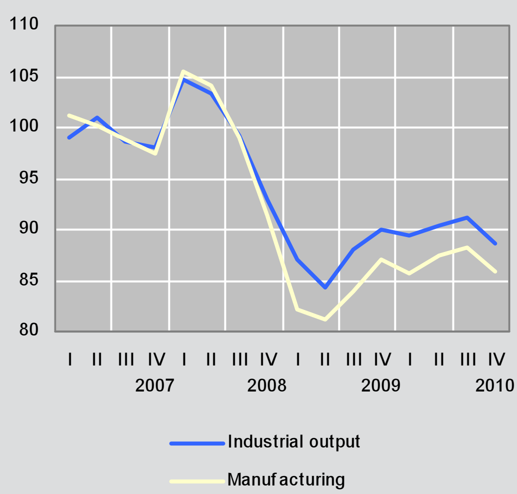
Chart IV.5.2 **Contribution to y-o-y GDP growth**
(in p. p.)



* NBS estimate.

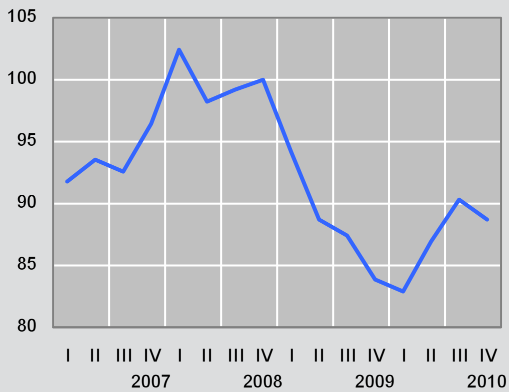
Slower economic recovery is expected in Q 4 .

Chart IV.5.3 **Industrial output**
(seasonally-adjusted data, 2008 = 100)



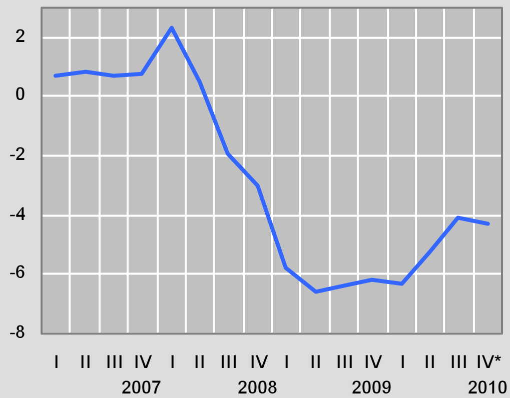
After two quarters of recovery, industrial output recorded a decline in Q 4 .

Chart IV.5.4 **Retail trade**
(seasonally-adjusted data, 2008 = 100)



After a rebound in previous two quarters, retail trade declined in Q4.

Chart IV.5.5 **Output gap***
(percentual deviation from the trend)



* NBS estimate.

Negative output gap deepened due to faltering economic activity in Q4 relative to Q3.

estimated to have risen by 1.5% sa relative to Q3. In y-o-y terms, a decline in the construction sector slowed down. Recovery is likely in the course of 2011 in response to rising investment, chiefly of the private sector. A boost to estimated GDP growth in Q4 came from the sector of transport, warehousing and communications, both in quarterly (0.2 pp) and y-o-y terms (1.0 pp). Growth in this sector was achieved primarily on account of an increase in passenger and freight transport.

Financial intermediation was yet another sector that recorded growth in quarterly terms. Accelerated growth in real lending (due to rising corporate lending) and a considerable rise in banking deposits (during the “Savings Week”) resulted in an upturn in the financial intermediation sector (0.1 pp).

Estimates point to a temporary nature of the economic downturn in Q4 (depressed production of electricity in above-average temperature conditions in November, the overhaul of the Pančevo refinery) and a rise in economic activity in Q1 2011, largely due to a rebound in the US Steel output.

Given the trends recorded over the past quarters and expectations for Q4, the GDP growth estimate for 2010 is placed at c. 1.7%. In view of a rise in agricultural output expected in 2011 (better agricultural performance and a low 2010 base) and faster recovery of manufacturing, GDP growth in 2011 is estimated at around 3.0%.

As a result of economic slowdown in Q4, the negative output gap measured by deviation of NAVA from the trend is deepening. This implies continuation of disinflationary pressures due to the persistently low aggregate demand.

6. Labour market developments

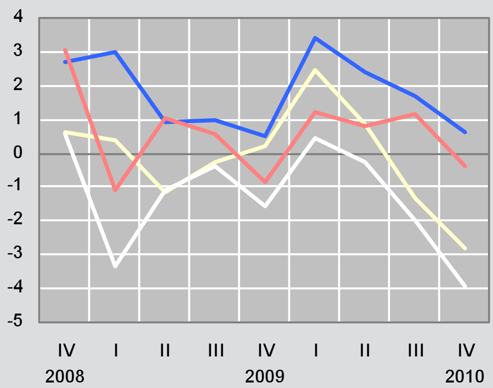
Wages

Real wages continued down both in the private and public sectors. The drop in industrial unit labour costs slowed.

According to seasonally-adjusted data, growth in nominal wages slowed down in Q4, while real wages declined from the previous quarter. Nominal net wages rose 0.6% (primarily due to growth in private sector wages), whereas real net wages (both private and public sector) fell 2.8% largely due to faster growth in the cost of living.

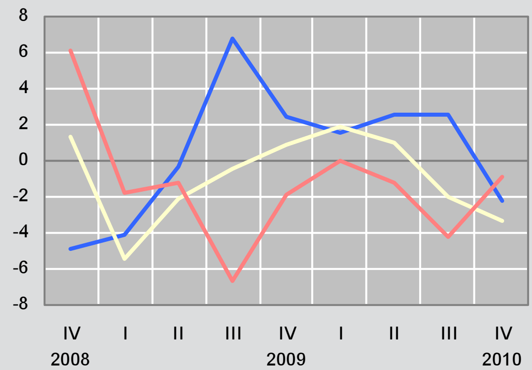
Nominal net wages rose in most industries, notably agriculture, fishing, construction, transport and finance.

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



Real wage drop in Q4 was prompted by falling public sector wages.

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



The decline in unit labour costs softened in response to a decrease in labour productivity, despite the continuing drop in real gross wages.

At the same time, they fell in trade (reflecting reduced turnover), mining and quarrying, and real estate.

Real net wages fell in almost all sectors of the economy, notably industry, and most sharply in mining and quarrying. Real net wages also declined in trade and hotels and restaurants. Practically the only sectors that witnessed a rise in real net wages were fishing and construction.

Seasonally-adjusted, public sector wages declined in both nominal and real terms (0.4% and 3.9%, respectively). At the same time, private sector wages rose 3.1% in nominal and fell 1.1% in real terms.

Y-o-y, nominal wages continued up (8.4%), while real wages headed further down (1.0%). According to original data, the average net wage in Q4 amounted to 36,141 dinars (around 339 euros). A rise in nominal wages was registered in both public and private sector (2.7% and 13.2% y-o-y). Real wages in the public sector continued down (6.1% y-o-y), while their growth in the private sector slackened (3.3% y-o-y).

The decline in industrial unit labour costs softened relative to Q3 in response to a decrease in labour productivity (after a year of increase), despite continuing drop in real gross wages. The same trend was recorded in manufacturing.

Overall in 2010, nominal and real net wages went up by 7.6% and 0.7%, respectively, primarily as a result of wage growth in the private sector (13.0% in nominal and 6.6% in real terms). Public sector wages, on the other hand, gained 2.4% in nominal and lost 3.4% in real terms.

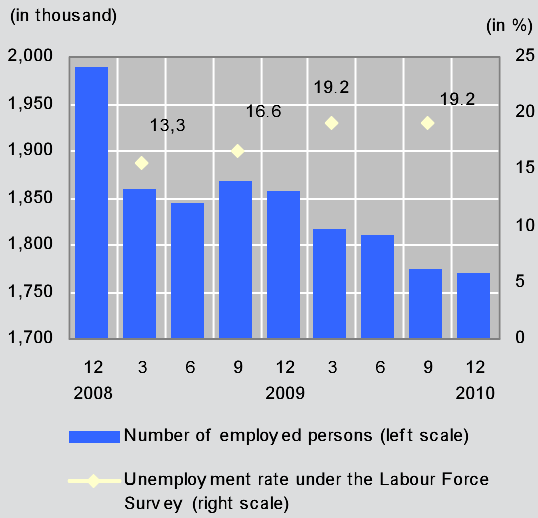
On 1 January 2011, the government lifted the freeze on pensions and public sector wages. The size of the increase in public sector wages will depend on movements in economic activity and inflation. Some pay rise is also expected in the private sector. Still, the estimates are that the wage increase in 2011 will not be big enough to bolster domestic demand to any major extent.

Employment

Employment numbers continued down, though at a slower pace than in Q3. The Labour Survey points to a stagnant unemployment rate (19.2% in 2010).

Official statistics signal a further, though slower q-o-q decline in employment numbers (by 3,836 persons or 0.2%). A scale-back in manufacturing employment (-0.2 pp), provoked by persistent slack in the sector, was the main factor behind the continuing fall in employment.

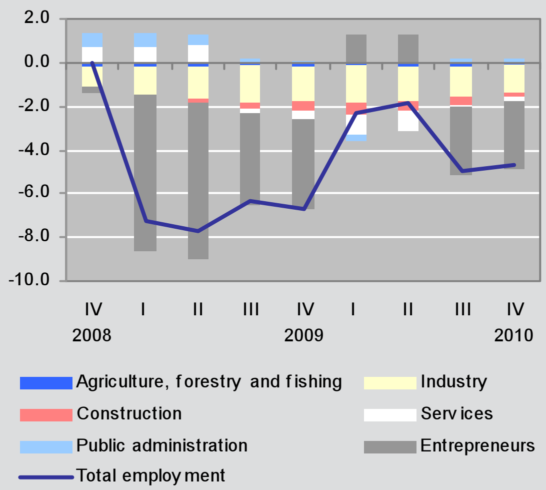
Chart IV.6.3 **Unemployment**



Source: National Employment Service and Serbian Statistical Office.

The decline in employment numbers decelerated in Q4 relative to Q3. The October unemployment rate remained unchanged from April 2010.

Chart IV.6.4 **Employment by sector**
(contribution to y-o-y growth in employment, in p.p.)



Source: Statistical Office.

Q4 experienced a slower decline in employment as a result of a decelerated decline in the number of employees in the manufacturing sector and construction.

Contraction was also observed in the transport, warehousing and communications sectors, as well as in the real estate sector. In contrast, total public sector employment picked up slightly in Q4 and is currently above the pre-crisis average (particularly in the educational sector and utilities).

Y-o-y employment shrank by 4.7% in Q4 because of a further decline in the number of entrepreneurs and their employees (-3.1 pp). However, a y-o-y fall in overall employment decelerated due to a slackening decline in employment in the majority of sectors, most notably manufacturing and construction. Employment in financial intermediation and real estate sectors, however, experienced a mild y-o-y pick-up in Q4.

Judging by the October 2010 Labour Survey, the unemployment rate remained unchanged from April (19.2%), but rose (2.6 pp) relative to October 2009.

In 2011, the National Employment Service plans to kick-start seven employment programmes worth RSD 5.6 bln. Around 60,000 people are expected to obtain jobs through programmes such as "First Chance 2011", "Professional Practice 2011" and implementation of other measures (job creation and self-employment subsidies, public works in social and humanitarian reliefs and training for employers' needs).

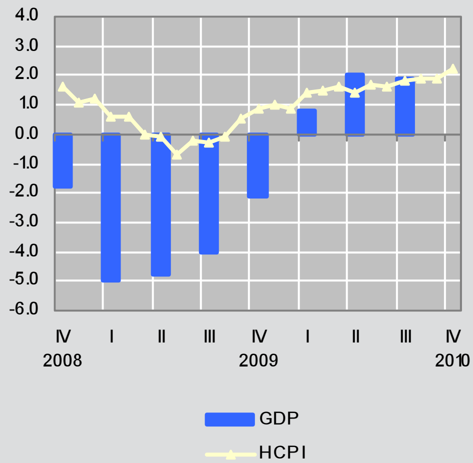
7. International environment

The year 2010 marked the start of recovery from the global economic crisis. The vigorous rebound of the German economy is important for Serbian exports.

The global economy recovered well in 2010 (most analysts estimate growth of over 4%), which tempts us to conclude that the crisis is over. The recovery is unevenly spread, though. It is expected that Asian, Latin American and Central and East European countries will restore their pre-crisis growth rates already in the first half of the year, while advanced economies should not hope for such results before 2013. Slower recovery of advanced economies is largely attributable to the fact that it was in these economies that the negative effects of the crisis unfolded most strongly.

Notwithstanding ample support provided by the ECB[12], eurozone financial markets failed to stabilise by end-2010. The crisis of confidence is deepening, still more so after the emergency bail-out for Ireland worth around EUR 85 bln. While the European authorities do not question sustainability of the monetary union, there is still no political consensus about the way to resolve the sovereign debt crisis. Uncertainty and stress will therefore probably linger in the financial markets for some time yet.

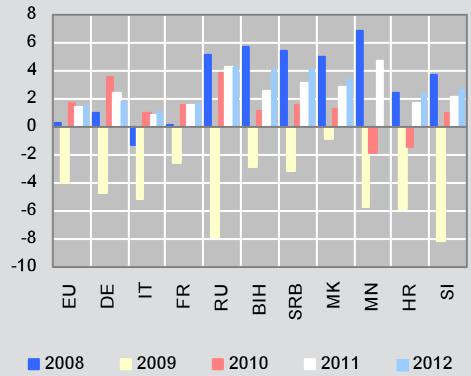
Chart IV.7.1 **Eurozone GDP and inflation**
(y-o-y growth rates)



Source: Eurostat.

GDP growth, begun in Q1, accelerated in Q2. Inflationary pressures remain in check and inflation growth negligibly small.

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



Source: Consensus Forecast, January 2011.

The recovery of the above economies in 2010 , notably that of Germany, resulted in strong export growth.

Eurozone growth slowed considerably in Q3, and is likely to have slowed further in Q4 according to preliminary estimates. Still, what is encouraging for the Serbian economy is the strong rebound recorded by Germany, an important trade partner of Serbia. Central and East European countries are expected to grow by around 3.6% in 2011, Poland and Slovakia leading the way. As for Serbia's trading partners, a more intense growth is forecast for Montenegro and Bosnia and Herzegovina. On the other hand, Italy, one of Serbia's most important trade partners, is poised for an even more modest growth than in 2010.

Despite mounting inflationary pressures, eurozone monetary stance will most probably remain accommodative reflecting the need to maintain liquidity levels. Although inflation exceeded the target of below, but close to 2% in December 2010, it is still not regarded as a threat and a reason for monetary tightening.

After pursuing expansionary monetary policies over a substantial period, central banks of Central and East European countries may decide to reverse their policy stance, especially in those countries that are set for stronger economic growth in 2011. To quell rising inflation expectations, the Hungarian National Bank raised its policy rate twice in Q4, which makes it, in addition to the NBS, the only central bank in the region to have tightened its monetary policy stance.

The US economy is showing signs of a mild recovery. It is evident that monetary and fiscal stimuli are producing results and that the economy boasts a high degree of resilience to shocks. Investor confidence in the sustainability of recovery is therefore much higher for the US economy than for the eurozone, and investors increasingly turn to US securities as a safe haven.

A rather expansionary monetary policy implemented by the Fed, as well as the program of Treasury bond purchases, is expected to continue in 2011. The aim is to lower long-term yields on Treasury bonds, leading to a drop in mortgage and commercial loan rates, and by extension, bolstering consumption and economic expansion.

[12] Such as the rescue deal for Greece worth EUR 110 bln, the European Financial Stability Facility worth EUR 750 bln, increased purchase of peripheral sovereign debt.

The Fed's accommodative measures, however, did not induce the weakening of the dollar in Q4. As a matter of fact, the dollar strengthened perceptibly against the euro in November despite Fed's decision to buy USD 600 bln worth of Treasury bonds. The main reasons behind the dollar's appreciation were uncertainties about public finance sustainability of the eurozone periphery, fears of contagion spreading to other advanced (and larger) economies, and investor concerns about the stability of the euro. Investment prospects in the eurozone appearing highly uncertain, investors turned not only to the US dollar, but also to the Swiss franc and the Japanese yen. As a result, in 2010, the Swiss franc strengthened against the euro by as much as 15% and by more than 10% against the dollar. Instability in the foreign exchange markets is likely to persist in the coming period.

V. Inflation projection

After overshooting the target tolerance band for most of 2011, inflation is expected to retreat close to its upper bound at the end of the year, and to move within the target band in 2012. The cost push pressure on food prices and a hefty rise in regulated prices will keep inflation elevated in H1 2011 despite low demand and current appreciation of the dinar. Inflation is expected to fall in H2 2011 and early 2012 on the back of anticipated relative drop in food prices and low aggregate demand. The economy is set for a faster growth in 2011 and 2012 than last year. The NBS Executive Board judges that the key policy rate is more likely to be raised or kept on hold rather than revised down.

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 fulfill its principal role as defined by the current monetary policy framework.

Initial conditions

Robust growth in consumer prices continued in Q4 2010, and y-o-y inflation exceeded the upper bound of the target for the first time since the official introduction of a full-fledged inflation targeting regime. Inflationary pressures stemmed mostly from high production costs of processed food, reflecting the increase in agricultural product prices this summer (in the country and abroad), as well as from the delayed pass-through of dinar's depreciation to consumer prices from H1 2010.

The rise in international agricultural product prices (wheat, corn, sunflower, sugar, coffee, etc.), particularly pronounced since June 2010, proceeded in Q4 and early 2011, sustaining the cost push pressure to processed food prices.

International prices of other primary commodities also marked an increase. Oil prices, for instance, soared by around 20% since September, and those of base metals exhibited similar trend. Prices of wool and cotton also headed up, pushing the clothing production costs higher.

By contrast to several previous years, the turn-of-the-year period saw moderate appreciation pressures. Apart from the key policy rate hike and the falling risk premium, appreciation pressures were aided by the gradual restoration of investor confidence in Serbia.

Although, on average, the dinar depreciated in nominal terms in Q4, a much higher domestic than eurozone inflation caused it to appreciate in real terms and the depreciation gap to narrow down after quite a while. The depreciation gap remained open, however, suggesting relatively low net importers' real profit margins in Q4.

After a moderate rise in Q4, inflation expectations steadied in early 2011.

Overall, aggregate demand remained low and as such, a damper on price growth. The widening of the negative output gap in Q4 signals that low demand will continue to be an important disinflationary factor in the coming period.

Following strong growth in Q3, economic activity declined in Q4 reflecting the drop in domestic demand and a bad agricultural year. On the other hand, as a result of the depreciation of the dinar, the rising international prices of our key export products (food and base metals), and the upswing in foreign demand, exports outpaced imports, giving a positive contribution to output growth.

Moderate economic growth in the eurozone, Serbia's key trading partner, continued in Q4 despite tighter fiscal policies implemented by many of its members in H2 2010.

The revision of the key policy rate from 9.5% to 11.5% and the real appreciation of the dinar resulted in a less expansionary monetary stance in Q4 than a quarter earlier. Early in the year, the NBS raised the key policy rate by 50 bp to its current level of 12%.

Projection assumptions

According to government announcements, regulated prices will already in Q1 increase by 6.9%, which is roughly the midpoint value of the growth agreed for the whole year (7±2%). We therefore expect a higher than agreed regulated price growth in 2011. A somewhat lower growth is anticipated in 2012.

Assuming average agricultural performance, the currently rather high prices of fruit and vegetables driven up by vigorous growth last year, are expected to record a relative drop in 2011, i.e. to grow slower than other prices.

For the same reasons, the projection assumes a moderate decline in prices of other agricultural products – inputs in the production of processed food (wheat, corn, sunflower…).

The trend of real appreciation of the dinar against the euro, i.e. Serbia's price convergence to the eurozone is expected to continue. In addition, the global economic recovery and strengthening of investor confidence in Serbia is likely to push the risk premium further down, all leading to a gradual decline in the real interest rate trend.

The eurozone appears to be on the path of a sustainable moderate recovery. Though inflation increased to 2.2% y-o-y in December 2010, the causes for the increase are assessed as temporary and inflation is expected to fall back below 2% in the course of 2011. The ECB will keep its policy rate unchanged (1%) until end-2011, and gradually raise it in 2012.

Inflation projection

After overshooting the target tolerance band for most of 2011, inflation is expected to retreat close to its upper bound at the end of the year, and to move within the target band in 2012 (Chart V.0.1.).

In early 2011 consumer price growth will be relatively high, chiefly because of the announced revision in regulated prices, but also because of the continuing surge in food prices. The regulated prices set to grow in Q1 are those of electricity, cigarettes, natural gas, public transport, utilities and medicaments. The rise in petrol prices, until recently under government regulation, should also be taken into account.

Although the prices of processed food products rose significantly in H2 2010, our estimates suggest that the effects of higher input costs (prices of corn, wheat, sunflower…) have not fully exhausted yet and that they will continue up in H1 2011.

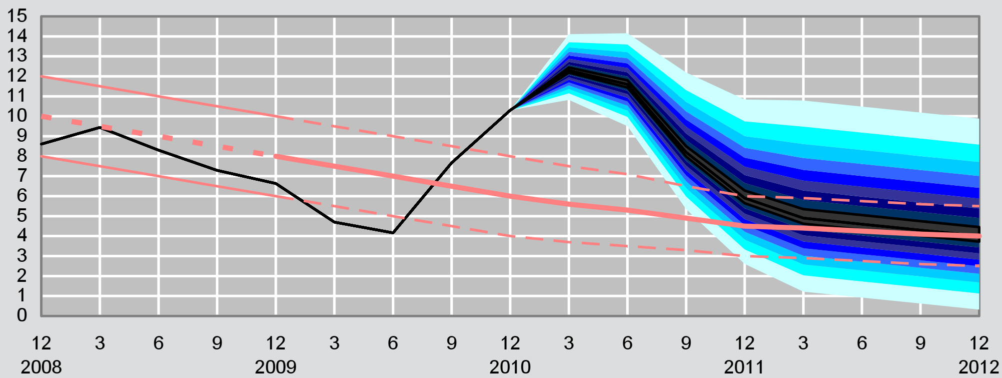
The above two components of CPI (regulated and food prices) will sustain high monthly inflation rates in H1, which will, due to the low base (low inflation rates in the same period last year), cause y-o-y inflation to rise further.

In H2 2011 and early 2012, on the other hand, food prices might work in the opposite direction. As they are currently rather high due to last year's poor agricultural season in Serbia and worldwide, it would be logical to expect that they will decline relative to other prices even

Table V.0.1 **Projection assumptions**

	2011	2012
External assumptions		
EU inflation (Q4 to Q4)	1.5%	1.6%
ECB policy rate (year-end)	1.0%	2.0%
Euro area GDP growth	1.5%	1.6%
Ural oil price per barrel (year-end, USD)	103	108
Internal assumptions		
Regulated prices excl. petroleum products (Dec to Dec)	10.0%	7.0%
Prices of agricultural products (Dec to Dec)	0.0%	5.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.5%	2.0%
Real interest rate trend (average)	4.5%	4.1%

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



After overshooting the target tolerance band for most of 2011, inflation is expected to retreat close to its upper bound at the end of the year, and to move within the target band in 2012. The risks to the projectior are tilted to the upside due to the possibly faster growth in public sector wages, regulated prices and prices of agricultural products.

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%.

in the event of average agricultural performance, feeding through into lower processed food production costs.

The medium-term disinflation process will be also strongly aided by low demand, particularly as the January increase in pensions and public sector wages (2%) was lower than announced earlier. True though, the gradual recovery of economic activity will lead to the narrowing of the negative output gap, i.e. gradual weakening of demand-side disinflationary pressures.

Depreciation gap, as an indicator of net importers' low profit margins, is expected to close early in the year, wherefore no inflationary pressures are likely from this source. The depreciation gap will close as a result of real strengthening of the dinar, prompted by high inflation rates and the dinar's nominal appreciation in early 2011.

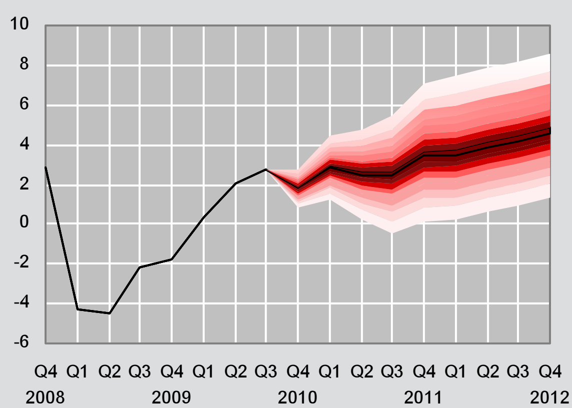
Low demand and a trend reversal in food prices will be the key factors leading to a drop in monthly inflation rates, and, coupled with the high base, to a considerable fall in y-o-y inflation rates in H2 2011 and early 2012. Consequently, inflation should return within the target band either in late 2011 or early 2012.

The Serbian economy is poised for moderate growth in the coming period (Chart V.0.2). In 2011, its growth is expected to step up to 3.0%.

It is expected that domestic demand will provide a stronger contribution to economic growth than earlier. This relates primarily to capital investment, which suffered a sharp decline in 2009 and 2010, but is likely to pick up in the near future in light of brighter growth prospects and announced arrival of many foreign investors attracted by government subsidies.

The economy is on the mend, but the unemployment rate is likely to stay high for some time yet, holding back

Chart V.0.2 **GDP growth projection**
(y-o-y rates, in %)



Economic growth is expected to step up in 2011 and 2012.

personal consumption despite the unfreezing of pensions and public sector wages.

Past depreciation of the dinar against the euro and currencies of CEFTA countries, as well as the surging international prices of our key export products (food and base metals), will continue to serve as a fillip to Serbian exports. On the other hand, the economic recovery and rising domestic demand will lead to an increase in imports, which is why the overall contribution of net exports to economic growth will be somewhat lower than in the prior period.

A higher GDP rate in 2011 will be also underpinned by the low agricultural production base. Namely, after a poor agricultural season in 2010, agricultural output will increase this year even in the event of average agricultural performance. Besides, high prices of agricultural products will probably encourage farmers to increase their production investment.

Risks to the projection

The key risks to inflation projection are uncertainties regarding movements in public sector wages, regulated prices, food prices, the risk premium and inflation expectations.

The announcement of strikes in the public sector raises concern that the government might raise wages above the level agreed for this year. In such a scenario, inflationary pressures would grow stronger than assumed by the projection, impelling the NBS to tighten its monetary policy stance.

The role of the government is also very significant in terms of growth in regulated prices. The agreed regulated price growth was exceeded in both 2009 and 2010, and early 2011 is likely to witness significant price revisions. Any major overshooting of the planned growth in regulated prices could delay yet further the projected return of inflation within the target band.

Whether and to which extent the rise in processed food prices will continue depends largely on movements in prices of primary agricultural products (input costs). The projection assumes a moderate decline in these prices, but deviation is possible in either direction. In the event of good local and global weather conditions, agricultural product prices might register a sharper drop from their lofty levels, attained as a result of a poor agricultural season last year. On the other hand, according to some analysts, the growth in these prices is demand-driven (growing demand from developing countries, biofuel production), and they could easily stay as high or shoot even higher.

The risk premium displayed great volatility in 2010 (rising in May and then falling at the close of the year), exerting a significant impact on exchange rate movements. In view of the lingering uncertainty associated with economic recovery and unease in the global and regional markets, movements in the risk premium remain uncertain, just as the resulting volatility in the exchange rate. The projection assumes a mild decline in the risk premium, but deviation is possible in either direction.

What also remains uncertain is for how long inflation expectations will keep steady. The more anchored inflation expectations, the speedier the process of disinflation.

On balance, the risks to the outlook for inflation are tilted to the upside due to the possibly faster growth in public sector wages, stronger increase in regulated prices and continuing rise in prices of primary agricultural products.

Comparison with the previous projection

The current inflation projection for 2011 is slightly higher than the one published in the November Report (Chart V.0.3), while projections for 2012 are more or less the same. Continuing growth in primary agricultural product prices and a rise in regulated prices are having a stronger inflationary impact, while lower than announced growth in pensions and public sector wages and the strengthening of the dinar are having more of a disinflationary impact than assumed in the November projection.

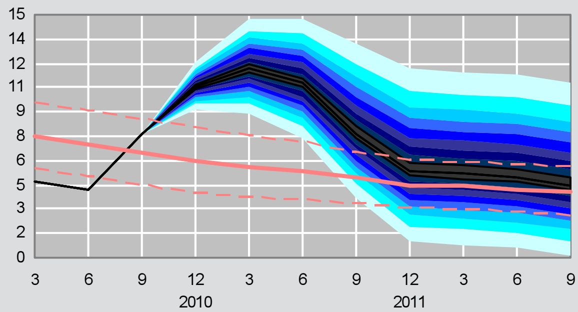
As the prices of primary agricultural products (wheat, corn…) increased further in late 2010 and early 2011, exceeding our expectations at the time of the November *Report*, this projection assumes a stronger cost-push pressure on processed food prices than the previous one.

A number of regulated price revisions already in the offing, the chances of keeping the 7±2% lid on regulated price growth are getting slimmer. We have therefore raised our assumption for regulated price growth in 2011 from 8% to 10%.

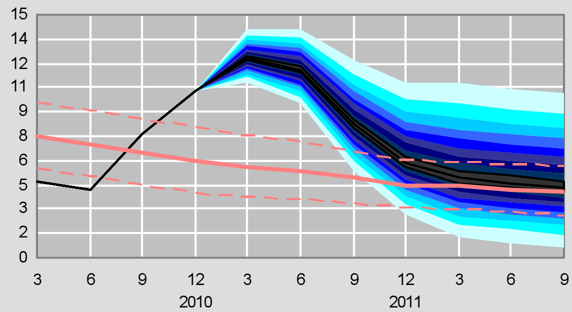
On the other hand, the government's decision to increase pensions and public sector wages by 2%, rather than to

Chart V.0.3 **Current vs. previous projection**

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

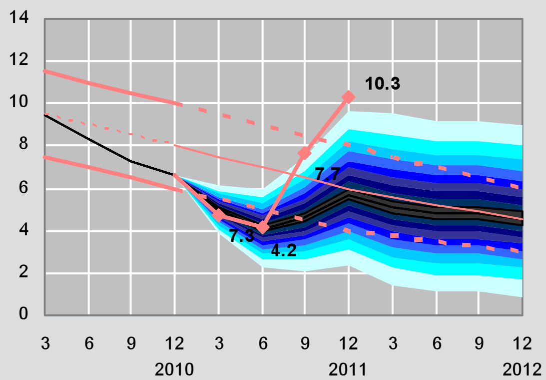


February projection
(y-o-y rates, in %)



The current inflation projection for 2011 is slightly higher than the one published in the November Report, while projections for 2012 are more or less the same.

Chart V.0.4 **Inflation outturn vs. February 2010 inflation projection**
(y-o-y rates, in %)



In H2 2010 inflation moved above the band projected in February 2010.

adjust them by CPI growth in H2 2010 (6.3%) planned earlier, will amplify the disinflationary effects generated by demand, i.e. it will ease overall inflationary pressures.

The drop in risk premium in late 2010 and early 2011 was sharper than anticipated at the time of the November Report, which in addition to other factors contributed to the strengthening of the dinar and to the easing of exchange rate-driven inflationary pressures (imported inflation).

The changes in assumptions about the growth in regulated and primary agricultural product prices in 2011 have a somewhat stronger impact than those in assumptions about the rise in wages and the drop in risk premium, which is why the current projection for 2011 is slightly higher than the previous one.

In H2 2010 inflation moved above the band projected in February 2010. The main reasons behind this deviation were a sharp rise in food prices in H2 2010 and May–July depreciation of the dinar triggered by the rise in risk premium, sparked by concerns over eurozone sovereign debt crisis.

Outlook for the key policy rate

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the key policy rate is more likely to be raised or kept on hold rather than revised down.

Table A
Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
EXTERNAL LIQUIDITY INDICATORS (in %)												
Forex reserves/imports of goods and services (in months)	4.1	4.8	3.9	6.2	9.1	7.2	5.2	9.4	9.8	8.6	7.6	7.4
Forex reserves/short-term debt	364.3	539.0	708.3	522.5	943.9	920.0	382.1	528.8	549.4	719.2	762.4	546.4
Forex reserves /GDP	13.8	16.5	16.5	24.4	38.8	33.6	24.5	35.4	34.7	34.9	32.8	33.5
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.0	10.3	11.1	13.0	11.1	9.3	12.3
Debt repayment/exports of goods and services	7.0	9.0	16.4	17.7	23.5	33.2	34.0	39.1	43.8	32.9	27.5	33.5
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	58.7	55.9	49.8	60.1	60.9	59.5	63.1	75.0	76.3	77.9	76.8	79.6
Short-term debt/GDP	3.8	3.1	2.3	4.7	4.1	3.6	6.4	6.7	6.3	4.8	4.3	6.1
External debt/exports of goods and services	300.9	251.6	211.5	228.9	204.1	197.3	207.6	265.3	265.9	260.8	244.7	236.2
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
Forex reserves/M1	144.8	196.3	222.0	292.1	357.0	307.6	301.4	393.4	463.2	468.0	431.7	416.5
Forex reserves/reserve money	133.3	168.9	166.9	170.8	179.9	174.3	141.1	190.5	201.7	206.8	196.8	196.2
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	59.3	63.9	73.7	73.6	81.2	85.8	86.8	73.6	77.5	83.1	83.7	88.3
MEMORANDUM: (in EUR million)												
GDP	16,028	17,306	19,026	20,306	23,305	28,785	33,418	29,967	6,743	7,428	7,870	7,841
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	22,943	23,456	23,115	23,786
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,314	879	824	733	967
Central bank foreign exchange reserves	2,208	2,854	3,131	4,952	9,041	9,660	8,190	10,602	10,445	10,493	9,876	10,002
Short-term debt	606	529	442	948	958	1,050	2,143	2,005	1,901	1,459	1,295	1,830
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-760	-610	-523	-181
			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: BB-/stable				Standard & Poor's and 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 harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.
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 2010 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.
7. As of 01.01.2010 Statistical Office, according to UN recommendations, applies general trade system which is broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using special trade system.
8. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 443.5 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 86.4 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 875.4 mln, of which EUR 397 mln related to domestic banks and EUR 478.4 mln to domestic enterprises).

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Real GDP growth (in %)	3.9	2.4	8.3	5.6	5.2	6.9	5.5	-3.1	0.3	2.0	2.7	1.8
Consumer prices (in %, relative to the same month a year earlier)[2]	14.8	7.8	13.7	17.7	6.6	11.0	8.6	6.6	4.7	4.2	7.7	10.3
Core inflation (in %, relative to the same month a year earlier)[2]	4.4	6.1	11.0	14.5	5.9	7.9	10.3	4.1	2.3	1.9	5.7	8.8
NBS foreign exchange reserves (in EUR million)	2,208	2,854	3,131	4,952	9,041	9,660	8,190	10,602	10,445	10,493	9,876	10,002
Exports (in EUR million)[3]	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	2,009	2,505	2,668	2,888
- growth rate in % compared to a year earlier	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-16.5	8.1	17.2	20.4	27.4
Imports (in EUR million)[3)7)]	-6,387	-7,206	-9,543	-9,613	-11,971	-16,016	-18,843	-13,577	-3,214	-3,665	-3,918	-4,036
- growth rate in % compared to a year earlier	27.2	12.8	32.4	0.7	24.5	33.8	17.7	-28.0	-4.4	12.5	16.1	12.7
Current account balance[4)7)]												
(in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-760	-610	-523	-181
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.6	-21.1	-7.0	-11.3	-8.2	-6.7	-2.3
Unemployment according to the Survey (in %)[5]	13.3	14.6	18.5	20.8	20.9	18.1	13.6	16.1	/	19.2	/	19.2
Wages (average for the period, in EUR)	152.1	176.9	194.6	210.4	259.5	347.6	358.4	337.9	321.5	335.0	324.8	339
RS budget deficit/surplus (in % of GDP)[6]	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.8	-3.2	-3.1	-3.7	-2.8	-4.2
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	0.9	-1.9	-2.0	-2.4	-4.4	-3.5	-4.1	-3.5	-6.4
RS public debt (external + internal, in % of GDP)[6]	71.9	63.7	50.9	50.6	40.1	31.4	26.3	32.9	33.8	35.9	38.6	40.7
RSD/USD exchange rate (average, in the period)	64.70	57.56	58.44	66.90	67.01	58.39	55.76	67.47	71.38	79.93	81.49	78.47
RSD/USD exchange rate (end of period)	58.98	54.64	57.94	72.22	59.98	53.73	62.90	66.73	74.38	85.48	78.11	79.28
RSD/EUR exchange rate (average, in the period)	60.66	65.13	72.70	83.00	84.10	79.96	81.44	93.95	98.67	101.37	105.15	106.56
RSD/EUR exchange rate (end of period)	61.52	68.31	78.89	85.50	79.00	79.24	88.60	95.89	99.76	104.37	106.17	105.50
Memorandum												
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,785	33,418	29,967	6,743	7,428	7,870	7841[1]

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) As of 1 January 2010, the Statistical Office, according to UN recommendations, applies the general trade system which is a broader concept and includes all goods entering/exiting the country's economic territory, apart from goods in transit. The Statistical Office published comparable data for 2007, 2008 and 2009. Previous years are disseminated under a special trade system.

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

Table C
IMF's projection for key macroeconomic indicators (January 2011)
(IMF Country Report No. 11/9, January 2011)

	2007	2008	2009	2010 (Projection)	2011 (Projection)
Output, prices and labor market (change in percent)					
Real GDP growth	6.9	5.5	-3.1	1.5	3.0
Real domestic demand (absorption)	11.5	6.3	-6.8	-0.2	1.0
Consumer prices (average)	6.5	12.4	8.1	6.2	9.4
Consumer prices (end of period)	11.0	8.6	6.6	10.6	5.8
Nominal gross wage	22.4	16.9	7.4	4.6	8.3
Real net wage	19.9	4.9	-0.7	-1.5	-1.0
General government finance (in percent of GDP)					
Revenue	43.5	41.9	40.7	40.0	38.7
Expenditure	45.4	44.5	45.0	44.9	42.8
Fiscal balance	-1.9	-2.6	-4.3	-4.9	-4.1
Public debt	35.2	33.4	36.8	43.5	40.9
Monetary sector (end of period 12-month change, in percent)					
Money (M1)	25.3	-3.8	8.7	1.9	18.3
M3[1)]	44.5	9.6	21.8	11.1	16.9
Domestic credit to non-government	36.9	35.0	8.9	16.1	15.5
Balance of payments (in percent of GDP)					
Current account balance	-15.9	-17.6	-6.9	-9.3	-8.6
Export of goods	22.2	22.2	20.0	24.6	25.7
Import of goods	45.2	45.0	37.1	41.4	40.4
Trade of goods balance	-23.1	-22.8	-17.1	-16.7	-14.7
Capital and account balance	18.4	12.7	10.7	3.0	9.4
External debt	61.8	65.2	76.5	79.6	73.3
of which: Private external debt	39.5	46.1	52.0	52.6	47.2
Gross official reserves (in billions of euro)	9.5	8.2	10.6	9.4	9.7
REER (annual average change, in percent; + indicates appreciation)	7.2	6.4	-5.1	-8.3	4.4

[1)] Excluding frozen foreign currency deposits.

Appendix 1: Monetary policy programme of the National bank of Serbia in 2011[13]

1. The primary monetary policy objective is to achieve the inflation target, whereby the National Bank of Serbia will contribute to the stability of the financial system and sustainable economic growth.

2. In 2011, monetary policy of the National Bank of Serbia will be based on the *Memorandum of the National Bank of Serbia on Monetary Strategy*[14] *and the Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012*[15].

3. Expressed numerically – in terms of the a**nnual percentage change in the consumer price index**, the monetary policy objective for 2011 is to gradually lower the beginning-of-year inflation of 6%±2 percentage points to 4.5%±1.5 percentage points by the year-end. The inflation target is defined as a continuously declining value (with a tolerance band) of annual changes in consumer prices. It is set for each month of the year, meaning that the achievement of the inflation target is watched continuously, which contributes to the accountability and credibility of monetary authorities and helps anchor inflation expectations.

4. Monetary policy decisions of the Executive Board of the National Bank of Serbia in the course of 2011 will be designed to facilitate the achievement of its medium-term inflation target. The objective is to gradually lower the beginning of 2012 inflation of 4.5%±1.5 percentage points down to 4.0%±1.5 percentage points by the end of 2012. The inflation target path set for the period until 2012 is consistent with the achievement of medium-term price stability and reflects the intention of the National Bank of Serbia to achieve price stability through gradual lowering of inflation without causing macroeconomic disturbances.

5. To pursue its inflation target, the National Bank of Serbia will use the interest rate on two-week repo operations as its main monetary policy instrument. This interest rate will be changed in a sustainable, consistent and predictable manner, in line with economic developments and inflation projections. In addition, the National Bank of Serbia will use all available instruments under its remit to achieve its medium-term inflation target.

6. Committed to transparent and accountable communication with the public, the National Bank of Serbia will a) issue press releases, b) hold press conferences, c) publish the Inflation Report, and d) issue other publications.

7. The National Bank of Serbia will continue to implement the managed floating exchange rate regime. The high level of foreign exchange reserves of the National Bank of Serbia will ensure the stability of the foreign exchange market. The National Bank of Serbia will intervene in the foreign exchange market to mitigate excessive daily volatility of the exchange rate and/or to encourage trading volumes, as well as to contain threats to financial and price stability.

8. In 2011, the National Bank of Serbia will continue to develop and strengthen market-based monetary instruments and to create conditions in cooperation with banks for the further upgrade of the interbank money market.

9. Given the still very high level of euroisation in Serbia, the National Bank of Serbia will continue to implement the dinarisation process. Dinarisation will be based on three pillars: the preservation of macroeconomic stability, development of the dinar money and capital markets and development of hedging instruments. Reducing euroisation will contribute to monetary policy efficiency and reduced vulnerability of the public and private sectors to exchange rate volatility.

10. A stable and competitive financial system is the precondition for an effective transmission mechanism of monetary policy. The National Bank of Serbia will continue to take all necessary measures to ensure the existence of sound and stable financial institutions and maintain trust in the overall financial system, so as to enable efficient mobilisation of savings and allocation of investment. This will contribute to stronger resilience to external disturbances and risks inherent to financial operation.

[13] RS Official Gazette, No 95/2010.

[14] *The Memorandum of the National Bank of Serbia on Monetary Strategy* was adopted at the meeting of the Monetary Policy Committee of the National Bank of Serbia of 22 December 2008.

[15] *The Memorandum of the National Bank of Serbia on Setting Inflation Targets for the Period 2010–2012* was adopted at the meeting of the Monetary Policy Committee of the National Bank of Serbia of 14 December 2009.

11. The coordination between monetary and fiscal policies is important in an inflation targeting regime. In 2011, the National Bank of Serbia will continue to cooperate with the Government of the Republic of Serbia. *The Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting*[16] commits the Government to pursue sustainable and predictable fiscal policy in line with the inflation target.

12. Should the actual inflation rate depart from its target for longer than six consecutive months, the National Bank of Serbia will notify the Government in writing about the reasons for such departure, propose policy action to be taken to deal with it and give an estimate of the period within which inflation can be expected to return within the target band.

[16] The Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting was adopted at the Government's meeting of 19 December 2008.

Index of charts and tables

Charts

Tables

Charts and tables in boxes

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

Executive Board Meetings and Changes in the Key Policy Rate*

2010

Date	Key policy rate (p.a., in %)	Change (in basis points)
12 January	9.5	0
21 January	9.5	0
4 February	9.5	0
22 February	9.5	0
5 March	9.5	0
23 March	9.0	-50
8 April	8.5	-50
20 April	8.5	0
11 May	8.0	-50
19 May	8.0	0
7 June	8.0	0
22 June	8.0	0
2 July	8.0	0
22 July	8.0	0
5 August	8.5	+50
19 August	8.5	0
7 September	9.0	+50
14 October	9.5	+50
11 November	10.5	+100
9 December	11.5	+100

2011

Date	Key policy rate (p.a., in %)	Change (in basis points)
17 January	12.0	+50
10 February		
10 March		
7 April		
12 May		
9 June		
7 July		
11 August		
8 September		
6 October		
10 November		
8 December		

* The Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No 44/2010) establishes the Executive Board as the National Bank of Serbia's body that takes over all responsibilities of the Monetary Policy Committee.

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 November 2010

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to raise the key policy rate by 100 basis points to 10.5 percent.

In making this decision, the Executive Board took into account the need to halt the rise in inflationary pressures spurred by food price increases, as well as the effects of past depreciation of the dinar and faster than expected recovery in aggregate demand.

Over the past several months, the rise in inflation has been driven primarily by the growth in food prices. In the coming period, upward pressures on inflation will also come from higher import prices reflecting past depreciation of the dinar. At the same time, continued economic recovery and the decision to lift the freeze on public sector wages and pensions will contribute to the weakening of the disinflationary effect of aggregate demand.

The NBS Executive Board judges that y-o-y inflation will be moving above the upper end of the target tolerance band over the coming months, and that the 100 basis point increase in the key policy rate is needed to bring inflation back within the target by the end of next year (4.5±1.5% at end-2011 and 4±1.5% at end-2012).

The next rate setting meeting of the NBS Executive Board is scheduled for 9 December 2010.

Press release from Executive Board meeting held on 9 December 2010

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to raise the key policy rate by 1 percentage point to 11.5 percent.

In making this decision, the Executive Board took into account the need to contain inflationary pressures stirred up by the rise in agricultural product prices, regulated price growth and the effects of past depreciation of the dinar.

Y-o-y inflation exceeded the upper limit of the target tolerance band in October, and is likely to continue rising over the coming months. According to our estimates, it will run above the upper end of the target tolerance band in the first half of 2011, and then fall back to the target in the second half of the year.

The Executive Board decided to tighten the monetary policy stance judging that the 100 basis point increase in the key policy rate is needed to bring inflation back within the 4.5±1.5% target band by the end of next year (4±1.5% at end-2012).

The next rate-setting meeting of the NBS Executive Board is scheduled for 13 January 2011.

Press release from Executive Board meeting held on 17 January 2011

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to raise the key policy rate by 50 basis points to 12 percent.

The Executive Board has taken into account that inflation is currently above the upper limit of the target tolerance band and that monetary policy tightening is needed in order to contain inflationary pressures stirred by the growth in regulated prices, inflation expectations, food prices and international oil prices.

The Executive Board's decision is also based on the assessment that low aggregate demand will continue to produce disinflationary effects particularly in view of the lower than announced growth in public sector pensions and wages.

By raising the key policy rate by 50 basis points, the NBS aims to ensure that inflation falls back within the projected range in the medium term (4.5±1.5% for end- 2011 and 4±1.5% for end-2012).

The next rate-setting meeting of the NBS Executive Board is scheduled for 10 February 2011.

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71(497.11)

INFLATION Report / National Bank of
Serbia. - 2006- . - Belgrade (Kralja Petra
12) : National Bank of Serbia, 2006- (Beograd :
Zavod za izradu novčanica i kovanog novca
"Topčider") . - 30 cm

Tromesečno
ISSN 1820-9394 = Inflation Report
(National Bank of Serbia)
COBISS.SR-ID 155775244