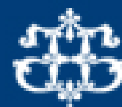

National Bank of Serbia

2014
February

INFLATION REPORT

February 2014

INFLATION REPORT

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Introductory note

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

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

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

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

The February *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 13 February 2014.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, *Governor*

Ana Gligorijević, *Vice Governor*

Veselin Pješčić, *Vice Governor*

Diana Dragutinović, *Vice Governor*

Đorđe Jevtić, *Director of the Administration for Supervision of Financial Institutions*

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
EMU – Economic and Monetary Union of the EU
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – gross domestic product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NBS – National Bank of Serbia
NPLs – non-performing loans
OFI – other financial organisations
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
SORS – Statistical Office of the Republic of Serbia
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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I. Overview

Tamped down by the fall in unprocessed food prices, year-on-year inflation moved below the lower bound of the target tolerance band during the last quarter of 2013.

Year-on-year inflation reached its historical low in the fourth quarter and ended the year at 2.2%. Its fall below the lower bound of the target tolerance band was set off by the prices of unprocessed food which headed down in response to good weather conditions, quite untypical for this time of the year. On the other hand, core inflation (CPI excluding energy, food, alcohol and cigarettes) as the inflation component most responsive to monetary policy measures, moved within the target tolerance band in the fourth quarter and ended the year just a whisper above the 4% target.

Both demand-side and cost-push inflationary pressures were rather low in the fourth quarter.

As inflationary pressures continued to run rather low in the fourth quarter, inflation turned out negative in the second half of 2013. The absence of cost-push pressures is indicated by the fall in industrial producer prices and low primary agricultural commodity prices, while weak demand-side pressures are indicated by the widening of the negative output gap and a contraction in credit activity. The weakening of inflationary pressures was also aided by the further decline in inflation expectations in all of the sectors surveyed. One-year ahead inflation expectations of the financial sector returned within the target tolerance band in October and have been stable ever since.

Developments in the international environment were again marked by the moves of the Fed.

In response to plummeting inflation in the euro area, the ECB cut its main refinancing rate in November to the record low of 0.25%. Central banks of Central and East European countries also maintained an accommodative monetary policy stance. The Fed decided to start winding down its quantitative easing programme beginning from January, as a result of accelerating economic growth and positive signals from the labour market.

Over the last several months the exchange rate of the dinar was under the dominant sway of developments in the international environment, notably the Fed's decision on the scale of quantitative easing.

Appreciation pressures in the domestic foreign exchange market in the last quarter of 2013 stemmed from the fall in country risk premium and increased non-resident investment into dinar securities after the Fed postponed its decision on the asset purchase tapering and the Serbian government adopted a set of fiscal consolidation measures to ensure public finance sustainability. Pressures in the foreign exchange market were lower also on account of a somewhat higher inflow of foreign direct investment and relatively favourable trends in foreign trade. Depreciation pressures since the beginning of the year have been generated by the seasonally higher foreign exchange demand of domestic enterprises, notably energy importers, and by the stress in the international financial

markets over the start of the quantitative easing taper in the United States. For this reason, similar to the dinar, nearly all currencies in the region depreciated, and so did the currencies of other emerging market economies.

Aware of potential instability in the international financial market, the National Bank of Serbia is cautiously easing its monetary policy stance.

After a 150 basis point cut in the last quarter of 2013, the key policy rate was kept on hold in January and February. Despite low inflationary pressures, the Executive Board of the National Bank of Serbia remained cautious and mindful of potential upheavals in the international financial market over the start of tapering of the Fed's quantitative easing programme. The Executive Board judges that consistent implementation of fiscal consolidation measures could strengthen Serbia's resilience to the said movements in the international environment. Agreement with the International Monetary Fund would serve as an additional assurance of consistency in the implementation of fiscal consolidation.

As the effects of the upswing in the automobile industry and related branches have been gradually waning, the pace of growth in net exports slowed in the fourth quarter...

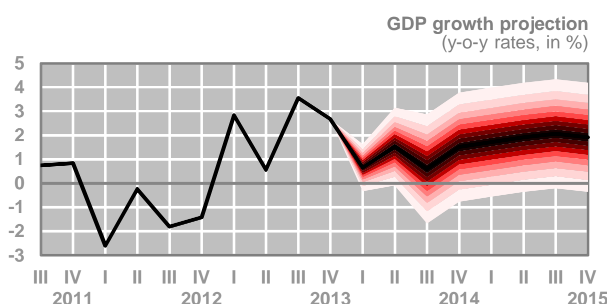
Though exports recorded high year-on-year growth in the last quarter of 2013, its pace slowed down due to the gradual waning of the effects of expansion in the automobile industry and related branches. Consistent with our projection in the November Report, the current account deficit in 2013 as a whole amounted to 5.0% of GDP. The share of the current account deficit in GDP is expected to stay broadly unchanged in 2014. Exports will be growing at a slower pace than in 2013, while low domestic demand will prevent a faster rise in imports.

...thereby dampening economic activity.

In the last quarter of 2013, economic activity contracted relative to the quarter before, hence slowing down its growth year-on-year. On the production side, this reflected the point of full capacity in the automobile industry and the slackening of activity in other branches of manufacturing, as well as continued negative trends in the construction industry. According to the estimates of the Serbian Statistical Office, economic growth in 2013 measured 2.4%, more than we expected at the time of the previous *Report*, thanks to the better performance of agricultural production and a smaller decline in construction industry than anticipated earlier.

Economic growth is expected to soften to around 1% this year.

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



In 2014, economic growth is expected to soften to around 1%. Nascent recovery of the euro area and the opening of Serbia's EU accession negotiations should provide a key boost to investment and net export growth. Final consumption will continue to give a negative contribution to GDP growth due to fiscal consolidation. However, the implementation of fiscal consolidation measures and the announced structural reforms will open the scope for a faster GDP growth in the years to come. On the production side, operating on the assumption of an average agricultural season, we expect a fall in

agricultural production, as well as slower growth of industrial production on account of the waning effects of the automobile industry, and a partial recovery of the construction industry.

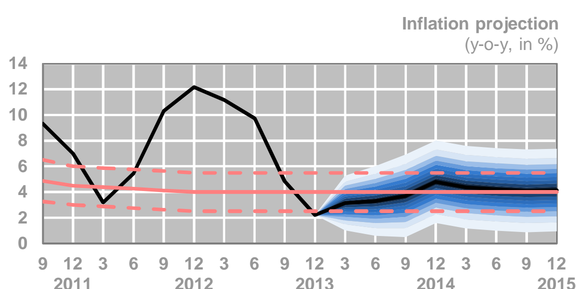
Labour market indicators were more favourable than in the last quarter of 2012.

Based on the Labour Force Survey conducted in October, the unemployment rate declined by as much as 4 pp from April, down to 20.1%, partly on account of seasonal factors. Consistent with the moderate recovery of economic activity, labour market indicators improved relative to the same period last year. Unemployment, however, remains high. Together with the anticipated cut in public sector wages and limited growth in pensions, this will keep domestic demand low this year as well.

Year-on-year inflation is expected to move within the target tolerance band in both 2014 and 2015.

Year-on-year inflation is expected to return within the target tolerance band in the first quarter of this year and to stay there over the next two years. A moderate year-on-year consumer price growth in 2014 will reflect primarily the one-off effect of the increase in the special VAT rate and excise tax and low last year's base attributable to the fall in food prices. Standing at the other end of the spectre as the main disinflationary factor is low domestic demand, which will prevent the full pass-through of the VAT increase to prices.

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



The character of monetary policy will depend crucially on how the situation in the international environment evolves.

Assuming fiscal consolidation is implemented as planned, further monetary policy easing in the coming period will depend primarily on the strength of potential negative effects of the quantitative easing tapering on the exchange rate of the dinar and the country risk premium.

II. Monetary policy since the November *Report*

The approach to monetary policy easing is cautious. The key policy rate was cut further in December and then kept on hold in January and February.

The NBS Executive Board lowered the rate in December guided by the weakening of inflationary pressures and the subsiding of risks associated with fiscal policy following the October announcement of fiscal adjustment measures. The weakening of inflationary pressures was aided primarily by the well-coordinated and calibrated monetary policy measures, falling prices of primary agricultural commodities, low aggregate demand and a stable exchange rate. Inflation expectations steadied around the target, boding well for the price stability outlook.

Though inflationary pressures remained on the downside in early 2014, the Executive Board decided in its January and February meetings to keep the key policy rate on hold. What made the Executive Board cautious was the potential turmoil in international financial markets over the start of QE tapering by the Fed.

According to the projection published in the November Report, inflation was most likely to move within the target tolerance band over the projection entire horizon (end-2013–Q3 2015). Negative output gap was to continue generating strong disinflationary effects despite gradual healing of the economy. The main risks to the projection were judged to be coming from the international environment, but also from fiscal movements at home. Given the subsiding of inflationary pressures and assuming compliance with the fiscal consolidation plan, the Executive Board announced it would consider further monetary policy easing in the coming period.

By the time of the Executive Board meeting in December disinflationary pressures intensified. As of October, y-o-y inflation was temporarily running below the lower bound of the target tolerance band (4±1.5%). In addition to monetary policy measures and relative stability of the exchange rate, sharp disinflation in conditions of economic growth was driven by the fall in food prices, low inflation expectations and weak domestic demand.

Good agricultural performance both at home and abroad led to a significant drop in prices of primary agricultural commodities and contributed to a further decline in prices of food. The disinflationary effect of food prices should be sustained at least until the next agricultural season.

Besides, low domestic demand was to remain the most important factor in slowing price growth in the medium term, as a result of sluggish economic recovery, past fiscal consolidation measures and a fall in lending activity. The disinflationary effect of domestic demand was expected to be reinforced by the Government's new measures bearing down on household consumption (introduction of the solidarity tax on above-average take-home pay in the public sector, in addition to restrictions on pension and public sector wage growth that were already in place).

The Executive Board assessed that inflation expectations had fallen considerably and that sectors of the economy (financial, corporate and household sectors) expected inflation to move within the target tolerance band in the coming period as well, which should by all means help minimise the cost of achieving price stability.

By contrast to the prior period, Q4 saw appreciation pressures. In order to ease excessive short-term volatility

of the exchange rate, the NBS intervened in the foreign exchange market by buying EUR 525.0 mln and by selling EUR 10.0 mln.

Appreciation pressures in the foreign exchange market emerged as the jittery nerves of international financial markets over the anticipated shift in US monetary policy calmed down. This was also aided by the delaying of the Fed's tapering decision and by the clinching of the US budget deal. In parallel, Serbia recorded distinctly favourable trends in its balance of payments, associated principally with growing exports. The new set of fiscal consolidation measures unveiled by the Government in early Q4 also had a stabilising effect.

Assessing the interplay of all of the above factors, the Executive Board decided in **December** it had sufficient leeway for further monetary policy easing and **lowered the key policy rate by 50 bp, to 9.5%**.

At the start of this year too inflationary pressures were running low, and so did inflation expectations. However, in its **January and February** meetings the Executive Board decided to **keep the key policy rate unchanged**, wary of the risks emanating from the international financial market, notably the Fed's decision to start winding down its monetary stimulus as of January.

The impact of the Fed's monetary policy on Serbia is generated primarily by our fiscal imbalance and the fact that a significant share of government securities is in the hands of non-residents. The level of their exposure to our and other emerging markets in the coming years will depend most on global liquidity, i.e. the degree of monetary expansiveness of the world's leading central banks.

The Executive Board assessed that consistent implementation of the fiscal consolidation measures would make Serbia more resilient to potential unrest in the international financial markets. Furthermore, it would have a positive effect on the nascent economic recovery and would create additional scope for further monetary easing.

To bolster lending in dinars, in November 2013 the Executive Board adopted the Decision on Terms and Conditions of Performing Foreign Credit Transactions in Dinars. The Decision allows IFIs to extend credits/loans in dinars to domestic legal entities, banks and entrepreneurs. The possibility of borrowing under more favourable and FX risk-free terms is expected to have a beneficial impact on economic activity and stability of the financial system. Since IFIs can finance dinar loans also from the proceeds of the sale of long-term dinar securities in the domestic market, the issue of these securities is expected to contribute to the deepening of the Serbian capital market.

III. Inflation developments

Inflationary pressures weakened further in Q4 and consumer prices followed the downward path for the second consecutive quarter. In y-o-y terms, inflation touched its historical low in Q4, reaching 2.2% in December. The decline in y-o-y inflation below the lower bound of the target tolerance band in Q4 is estimated to have been temporary and under the strongest sway of falling food prices. This is also signalled by y-o-y core inflation rate which stood only slightly above the 4% target in late 2013.

Reduced inflation expectations of all sectors added to dampened inflation pressures. One-year ahead financial sector expectations returned in October within the target tolerance band, and remained there afterwards.

We expect y-o-y inflation to return within the target tolerance band in Q1. Consumer price growth in Q1 will be largely driven by the one-off effect of the increase in special VAT and excise rates, and the seasonally expected rise in fruit and vegetable prices. In contrast, low demand and food production costs will act as a damper on inflationary pressures.

Inflation developments in Q4

In the course of Q4, y-o-y inflation trended below the lower bound of the target tolerance band, reaching 2.2% in late 2013. Compared to the central projection published in the November *Report*, inflation declined chiefly due to propitious weather that drove down fruit prices and brought about a lower-than-seasonal rise in vegetable prices.

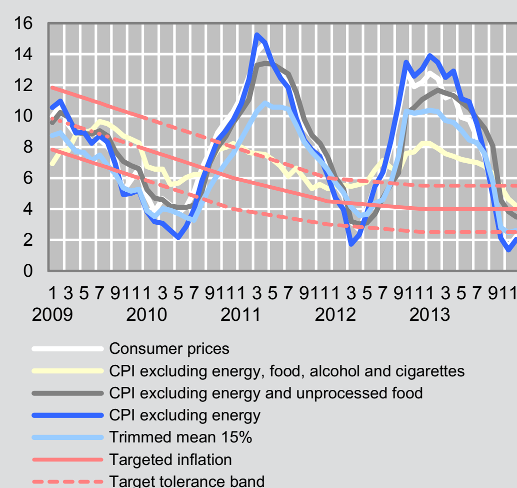
Inflationary pressures were rather low in 2013, chiefly owing to monetary policy measures, falling prices of primary agricultural products, low aggregate demand,

Table III.0.1 **Consumer price growth by component**
(quarterly rates, in %)

	2012	2013			
	IV	I	II	III	IV
Consumer prices (CPI)	2.3	1.1	1.8	-0.5	-0.2
Unprocessed food	-7.8	2.2	10.9	-13.4	-4.3
Processed food	6.3	1.1	-0.4	-0.3	-0.7
Industrial products excluding food and energy	4.8	1.7	0.9	2.0	1.0
Energy	1.1	-0.2	-0.9	5.1	-0.4
Services	3.3	0.6	1.8	0.7	1.2
Core inflation indicators					
CPI excluding energy	2.6	1.4	2.3	-1.4	-0.2
CPI excluding energy and unprocessed food	5.0	1.2	0.7	1.0	0.5
CPI excluding energy, food, alcohol and cigarettes	3.1	0.7	1.7	0.7	1.0
Administered prices	5.2	2.9	0.7	5.6	0.9

Sources: SORS and NBS calculation.

Chart III.0.1 **Price movements**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

Core inflation returned within the target tolerance band in Q4. Owing to declining food prices, y-o-y inflation fell below the lower bound of the target tolerance band.

relatively stable exchange rate and subsiding inflation expectations later in the year. In 2013, inflation was almost fully determined by administered price growth (2.1 pp). In contrast, a good agricultural season and, consequently, lower production costs, drove down the prices of food and non-alcoholic beverages (2.5%). The relatively high average inflation in 2013 (7.8%) was prompted by high y-o-y inflation in H1 caused by the bad agricultural season of 2012.

Subsiding inflationary pressures, in place from end-2012, continued into Q4 – **consumer prices** followed the downward path for the second quarter in a row (0.2%).

Prices of food and non-alcoholic beverages lost 2.0% in Q4. Unprocessed food prices fell by 4.3%, adding 0.5 pp to a decline in headline inflation. The largest decline was recorded for fruit and meat prices – by 26.7% and 5.6% respectively. Further weakening of cost-push pressures in food production brought about a 0.7% drop in processed food prices and gave negative 0.2 pp to headline inflation. The strongest negative contribution within this category came from falling prices of beverages, bread and cereal products, oils and fats.

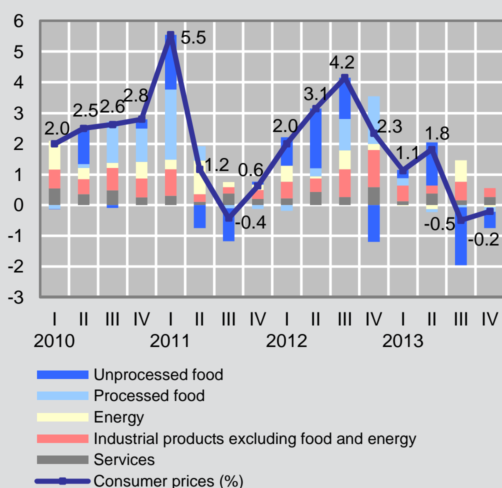
Prices of industrial products excluding food and energy rose by 1.0% in Q4, or by half of the increase in Q3. The slowdown in these prices was under the impact of exchange rate stability. The major boost to consumer price growth within this group was provided by the price increase in cigarettes and seasonal clothes.

Energy prices lost 0.4%. A negative contribution came from lower prices of natural gas and petroleum products, while prices of central heating and solid fuels went up with the start of the heating season. Petroleum product prices decreased, mirroring a drop in global oil prices, prompted by easing geopolitical tensions.

Services prices rose more than in Q3 (1.2%). The strongest boost came from increased costs of child welfare benefits, utilities and recreation and culture.

Core inflation growth (measured by CPI excluding prices of energy, food, alcohol and cigarettes) slowed down further in y-o-y terms. It returned within the target tolerance band in October and stayed there over the following two months. This confirms that the movement in headline inflation below the lower bound of the target tolerance band in Q4 was driven by falling food prices, primarily unprocessed. The rise was slightly higher q-o-q (1.0%), mainly on the back of the seasonal increase in prices of clothes and footwear, child welfare benefits and travel arrangements.

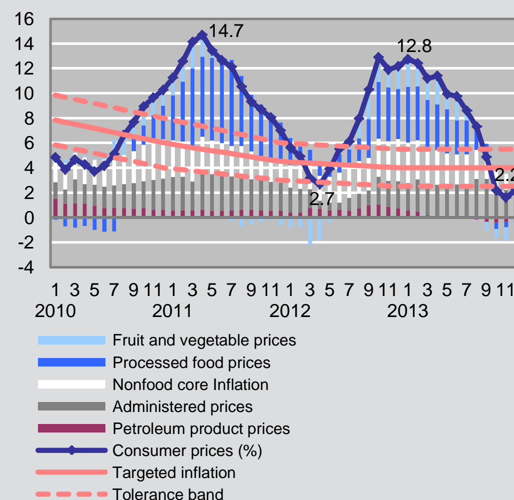
Chart III.0.2 **Contribution to quarterly consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

The strongest contribution to falling consumer prices came from unprocessed food prices in Q4 as well.

Chart III.0.3 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Food prices added over 70% to a 10.6 pp drop in y-o-y inflation in 2013.

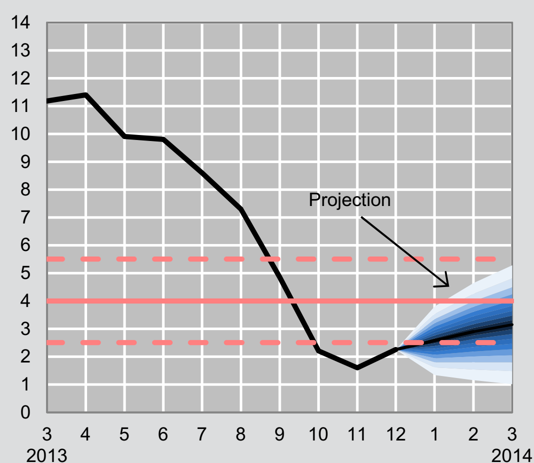
Administered prices gained 0.9% in Q4, reflecting higher prices of cigarettes and costs of child welfare benefits. In y-o-y terms, the rise slowed to 10.4% in December. Given that the contribution of administered prices to headline inflation, like in previous years, was at least 2 pp in 2013, and the fact that the convergence of domestic, notably administered prices, to the EU levels is still underway, the inflation target has been set at 4% until the end of 2016.

Projection for Q1

Under our estimates, a moderate rise in y-o-y inflation in Q1 will lead to its return within the target tolerance band. However, it will most probably trend below the 4% target. Core inflation is also expected to pick up somewhat in y-o-y terms, but will continue to move within the target tolerance band.

Consumer price growth in Q1 will largely reflect the one-off effect of special VAT and excise rate hikes, and the seasonal increase in fruit and vegetable prices. In contrast, low demand and food production costs will act as a damper on inflationary pressures, preventing the full spill-over of the VAT and excise increase on prices.

Chart III.0.4 **Short-term inflation projection** (y-o-y rates, in %)



Source: NBS.

Y-o-y inflation is expected to return within the target tolerance band in Q1.

In terms of **unprocessed food**, we expect a seasonal rise in fruit and vegetable prices and lower prices of fresh meat. Further, the VAT increase is likely to trigger a moderate increase in **processed food** prices. However, due to low demand, this effect will be partly offset by reduced trade margins.

The rise in **industrial product prices excluding food and energy** is expected to be largely driven by the cigarette price increase on account of the adjustment of excise rates and medicament prices, notably due to the VAT rise.

Within the group of **energy**, petroleum product prices are likely to go up, reflecting the excise adjustment and rising solid fuel prices. Central heating prices are also expected to increase, as customary for this period of the year.

A higher VAT rate will push up prices of restaurant and hotel **services**, while prices of travel arrangements are expected to decline. Within services, public utility prices are also expected to go up.

The greatest uncertainty of the Q1 projection concerns the expected effect of the VAT hike on prices, and the potential impact of international developments on the risk premium and exchange rate.

Import and producer prices

Industrial producer prices for the domestic market declined by 0.6% in Q4, notably on the back of falling food production prices (-0.4 pp). Prices declined also in the production of petroleum products, chemicals and chemical products, and motor vehicles. A rise was recorded for the production of tobacco products and electricity supply. The downward tendency continued in y-o-y terms (0.8% in December).

Agricultural producer prices[1] gained 18.4% in December relative to Q3, down by 11.6% y-o-y. In q-o-q terms, a rise was registered in the categories of cereals and industrial plants. However, cereal prices remained by over 20% and prices of industrial plants by around 7% lower than in the same period last year. A decline was also noted for prices of fruit and livestock, resulting in a drop in retail prices of fresh meat.

Prices of elements and materials incorporated in construction fell by 1.8% in Q4. Their y-o-y growth slowed further, to 2.1% in December.

[1] Producer prices in agricultural and fishing sectors.

Import prices expressed in dinars[2] lost 0.8% in Q4[3]. The main contribution was provided by import prices of intermediate products, which declined for the third consecutive quarter. Global oil prices also declined in Q4. In contrast, a moderate rise was recorded for import prices of consumer goods and world food prices. Being stable throughout Q4, the exchange rate had no impact on import prices. Y-o-y, a decline in import prices decelerated to 0.9% in December.

Table III.0.2 **Price growth indicators**
(y-o-y rates, in %)

	III 2013 / III 2012	VI 2013 / VI 2012	IX 2013 / IX 2012	XII 2013 / XII 2012
Consumer prices	11.2	9.8	4.9	2.2
Domestic industrial producer prices	5.4	4.3	1.6	0.8
Agricultural producer prices	17.3	5.2	-26.1	-11.6
Prices of elements and materials incorporated in construction	3.3	3.1	2.5	2.1

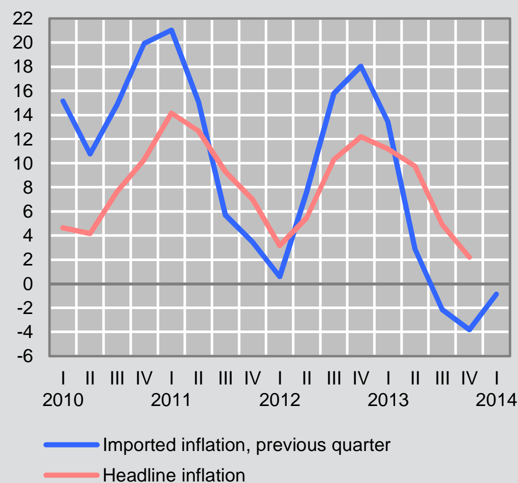
Sources: SORS and NBS calculation.

Inflation expectations

Low inflation was accompanied by a further decline in inflation expectations. According to **Bloomberg** and **Ipsos** surveys, financial sector inflation expectations stabilised within the target tolerance band, thus reducing the cost of price stability in the coming period.

After reaching the upper bound of the target tolerance band in October, **financial sector** expectations fell to 5.0% and 4.4% in November and December respectively, according to the **Bloomberg** survey. In the first two months of 2014, financial sector expectations stabilised

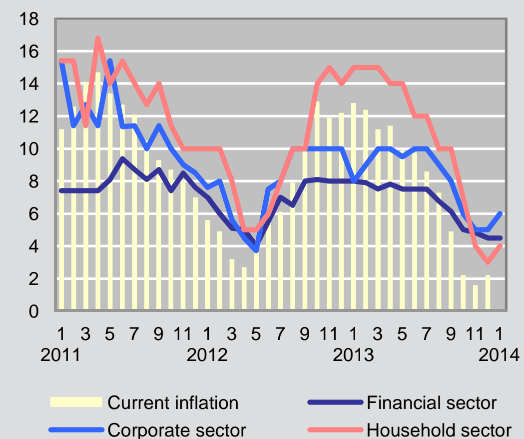
Chart III.0.5 **Domestic and imported inflation**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

Declining import prices in Q4 are likely to generate low inflationary pressures in Q1.

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



Sources: Gallup, Ipsos and NBS.

* Ipsos from November 2011 and Gallup in the earlier period.

Financial and household sector expectations stood within the target tolerance band.

[2] As an indicator of import prices, we used the weighted average indices of global oil and food prices, export and consumer prices of Germany as our most important foreign trade partner.

[3] The ratio of averages for two consecutive quarters.

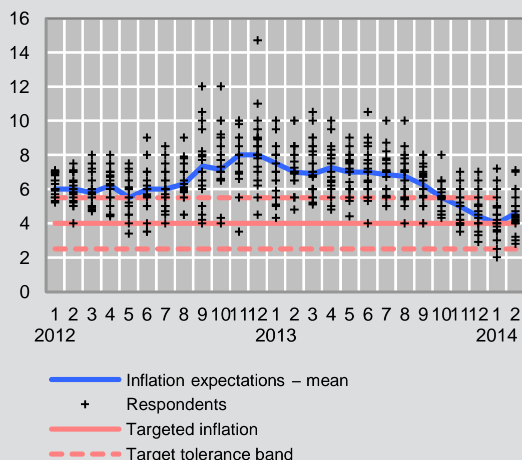
within the target band – they stood at 4.0% and 4.6% in January and February respectively.

A sharp decline in inflation expectations of all sectors was also recorded according to the **Ipsos** agency. One-year ahead **financial sector** expectations entered the target tolerance band in October (5.0%). They fell to 4.8% in November and 4.5% in December, while staying flat in January. **Corporate** expectations first slid to 5.0% in November and December, and then went up to 6.0% in January. **Household** expectations declined the most – by as much as 3.0 pp to 4.0% in November, and to 3.0% in December, this being the lowest level on record. In January, household expectations rose to 4.0%.

The pattern of the dispersion of responses was mixed. After a longer time, the dispersion of responses of financial sector respondents increased as of October according to the Bloomberg survey. Under the Ipsos survey, the dispersion increased in November, declined sharply in December, but went up again in January. As a result, the dispersion in the financial sector is at a similar level under both surveys. Among corporate sector respondents, following stagnation, the dispersion increased slightly in November and December. Though still the largest, the disagreement about future inflation was on a constant decline in the household sector, but it widened in January.

Following the October drop to zero, the net percentage[4] of enterprises expecting a rise in their product and services prices over the next three months increased in November and December, but declined significantly in January 2014 (4.4%). In regard to inputs, the net percentage of enterprises expecting a rise was at a relatively low level throughout the year, but increased significantly in December. The rise was temporary and was triggered mainly by expectations of enterprises from the energy sector. In January, the net percentage of enterprises expecting a rise in their input prices declined.

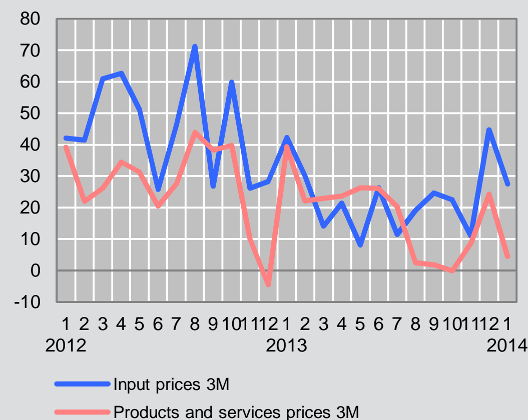
Chart III.0.7 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

Financial sector expectations have been within the target tolerance band since October.

Chart III.0.8 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos and NBS.

Following the December increase, the share of enterprises expecting a rise in their input and product prices declined in January.

[4] The difference between the percentage of enterprises expecting an increase and those expecting a reduction in the prices of their inputs, products and services. To increase representation, data are weighted by operating revenue.

IV. Inflation determinants

1. Financial market trends

A reduction in the key policy rate triggered a fall in money market and government securities rates, including the rates on dinar corporate and household loans. As the risk premium contracted, foreign investors stepped up investment in domestic securities in Q4. This was one of the factors which fuelled appreciation pressures for most of Q4.

Interest rates

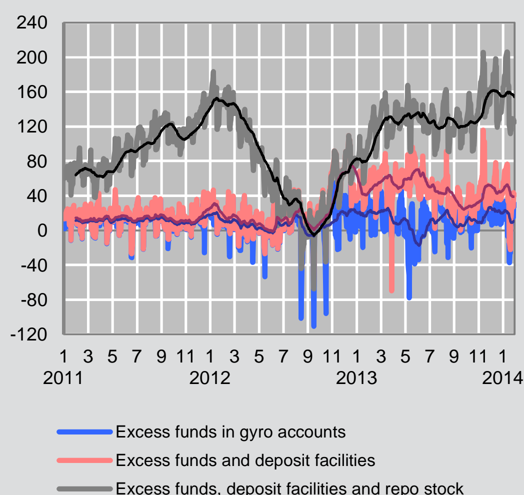
The average repo rate[5] was down 1.8 pp to 7.6% in late December. Reflecting elevated banking sector liquidity, the fall was somewhat sharper than that in the key policy rate (1.5 pp).

Average daily trading volumes in the interbank overnight money market amounted to RSD 1.3 bln, thereby staying at the Q3 levels, but significantly undershooting the average three-month figures of the previous year. BEONIA mirrored the weighted average repo rate throughout Q4. Average monthly BEONIA stayed flat in October, only to fall in November and December (by 0.6 pp and 0.4 pp respectively) to 7.6%.

A decline in the average repo rate spilled over to BELIBOR rates, which fell between 0.9 pp and 0.6 pp, most notably for shorter maturities. Average BELIBOR rates moved in December from 8.3% for the shortest to 9.4% for the longest maturity.

Money market rates continued down in January, while trading volumes in the overnight money market rose slightly.

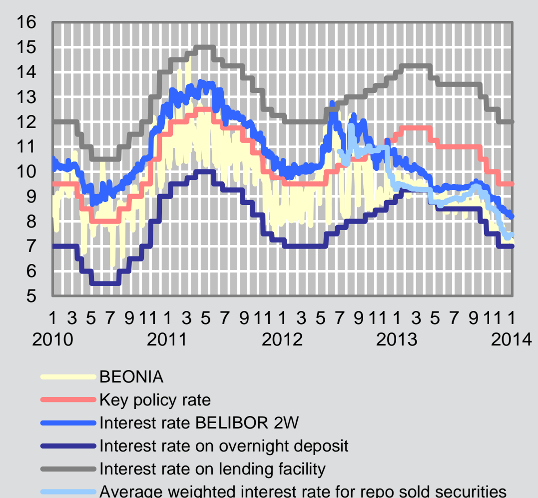
Chart IV.1.1 **Dinar liquidity**
(daily stock and moving averages, in RSD bln)



Source: NBS.

As banking sector liquidity increased somewhat in Q4...

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



Sources: Thomson Reuters and NBS.

... the deviation of the average repo rate from the key policy rate slightly widened.

[5] Rate achieved at repo auctions, weighted by the amount of sold securities.

Key policy rate cuts and rising non-resident investment in dinar securities drove down the rates in the primary market of dinar securities. Almost all rates declined, most notably for longer maturities. The weighted average rate on dinar government securities fell by 1.2 pp to 9.5% in December. Rates at December auctions ranged from 8.9% for one-year to 10.2% for three-year maturity.

A fall in government securities rates was largely determined by elevated non-resident demand, falling risk premium, the announcement of fiscal consolidation measures, and record low inflation. Non-resident demand rose primarily on the back of the Fed's September decision to postpone QE tapering and the November cut in the ECB's key interest rate.

The total amount on offer was RSD 120.3 bln, of which securities in the nominal value of RSD 105.6 bln were sold. At the same time, RSD 50.5 bln fell for redemption. Thus the stock of debt under dinar securities sold in the primary market rose by RSD 55.1 bln to RSD 446.9 bln.

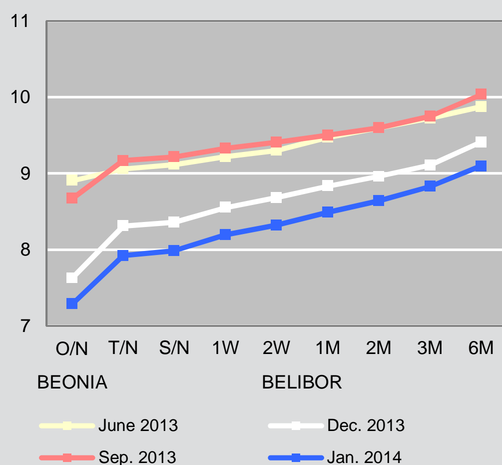
Eight auctions of euro-denominated securities were organised in Q4. Of EUR 400.2 mln on offer, securities worth nominal EUR 334.7 mln were sold, almost fully to domestic investors. One-year rates went up (0.3 pp), while two-year rates declined (0.2 pp). At the same time, rates on five-year securities remained unchanged from Q3. In late 2013, the rates ranged from 3.5% for one-year to 5.2% for five-year maturity. In November and December, securities worth EUR 246.8 mln fell due and the stock of debt reached EUR 1.2 bln in late 2013.

Total trading in the secondary market increased significantly relative to Q3 and amounted to RSD 96.2 bln in Q4. Most traded were three- and two-year securities. Excluding trading up to two business days from the primary settlement date, trading was up by RSD 51.8 bln to RSD 64.7 bln. Yield to maturity rates declined reflecting an increase in trading volumes. In December, they ranged from 8.7% for the remaining two-month maturity, to 10.7% for 29-month maturity.

January rates declined further, trending below 10% both in primary and secondary trade, though the Fitch downgraded Serbia's credit rating by one notch.

Mirroring movement in the key policy rate and consistent with lower dinar deposit rates, the rates on dinar loans shifted down in Q4. The weighted average rate on new dinar loans fell by 1.8 pp to 17.1% in December. The fall

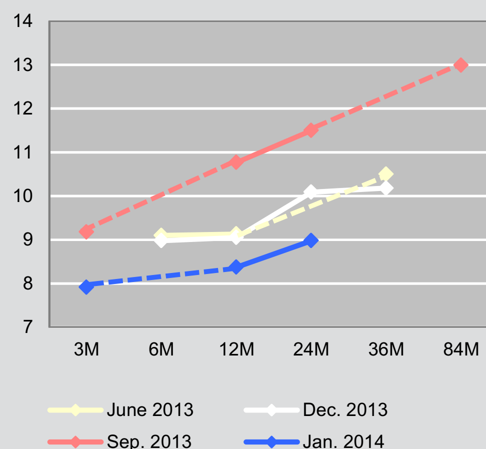
Chart IV.1.3 **Yield curve in the interbank money market**
(average values, p.a., in %)



Sources: Thomson Reuters and NBS.

A decline in interest rates continued from Q4 into early 2014.

Chart IV.1.4 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

Following a rise in Q3, the dinar yield curve went back to the June level in late 2013, but narrowed further in January.

was sharper for corporate rates which fell by 3.4 pp to 14.2%, while rates on household loans went down by 0.3 pp to 19.7%. Among other factors, changes in the structure of new dinar loans prompted a decline in the weighted average rate on total dinar loans, given a slight increase in the share of corporate loans (which are cheaper than household loans).

Rates on dinar corporate loans declined as rates on current assets loans fell by 5.4 pp to 13.5% in Q4. Besides, rates on 'other loans', which were the most common category among dinar corporate loans, also declined (by 1.4 pp to 15.1% in December). Rates on dinar household loans declined primarily due to a 0.5 pp fall in rates on cash loans (19.5% in December). In the same period, rates on consumer loans picked up by 3.2 pp to 23.4%.

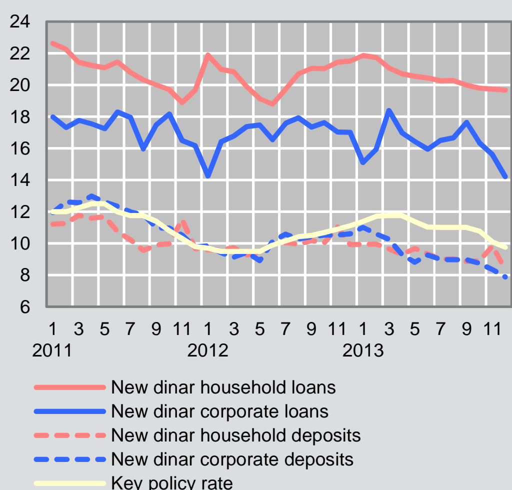
Rates on new euro and dinar euro-indexed loans also declined – by 0.6 pp relative to September, to 6.5% in December, chiefly due to the lower price of corporate loans (by 0.7 pp to 6.3%). Further, rates on all types of loans declined, most notably for the most attractive categories – current assets, investment and other loans. A drop was also noted for household loans (by 0.2 pp to 7.9%), chiefly on the back of falling rates on cash loans. At the same time, rates on consumer loans increased.

To promote the World Savings Day, the NBS called on banks to direct their efforts on the improvement of conditions and widening of the range of products in order to attract new savings deposits. Banks were also advised not to raise their interest rates above the levels normally paid throughout the year. As banks accepted the NBS's recommendation, the usual significant increase in euro savings rates was not observed in November. Banks however did offer slightly higher rates on dinar deposits relative to the previous month (the weighted average rate was up by 0.9 pp to 9.8%), resulting in the record amount of new and renewed dinar term deposits in November (RSD 12.9 bln). As a result, the stock of dinar savings rose by RSD 6.7 bln.

The weighted average rate on new dinar corporate deposits fell by 1.1 pp to 7.9% in December. It fell by 0.6 pp to 8.3% in the household sector. In November, the rate rose temporarily under the impact of somewhat more favourable interest rates offered by banks in the savings month, notably for deposits up to one year and those over one to two years.

Rates on euro corporate deposits lost 0.3 pp in Q4 and reached 1.8% in December. Rates on euro household savings stayed flat at 2.8% in December.

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

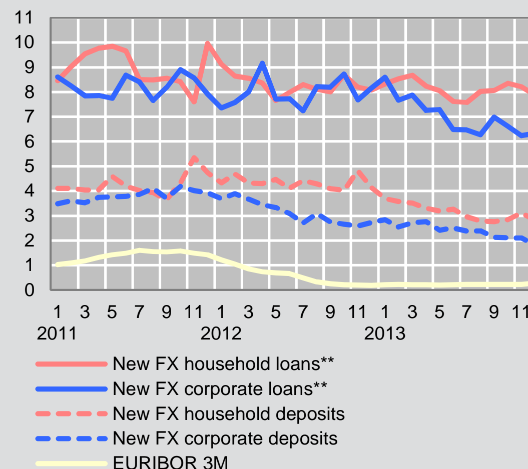


Source: NBS.

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

A fall in interest rates on dinar loans had the strongest impact on a reduction in the interest margin on dinar sources in Q4.

Chart IV.1.6 **Lending rates on FX loans and corporate and household deposits***
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.

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

** Euro and euro-indexed.

In contrast to earlier years, the seasonally sharper rise in interest rates on FX household savings did not take place in November 2013.

Risk premium

Measured by EMBI, risk premia across the region declined in October, but kept rising a tad through most of November. The rise was halted by late-November, after the Fed announced its intention to continue to pursue expansionary monetary policy for as long as warranted by macroeconomic indicators. A palpable decline in the risk premium in late November was recorded only in Serbia, and may be correlated with the implementation of fiscal consolidation measures. Though the Fed announced in mid-December to start tapering in January, EMBI declined that month on account of higher yield on US government bonds and falling yields on eurobonds of the countries observed.

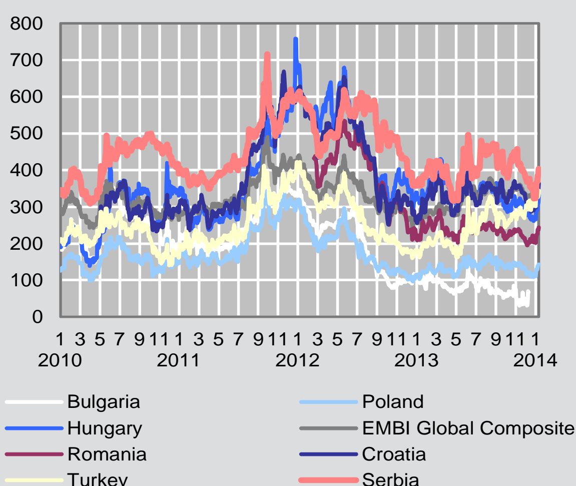
On 31 December 2013, EMBI for Serbia stood at 374 bp, down by 58 bp on end-September and 17 bp on end-2012. In the course of Q4, a heftier decline was noted only for Croatia's risk premium (60 bp). Risk premia of other countries also shifted down, though less than in Serbia. Turkey is the only exception as its risk premium went up 26 bp in an environment of political instability and deterioration in economic indicators. In terms of period-average, in Q4, the risk premia of Hungary (37 bp), Bulgaria (29 bp) and Serbia (25 bp) tumbled down the most.

In January, the Fitch downgraded Serbia's credit rating by one notch, to B+. This was partly counterbalanced by the announcement of possible conclusion of an arrangement with the IMF and the start of negotiations on Serbia's EU membership. The risk premium thus continued down over most of January. However, in late January, the Fed decided to further taper its quantitative easing programme, driving up risk premia across the region. EMBI for Serbia stood at 403 bp in late January, only to fall to around 350 bp in mid-February. Given that Serbia's fiscal position is the centrepiece of attention of foreign investors, international financial institutions and rating agencies, the conclusion of an arrangement with the IMF, as a guarantee of consistency of fiscal consolidation, would contribute to lowering of the risk premium.

Foreign capital inflow

Net FDI inflow came at EUR 242.4 mln in Q4, most of it being channelled to manufacturing (24.9%), agriculture

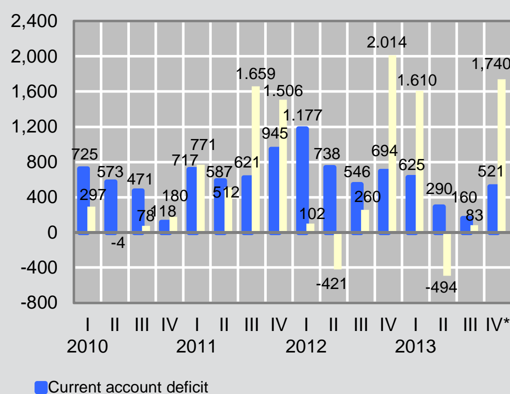
Chart IV.1.7 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Risk premia of almost all countries observed declined in Q4.

Chart IV.1.8 **Current account deficit and net capital inflow**
(in EUR mln)



Current account deficit

Capital and financial account (excl. IMF loan, SDR allocation and changes in NBS FX reserves)

Sources: SORS and NBS.

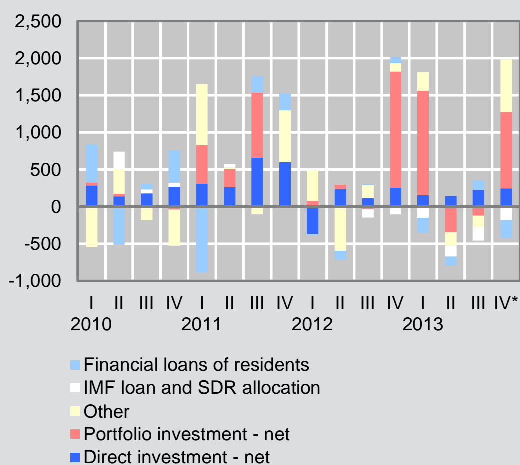
* Preliminary data.

The net capital inflow in 2013 exceeded the needs for financing the current account deficit.

(20.5%), trade (15.4%) and transport (12.8%). Similar to what the NBS forecast, net FDI inflow amounted to EUR 760.5 mln in the year as a whole, exceeding the amount recorded in 2012, but still falling short of those recorded in the years before. Available data suggest similar trends elsewhere in the region.

Portfolio investments accounted for a net inflow of EUR 1,034.9 mln in Q4 or EUR 1,967.0 mln in 2013 as a whole. The bulk of that inflow came from the issue of the five-year eurobond in the international financial market (USD 1.0 bln or EUR 730.1 mln). The second eurobond issue was oversubscribed, but the terms of borrowing deteriorated relative to the previous one.[6] The deterioration is indicated also by the higher yields on Croatian and Hungarian Eurobonds that were sold during the same week. By contrast to Q3 when foreign investors were reluctant to invest in the Serbian market, in Q4 they stepped up their participation in the auctions of government securities to an average 40.3%. They were reassured by the delaying of Fed's decision on QE tapering in September and by the adoption of fiscal consolidation measures.

Chart IV.1.9 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Most of the capital inflow in 2013 was achieved through the sale of RS eurobonds in the international market.

Residents' net foreign debt repayment under financial loans came at EUR 242.6 mln in Q4 and at EUR 430.6 mln in 2013 overall. At the same time, banks reduced their foreign debt by additional EUR 211.3 mln in Q4, putting the outflow on account of their net foreign debt repayment since the beginning of the year to EUR 777.0 mln. Government net liabilities also declined – by EUR 58.2 mln. Of this amount, EUR 169.5 mln relates to loan repayment and EUR 111.3 mln to loan disbursements including from EIB, EBRD and KfW. In 2013 government net borrowing under financial loans increased by EUR 418.9 mln. In Q4, the corporate sector net borrowed EUR 26.9 mln in financial loans, whereas in the whole of 2013 it net repaid EUR 72.5 mln.

Corporate trade credits rose by EUR 327.3 mln in Q4.

To service its liabilities to the IMF, the NBS paid out a total of EUR 179.9 million in Q4. In 2013, debt payment to the IMF totalled EUR 649.8 mln.

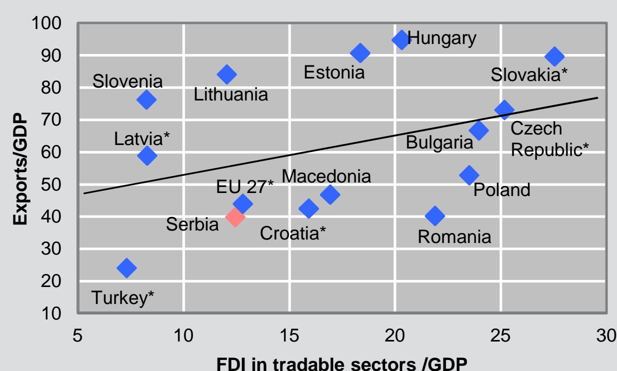
[6] Demand was three times higher than supply and the rate achieved was 6.125% (5.875% coupon rate), 0.675 pp higher than the rate on the previous issue of five-year bonds released in November 2012 under much more favourable conditions in the international market.

Text box 1: FDI as a factor of export growth

After political changes of late 2000, Serbia became an attractive investment destination. Amendments to the legal framework significantly facilitated the entry of foreign capital and ensured equal treatment of domestic and foreign investors. From 2001 to 2012, Serbia attracted net FDI inflow of EUR 16.6 bln, equivalent to average annual per capita inflow of EUR 188. Nearly half of this amount (EUR 7.9 bln) was recorded in the run-up to the crisis (2006–2008). As foreign investors opted mostly for the purchase of existing enterprises, around 95% of all FDIs were brownfield investments. The onset of the crisis and uncertainty made investors more risk-averse and the most significant investments from 2008 onwards were channelled through joint ventures initiated by the state in manufacturing enterprises (NIS and Fiat Automobiles Serbia).

At end-September 2013, the stock of FDI in Serbia was EUR 19.6 bln, of which nearly three fourths flowed to non-tradable sectors. The share of FDI in tradable sectors[1] is lower in Serbia than in most of the new EU member states. FDI flows to tradable sectors are however improving steadily: from 2004 to 2008 they accounted on average for 21% of total FDI, whereas from 2010 to 2013, they made up 31%. In 2009 more than half of FDI (53%) went to tradable sectors, owing primarily to investments in NIS and Fiat Automobiles Serbia. Since FDI in tradable sectors has a positive effect on export growth and given that Serbia is currently below the trend, there is a distinct need for attracting additional, preferably greenfield investments into those sectors.

Chart O.1.1 **Stock of FDI in tradable sectors and exports in 2012**
(share in GDP)



Source: NBS calculations based on data from the websites of central banks, Eurostat and OECD.

* 2011.

Looking at sectoral distribution, bulk of FDI ended in the finance industry (around 40%), notably the banking sector. In fact, these were the first major investments in the aftermath of the year 2000. Next in size are investments in the manufacturing industry (around 20%), more specifically enterprises engaged in the production of food, base metals, rubber and plastic products, motor vehicles and trailers, pharmaceuticals, non-metallic minerals, and chemicals and chemical products. Trade is also a significant recipient of FDI (around 15%), while the sectors of information and mining each absorbed 5% of FDI.

Most of the investments in manufacturing were channelled to export-oriented industries. Hence, 12 out of 15 top exporters in 2013 are in majority foreign ownership[2]. The automobile industry (production of automobiles and related branches) stands out by the positive effects it has had on Serbian exports. In fact, in late 2012 and throughout 2013, it acted as the key propellant of robust export growth. In 2012, its products accounted for 7.9% and in 2013 as much as 17.8% of total Serbian exports. Positive, albeit more moderate, effects of these investments are expected in the coming years as well. Majority foreign-owned enterprises are also large exporters of rubber and plastic, pharmaceutical products, electrical equipment, articles of apparel, base metals and paper and paper products. Another important export product of Serbia is food and this again is an industry which has attracted foreign capital inflow.

[1] Agriculture, forestry and fishing, mining, manufacturing, electricity, gas, steam and air conditioning supply.

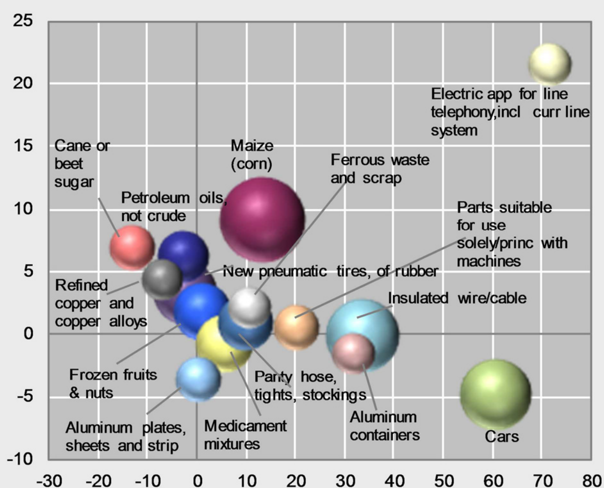
[2] According to the Customs Administration data.

At the same time, if we consider the competitiveness[3] of the main export products, including those produced by foreign-owned enterprises, Serbia's position is relatively favourable.

Though FDI in non-tradable sectors tends to push domestic demand up and deepen external imbalances, it has had a positive, albeit indirect impact on the growth in Serbian exports. To illustrate, the entry of foreign banks significantly increased the credit potential of the domestic banking sector. This in part paved the way for a greater volume of lending and financing of domestic production, which in turn helped boost exports and/or reduce imports.

In 2012, Serbia recorded a net FDI inflow of mere EUR 274.1 mln, due largely to the outflow brought about by changes in ownership structure in the sector of telecommunications (acquisition of **foreign investor's stake** in one mobile telephony operator and pulling out of a part of capital by another operator). In 2013, it received an FDI inflow of EUR 770.5 mln. FDI flows are expected to recover further in 2014 and 2015 (around EUR 1.0 bln a year). This expectation is based on the announced investments in the energy sector, manufacturing industry, trade, agriculture and the financial sector. FDI flows to export-oriented sectors will additionally reduce the external imbalance, which is consistent with the new, more sustainable model of economic growth based on net exports. Channelling investment into export branches, or more specifically industries for whose products external demand is rising, will by all means contribute to the improvement of Serbia's competitiveness on a global scale.

Chart O.1.2 **Sector specialisation of Serbian exports**



Source: NBS calculation based on UN COMTRADE statistics.

X axis: difference in the exponential growth rate of Serbian exports and the global growth rate of exports in relevant sectors;
Y axis: difference in the exponential growth rate of global exports for individual sectors and the growth rate of total global exports.

[3] Following the methodology applied by Orszaghova et al. (2013) in the External Competitiveness of the EU Candidate Countries, ECB Occasional Paper 141/2013, we made a graphic presentation of trends in exports of Serbia's 15 key export products and compared them with global exports. The growth rate was calculated based on data for the period 2005–2012. The size of the bubble for each individual sector is proportionate to its share in the country's total exports in 2012. A bubble in the upper right quadrant means that the country is specialising in the production of those products (growing country specialisation) and that their exports are rising at global level as well (fast-growing world sectors). The upper left quadrant indicates falling country specialisation and growing world sectors. The lower left quadrant stores products whose exports are falling at both country and global level, while the lower right quadrant stores products whose exports are rising at country level and declining at global level.

Trends in the FX market and exchange rate

Appreciation pressures marked the entire Q4, apart from early December when they were temporarily stalled on the back of heightened demand for foreign currency used for paying energy imports. In terms of average and end-of-period values, the exchange rate of the dinar against the euro remained largely unchanged relative to Q3, moving from 113.9 to 115.0 dinars for one euro. At the annual level, the dinar lost nominal 0.8% against the euro end-of-period.

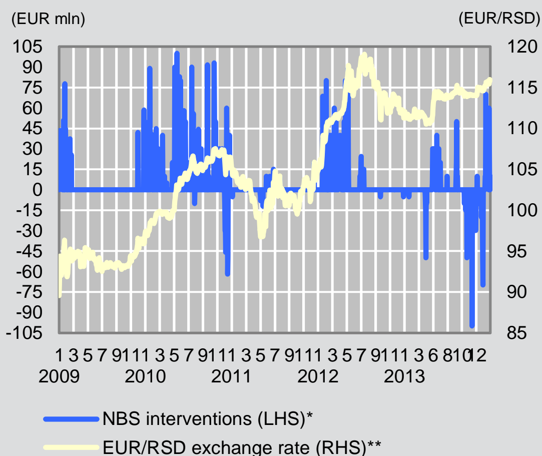
Stable dinar/euro exchange rate movements and dollar's weakening against the euro triggered a 2.7% appreciation of the dinar vis-à-vis the dollar on average in Q4, or 2.1% end-of-period. Consistent with such trends, the nominal effective exchange rate of the dinar[7] gained 0.4% on average in Q4.

Appreciation pressures in Q4 were fuelled by narrowing of the risk premium and elevated non-resident investment in dinar securities. In addition, the FDI inflow, foreign trade and increased inflow based on net purchase of foreign currency from exchange dealers added to dinar's stability.

Following a four-month break, non-residents stepped up investment in dinar securities in October. A similar degree of interest was sustained over the ensuing months. Among other things, this was due to a sharp fall in Serbia's risk premium, precipitated by global factors, notably Fed's monetary policy, and the adoption of additional measures aimed at resolving the problem of domestic public finance. A portion of the FX inflow also came from somewhat higher FDI inflows relative to Q3. Pressures in the FX market lessened also on account of foreign trade developments. At the same time, an increase in net purchase of foreign currency by exchange dealers propped up FX supply in the domestic market.

IFEM trading slackened further in Q4. Average daily trading volumes amounted to EUR 29.2 mln at the quarterly level. Record low values were observed in November (EUR 20.6 mln), while December saw a rise to EUR 35.0 mln (still much less than in earlier years). Exchange rate volatility, measured by EWMA[8] and EGARCH[9], was consistent with trading volumes in the IFEM. Throughout the quarter, the exchange rate volatility was low, with the lowest levels recorded in November.

Chart IV.1.10 **Movements in EUR/RSD exchange rate and NBS FX interventions**

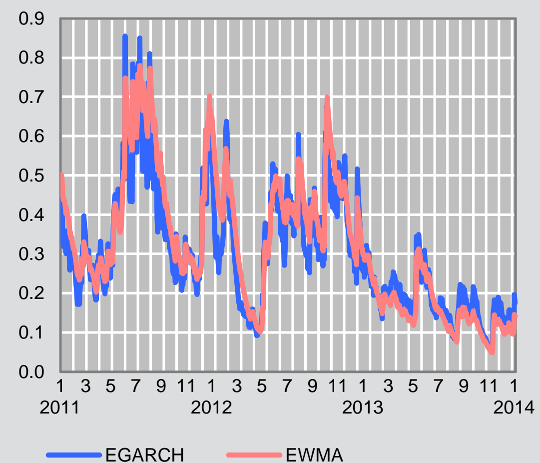


Source: NBS.

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

To ease excessive short-term strengthening of the dinar, the NBS net purchased EUR 515.0 mln in Q4.

Chart IV.1.11 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

The dinar volatility narrowed further in Q4.

[7] Calculated as the geometric mean of nominal exchange rates of EUR/RSD and USD/RSD, with respective weights of 0.8 and 0.2, i.e. according to the formula: (EUR/RSD^0.8)*(USD/RSD^0.2).

[8] EWMA – Exponentially Weighted Moving Average.

[9] EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

As appreciation pressures marked the major part of Q4, the NBS intervened by purchasing EUR 525.0 mln in order to ease excessive short-term volatility of the dinar. It intervened once on the sale side, in early December, when it sold EUR 10.0 mln. In 2013, the NBS purchased EUR 180.0 mln net.

In Q4, the NBS continued to organise three-month and two-week FX swap auctions. At three-month swap auctions, it sold EUR 6.0 mln and bought the same amount. At two-week auctions, it sold EUR 14.0 mln and bought the same amount.

Among currencies of countries in the region running similar exchange rate regimes, the Polish zloty (1.7%) and Hungarian forint (0.5%) strengthened in Q4. Depreciation was observed for the Romanian lei (0.5%) and most notably for the Czech korona[10] (6.2%) and Turkish lira (6.4%).

The Fed's decision on QE tapering spurred a rise in the risk premium and triggered depreciation pressures across the region in the course of January. In case of Serbia, this was also due to increased demand for foreign currency by enterprises, chiefly by energy importers. To ease excessive short-term volatility of the dinar, the NBS sold EUR 330.0 mln in January.

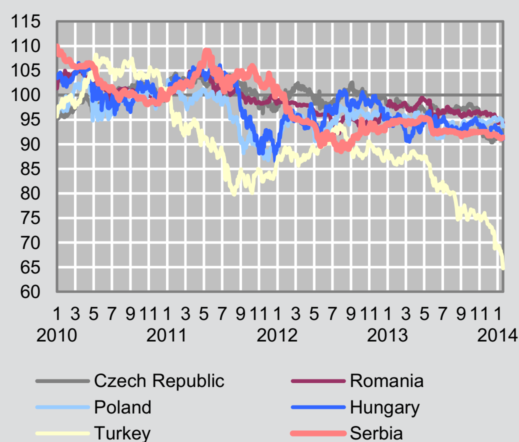
Stock exchange trends

Belgrade Stock Exchange (BSE) indices continued up from July into Q4. In late 2013, BELEX15 equalled 558.0 points, up by 6.3% from end-September. BELEXline also upped, by 6.7% to 1,104.9 in late December. In annual terms, BELEX15 and BELEXline gained 6.5% and 9.9% respectively.

Rising stock prices may be associated with positive expectations of BSE participants, based on favourable macroeconomic indicators for H2 – low inflation, economic growth, a rise in exports and a stable exchange rate for the dinar.

Trading in BSE shares totalled RSD 6.6 bln in Q4, up by RSD 1.5 bln on Q3. The highest volume was recorded in October (RSD 4.4 bln), largely on the back of one block trading in shares from the open market[11] segment. Trading in shares covered by BELEX15 came at RSD 1.8 bln, down by RSD 2.2 bln on Q3.

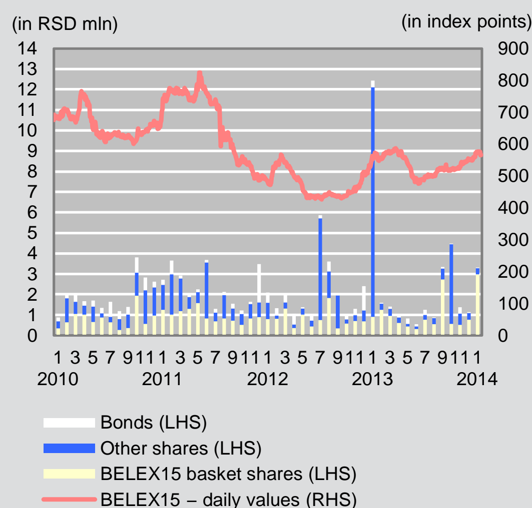
Chart IV.1.12 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)



Sources: NBS and websites of central banks.
* Growth indicates appreciation.

In terms of the end-of-period and period-average, the dinar was the most stable currency among the currencies observed in Q4.

Chart IV.1.13 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

Owing to the H2 rise, the Q2 fall in indices was almost fully compensated for.

[10] Due to central bank interventions in the FX market.

[11] A regulated market segment, consisting of shares not eligible for BSE listing.

In Q4, foreign investors were net sellers of shares worth RSD 2.6 bln, with the major part relating to the above block transaction of ownership change.

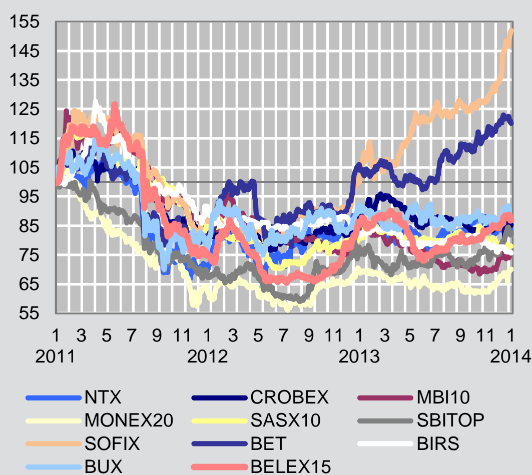
Trading in frozen FX savings bonds amounted to RSD 0.4 bln in Q4, up by 5.3% on Q3. Most traded were bonds maturing this year. The yield to maturity rates for this series increased to 6.15% in late 2013. The rates for A2015- and A2016-series fell to 3.7% and 3.8% respectively.

Corporate bonds were not traded in Q4 either.

BSE market capitalisation rose by RSD 22.4 bln to RSD 772.4 bln in late 2013. The share of market capitalisation in estimated GDP[12] was down by 0.4 pp to 21.6% in December. Broken down by segment, regulated market capitalisation expanded by RSD 22.7 bln to RSD 434.6 bln, while the MTP[13] capitalisation contracted by RSD 0.2 bln to RSD 338.0 bln.

Indices on most stock exchanges in the region rose to a similar extent as on the BSE. The sharpest increase was recorded for Podgorica (8.4%) and Sofia (7.7%) indices, while those in Sarajevo and Banjaluka shed 3.4% and 2.9% respectively.

Chart IV.1.14 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

Indices of most regional stock exchanges picked up in Q4.

In the course of January, BELEX15 and BELEXline continued up, by 2.8% and 2.5% respectively. Relative to December, total trading also picked up. Regional indices displayed divergent movements – the sharpest rise was seen on the Sofia (11.3%) and the steepest slump on Sarajevo (1.9%) stock exchange.

2. Money and loans

The last year's rise in monetary aggregate M3 was fully determined by a rising dinar component. Dinar household savings almost doubled thanks to higher interest rates on dinar savings and their more favourable tax treatment, but also due to low inflation and a stable exchange rate. Corporate lending continued to exert an adverse impact on M3, whilst lending to households subsided in Q4 only.

Monetary aggregates

Dinar reserve money expanded in Q4 by 8.2% in nominal and 8.4% in real terms. Given a decline in bank FX deposits with the NBS, total reserve money increased somewhat less – by 2.5% in nominal and 2.7% in real terms. Y-o-y, dinar reserve money gained real 9.2%, while total reserve money stayed almost unchanged (a 0.3% rise).

In the course of Q4, dinar reserve money was created chiefly through NBS FX purchases in the IFEM (RSD 50.8 bln). Payment operations with Kosovo and Metohija (RSD 9.2 bln) and monetisation of government FX deposits (RSD 6.0 bln) played a lesser role. The major portion of funds obtained from the sale of dinar securities in October and November was retained by the government in its dinar accounts. As a result, these balances grew by RSD 29.7 bln in Q4. In addition, a part of created liquidity was withdrawn through repo operations (RSD 15.0 bln).

In the structure of dinar reserve money, bank excess reserves[14] were up RSD 12.8 bln, entirely based on the increased use of deposit facilities. Cash in circulation also went up (by RSD 9.7 bln), mainly on account of the seasonal increase in December. Balances in dinar accounts of local government authorities with the NBS went up by RSD 3.5 bln, while the level of required reserves allocated in dinars stayed flat relative to end-Q3.

[12] Estimated GDP over the last four quarters.

[13] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

[14] Including balances in bank gyro accounts, vault cash and overnight deposits with the NBS.

Money supply increased further in real terms in Q4. The sharpest rise was noted for M1 (8.6%), mainly driven by higher transaction deposits of corporate and household sectors. As a result, money supply M2 gained 6.1% in real terms. A drop in FX deposits, notably of corporates, bore down on real growth in the broadest monetary aggregate M3 (1.0%).

Along with subsiding inflation, real y-o-y growth in money supply continued to accelerate in Q4. Under the impact of rising transaction deposits, the narrowest aggregate M1 increased the most (23.2% y-o-y). Relative to end-2012, M2 and M3 edged up by 11.9% and 2.5% in real terms respectively.

Foreign currency purchases in the IFEM by the NBS had the strongest influence on M3 growth in Q4. In its accounts with the NBS, the government retained the major portion of dinar and FX balances obtained through the sale of securities in domestic and international markets. Therefore, this had no major impact on M3 developments. Reduced lending to the non-government, notably the corporate sector, sent further negative pressures on M3 in Q4.

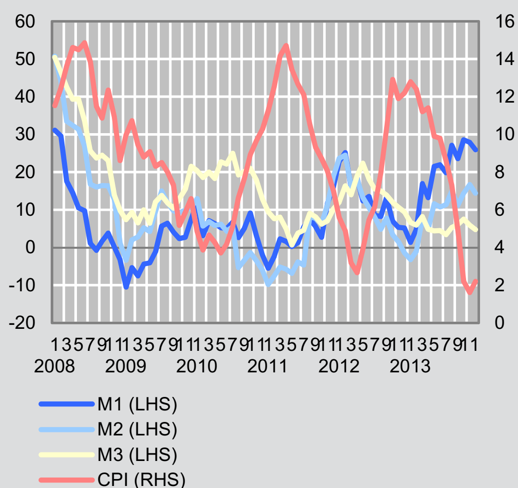
Among the components of M3, demand deposits increased the most (RSD 20.4 bln), primarily balances in accounts of households and enterprises belonging to the sector of trade and supply of electricity, gas and steam. In contrast, savings and term dinar deposits rose by mere

Table IV.2.1 **Monetary aggregates**
(real y-o-y rates, in %)

	2013				Share in M3 Dec. 2013 (%)
	March	June	Sep.	Dec.	
M3	-2.7	-4.8	1.2	2.5	100.0
FX deposits	-2.5	-7.1	-0.8	-1.5	68.0
M2	-3.2	0.9	5.9	11.9	32.0
Time and savings dinar deposits	-15.8	-14.7	-13.4	-8.2	9.4
M1	5.2	11.0	17.8	23.2	22.6
Demand deposit	18.1	21.9	30.8	31.5	15.5
Currency in circulation	-14.1	-5.8	-3.2	8.4	7.1

Source: NBS.

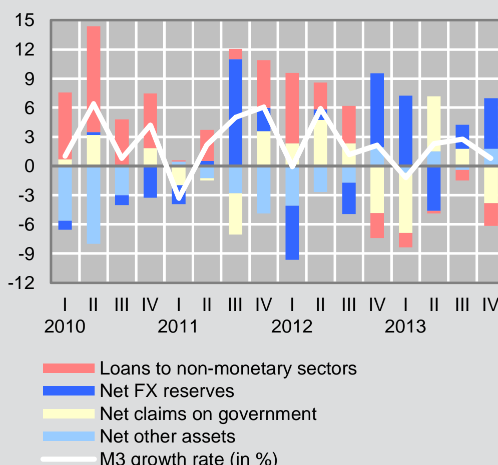
Chart IV.2.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

The real growth in money supply, notably dinar, accelerated further in Q4 partly due to subsiding inflation.

Chart IV.2.2 **Contribution to M3 3-month growth rate**
(in percentage points)



Source: NBS.

With a negative impact of lending activity and the neutral government effect, the marginal M3 growth in Q4 was due mainly to IFEM interventions.

RSD 0.4 bln, while balances in accounts of the local government and companies declined. At the same time, the upward trend in dinar household savings continued. Dinar savings thus climbed up by RSD 10.3 bln in Q4, most notably those maturing between six months and one year. In late 2013, dinar household savings amounted to RSD 33.7 bln, more than double the amount of end-2012. FX deposits declined (EUR 151.9 mln) mostly on account of falling balances in corporate accounts, while no rise in FX savings was recorded at the time of the World Savings Day. A decline in inflation, a stable exchange rate and more favourable interest rates and tax treatment for dinar compared to FX savings induced greater household interest in dinar savings in 2013.

Monetary multiplier remained broadly unchanged in Q4 – it stood at 1.1 and 1.6 for M1 and M2 respectively. As transaction deposits continued up, the velocity of circulation of dinar monetary aggregates decreased, but kept its q-o-q pace in the case of M3.

Bank lending

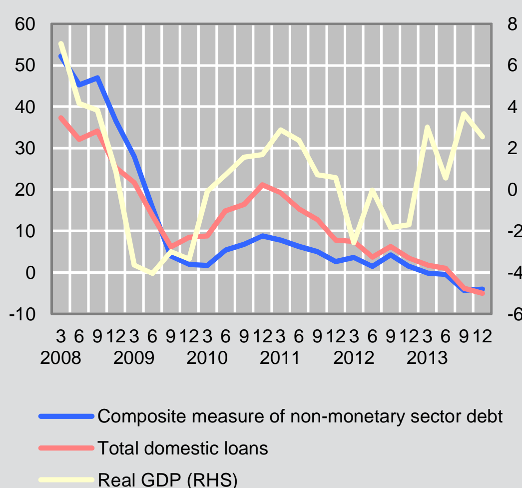
Adverse developments in the lending market extended into Q4. Excluding the exchange rate effect[15], lending activity contracted by 5.0% in 2013. Lending declined y-o-y, though to a smaller extent, even excluding receivables of banks delicensed over the past year.

At the quarterly level, excluding the exchange rate effect, domestic lending was down 2.3% in Q4, mainly because of a reduction in corporate lending. This was partly due to the delicensing of Privredna banka Beograd in October. However, excluding the effect of delicensing, lending continued further down, at a pace similar to that of Q3. As lending diminished, its share in estimated GDP[16] fell by 1.6 pp to 50.6% in late 2013.

In terms of traditional sources of bank funding, growth was recorded for dinar deposits of the household sector and other financial organisations, while FX deposits shrank.[17] Banks held a smaller portion of their FX deposits with the NBS. Further, balances in their accounts abroad also went down. On the other hand, banks continued to increase investment in safer, repo and government securities in Q4. They used a portion of funds to repay their external debt, notably in respect of long-term loans.

Excluding the exchange rate effect, corporate lending fell by RSD 35.6 bln or 3.9% in the review period. Thus receivables against corporate loans dwindled by RSD 107.5 bln or 10.7% in the entire 2013. As shown by preliminary results of the pilot survey on lending activity[18], such trends were precipitated by receding supply of loans, but also by lower demand. Loan supply tightened mainly reflecting the increased risk perception in regard to the collection of receivables. By contrast, the steepest decline in enterprise demand was noted for capital investment loans, whereas demand for current assets and debt restructuring loans rebounded. This is corroborated also by a moderate increase in new current assets and other loans, and a smaller amount of new investment loans in Q4. However, Q4 saw somewhat increased fresh lending (2.8%) than in Q3, though the y-o-y figure is lower by 38.5% when subsidised loans served as an important stimulus. Lending activity abated mainly because these loans fell due and bank receivables were assigned to non-financial entities. In the long run, the assignment of receivables is likely to encourage lending by means of a reduction in credit risk capital requirements and the collection of a portion of the receivables assigned.

Chart IV.2.3 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

Lending and economic activity displayed opposite tendencies in 2013.

[15] Calculated at the RSD/EUR exchange rate on 31 August 2008, assuming that all FX and FX-indexed loans were extended in euros.

[16] Estimated GDP for the last four quarters.

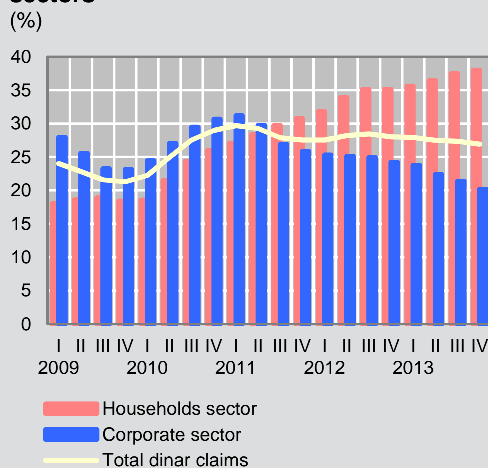
[17] A rise in the deposit base and reduced lending dragged down the LTD ratio by 2.5 pp to 115.7% in December.

[18] See Text box 2 on page 27.

Household lending also declined in Q4. Under the impact of lower demand, fewer new loans were disbursed in Q4 relative to Q3. As a result, the amount of loan repayments exceeded the volume of fresh loans extended. Excluding the exchange rate effect, lending to households dropped by RSD 3.3 bln or 0.3%. Still, thanks to growth of earlier quarters, household lending stepped up by RSD 19.0 bln or 4.0% at the year level. Fewer loans were extended in all categories. Among new loans, cash dinar loans remained predominant. The fact that housing loans were approved to a lesser extent is also due to tightened bank criteria and ending of the subsidised lending programme as new funds for these purposes have not been earmarked in the 2014 budget. Of more expensive loan categories, citizens were somewhat more reluctant to use revolving loans and current account overdrafts, while the level of borrowing under credit cards remained unchanged from Q3. In Q4, banks extended subsidised housing loans worth RSD 1.2 bln.

The share of dinar loans in total corporate and household lending contracted relative to September and reached 26.8% in December. In addition, the share of dinar household loans continued up (by 0.5 pp to 37.9% in

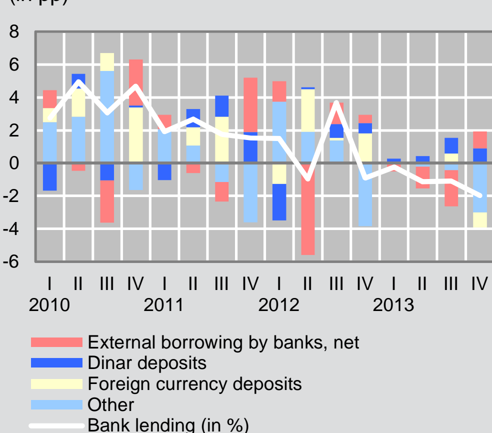
Chart IV.2.5 **Share of dinar in total bank receivables on corporate and household sectors**
(%)



Source: NBS.
* Excluding the exchange rate effect.

The tendency of a rising degree of dinarisation for household loans and a decline for corporate loans continued into Q4.

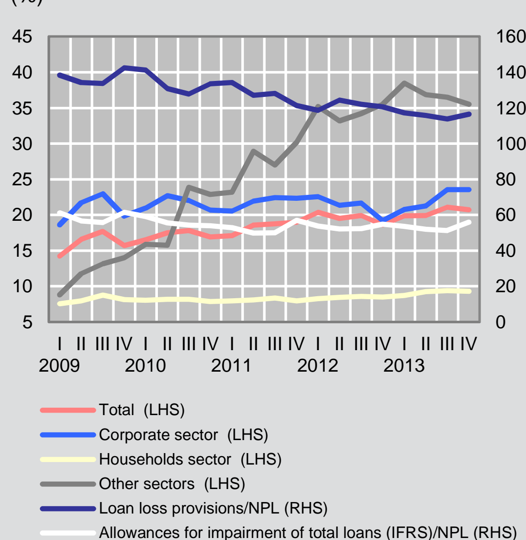
Chart IV.2.4 **Contributions to quarterly rate of lending growth***
(in pp)



Source: NBS.
* Loans to non-monetary sectors excluding the exchange rate effect.

An increase in dinar deposits and reduced bank external receivables exerted a positive impact, while a drop in FX deposits and elevated investment in dinar securities had a negative impact on lending growth.

Chart IV.2.6 **NPLs share in total loans, gross principle**
(%)



Source: NBS.

The share of NPLs in total loans declined in Q4.

December), partly due to dampened demand for FX and FX-indexed loans. In the corporate sector, it fell by additional 1.2 pp to 20.0% in December.

The ratio of NPLs in total loans (gross principle) fell by 0.4 pp relative to September, reaching 20.7% in December according to prefinal entries. The NPL ratio in the corporate sector remained flat at 23.5%. It fell by 0.1 pp to 9.3% in the household sector. A decline in NPLs was due mainly to the delicensing of Privredna banka Beograd, but also to the assignment of due receivables to non-financial entities. According to data submitted to the NBS, banks assigned RSD 10.9 bln in due loans to non-financial entities in Q4, i.e. RSD 32.1 bln since early 2013.

Despite a high NPL share in total loans, the capital adequacy ratio of around 20% indicates unimpaired stability of the domestic banking sector. Allowances for impairment equalled 55.9% of NPLs in December. At 116.5% in December, loan loss provisions fully covered the level of gross NPLs.

Text box 2: First results of the NBS survey on bank lending

The global economic crisis has hit the world severely, Serbia included. The initially declining lending to the private sector soon entered the negative interest rate zone, hampering economic recovery. In order to gain a better perception of the credit market, primarily in terms of factors affecting supply and demand, and hence improve the basis for economic decision-making, the NBS introduced a bank lending survey as of the beginning of 2014. The participation of banks in the survey is voluntary, and since almost all banks agreed to take part, all segments of the credit market have been covered and reliability of data ensured.

In terms of the methodology applied, the NBS survey is aligned with those conducted by central banks of the euro area, with modifications specifically tailored to suit our own credit market. Combined with the statistics of interest rates and bank loans, data on the supply of and demand for bank loans generated by the survey will help towards a more comprehensive assessment of developments in the credit market. Though the results of the survey cover the views of credit market participants on the supply side only, they will nevertheless be useful to all economic subjects – to the central bank when assessing lending activity and making decisions on monetary and macroprudential policies, to the Government when making decisions on economic policy, to banks when defining lending standards and terms of loan offer, and to corporates and households when considering their financing options.

Looking forward, we expect the bank lending survey to provide data needed to identify and analyse restrictions in bank lending: whether banks are less willing to lend (supply-side restrictions) or corporates and households less willing to borrow (demand-side restrictions), or perhaps both. Furthermore, it is immensely important to identify factors of loan supply and demand, and the way they change over time. Why have banks become less eager to lend and/or corporates and households to borrow? Answers to these questions will help economic policy makers to select lending policy measures that can be applied, as measures differ depending on the side of the market where major constraints lie and on their determining factors.

The results of an NBS pilot survey on bank lending, conducted in January this year, suggest that the constraining factors are found on both the supply and demand side, but that it is the supply-side factors which primarily underlie the current lending dynamics. The results of the most recent bank lending survey conducted by the EIB in Serbia and across the region lead to the same conclusion[1]. According to this survey, loan supply and demand in Serbia are in a restrictive phase, with the supply being more and demand less constraining than elsewhere in the region. Loan supply was tightened primarily in terms of lending to enterprises and housing loans. In the period ahead, banks expect loan demand to remain unchanged and loan supply to perk up a little, though lending will remain more supply-constrained than elsewhere in the region.

Both surveys indicate that loan supply is mostly constrained by heightened risk perception regarding the collectibility of loans. Expectations as to the overall economic activity and the risk associated with required collateral also have an adverse effect on loan supply. These factors will continue to exert a powerful negative influence on loan supply in the foreseeable future. Positive influence is expected from the sources of bank financing which, though at low levels, tend to become more accessible. According to the EIB survey, banks rely the most on local sources of funding, most notably corporate and household deposits, but also on international financial institutions, mirroring trends across the region. However, contrary to the position held by banks in the rest of the region, our banks believe that financing received from parent banks abroad is also becoming more accessible. The question remains as to whether the problem of financing will

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[1] The survey is conducted within Vienna Initiative 2 and it covers 14 international bank groups operating in the region and 90 local banks/subsidiaries of these groups. In addition to Serbia, the survey covers: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Hungary, Macedonia, Poland, Romania, Slovakia, Slovenia and Ukraine. The survey has been conducted semi-annually since October 2012, and the latest one was published at end-December 2013 for H2 2013 (*EIB CESEE Bank Lending Survey H2 2013*, http://www.eib.org/infocentre/publications/all/cesee-bank-lending-survey.htm).

emerge once loan demand picks up. At the same time, the maturity structure of bank sources of funding is unfavourable – short-term sources of funds are not a constraining factor on the supply side, unlike long-term ones.

Though loan demand has shrunk both in Serbia and across the region, the results of the two surveys indicate that it was mainly triggered by the household sector. Although at a low level, household demand is focused on loans in the domestic currency. As for enterprises, the stimulus arising from the demand for current assets and debt restructuring loans has been more than offset by the sharp drop in the demand for capital investment loans.

It would appear that loan demand is currently recovering better than loan supply, and that a key challenge for lending policy makers is to find a way to revive lending by banks in a difficult phase of restructuring of their balance sheets and adjusting their financing strategies to rely more on the local sources of funding.

Measures aimed at boosting lending are not all-powerful, given that they increase the amount of the risk underwritten. These measures are constrained by the effects they exert on financial and macroeconomic stability. Hence lending policy measures should be analysed and their short-term benefits weighed against their long-term costs. This requires access to detailed data on developments in the credit market, which additionally heightens the importance of conducting a bank lending survey. The results of the survey are useful not only in the negative, but equally so in the positive stage of the credit cycle, when a prompt response is required to prevent, or at least tone down the rise of imbalances and risks.

3. Aggregate demand

Q4 saw a real drop in the export of goods and services which, coupled with the growth in imports, drove down aggregate demand. At the same time, domestic demand rose on the back of private investments and household consumption. Although slow, real y-o-y rise in exports remained strong. Domestic demand continued to fall y-o-y, driven entirely by cuts in government investments. The prices of raw material in the global market were relatively stable throughout Q4.

During Q4, real s-a import of goods and services recorded growth, while exports receded. On the other hand, domestic demand rose, aided by the positive contribution of private consumption and investment. Due to such movements, aggregate demand recorded a 0.5% s-a fall, with the positive contribution of domestic demand (1.1 pp) and the negative contribution of net exports (1.6 pp).

Y-o-y, the growth of demand slowed down in Q4 and came at 2.6%, mostly on account of the lower rise in exports. Namely, although exports in Q4 registered a high growth rate (20.9% y-o-y), their dynamics decelerated visibly because the high growth rates from Q4 2012 were applied in the calculation. Domestic demand continued to subside by 1.0% y-o-y, though the decline is significantly milder relative to the previous quarter (2.3% y-o-y). The fall in domestic demand in Q4 is fully attributable to cuts in government investments, while final consumption and private investments recorded growth.

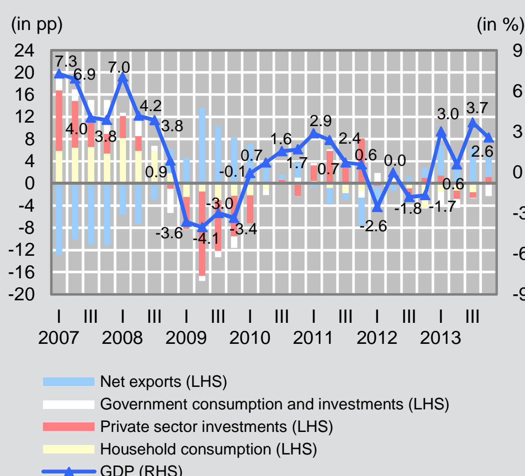
At the annual level, demand rose by 2.4%, driven entirely by net exports. Robust growth in net exports in 2013 was achieved owing to earlier investments in the automobile and oil industries that were now activated, while an additional impetus in H2 came from the recovery of the export of agricultural products. Conversely, all domestic demand components in 2013 were on the decline, most notably government investments, which were curbed on account of contracted activities in the construction sector.

In 2014, demand growth is expected to slow down at around 1.0%. Net exports will give a positive push to growth as a result of economic recovery in the euro area, while private and government investments are also likely to exert a positive effect. Final consumption in 2014 will decline due to the effective implementation of the fiscal consolidation process. However, together with the announced structural reforms, this process will make room for faster GDP growth in the years to come.

Domestic demand

According to our estimates, **private consumption** stagnated in Q4 (growth of 0.1% y-o-y). Based on the movements of leading indicators, private consumption is

Chart IV.3.1 **Contributions to quarterly GDP growth rate – expenditure side**

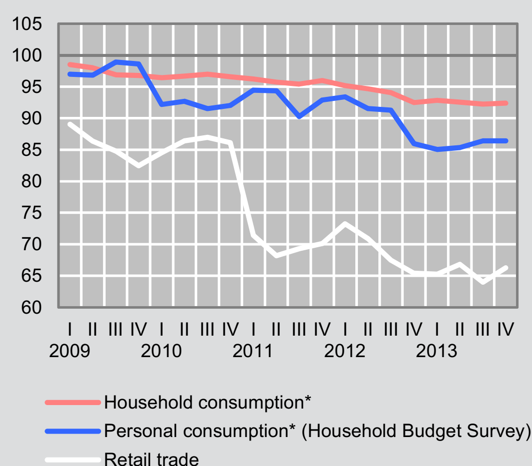


Sources: SORS and NBS calculation.

Note: Q4 2013 is an NBS estimate.

Real growth in exports decelerated in y-o-y terms, inducing a slowdown in total demand.

Chart IV.3.2 **Household consumption**
(s-a data, H1 2008 = 100)



Source: SORS and NBS calculation.

* NBS estimates for Q4 2013.

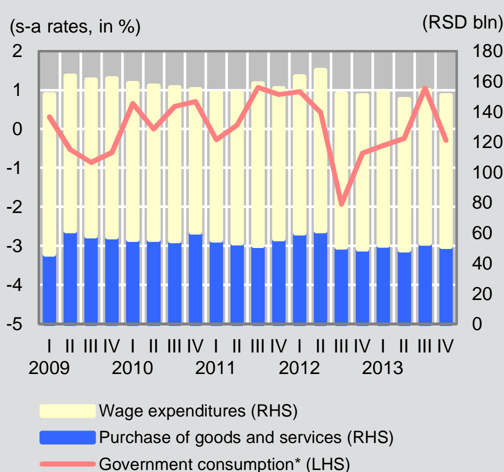
Increase in retail trade in Q4 indicates a halt in the downwards trend of household consumption .

Table IV.3.1 **Investment indicators**

	2012	2013			
	Q4	Q1	Q2	Q3	Q4
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Construction	-11.3	-3.8	-16.2	2.2	-8.5*
Industrial inventories	1.4	0.8	0.8	-1.7	3.2
Industrial production of capital goods (physical volume)	17.3	4.4	11.4	5.1	-14.8
Exports of equipment**	-1.2	10.4	-14.7	12.6	-12.7
Imports of equipment**	-9.2	4.5	-2.7	-3.5	1.4
Inventories of capital goods	3.6	-1.1	5.9	-2.7	-3.0
Industrial production of intermediate goods (physical volume)	-1.1	-1.8	2.3	3.3	1.0
Exports of intermediate goods**	2.8	11.3	-0.1	7.2	-1.3
Imports of intermediate goods**	1.2	0.5	-2.5	1.5	-0.1
Inventories of intermediate goods	2.6	4.2	2.8	4.3	1.0
Industrial production of construction materials (physical volume)	-1.7	-6.0	-6.7	-0.9	-2.9
Inventories of construction materials	1.2	-4.6	0.8	-2.6	-7.7
Government investment***	1.3	-26.5	-2.9	-3.8	-9.2

* NBS estimate.
** Exports and imports are denominated in euros.
*** Government investment spending is deflated by the industrial producer price index.

Chart IV.3.3 **Government consumption**
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.

* NBS estimate for Q4 2013.

Following a growth episode in Q3, final government consumption recorded a fall in Q4.

estimated to have grown by 0.2% s-a. Retail trade, the key indicator, rose by 3.6% s-a in Q4, while turnover in green markets and VAT receipts also picked up. However, private consumption is still 7.6% below the pre-crisis level[19], and fiscal consolidation measures, which include cuts in public sector income and indexation of wages and pensions, will continue to hamper its recovery in the foreseeable future.

Sources of consumption data in Q4 also point to a stall in private consumption. Mild growth was recorded only in the real wage bill, whereas social transfers, remittances and household consumer loans registered a fall. Real sources of household consumption rose y-o-y, mostly prompted by decelerated inflation.

In our best judgement, **private investments** in Q4 rose by 4.6% y-o-y, yielding a positive contribution of 1.0 pp to aggregate demand. Relative to a quarter earlier, private investments perked up by 7.3% s-a.

The recovery of investments in Q4 was most evidently signalled by the growth of equipment imports, with the major part of the rise attributable to the build-up of inventories, as confirmed by the 3.2% s-a rise in the physical volume of industrial inventories. Considering the continued contraction in new investment loans to corporates in this period and a real decline in foreign indebtedness of enterprises, we estimate that the largest portion of funds for investments came from own funds of the successfully operating enterprises.

In Q4, **government consumption** continued to edge up, coming at 0.3% y-o-y (contribution of 0.1 pp to total demand). In quarterly terms, a 0.3% s-a drop was recorded, prompted by lower outlays for the procurement of goods and services and wage outlays. In line with fiscal consolidation measures, this category of demand is expected to weaken in 2014.

A fall in **government investments** accelerated to 45.9% y-o-y in Q4, while q-o-q the drop measured 9.2% s-a. According to the budget plan for the on-going year, capital expenditures are expected to rise, therefore government investments will give a positive contribution to the growth of demand in 2014.

Net external demand

The automobile industry production lost some momentum in Q4, leading to a 0.6% s-a decline in real

[19] H1 2008.

exports of goods and services. At the same time, real imports of goods and services edged up by 2.3% s-a. In y-o-y terms, the growth in real exports, though slower, remained strong at 20.9%, while imports rose by 7.4%. As a result, net exports added 3.8 pp to total demand.

Foreign trade flows improved significantly in 2013, reflecting positively on the stability of the foreign exchange market. The current account deficit is estimated to have contracted to 5.0% of GDP, owing primarily to the robust growth in automobile and oil industry exports. The largest individual contribution to the deficit reduction (1.0 pp of GDP) came from the exports of Fiat Automobiles Serbia, which amounted to EUR 1,531 mln in 2013, as indicated by the Customs Administration data.

The share of the current account deficit in GDP is expected to stay broadly unchanged in 2014. Exports will be growing at a slower pace than in 2013, while low domestic demand will prevent a faster rise in imports.

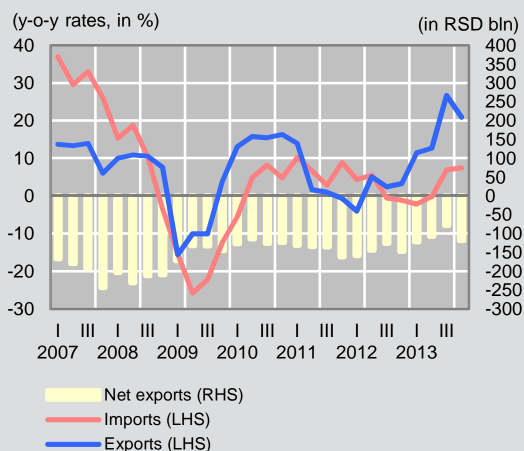
Euro-denominated commodity exports declined by 6.0% s-a in Q4 as a result of underperforming manufacturing exports. The key drivers of this decline were motor vehicles (19.7% s-a) and rubber and plastic products (9.9% s-a), which in fact worked in the opposite direction in the first three quarters of 2013. Quarterly decline was also registered for exports of metal products, articles of apparel and other machinery and equipment. On the other hand, exports of petroleum products, electrical equipment and food continued to grow, mirroring the increase in the physical volume of their production.

Exports of agricultural commodities went down by 8.8% s-a in Q4. Note however that this fall is a consequence of robust growth in Q3 and the high comparison base, because in absolute terms, exports were only slightly lower than in Q3. Good agricultural season and the market surpluses of the key export agricultural commodities (corn and wheat) should contribute to export growth in H1 2014 as well.

Euro-denominated commodity imports edged up by 2.8% s-a in Q4. The strongest growth was registered for imports of consumer goods (4.1% s-a). Imports of equipment rose 1.4% s-a. Consistent with the slowing pace of economic activity, imports of intermediate goods contracted by 2.0% s-a.

Despite a slight decrease in Q4, year-end exports were 42.8% higher than pre-crisis[20], while imports were 4.2% lower. The export to import ratio, measured as the 12-month moving average, reached 73.1% in December.

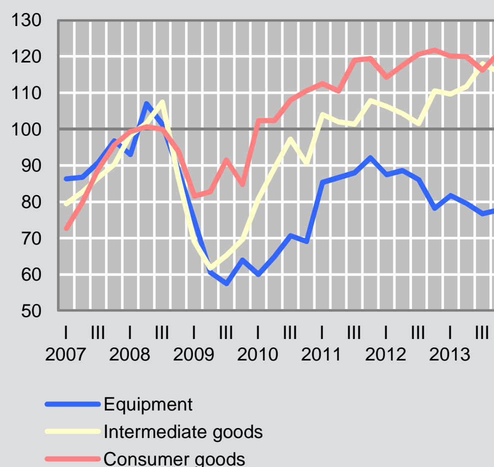
Chart IV.3.4 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
Note: Q4 2013 is an NBS estimate.

Slower y-o-y growth in exports, coupled with stagnant imports, resulted in sluggish growth of Q4 demand.

Chart IV.3.5 **Imports by key components**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

During Q4, equipment and consumer goods imports rose, whereas the import of intermediate goods declined.

[20] H1 2008.

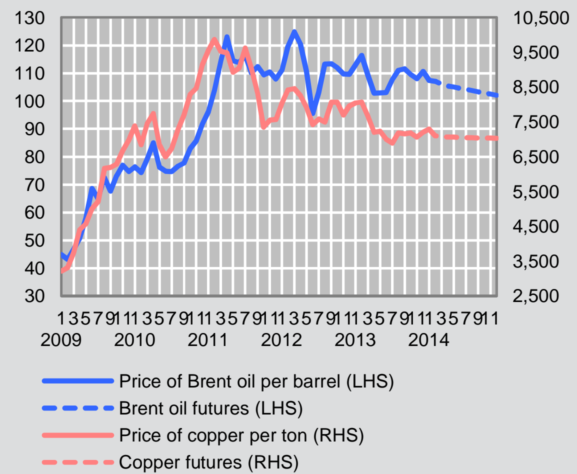
The leading indicator of external demand for Serbian exports[21] continued to rise. The anticipated recovery of our key foreign trade partners should also have a positive effect on Serbian exports in the coming period.

Price competitiveness of domestic exports deteriorated mildly in Q4 on the back of a 0.2% appreciation of the real exchange rate. This was largely down to the 0.4% appreciation of the nominal effective exchange rate of the dinar[22], which was somewhat moderated by the fall in domestic and a rise in foreign prices.

The price of Brent oil in the London Commodity Exchange was on average 0.6% lower than in Q3. It fell in October and early November following progress in negotiations over the Iran's nuclear programme and a cut in the ECB's rate. However, it started rising in mid-November, driven primarily by more favourable macroeconomic indicators in the United States, which pointed to the likely start of QE tapering. The international price of copper was 1.0% higher than in Q3.

Cereal prices plummeted further (6.7%), though not low enough to offset the rise in all other FAO Index

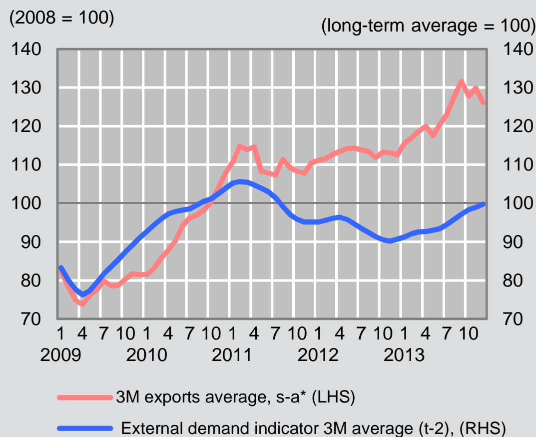
Chart IV.3.7 **Oil and copper price movements**
(average monthly prices, in USD)



Sources: Bloomberg.

The price of oil in the global market stagnated throughout Q4, while futures suggest it will fall in the period ahead.

Chart IV.3.6 **External demand and Serbian exports**

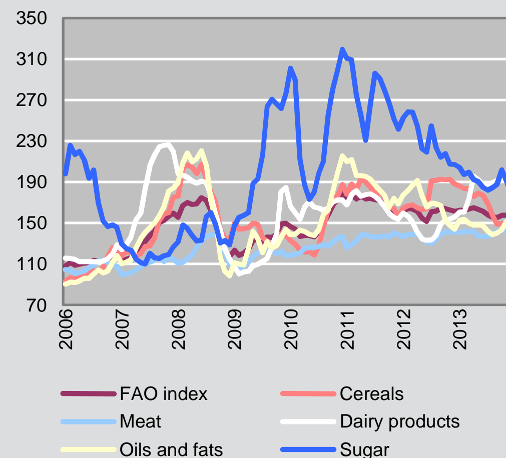


Sources: European Commission, SORS and NBS.

* Excluding automobile industry.

Our trade partners are showing signs of economic recovery, which should have a positive effect on the growth of domestic exports.

Chart IV.3.8 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

Global food prices in Q4 edged up slightly on account of the rise in the prices of dairy and vegetable oils.

[21] Leading indicator of external demand for Serbian exports was construed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners – their shares in Serbian exports being used as weights.

[22] Calculated as the geometric average of nominal EUR/RSD and USD/RSD exchange rates, with 0.8 and 0.2 weights respectively, i.e. by the formula (EUR/RSD^0.8)*(USD/RSD^0.2).

components. Thus, the FAO Food Price Index gained 0.6% in Q4. In 2013 as a whole, the FAO Index was on average 1.6% lower than in 2012. Cereal, vegetable oil and sugar prices recorded a fall, while meat and dairy prices reached their historical highs in 2013.

Prices of primary agricultural commodities included in the composite index[23] in global commodity exchanges recorded different movements in Q4. Corn and soybean dollar prices fell by 4.2% and 7.4%, respectively, as a result of good output (record corn harvest in the United States and high export supplies) and bright prospects for the soybean harvest in South America. Following a decline in Q3, the dollar price of wheat climbed 13.1% in Q4, fuelled by the surging global demand and bad weather conditions for the sowing in Russia, Ukraine and harvest in Argentina. Still, the rise in global wheat supplies after record harvest this season should alleviate the pressure on further price growth. This is also confirmed by the movements in January, when wheat prices lost 0.4% at monthly level and corn and soybean prices 4.6% and 3.3% respectively.

4. Economic activity

GDP is estimated to have dropped by 0.5% s-a in Q4 relative to Q3, which in turn slowed down its y-o-y growth to 2.6%. The quarterly GDP fall was mostly precipitated by the contracted activity in industry and construction. By contrast, trade recovered slightly and agricultural production continued up. The fall in GDP induced a further widening of the negative output gap. Preliminary estimates of the Statistical Office put GDP growth in 2013 at 2.4%, while we estimate that in 2014 it will slow down to around 1.0%.

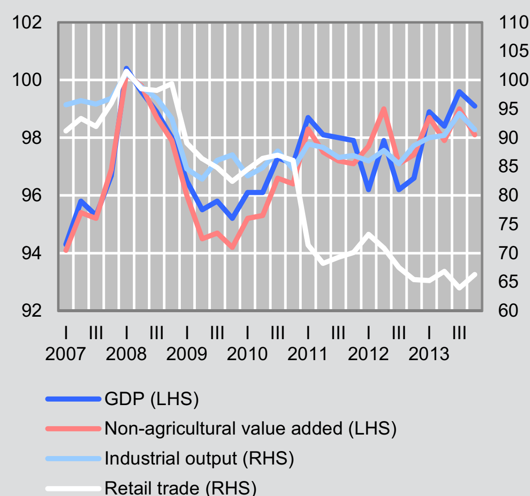
According to our estimates, GDP lost 0.5% s-a in Q4 and is currently 0.9% below the pre-crisis level[24]. The GDP fall is chiefly attributable to dampened activity in the manufacturing and construction sectors (contribution -0.3 pp each), as well as in electricity, gas and steam supply (contribution -0.2 pp). The quarterly drop was somewhat offset by positive developments in agricultural production and the information and communications sector, which exerted a positive push of 0.1 pp and 0.2 pp, respectively.

Economic activity measured by NAVA went down by 0.9% s-a in Q4, while compared to the pre-crisis period, it was 1.9% lower.

After four straight quarters of growth, the physical volume of industrial production shrunk by 2.9% s-a in Q4. Decrease was recorded in manufacturing (2.1% s-a), with a 1.3 pp negative contribution to the physical volume of total industry. Electricity, gas and steam supply induced another negative contribution of 1.6 pp, having suffered a 6.5% s-a fall in the physical volume from a quarter earlier. Contrary to this, mining recorded a mild 0.8% s-a growth in the physical volume of production, which helped cushion the fall in the physical volume of total industry with 0.1 pp.

Slumped production in Fiat Automobiles Serbia, reflected in the s-a drop in motor vehicle output (16.7%), led to a fall in the physical volume of production in manufacturing in Q4. A quarterly drop was also recorded in the production of chemical, rubber and plastic, and pharmaceutical products, basic metals and computers. To an extent, such movements account for the stagnant

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



Sources: SORS and NBS calculation.

Retail trade growth slightly offset the negative movements in economic activity in Q4.

[23] Composite index of primary agricultural commodities, used to approximate cost pressure in the production of food, comprises the prices of corn, wheat and soybean from the relevant international commodity markets.

[24] H1 2008.

exports in Q4 given that these sectors generate most of the export products. On the other hand, Q4 saw a rebound in the production of tobacco products, electrical equipment and metal products, while food production edged back into growth territory driven by good agricultural results.

Retail trade expanded by 3.6% s-a in Q4, indicating nascent recovery in the trade sector, although trade figures still remain lower than pre-crisis (13.6%). The information and communications sector maintained a stable growth trend in Q4, pushing up employment figures in this sector, according to the October Labour Force Survey.

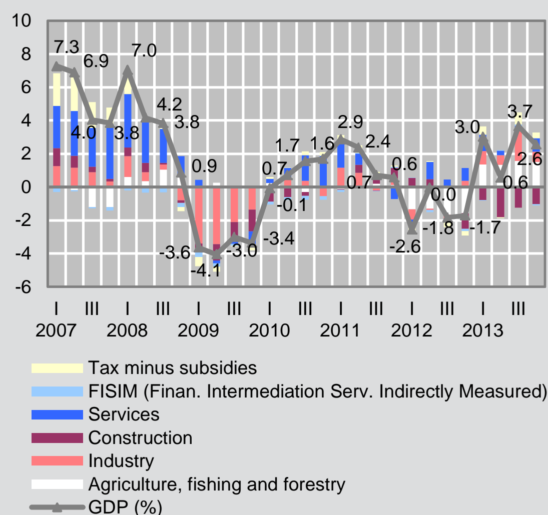
Y-o-y, GDP growth in Q4 is estimated to have decelerated to 2.6%. Key positive contribution to y-o-y growth came from agricultural production (1.6 pp). Industrial production also had a positive contribution (0.6 pp), though much lower than in Q3. As in the previous three quarters, the construction sector exerted the largest negative drag on GDP movement in Q4 (1.0 pp).

In Q4 2013, the sluggish y-o-y growth in the physical volume of industrial production (3.2%) was mostly attributable to the high base, i.e. the gradual exhaustion of the positive effects of automobile industry production, launched in Q4 2012. Y-o-y, growth slowed down in all three sectors of industry and was most pronounced in manufacturing (from 9.8% in Q3 to 2.1% in Q4). Yet, Q4 witnessed manufacturing give another major push to y-o-y growth in the physical volume of total industrial production (1.5 pp), while the contributions of electricity supply and mining were more modest (1.2 pp and 0.4 pp, respectively).

Although languid, the high y-o-y growth in the physical volume of production continued in the production of motor vehicles (41.5%) and petroleum products (14.5%). In addition, for the first time in four quarters, the food industry registered a 5.9% y-o-y growth in Q4, and the production of chemical products, electrical equipment and basic metals continued up. On the other hand, y-o-y fall was recorded in the production of pharmaceutical products, computers, machinery and equipment, and construction material.

The Statistical Office estimates that economic activity grew by 2.4% in 2013, slightly exceeding the projected 2.0% from the November *Inflation Report*. Y-o-y growth of GDP was also revised up for each quarter – from 2.7% to 3.0% for Q1, from 0.2% to 0.6% for Q2 and from 3.2% to 3.7% for Q3. The major positive

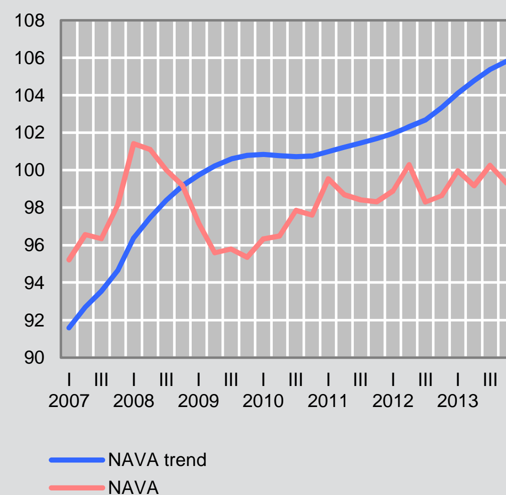
Chart IV.4.2 **Contribution to y-o-y GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

Decelerated growth in industrial production reflected on lower y-o-y growth in GDP in Q4.

Chart IV.4.3 **Output gap**
(Q3 2008 = 100)



Source: NBS calculation.

A drop in Q4 economic activity induced a widening of the negative output gap.

contribution to GDP growth in 2013 arose from agricultural (1.5 pp) and industrial production (1.0 pp), while a sharp contraction in the construction sector induced a negative effect of -1.2 pp.

According to our estimates, agricultural production in 2013 bulked up by around 20.0%, with robust growth in the production of all major crops. Fruit and vegetable production also picked up and their increased supply had a direct effect on lower prices of unprocessed food.

Construction sector activity was curtailed by as much as 27.9% in 2013, which was particularly evident in H1. Yet, the downward trend slackened in H2 2013 and gradual recovery in this sector can be expected in 2014.

According to our estimates, GDP growth is likely to slow down at around 1.0% in 2014. The assumptions behind this projection include an average agricultural season, slower growth of industrial production on account of the gradual exhaustion of effects of the automobile industry, partial rebound in the construction sector and moderate GDP growth of 1.0% in the euro area.

The widening of the negative output gap in Q4, induced by muted economic activity and a further boost in the economic production potential[25], points to continuing disinflationary effects of aggregate demand.

5. Labour market developments

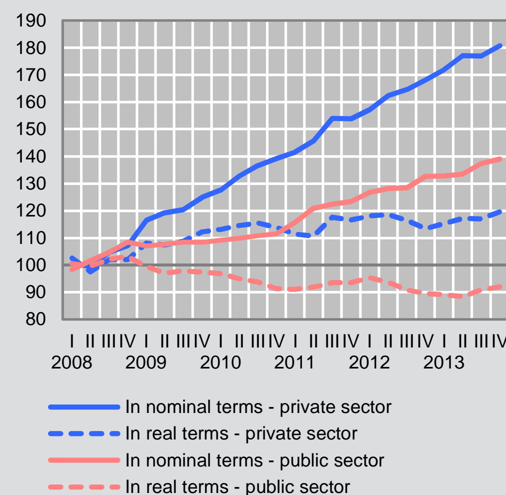
Real net wages in Q4 rose in both private and public sectors. The growth in wages, combined with a drop in productivity, lowered the competitiveness of domestic economy in Q4, measured by industrial unit labour costs. According to the Labour Force Survey, labour market indicators in October improved relative to April, but the RAD research indicates a decrease in the number of formally employed.

Wages and labour productivity

The average nominal net wage scaled up in Q4. Coupled with the stagnant quarterly inflation, this led to a 2.2% s-a increase in real net wages. **Real net wages** in the private sector (2.2% s-a) rose quicker than the ones in the public sector (1.2% s-a). Relative to the pre-crisis level[26], real net wages in the private sector gained 19.6%, while those in the public sector were 8.0% lower.

After falling for two quarters, real net wages in the construction sector picked up in Q4, and the growth continued in all other industrial sectors, including the information and communications and financial services

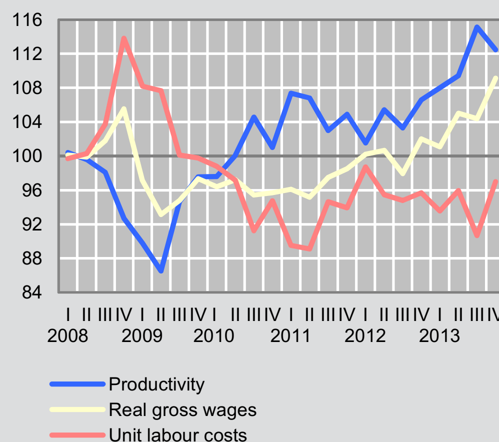
Chart IV.5.1 **Average net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Real net wages in Q4 perked up in both the private and the public sector.

Chart IV.5.2 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

During Q4, unit labour costs rose, though they still remain below pre-crisis figures.

[25] The NAVA trend estimated by Kalman filter is used for approximation of the production potential.

[26] H1 2008.

sectors. Moreover, wages also recorded real growth in trade and transportation sectors and administration. As shown by the January Ipsos survey, companies not planning any employee wage increases over the coming quarter are still in majority.

In y-o-y terms, after five consecutive quarters of decrease, real net wages in Q4 finally started going up, with the growth more noticeable in the private (5.5%) than in the public sector (2.2%).

The growth in the real net wage bill continued from Q3 into Q4, although at a slower pace, reflecting the current trend in the economy. Average nominal take-home wage in Serbia equalled RSD 46,167 – up by 5.1% from Q3.

The positive tendency of reducing **unit labour costs** of total industry that began in Q3 was discontinued in Q4. The rise in real gross wages, together with slackened productivity, induced a 7.0% s-a increase in unit labour costs. A somewhat slower rise of unit labour costs in Q4 was recorded within manufacturing (4.4% s-a). Overall industrial unit labour costs may have risen in Q4, but they are still 3.0% below the pre-crisis level.

Employment

According to the October 2013 **Labour Force Survey**, unemployment fell by 4.0 pp to 20.1% compared to April. During this period, employment gained 2.8 pp, and the activity rate increased by 1.1 pp. As the fall in unemployment and the rise in employment had no foothold in economic activities, such major change could be attributed to seasonal factors. This means that more relevant conclusions can be drawn by comparing the data with the results of the survey from October 2012. The impact of the seasonal factor on the results of the Labour Force Survey should be softened in the coming period given that as of 2014 the Survey will be conducted quarterly.

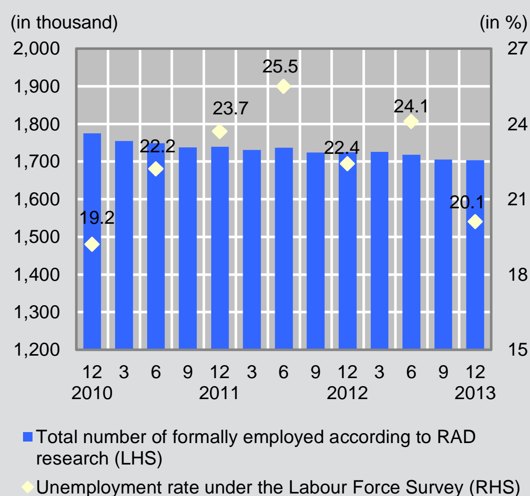
When compared to October 2012, the improvement in labour market indicators appears more moderate. Unemployment rate decreased by 2.3 pp, while employment and activity rates rose by 2.5 pp and 1.7 pp, respectively. Note that unemployment was reduced when the activity was on the rise, i.e. that the reduction was not a result of a part of the jobless moving into the inactive category. Most of the rise in employment can be ascribed to the increase in informal employment which climbed by 2.4 pp to 20.3% over the past year.

Broken down by sector, the largest upward sweep in employment last year was seen in agriculture (27,384 persons), which can be put down to the sector performing much better in 2013 and to larger-scale engagement of seasonal workers during the period of the survey. The number of persons in employment also rose in the information and communications sector (14,968 persons) and manufacturing (4,662 persons), which, along with agriculture, exerted the largest upward pressure on economic growth. In contrast to this, employment in the trade sector shrunk by 18,530 in response to dampened activity throughout 2013.

The positive trends were partly subdued by the fact that the previous year again recorded a faster rise in the number of part-time workers (70,881 persons) relative to those with full-time employment (24,029 persons). In parallel to this, self-employment figures were up by 55,473 and the number of contributing family workers by 25,783.

As estimated by the **RAD**[27] **research**, monitoring formal employment, Q4 saw a fall of 2,149 persons in the

Chart IV.5.3 **Employment figures and unemployment rate**



Source: SORS.

Q4 saw lower unemployment rate, though formal employment continued to edge down slightly.

[27] RAD research is conducted twice a year, in March and September, while data for the remaining months are obtained based on an assessment.

number of formally employed.[28] Private sector employment went further down (4,836 persons), mostly in the trade sector and manufacturing. On the other hand, formal employment in the public sector rose by 2,687 persons, mostly on account of new hiring in the education sector.

According to the **National Employment Service**, after receding for two quarters, unemployment in Q4 rose by 10,174 to 769,546 persons. A similar trend[29] was recorded in 2011 and 2012, which may point to a conclusion that the rise in unemployment is attributable to the lower demand for seasonal jobs. This would explain the discrepancies in unemployment figures relative to the October Labour Force Survey, because the survey was conducted during the season in agriculture, construction and catering.

As unemployment scaled up, the National Employment Service records showed an increase of 2,335 in the number of unemployment beneficiaries in Q4, which in December came at 63,582 persons.

6. International environment

Economic recovery in the euro area slowed down in Q3 and unemployment remains high. In contrast, economic recovery in the USA stepped up, inducing the Fed to trim asset purchases in January 2014. Inflationary pressures in the USA, the euro area and the region continue to abate in Q4.

Economic activity

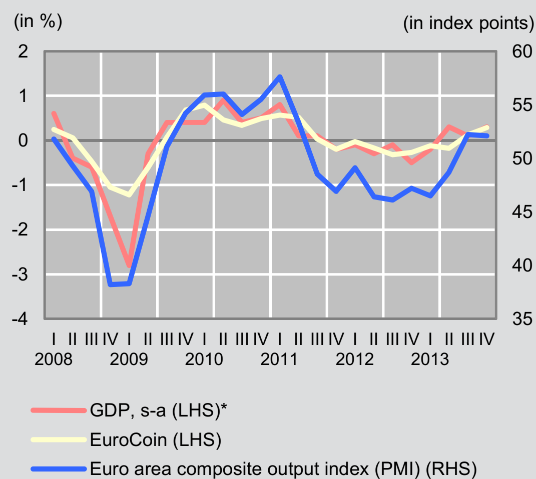
Economic growth in the **euro area** slowed to 0.1% s-a in Q3, but there are optimistic signs that the recovery is more broadly based given that Spain has bottomed out of a two-year recession and GDP in Italy is finally standing still after falling for eight consecutive quarters. Nonetheless, the pace of economic recovery is still relatively tepid and uneven, and as such it lacks the strength to bring down unemployment which in December stood at a high 12.0%.

The German economy slowed from 0.7% s-a in Q2 to 0.3% s-a in Q3, though only temporarily given that stronger growth is expected already in Q4, as indicated by PMI Composite, a leading economic activity indicator, which equalled 55.0[30] in December. The production and services sector activity is also looking up.

According to the January Consensus Forecast, the euro area's GDP growth projection for 2013 was trimmed down by 0.1 pp to -0.4%, relative to October, whereas for 2014 growth has been revised up by 0.1 pp to 1.0%. The same growth rates have been forecast by the IMF in its January WEO Update. According to the ECB, financial market risks have subsided[31] and the negative effects of fiscal consolidation are expected to wane in certain countries, creating the grounds for private consumption and investment to rebound. On top of that, faster growth at the global level should continue to encourage net exports in countries of the euro area.

Economic recovery in the euro area is likely to quicken the growth in the region of **Central and Eastern Europe**. According to the January Consensus Forecast, GDP in the region will gain 2.6% in 2014, up by 0.7 pp on 2013, which corresponds to the IMF's January forecast.

Chart IV.6.1 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



Sources: Eurostat, Markit Group and Banca d'Italia.
* Consensus Forecast estimate for Q4 2013.

Economic activity indicators suggest that sluggish euro area growth in Q3 is only temporary.

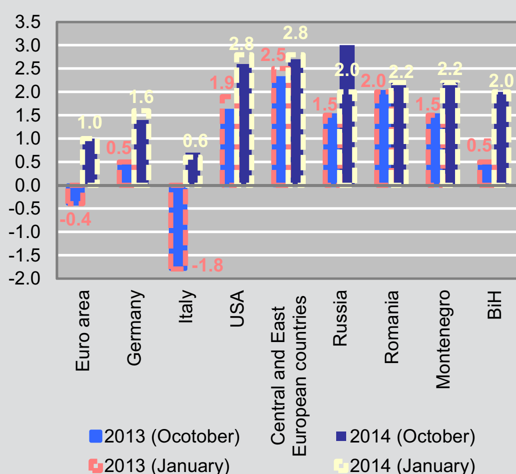
[28] This partly corresponds to the results of the Labour Force Survey, according to which the increase in employment is almost entirely explained by the rise in informal employment.

[29] Lower unemployment during Q2 and Q3, followed by a rise in Q4 and Q1 the following year.

[30] PMI index over 50 represents expansion, and below 50 recession.

[31] Euro area credit market fragmentation continued to decrease and the resilience of banks in terms of strengthening domestic sources of funding increased, especially in highly indebted countries. The announced banking system stress-tests will additionally help identify and eliminate potential problems, while further steps towards the formation of the banking union will help regain confidence in the financial system.

Chart IV.6.2 **Revisions of real GDP growth forecasts for 2013 and 2014 by the IMF***
(%)



Sources: IMF WEO (October 2013) and IMF WEO Update (January 2014).

* Revision compared to October WEO.

GDP growth forecasts for Germany and the USA in 2014 have been revised up, while the projection for Russia has been revised down.

Though faster, economic growth will be uneven across the region, with risks skewed to the downside. Political risks have surfaced in Ukraine and Turkey, the latter being additionally weighed down by the deepening external imbalances. The Russian economy will be highly dependent on energy prices, which means that if oil and natural gas prices should fall sharply, Russia's economic growth could be slowed. Slovenia's economy has been forecast to contract in 2014 due to the still present imbalances in the banking system, whereas Croatia should finally enter positive territory after two years of recession. Quicker GDP growth is expected in Hungary, the Czech Republic, Poland and Slovakia as these countries are deeply integrated into the euro area's economy.

Growth of the US economy picked up vigorously to 1.0% s-a in Q3 (from 0.6% s-a in Q2) on account of a stronger rise in private investments and household consumption. Despite a mild monthly dip, a leading economic activity indicator in the production sector, ISM Manufacturing, was in the expansion zone in December for the seventh month in a row. The Consumer Confidence Index registered growth in December and January, after a drop in October and November. According to preliminary estimates, US economic growth in Q4 slightly slowed to 0.8% s-a.

The faster paced economic growth spilled over onto the labour market, forcing unemployment down from 7.2% in September to 6.7% in December. However, lower unemployment can also be partly attributed to the fact that some of the jobless shifted to inactive persons, as confirmed by the fall in the participation rate. In addition, new nonfarm payroll employment fell sharply in December (75,000), undershooting the monthly average for 2013 (194,000). Yet, January saw some positive trends – unemployment went further down to 6.6%, and new nonfarm payroll employment rose to 113,000.

Inflation movements

Over the past year, price growth in the **euro area** decelerated considerably, bringing down average annual inflation from 2.5% in 2012 to 1.3% in 2013, mostly in response to lower prices of energy and food. Inflation continued to fall in January and equalled 0.7% y-o-y, as estimated by Eurostat. This year, prices are likely to edge up slightly, but long-term inflation expectations are firmly anchored and show no signs of major inflationary pressures.

Decreased energy and food prices and lower aggregate demand induced a weakening of inflationary pressures in **Central and Eastern Europe** too. The highest inflation in December was registered in Turkey (7.4% y-o-y) and the lowest in Bulgaria (-0.9% y-o-y), which recorded deflation for five straight months.

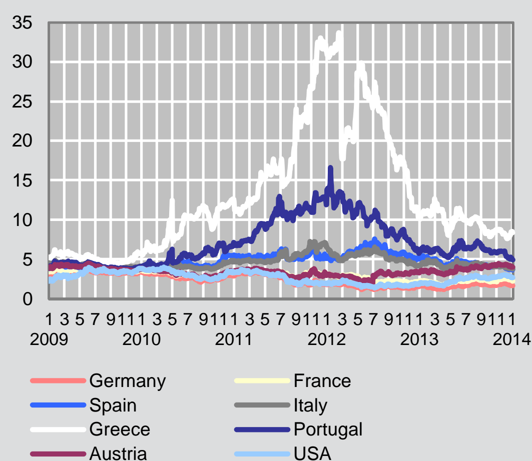
Average annual inflation in the **USA** equalled 1.5% in 2013, down from 1.7% in 2012, moving below the target for two years now. During Q4, a marginal growth in inflation was detected – 1.5% y-o-y in December.

Monetary policy

As the price growth in the euro area slowed significantly in Q4, the **ECB** trimmed the main refinancing rate in November to an all-time low of 0.25% and announced the possibility of using all available instruments to avoid deflation and encourage economic growth. The main refinancing rate remained unchanged in December and January and, according to announcements, the monetary policy will remain expansive for as long as it is deemed necessary.

Throughout Q4, policy rates were also lowered in some countries of the **Central and Eastern Europe**. The central banks of Hungary, Albania and Romania trimmed

Chart IV.6.3 **Yield on 10-year bonds of euro area members**
(daily data, in %)



Source: Bloomberg.

Abated risks related to the financial environment induced a fall in the yield of government bonds of peripheral euro area countries in Q4.

their policy rates by 60 bp, 50 bp and 25 bp, respectively. With a close-to-zero policy rate, the Czech central bank opted for interventions in the FX market in order to depreciate the koruna to the exchange rate of around 27 CZK/EUR and thus stimulate economic recovery. As of the beginning of 2014, the main policy rates were further revised down in Romania (50 bp) and Hungary (15 bp).

In January, Turkey's central bank raised the main policy rate by as much as 550 bp, to 10.0%. The reasons behind this decision are the growth in the risk premium and strong depreciation pressures, which were partly a result of the Fed's QE tapering programme, and partly of the political crisis in the country and the growing external imbalances.

With economic growth picking up and positive signals coming from the labour market, the **Fed** decided to start with QE tapering in January 2014. Asset purchases are to be reduced by USD 10 bln – mortgage-backed and government securities by USD 5 bln each, to a total of USD 75 bln a month. The Fed reiterated that despite gradually backing out of the QE programme, monetary policy will remain accommodative for a longer period, i.e. until the economy shows signs of permanent sustainability. At a policy meeting on 28–29 January, the Fed decided to further cut the asset purchases of mortgage-backed and government securities as of February, again by USD 5 bln each, bringing them down to USD 65 bln a month.

Financial and commodity markets

The dollar continued to weaken against the euro in Q4 – at end-December it depreciated by 2.1% relative to end-September. This was largely due to the uncertainties regarding the beginning of the Fed's new QE programme, which were eliminated following a meeting in mid-December. Analysts have estimated that the cuts in asset purchases, to be applied as of January, and the fact that the US economic growth is outpacing that of the euro area should propel the dollar up in 2014. These estimates have been confirmed in January when the dollar appreciated 1.8% against the euro.

Throughout Q4, Standard & Poor's revised the credit ratings of several countries in the region. Albania was downgraded from B+ to B, with the outlook changed from stable to negative on account of an increase in the fiscal deficit and possible problems with public debt refinancing. Montenegro's outlook was also degraded from stable to negative because of the heightened risk of refinancing the high external debt. Credit rating for Bulgaria also suffered a downgrade on account of poor economic growth outlooks, soaring unemployment and political uncertainties. By contrast, Romania's stable outlook was raised to positive owing to a reduction in external imbalances and consolidation of the country's public finances. Due to weak economic competitiveness, caused by a rigid labour market and business environment, Croatia's credit rating was downgraded in January from BB+ to BB, with the outlook changed from negative to stable.

Gold prices fell by around 10% in Q4 triggered by, among others, the Fed's announcements of QE tapering, favourable economic growth outlooks at the global level and lower investor risk aversion.

Text box 3: Recent changes in monetary policies across the world

Right before the global economic crisis broke out, a number of developed and emerging market central banks embraced inflation targeting regimes complemented by floating exchange rates. Featuring one objective and one instrument – low and stable inflation and the policy rate, such an approach was generally believed to most effectively underpin macroeconomic stability. In this context, economic activity is sustained by allowing inflation to temporarily deviate from the target in order to stabilise the estimated output gap (flexible inflation targeting). The exchange rate oscillates freely and ensures the balance of payments adjustment. On the other hand, prudential and supervision measures help ensure financial stability and pre-empt excessive risk taking by economic entities.

However, the financial crisis of 2008 and the ensuing recession brought about the re-examination of the above monetary consensus and opened the question of whether a central bank should have several objectives and instruments. The main policy focus shifted from efforts to curb inflation to activities aimed at sustaining financial stability and tackling severe liquidity strains and the economic downturn. Sharp monetary loosening and lowering of policy rates in developed economies to near zero obstructed the interest rate channel and prompted experiments with non-standard instruments in order to buoy up lending and economic activity. The stimulative power of the policy rate has been reinforced in many ways, depending on macroeconomic and financial sector developments. To prevent the financial system collapse and foster the recovery of real economy, central banks of developed countries took new measures, some of which included: purchasing long-term private and government debt securities, lending to institutions never lent to before, amending collateral rules. They thus changed the size and composition of their assets – from around USD 4 trillion pre-crisis to USD 10 trillion today, including significant lengthening of maturities. Furthermore, experiments were made in some countries (Denmark and Sweden) with setting term deposit facility rates at negative values. Another unconventional tool has been forward guidance, first introduced by the Fed in late 2008 – the Fed pledged at the time to maintain the key rate at an exceptionally low level for some time. The Fed's move was followed by other central banks. In August 2013, the Bank of England said it would keep its rate at 0.5% until unemployment fell below 7.0%, unless inflation threatened to go out of control or there was a danger to financial stability. Targeted primarily at investors, forward guidance aims to reduce their reluctance to invest, assuring them that incentives will not suddenly disappear once the economy starts to recover. In small open economies not facing liquidity strains, reducing the level of policy rates to near zero led to interventions in the FX market as an additional instrument of monetary policy easing. In November 2013, the Czech central bank decided to intervene, its move supported by the IMF which assessed interventions as an efficient additional instrument in the struggle against deflationary risks in an inflation targeting regime.

The global financial and economic crisis in emerging countries showed the full-blown impact of external disturbances and volatile capital flows. FX market interventions have traditionally been an important monetary policy instrument in these countries. Their use, however has amplified significantly during the crisis. A general recommendation on monetary policy easing as a response to the crisis and a prop-up for domestic economies was not always attainable. Countercyclical policies were hampered by considerable currency mismatches in balance sheets of corporate, household and government sectors, including the strong pass-through of the exchange rate to inflation, shallow financial markets and expansionary fiscal policy. However, as shown by analyses, emerging countries made progress in the field of monetary policy as their capacity for significant monetary loosening increased relative to previous crisis episodes. The major contributing factors included financial sector reforms and inflation targeting.[1]

[1] Coulibaly, B. (2012), *Monetary Policy in Emerging Market Economies: What Lessons from the Global Financial Crisis?,* International Finance Discussion Papers No. 1042, Board of Governors of the Federal Reserve System, Washington.

There are several main lessons to be learnt from the crisis. First, inflation and the output gap may be low and stable despite heightening financial sector tensions which trigger macroeconomic instability. For this very reason, there is almost a consensus today that the interdependence between macroeconomic and financial stability requires coordination between monetary policy and macroprudential regulation. Besides macroeconomic stability, central bank objectives must also include the maintenance of financial stability. Second, the link between inflation and output gap stability is probably not quite as strong as earlier believed. It seems that inflation developments have in many countries moved significantly away from output gap movements. Therefore, to ensure macroeconomic stability, a central bank must target not only low and stable inflation, but a low and stable output gap as well. Third, the spill-over of developed countries' monetary policy effects and volatile capital flows in emerging economies have undermined the belief that a flexible exchange rate per se is sufficient to absorb disturbances. It is now increasingly accepted that flexible inflation targeting must encompass FX market interventions, but not in terms of targeting a particular level or range of the exchange rate, but in terms of preventing significant deviations of the exchange rate from the values consistent with economic fundamentals and preservation of macroeconomic stability. Sterilised interventions in the FX market yield results in the absence of perfect capital mobility. As this holds true for emerging markets, central banks have the opportunity to use both the policy rate and FX interventions, in order to achieve their objectives regarding inflation and the exchange rate.[2]

New trends in monetary policy, which unfolded during the crisis, opened the discourse about the concept of monetary policy as we have known it so far. Whether the post-crisis monetary policy will continue to work in the same way as before the crisis, and whether some of the new monetary policy instruments introduced during the crisis should be maintained and fit within the context of flexible inflation targeting, are only some of the basic questions facing us today. There is no disputing that central banks across the world are changing their monetary policy and have been debating its future outlook over the last two or three years. However, the outline of future monetary policy is still in the shaping.

[2] *Ostry J., A. Ghosh, and M. Chamon (2012), Two Targets,* Two Instruments: Monetary and Exchange Rate Policies in Emerging Market Economies, IMF Staff Discussion Note, SDN/12/01, February 2012.

V. Inflation projection

After undershooting it temporarily in Q4 2013, inflation is expected to move within the target tolerance band in 2014 and 2015. The main disinflationary factor in the coming period will be low aggregate demand and the main inflationary – upward revision of VAT and administered prices. The risks to the projected inflation path are associated primarily with the outcome of this year's agricultural season and developments in the international environment, and to a degree, with fiscal movements at home.

According to our projection, GDP growth should soften to 1.0% in 2014 because of fiscal consolidation, and then step up to 2.0% in 2015.

The medium-term inflation projection aims to show the 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 assumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Initial conditions

Though within the bounds of the short-term projection published in the November *Report*, y-o-y inflation moved below the lower bound of the target tolerance band in Q4 and ended the year at 2.2%. Inflation turned out lower than envisaged by the central projection as a result of a surprisingly sharp drop in fruit prices, which dragged consumer prices in Q4 down (0.2%).

Inflationary pressures were rather low in 2013, especially in H2 when the monthly inflation rate averaged -0.1%. Downward pressures on inflation came from low aggregate demand, good agricultural season and the consequently lower food production costs, while upward pressures originated from administered prices. In fact, administered prices accounted for 2.1 pp of the total price growth in 2013 (2.2%).

The cost of raw materials in food production remains low despite the rise in domestic prices of primary agricultural commodities in Q4. Driven by buoyant export demand, average wheat price rose more at home than abroad (20% vs. 13%). At the same time, defying downward trends in the international market, average price of corn in the domestic market rose by 5.1%, reflecting chiefly the initial low trading price level of new corn crops.[32] Still, wheat and corn prices in Q4 were well below the levels recorded in Q4 2012 (by around 30%). In January 2014 they fell by around 5%.

Inflation decline was accompanied by a considerable drop in inflation expectations in all of the sectors surveyed. Since October one year-ahead inflation expectations of the financial sector have been stable within the target tolerance band.

Appreciation pressures marked most of the period October 2013–January 2014. Exceptions to this trend were early December and January, when corporate demand for foreign exchange gathered momentum on the back of (seasonal) energy imports. Downward pressures in January were stirred up additionally by the anticipated downscaling of the US monetary stimulus. Appreciation pressures in the above period reflected the interplay of several factors, notably the fall in country risk premium and increased non-resident investment into dinar securities, FDI inflow, continued positive trends in

[32] September price averaged 12.8 RSD/kg in the Novi Sad Commodity Market and 15.9 RSD/kg in the Budapest Commodity Exchange.

foreign trade and higher net purchase of foreign exchange in respect of exchange transactions. To ease excessive short-term volatility of the exchange rate of the dinar, the NBS intervened in the IFEM by buying EUR 515.0 mln net in Q4 and by selling EUR 330.0 mln in January.

As a result of real depreciation of the dinar, the depreciation gap of the real exchange rate widened slightly in Q4[33], indicating a moderate rise in net importers' marginal costs.

Consolidated budget deficit in 2013 was lower than envisaged by the revised budget. It amounted to RSD 179.0 bln or 5.0% of GDP. Based on the *Fiscal Strategy for 2014 with Projections for 2015 and 2016*, consolidated budget deficit will stay high in 2014. Namely, it is projected at 5.5% of GDP or 7.1% if "below-the-line expenses" are included.

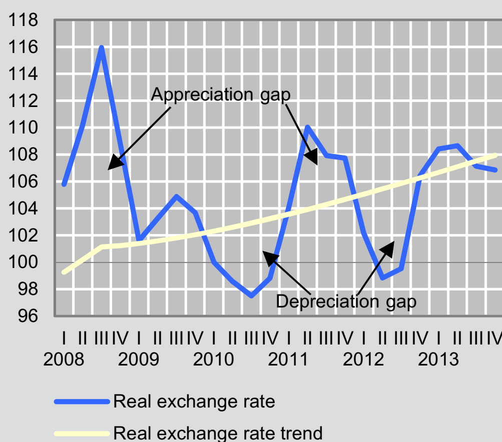
According to NBS estimates, GDP contracted by 0.5% s-a in Q4, i.e. its growth slowed down to 2.6% y-o-y. On the expenditure side, net exports dragged GDP down as the effects of the automobile industry upswing have been waning, while domestic demand recorded a rise and provided a positive contribution. On the production side, the strongest negative contribution to GDP growth came from industrial production (notably automobile, chemical and pharmaceutical) and the strongest positive from agriculture and information and telecommunications.

Based on the preliminary estimates of the Serbian Statistical Office, GDP grew 2.4% in 2013. According to our estimates, this growth was led entirely by net exports since all other domestic demand components recorded a decline.

Driven by the fall in NAVA, negative output gap[34] widened slightly in Q4, indicating further strong demand-side disinflationary pressures in the medium run.

In Q3, the euro area growth slowed to 0.1% s-a. In response to plummeting inflation in Q4, the ECB cut its main refinancing rate to the record low of 0.25% and hinted at further monetary accommodation if economic conditions deteriorate. The recovery of the US economy, on the other hand, stepped up, prompting the Fed to start winding down its asset purchase programme.

Chart V.0.1 **Real exchange rate and its trend***
(base index, Q1 2010 = 100)



Source: NBS.

* The estimate is based on the assessment of the impact of the real exchange rate on inflation.

The depreciation gap of the real exchange rate widened slightly in Q4.

Projection assumptions

The assumption for the euro area's GDP growth in 2014 and 2015 has been slightly revised up from the November projection to 1.0% and 1.4%[35] respectively. The recovery of the euro area economy should be based on stronger domestic demand, supported by accommodative monetary policy, and a gradual increase in export demand.

Though euro area inflation measured 0.8% y-o-y in December, medium-term inflation expectations remain firmly anchored below, but close to, 2.0%. According to Consensus Forecast, the markets expect no change in the ECB's main refinancing rate this year and the projection assumes the same for 2015 as well.

The movements of primary agricultural commodity prices internationally have a decisive impact on the movements of these prices locally. The current commodity futures herald a mild fall in international primary commodity prices in 2014. However, given that they are now rather low thanks to the high yields last year, an average

[33] Real exchange rate trend is estimated by applying the Kalman filter.

[34] Output gap is calculated based on NAVA (GDP less agricultural production and net taxes). NAVA trend estimated by the Kalman filter is used as an approximation of the potential output.

[35] The assumption for the euro area's GDP growth in 2014 and 2015 is consistent with the latest *Consensus Forecast*.

agricultural performance this year is likely to send them higher. The projection therefore operates on the assumption that international primary agricultural commodity prices will rise in 2014 (13.0%). What we have primarily taken into account is the anticipated rise in prices of wheat, corn and soybean which are the most significant inputs to the domestic food production.

Even though oil futures suggest a decline in 2014 and 2015, the projection is more conservative in assuming oil prices[36] to stay close to the level recorded at end-2013.

The projection envisages that administered prices will grow faster than headline CPI in 2014 and 2015 due to the gradual removal of price disparities.

The current medium-term inflation projection is based on the assumption that administered prices will go up by 10.5% in 2014 and that they will contribute, as in 2013, around 2.0 pp to headline inflation. The strongest contribution to this year's inflation is expected from cigarette and electricity prices (0.5 pp each) whose upward revision is foreseen to take place in June.

Table V.0.1 **Projection assumptions**
(changes relative to the prior projection are given in brackets)

	2014		2015	
External assumptions				
EU inflation (Q4 to Q4)	1.4%	(-)	1.5%	(-0.2)
ECB policy rate (year-end)	0.25%	(-)	0.25%	(-0.25)
Euro area GDP growth	1.0%	(+0.1)	1.4%	(+0.1)
International prices of primary agricult. commodities (Q4 to Q4)*	13.0%	(-2.0)	4.0%	(-)
Brent oil price per barrel (year-end, USD)	107.0	(-2.0)	107.0	(-2.0)
Internal assumptions				
Administered prices (Dec to Dec)	10.5%	(+0.5)	9.0%	(-)
Trends				
Appreciation trend of the real exchange rate (average)	1.8%	(-0.3)	2.0%	(-0.2)
Real interest rate trend (average)	3.4%	(+0.3)	3.6%	(+0.2)

* Composite index of soybean, wheat and corn prices.
Source: NBS.

Inflation projection

Y-o-y inflation should return within the target tolerance band in Q1. Though low last year's base, attributable to the drop in food prices, will contribute to the gradual rise in the inflation rate in the course of the year, according to the central projection, inflation will stay within the bounds of the target tolerance band (4±1.5%) in both 2014 and 2015.

Looking ahead, the main disinflationary factor will be low aggregate demand, while upward pressures will be coming from administered price growth and increase in the special VAT rate. With the coming of new growing season fruit and vegetable prices are likely to rise somewhat, but other food prices are not expected to produce inflationary pressures.

Low domestic demand will act as the main brake on price growth in the medium term. The disinflationary effect of domestic demand could be reinforced by fiscal consolidation and its bearing on government and household consumption, depending on the intensity of fiscal consolidation this year.

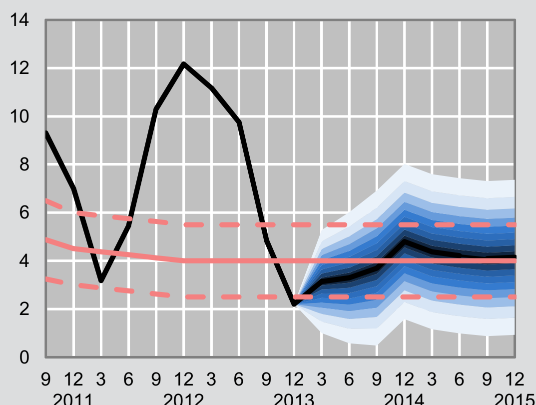
The lowering of inflation expectations by around 3.0 pp since mid-2013 shows that they no longer have an inflationary, but rather a neutral effect.

On the other hand, the upward revision of the special VAT rate (from 8.0% to 10.0% or 20%) postponed for January will have an effect on inflation. According to our estimates, the one-off inflationary effect of this revision will amount to 0.5 pp. However, having in mind low aggregate demand, the effect on inflation could be lower to the extent the VAT increase is absorbed by the cut in merchant margins.

Despite the upsurge in Q4 2013, primary agricultural commodity prices remained much lower than in Q4 2012, which suggests that the costs of raw materials in the production of food are still subdued. The projection operates on the assumption of an average agricultural season this year. Given that the currently low level of primary agricultural commodity prices is attributable to last year's season which was above average, these prices may be reasonably expected to rise once the new season begins. The rise would bring the cost of raw materials in

[36] Brent.

Chart V.0.2 **Inflation projection**
(y-o-y, in %)

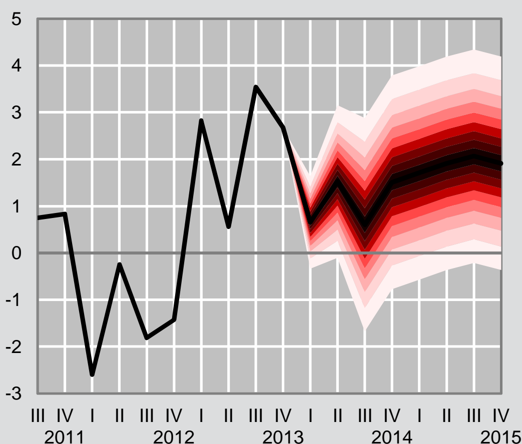


Source: NBS.

Inflation is expected to return within the target tolerance band in Q1 and stay there in the coming period.

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%.

Chart V.0.3 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

GDP should grow around 1.0% in 2014 and around 2.0% in 2015.

food production to neutral level, ending their disinflationary impact.

The widening of the depreciation gap of the real exchange rate of the dinar in Q4 could send some upward pressure on inflation through the rise in import prices, but the intensity of this pressure will depend on the net importers' ability to command higher prices against the backdrop of depressed domestic demand.

GDP growth projection for 2014 has been cut from the previous Report by 0.5 pp to accommodate the upward revision of the 2013 agricultural production by the Serbian Statistical Office which increased the last year's base for agricultural production. Hence, the Serbian economy is projected to grow around 1.0% this year. The projection assumes average agricultural season, leading to a fall in agricultural production relative to last year, and a slower industrial production growth (due to the gradual waning of the effects of the automobile industry expansion). The projection also envisages a partial recovery of the construction industry. On the expenditure side, growth should be led by net exports, given the nascent euro area recovery. Coupled with the formal opening of Serbia's EU accession negotiations and low last year's base, this should lead to a certain positive contribution of investments as well. The contributions of government and household consumption, on the other hand, will be negative due to fiscal consolidation. Still, the implementation of fiscal consolidation measures and the announced structural reforms will open the scope for faster GDP growth in the years to come, and so will the expected further recovery of the euro area.

In 2015, GDP is projected to grow around 2.0%, led by investments and net exports. The contribution of final consumption will remain negative because of fiscal consolidation.

The risks to the GDP growth projection are balanced, i.e. deviations are equally possible in either direction. Uncertainties surrounding the projection relate mainly to the speed of economic recovery of the euro area, notably Serbia's main foreign trade partners, and the extent to which tighter access to external financing (due to QE tapering) will reflect on movements in the real sector.

Risks to the projection

The risks to the projected inflation path are associated primarily with primary agricultural commodity prices and developments in the international environment, and to a certain degree, with fiscal movements at home.

Though the expected rise in primary agricultural commodity prices is not likely to trigger growth in food prices this year, a below average agricultural season could turn food prices once again into an inflationary factor, especially so in the event of an upsurge in global food prices and an increase in export demand.

The international environment is currently marked by heightened uncertainties over the intensity of the effect of QE tapering on the financial markets of emerging economies. The Fed's decision to wind down its asset purchases has caused a capital outflow from emerging markets, notably those running large current account deficits, and sent depreciation pressures on their currencies. Several central banks of emerging market economies have already responded by raising their policy rates. In late January, ECB officials signalled they would be prepared to additionally ease the monetary policy stance by buying packages of bank loans to the private sector, which could perhaps release some of the pressure stemming from QE tapering in the United States. The threat of growing risk aversion towards investment in Serbia can therefore not be excluded. A potential rise in the country risk premium and the strengthening of depreciation pressures could lead to a higher-than-projected inflation outturn. For this reason, the authorities should continue working on the reduction of the fiscal imbalance and should step up the implementation of structural reforms with a view to strengthening macroeconomic fundamentals. Any departure from the announced fiscal consolidation plan could trigger a rise in inflationary pressures over the projection horizon, while consistent implementation of the fiscal adjustment measures could ease the potential spill-over of the effects of monetary policies of some developed economies on the domestic financial market.

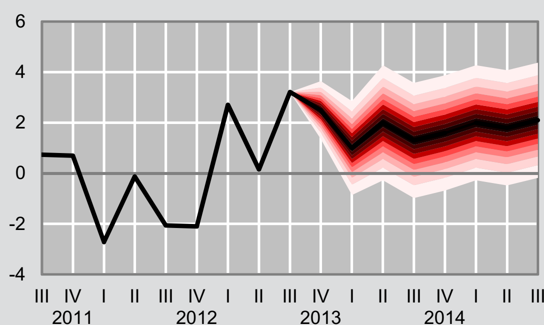
With the base of comparison being high in H1 and low in H2 2013, a potential increase in electricity prices in H2 2014 is perceived as an upside risk to the projected inflation trajectory.

On balance, the risks to inflation projection are judged to be symmetrical.

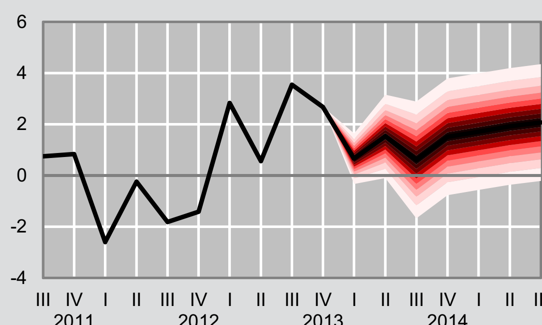
Assuming fiscal consolidation is implemented as planned, further monetary policy easing in the coming period will depend primarily on the strength of potential negative effects of QE tapering on the exchange rate of the dinar and the country risk premium.

Chart V.0.4 **Current vs. previous GDP growth projection**

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



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

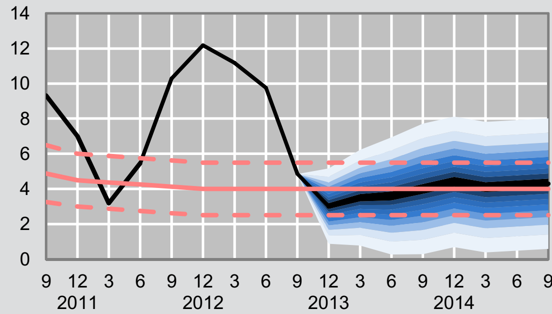


Source: NBS.

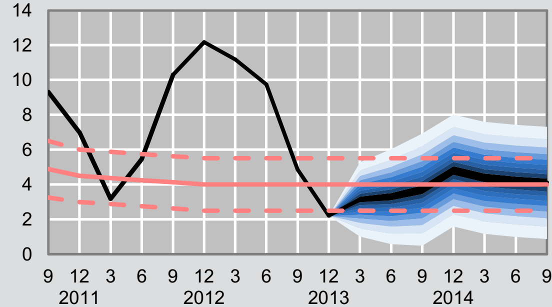
GDP growth projection for 2014 has been revised down from November 2013.

Chart V.0.5 **Current vs. previous inflation projection**

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



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



Source: NBS.

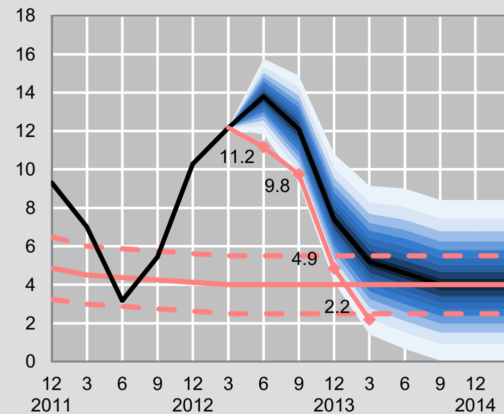
New inflation projection for 2014 is slightly higher than the one released in November 2013.

Comparison and achievement of previous projection

The projected inflation in 2014 is somewhat higher than in the November Report and the medium-term projection band is slightly narrower. Higher inflation projection is primarily a result of a lower late last year's base of comparison for food prices (notably fruit) relative to the one anticipated earlier.

During the last twelve months, y-o-y inflation was hovering around the lower edge of the band projected in February 2013 as the disinflationary effect of food prices proved stronger than envisaged by the central projection.

Chart V.0.6 **Achievement of February 2013 inflation projection**
(y-o-y rates, in %)



Source: NBS.

In the last twelve months, y-o-y inflation hovered around the lower edge of the band projected in February 2013.

Table A

Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013
EXTERNAL LIQUIDITY INDICATORS (in %)												
FX reserves/imports of goods and services (in months)	6.1	9.0	7.2	5.2	9.5	8.2	8.7	7.6	8.2	7.4	7.1	7.4
FX reserves/short-term debt	177.2	267.2	253.8	154.5	214.9	189.6	298.9	245.6	263.9	245.2	243.5	250.7
FX reserves /GDP	24.3	38.5	33.8	24.9	36.6	35.8	38.3	36.9	39.3	34.8	33.3	35.4
Debt repayment/GDP	5.2	10.8	10.7	10.9	13.5	12.7	13.3	14.0	14.1	14.1	12.5	15.2
Debt repayment/exports of goods and services	19.8	36.2	34.9	35.1	46.0	35.3	36.4	34.7	35.4	31.2	25.3	32.4
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	60.1	60.9	60.2	64.6	77.7	85.0	76.7	86.9	88.7	84.9	81.9	81.7
Short-term debt/GDP	13.7	14.5	13.3	16.2	17.0	18.9	12.8	15.0	14.9	14.2	13.7	14.1
External debt/exports of goods and services	228.9	204.1	197.3	207.6	265.3	236.2	210.3	215.9	218.0	204.1	186.8	179.8
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	425.6	371.5	333.9	330.0
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	213.6	192.1	191.0	199.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	73.6	81.2	86.8	88.8	75.6	88.2	89.3	97.3	95.3	102.1	106.1	105.9
MEMORANDUM: (in EUR million)												
GDP (in EUR million)	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	7,353	7,791	8,175	8,310[1)]
External debt	12,196	14,182	17,139	21,088	22,487	23,786	24,125	25,721	26,722	26,072	25,686	25,842
External debt servicing	1,054	2,513	3,035	3,563	3,897	3,556	4,176	4,139	1,039	1,095	1,020	1,263
Central bank foreign exchange reserves	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,844	10,673	10,444	11,188
Short-term debt[2)]	948	958	1,050	2,143	2,005	1,830	648	493	361	309	180	212
Current account balance	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,155	-625	-290	-160	-521[1)]

		2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
		May/July	Feb./Apr.	June	Dec.	Dec.	Nov.	Mar.	Aug.	July	Jan.
CREDIT RATING	S&P	BB-	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative		
	Fitch	BB-	BB- /stable		BB- /negative		BB- /stable		BB- /negative	BB- /negative	B+ /stable
	Moody's									B1 /stable	

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio ofend-of-period foreign exchange reserves to average monthly imports of goods and services during period under review.

Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.

Foreign exchange reserves/GDP (in %) - ratio of end-of-period foreign exchange reserves to GDP.

Debt repayment/GDP (in %) - ratio of debt repayment (excluding early repayments to the London Club) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excluding early repayments to the London Club) to exports of goods and services during period under

Debt/GDP (in %) - ratio of end-of-period outstanding debt to GDP.

Short-term debt/GDP – ratio of end-of-period short-term debt at remaining maturity to GDP.

Debt/exports (in %) - ratio of end-of-period outstanding debt to annual value of exports of goods and services.

Foreign exchange reserves/M1(in %) - ratio of foreign exchange reserves to money supply at end-of-period.

(Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

1) NBS estimate.

2) At original maturity.

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: short-term debt repayment and advanced debt repayment.

5. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

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

7. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 433.7 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 12.2 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 836.3 mln, of which EUR 383.2 mln relates to domestic banks and EUR 453.1mln to domestic enterprises).

Table B

Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013
Real GDP growth (in %)[1]	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	3.0	0.6	3.7	2.6
Consumer prices (in %, relative to the same month a year earlier)[2]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	11.2	9.8	4.9	2.2
NBS foreign exchange reserves (in EUR million)	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,844	10,673	10,444	11,188
Exports (in EUR million)[3][8]	5,329	6,948	8,687	10,157	8,478	10,070	11,472	11,913	2,933	3,511	4,036	3,894
- growth rate in % compared to a year earlier	19.1	30.4	25.0	16.9	-16.5	18.8	13.9	3.8	17.1	17.3	31.9	19.1
Imports (in EUR million)[3][8]	-9,612	-11,970	-16,016	-18,843	-13,404	-14,643	-16,627	-17,211	-4,050	-4,437	-4,631	-4,906
- growth rate in % compared to a year earlier	0.7	24.5	33.8	17.6	-28.9	9.2	13.6	3.5	0.5	3.0	9.8	6.6
Current account balance[4][8]												
(in EUR million)	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,155	-625	-290	-160	-521[9]
as % of GDP	-8.8	-10.1	-17.7	-21.6	-6.6	-6.7	-9.1	-10.5	-8.5	-3.7	-2.0	-6.3
Unemployment according to the Survey (in %)[5]	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9		24.1		20.1
Wages (average for the period, in EUR)	204.0	274.8	350.3	369.6	330.9	323.6	362.9	363.9	370.8	394.8	384.5	404.2
RS budget deficit/surplus (in % of GDP)[6]	0.7	-1.7	-1.1	-1.9	-3.3	-3.5	-4.1	-5.7	-6.2	-5.3	-5.6	-2.4
Consolidated fiscal result (in % of GDP)	1.1	-1.5	-1.9	-2.6	-4.5	-4.7	-4.9	-6.5	-4.7	-4.9	-6.1	-4.2
RS public debt, (external + internal, in % of GDP)[6][7]	52.2	37.7	31.5	29.2	34.7	44.5	48.2	60.0	63.3	61.9	61.7	64.4
RSD/USD exchange rate (average, in the period)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	84.61	85.90	86.20	83.96
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	87.43	87.41	84.89	83.13
RSD/EUR exchange rate (average, in the period)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	111.70	112.15	114.18	114.33
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	111.96	114.17	114.60	114.64
MEMORANDUM:												
GDP (in EUR million)	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	7,353	7,791	8,175	8,310[9]

[1] At constant prices of previous year.

[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: MoF for public debt and NBS for estimated GDP.

[7] Government securities at nominal value.

[8] 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.

[9] NBS estimate.

Notes:

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

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Executive Board meetings and changes in the key policy rate

2013

Date	Key policy rate (p.a, in %)	Change (in basis points)
17 January	11.50	+25
5 February	11.75	+25
12 March	11.75	0
11 April	11.75	0
14 May	11.25	-50
6 June	11.00	-25
11 July	11.00	0
8 August	11.00	0
10 September	11.00	0
18 October	10.50	-50
7 November	10.00	-50
17 December	9.50	-50

2014

Date	Key policy rate (p.a, in %)	Change (in basis points)
16 January	9.50	0
13 February	9.50	0
6 March		
17 April		
8 May		
12 June		
10 July		
7 August		
11 September		
16 October		
13 November		
11 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 17 December 2013

At its meeting today, the NBS Executive Board decided to cut the key policy rate by half a percentage point to 9.5%.

The Executive Board stated that y-o-y inflation was 1.6% in November, and thus below the lower bound of the target tolerance band (4±1.5%).

In addition to monetary policy measures and relative stability of the exchange rate, sharp disinflation in conditions of economic growth was driven also by the fall in food prices, low inflation expectations and weak domestic demand. The Board members agreed that the rather favourable balance of payments trends, notably export growth, had a positive impact on the stability of the foreign exchange market.

The Executive Board assessed that inflation expectations have fallen to their historical low and that economic entities expect inflation to move within the target tolerance band in the coming period as well. In addition to producing disinflationary pressures, fiscal consolidation will help mitigate the risks which may arise from the international environment.

Medium-term inflation is expected to move close to the target, set at 4% until 2016, and monetary policy measures will be geared towards that end.

The next rate-setting meeting of the Executive Board will be held on 16 January 2014.

Press release from Executive Board meeting held on 16 January 2014

At its meeting today, the Executive Board of the National Bank of Serbia decided to keep the key policy rate at 9.5%.

The Executive Board stated that y-o-y inflation measured 2.2% at the end of 2013 and that it is temporarily below the lower bound of the target tolerance band (4±1.5%). Inflation will return within the target tolerance band in the coming period, and the Executive Board is determined to gear monetary policy at stabilising inflation at that level on a long-term basis.

Though inflationary pressures and expectations have both lessened significantly, the Executive Board accentuated the need for a cautious monetary policy considering the risks emanating from movements in international financial markets, and in particular the Fed's decision on tapering the quantitative easing programme. The Executive Board also concurred that the consistent implementation of fiscal adjustment measures, supported by weaker inflationary pressures, will help increase resilience to external risks and thus aid the nascent economic recovery.

The next rate-setting meeting of the Executive Board will take place on 13 February.

Press release from Executive Board meeting held on 13 February 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 9.5%.

Reaffirming its commitment to keeping inflation at the target level on a durable basis, the Executive Board accentuated the need for a cautious monetary policy, particularly in light of the developments and expected liquidity strains in international financial markets. Despite significant narrowing of external imbalances, aided mainly by rising exports, the need for external sources of financing persists.

Consistent implementation of fiscal consolidation measures is expected to help increase resilience to the above risks stemming from the international environment.

The Executive Board also concluded that demand-side and cost-push inflationary pressures have lessened significantly, while inflation expectations have stabilised within the target tolerance band.

The February Inflation Report was adopted at today's meeting and will be presented at a press conference on 20 February 2014.

The next rate-setting meeting will be held on 6 March 2014.

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