



National Bank of Serbia

2015
February

INFLATION REPORT

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NATIONAL BANK OF SERBIA

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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 12 February 2015.

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

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ABBREVIATIONS

bln	– billion
bp	– basis point
CPI	– Consumer Price Index
ECB	– European Central Bank
EIB	– European Investment Bank
EMBI	– Emerging Markets Bond Index
FAO	– UN Food and Agriculture Organization
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
LTROs	– long-term refinancing operations
LHS	– left hand scale
mln	– million
NAVA	– non-agricultural value added
NBS	– National Bank of Serbia
NPLs	– non-performing loans
OFOs	– other financial organisations
OPEC	– Organization of the Petroleum Exporting Countries
pp	– percentage point
Q	– quarter
QE	– quantitative easing
q-o-q	– quarter-on-quarter
RHS	– right hand scale
s-a	– seasonally-adjusted
SDR	– Special Drawing Right
SORS	– Statistical Office of the Republic of Serbia
WTO	– World Trade Organization
y-o-y	– year-on-year

Other generally accepted abbreviations are not cited.

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I. Overview

Pushed by factors with a temporary effect, year-on-year inflation continued to move below the lower bound of the target tolerance band.

Inflation expectations of the financial sector and businesses have stabilised within the target tolerance band.

The international environment was marked by the continuing sluggish recovery of economic activity, except in the United States, by the collapse of oil prices, which only added to deflationary pressures in the majority of countries in the region, and by the divergent monetary policies of the world's major central banks.

Volatility in the international financial market gathered pace, led by the oil price collapse, geopolitical tensions, and reduced predictability of the monetary policy moves of the world's major central banks.

Consistent with the expectations stated in the November *Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band in the fourth quarter. At the same time, core inflation rose moderately and trended closer to the lower bound of the target band in December, aided inter alia by the depreciation of the dinar in the second half of 2014. The undershooting of the target band during most of 2014 is largely attributable to factors having a temporary effect – unexpectedly weak administered price growth and a sharp fall in primary agricultural commodity prices and global oil prices. On the other hand, the disinflationary pressures from low aggregate demand and low inflation in the international environment matched our expectations from the previous *Report*.

Owing to the extended period of low inflation and anticipation of weak inflationary pressures in the period ahead, short- and medium-term inflation expectations of the financial sector and businesses have been moving within the target tolerance band for over a year now, which is the longest period on record. According to the results of both surveys, one-year ahead inflation expectations of the financial sector are on the 4.0% target.

The recovery is proceeding at a sluggish pace worldwide, except in the United States which experienced strong economic growth and a rebound in the labour market. The recovery of the euro area, our key foreign trade partner, is much more moderate and has not yet translated into more jobs. In the region of Central and East Europe, economic activity is slowing down, mainly as a consequence of the current geopolitical tensions. Commodity markets have seen a further decline in oil prices, which is even steeper than in the quarter before. Faced with the deflation threat, exacerbated by the on-going decline in oil prices, the ECB has become increasingly reliant on unconventional monetary policy measures and has decided to extend its asset purchases to include government securities of the currency bloc's members. The Fed, in contrast, ended its asset purchase programme and is likely to start raising its interest rate in the course of this year.

The collapse of global oil prices and the geopolitical tensions have increased uncertainties in the international financial market. An additional blow came in January from the unexpected move of the Swiss National Bank which removed the 1.20 cap on the Swiss franc against

the euro. These circumstances prompted investors to re-examine their risk perception of emerging market economies and caused a widening in the average spread on dollar-denominated emerging market government bonds over US treasuries relative to the previous quarter. Serbia's risk premium also increased under the impact of global factors. The affirmation of Serbia's credit rating by Fitch and Standard & Poor's owing to the adoption of fiscal consolidation measures, the implementation of structural reforms and the expected agreement with the IMF, has helped halt the increase in the risk premium. At end-January, the risk premium was lower than at the end of the month before.

Depreciation pressures on the dinar in the course of the fourth quarter reflected the interplay of global and domestic factors.

For most of the fourth quarter the dinar was under depreciation pressures caused not only by the above global, but domestic factors as well. The demand for foreign exchange gathered pace, partly due to the increase in payments of energy imports. The pressures on the dinar also came from dividend payments to foreign owners, from the rising bank demand for foreign exchange driven by the need to balance foreign currency positions, as well as from the cut in net foreign debt of enterprises and the slowing of exports. To ease excessive short-term volatility of the exchange rate, without any intention of influencing the exchange rate trend, the NBS intervened in the interbank foreign exchange market in the fourth quarter by selling EUR 765.0 mln net.

Despite low inflationary pressures, monetary easing was cautiously paced, primarily because of increased risks in the international environment and the temporary disinflationary effect of some factors.

Despite low inflationary pressures, caution in monetary policy easing over the past months was dictated mainly by the risks stemming from the international environment, which added to depreciation pressures, and by the temporary disinflationary impact of some factors. The adoption of a new set of fiscal consolidation measures, however, alleviated the risks associated with sustainability of domestic public finances. The key policy rate was last cut in November by 50 bp, to 8%.

Owing to the subsidised loan programme for the corporate sector, credit activity recorded a modest real growth in 2014.

Credit activity recorded a positive growth rate in 2014. However, the subsidised loan programme, which channelled more than RSD 135 billion to the corporate sector and gave a positive impetus to credit activity in 2014, was halted late in the year, while no hint has yet been given of a new programme. Considering the above as well as the short-term negative effects of new fiscal consolidation measures on consumption, lending will most likely continue to slow down this year. The NBS seeks to moderate this trend by lowering the foreign exchange reserve requirement ratio.

The fiscal consolidation measures adopted so far are a positive step towards ensuring sustainability of public finances in Serbia.

Fiscal trends improved in the second half of 2014 mainly as a result of fiscal consolidation measures to curb grey economy and tax evasion and to decrease pensions and

public sector wages. Consolidated fiscal deficit, inclusive of payments made in respect of called guarantees and capital increase of banks and majority state-owned enterprises, reached 6.6% of GDP, of which 3 pp related to interest payments. The fiscal strategy envisaged for the period of two to three years ahead implies not only keeping public sector wages and pensions subdued, but also public sector rightsizing, cuts in subsidies and the reform of public enterprises. All these measures should narrow consolidated budget deficit to 3.8% of GDP by 2017, stabilise the share of public debt in GDP and pave the way for its gradual reduction.

The adverse effects of floods on economic activity are gradually waning...

Gradual rehabilitation of the energy and mining production facilities damaged by the May flooding led to a recovery in total industry in Q4, and by extension, to the rise in quarterly GDP (0.5% s-a). Furthermore, manufacturing, construction and the majority of service sectors recorded growth. Year-on-year, GDP contracted by 1.6% in Q4, which is a considerable slowdown from a quarter earlier.

... and so are the effects of lower external demand.

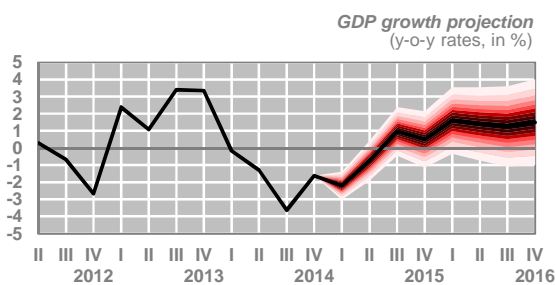
A rebound in exports and an upturn in government investments and consumption contributed positively to aggregate demand growth in Q4, while continued decline in household consumption and lower private investments pushed in the opposite direction. We estimate that at year level the contribution of net exports to aggregate demand was neutral, i.e. that the deceleration of export growth due to floods and lower external demand was offset by the weaker growth in imports resulting from fiscal consolidation measures.

According to the Labour Force Survey, the labour market continues to recover.

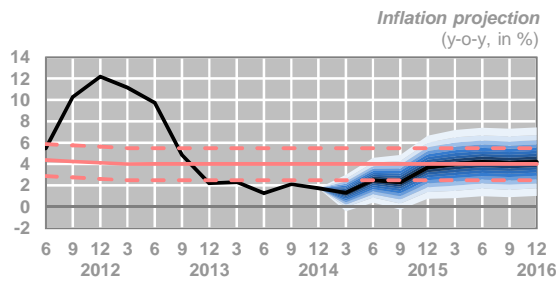
Judging by available indicators, the labour market seems to be recovering at a faster pace than economic activity. The unemployment rate continued to fall, ending 2014 at 16.8%, or 3.3 pp lower than a year earlier. At the same time, formal employment went further down, while informal employment went up.

Economic activity is expected to recover from 2016, aided chiefly by the expected stronger recovery of the euro area and the waning of the short-term negative effects of fiscal consolidation and structural reforms.

Fiscal consolidation will most likely cause a mild fall in this year's GDP (around 0.5%). Still, consistent implementation of fiscal consolidation measures and structural reforms should help increase investments and net exports. The positive contribution of net exports to this year's GDP will also stem from the healing of external demand and the fall in imports amid reduced final consumption. Economic activity is expected to recover in 2016. A positive contribution to this recovery is expected also from household consumption which should rise as a result of a gradual increase in employment and real income in an environment of low inflation.



Inflation is expected to return within the target tolerance band around mid-year and to stay within the band thereafter.



The character of monetary policy in the period ahead will depend chiefly on developments in the international environment and the movement in prices of primary commodities.

Year-on-year inflation is expected to return within the target tolerance band around mid-year and to continue moving within the band thereafter. Such movements in inflation will be driven by the expected adjustment in administered prices, the effects of past depreciation of the dinar and the gradual waning of the disinflationary pressures generated by the primary agricultural commodity prices. On the other hand, price growth will be slowed by the low aggregate demand, its disinflationary effects reinforced by additional fiscal consolidation measures, and by the foreign inflation which continues to run low irrespective of accommodative monetary policy measures.

Looking ahead, monetary policy easing will depend primarily on the assessment of the potential impact of developments in the international environment on capital flows and Serbia's risk premium, as well as on the movement in international and domestic prices of primary commodities and their effect on other prices. Additional fiscal consolidation measures, both taken and announced, have lessened the risks associated with fiscal policy.

II. Monetary policy since the November *Report*

Following the November cut to 8.0%, the key policy rate was kept on hold over the next three months.

In keeping the key policy rate unchanged, the NBS Executive Board was guided by the assessment that the undershooting of the inflation target tolerance band was largely attributable to factors with a temporary disinflationary effect. Uncertainties in the international environment were also running high. Because of this, despite the strong disinflationary effect of weak aggregate demand, caution was exercised in the conduct of monetary policy in order to stabilise inflation at low levels in the long run.

FX reserve requirement ratios were lowered further in January, with a view to supporting bank lending to the real sector.

The projected spread of inflation outcomes by mid-2015 was lower in the November relative to the August projection due to the fall in primary commodity prices and the absence of adjustment in electricity prices. The November projection indicated inflation would return within the target tolerance band around mid-2015, trend closer to the 4% target by the end of that year and continue to revolve around the target in the period thereafter. Inflation's rise towards the target in 2015 was to be driven primarily by administered prices, since their contribution to headline inflation was expected to be similar to those recorded in the previous years. Besides, the cost-push pressures in the production of food were to remain subdued until the next agricultural season. However, it was expected that food prices would rise once the agricultural season kicked in during the second half of the year.

Starting from such inflation projection, **the NBS Executive Board cut the key policy rate in November by 50 bp, down to 8.0%, and kept it on hold over the next three months.** When deciding to keep the key policy rate unchanged, the Executive Board took into account that y-o-y inflation continued moving below the lower bound of the target tolerance band, chiefly as a result of the factors with a temporary disinflationary effect, such as low primary commodity prices, a sharp fall in oil prices and a small rise in administered prices. The short-term disinflationary impact of these factors was indicated by

the gradual increase in y-o-y core inflation, which measured 2.3% last December, drawing closer to the lower edge of the target tolerance band.

The Executive Board judges that past monetary policy measures and the gradual weakening of the disinflationary effects of low food production costs, coupled with the anticipated adjustment in administered prices, will help nudge inflation around mid-year back within the target band ($4\pm 1.5\%$). Inflation will stay low and stable in the medium term as a result of weak aggregate demand and low euro area inflation. The disinflationary effect of low aggregate demand will be reinforced by the cut in pensions and public sector wages.

Caution in the conduct of monetary policy was also warranted by the risks emanating from the international environment, which increased investor risk aversion towards emerging markets. International capital flows exhibited a great deal of volatility amid monetary policy moves of the world's leading central banks and geopolitical events. Faced with the threat of deflation, the ECB relied extensively on unconventional measures and increased the volume of asset purchases (extending them to include government securities), while the Fed ended such programmes and announced it was likely to start raising its policy rate in the course of this year. The divergence of monetary policies pursued by the ECB and the Fed will continue, making the dollar's strengthening in

the coming period all the more reasonable to expect. The collapse of global oil prices and geopolitical events have lessened the predictability of the monetary policy moves of these two central banks and heightened the volatility in the international financial market. An additional blow to the financial markets in January came from the unexpected decision of the Swiss National Bank to remove the 1.20 cap on the exchange rate of the Swiss franc against the euro.

Given elevated uncertainties in the international financial markets, the NBS will continue to monitor carefully the changes in exchange rates of the world's major currencies and will seek to moderate the spill-over of their negative effects to the domestic market. The NBS will intervene in the foreign exchange market only to ease excessive daily volatility of the exchange rate, without any intention of influencing the exchange rate trend. The NBS will be particularly alert to the effects of changes in the exchange rates of the world's major currencies on the stability of the Serbian financial system.

The Executive Board expects the implementation of fiscal consolidation measures and structural reforms will help ease internal and external imbalances, hence increasing the resilience of the domestic economy to shocks from the international environment. Agreement with the IMF on a new arrangement will serve as an additional assurance of the credibility of Serbia's economic policy.

Following a cut in November and December, the **FX reserve requirement ratios were lowered further in January** by 1 pp (from 27% to 26% and from 20% to 19%, depending on maturity). At the same time, the structure of FX required reserves was changed by increasing the share of allocations in dinars (from 36% to 38% and from 28% to 30%, depending on maturity). Additional reduction of the FX reserve requirement ratios aims to lower the cost of funding for banks and unlock a part of their credit potential.

III. Inflation movements

Consistent with expectations presented in the November Inflation Report, y-o-y inflation continued to move below the lower bound of the target tolerance band in Q4, mostly on account of temporary factors – muted administered price growth, low prices of primary agricultural commodities and a precipitous fall in global oil prices. In contrast, core inflation rose moderately in Q4 and came close to the lower bound of the target tolerance band, reflecting, among other things, the dinar’s depreciation from the second half of the year.

Owing to a protracted period of low inflation and subdued expected inflationary pressures, short- and medium-term inflation expectations stabilised. Inflation expectations have moved within the target band for the longest time on record.

Inflation movements in Q4

In Q4, y-o-y inflation continued to move below the lower bound of the target tolerance band. While the disinflationary effects of low aggregate demand and low inflation in the international environment were consistent with our previous expectations, the undershooting of the target tolerance band was prompted mainly by temporary factors. These factors include the unexpectedly tepid

administered price growth, falling prices of primary agricultural commodities and a collapse in global oil prices, whose effect was partly neutralised by the dinar’s weakening against the dollar.

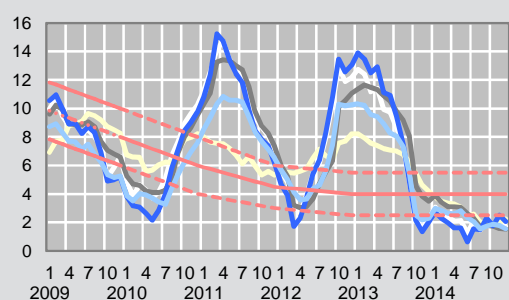
Broken down by month, following the October drop to 1.8%, y-o-y inflation picked up in November and came close the lower bound of the target (2.4% y-o-y), only to decline again in December – to 1.7% y-o-y.

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

	2013		2014		
	IV	I	II	III	IV
Consumer prices (CPI)	-0.2	1.2	0.8	0.3	-0.6
Unprocessed food	-4.3	3.9	4.9	0.8	-4.0
Processed food	-0.7	0.6	-0.5	0.2	0.2
Industrial products	1.0	1.6	-0.1	-0.3	-0.6
Energy	-0.4	0.9	-0.4	1.0	-1.8
Services	1.2	0.0	1.6	0.7	1.6
Core inflation indicators					
CPI excluding energy	-0.2	1.3	0.9	0.2	-0.4
CPI excluding energy and unprocessed food	0.5	0.8	0.3	0.1	0.3
CPI excluding energy, food, alcohol and cigarettes	1.0	-0.1	0.8	0.2	1.3
Administered prices	0.9	1.8	0.2	-0.6	-1.4

Sources: SORS and NBS calculation.

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



— Consumer prices (CPI)
 — CPI excluding energy, food, alcohol and cigarettes
 — CPI excluding energy and unprocessed food
 — CPI excluding energy
 — Trimmed mean 15%
 - - - Targeted inflation
 - - - Target tolerance band

Sources: SORS and NBS calculation.

In quarterly terms, consumer prices shed 0.6% in Q4, with lower prices of unprocessed food, petroleum products and cigarettes as the main contributors.

In keeping with our expectations, **prices of food and non-alcoholic beverages** were scaled down (1.4%), reflecting lower **unprocessed food** prices (4.0%). This price category was under the strong sway of seasonal factors in light of the receding prices of fruit and fresh meat, whilst prices of vegetables and eggs went up. **Processed food prices** practically stagnated in Q4 (up by 0.2%) as a rise in prices of milk and dairy products was offset by a drop in prices of edible oil and sugar. In y-o-y terms, prices of food and non-alcoholic beverages sped up to 2.2% in Q4 and became a positive contributor to headline inflation as of mid-2014.

Prices of industrial products excluding food and energy shed 0.6% in Q4, trending down for the third consecutive quarter. Almost the entire decline in this price category was due the 8.0% cut in cigarette prices amid heightened competition among producers led by plummeting trade volumes. Still, this downturn was moderated by an upswing in prices of cars and pharmaceutical products.

A drop in prices of petroleum products (8.6%), reinforced by a vigorous decline in global crude oil **prices**, was the

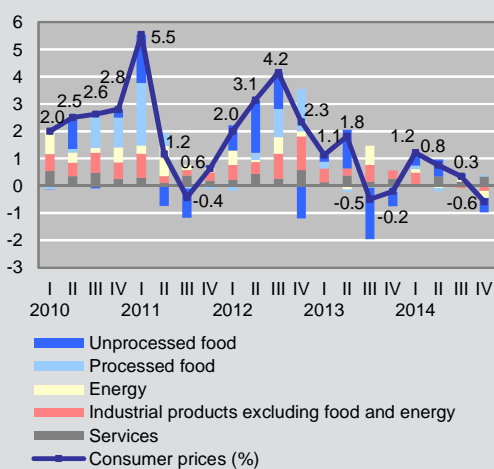
main determinant of **energy prices** which lost 1.8% in Q4. Working in the opposite direction were rising prices of firewood and natural gas, consistently with their seasonal dynamics.

Up by 1.6%, **prices of services** were the only consumer price category that contributed positively to headline inflation in Q4. The rise was driven notably by higher prices of travel arrangements and mobile telephony services.

Core inflation (CPI excluding prices of energy, food, alcohol and cigarettes) exhibited stronger growth in Q4 (1.3%) than in Q3 (0.2%). In y-o-y terms, core inflation was on a moderate rise in Q4 and reached 2.3% in December, getting closer to the lower bound of the target tolerance band, below which it has been moving since August. The major boost to core inflation came from higher prices of travel arrangements and cars, which came under the pressure of the dinar's losses against the euro.

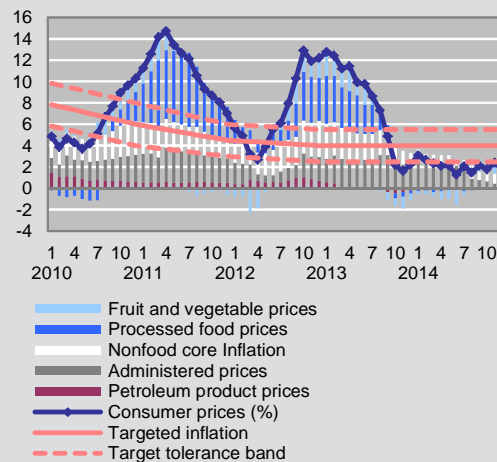
Administered prices continued down in Q4 (1.4%), reflecting primarily depressed cigarette prices, which was partly offset by rising prices of natural gas and utilities services. A fall in cigarette prices, along with the absence of the electricity price adjustment, prompted an unusually low y-o-y rise in administered prices of 1.1% in

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

December vs. around 10% recorded on average over the previous years.

Producer and import prices

A dramatic drop in global oil prices had a major impact on **industrial producer prices in the domestic market**, which dropped by 1.5% in Q4. The steepest decline was noted for the production of coke and petroleum products (26.6%), adding negative 1.6 pp to overall producer prices. In addition, a 23.1% slump in producer prices was posted in the exploitation of crude oil and natural gas. On the other hand, the exploitation of metal ores and the production of wearing apparel, furniture and paper recorded a modest rise. Broken down by purpose, producer prices in the energy group precipitated down. In y-o-y terms, growth in industrial producer prices slowed down by 0.8 pp from Q3 to 0.2% in December.

A quarterly decline in **agricultural producer prices**¹, which protracted into Q4, amounted to 5.0%. A sharper drop relative to the previous quarter fuelled the y-o-y decline in agricultural producer prices to 7.9% in December. Producer prices shifted down in all agricultural sectors, most notably in fruit and wine growing. A decrease was also seen for producer prices of cereals, industrial plants and livestock, whilst an upturn

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

	III 2014	VI 2014	IX 2014	XII 2014
	III 2013	VI 2013	IX 2013	XII 2013
Consumer prices	2.3	1.3	2.1	1.7
Domestic industrial producer prices	0.2	1.0	1.0	0.2
Agricultural producer prices	-6.1	-4.2	-0.1	-7.9
Prices of elements and materials incorporated in construction	3.5	3.9	3.8	4.6

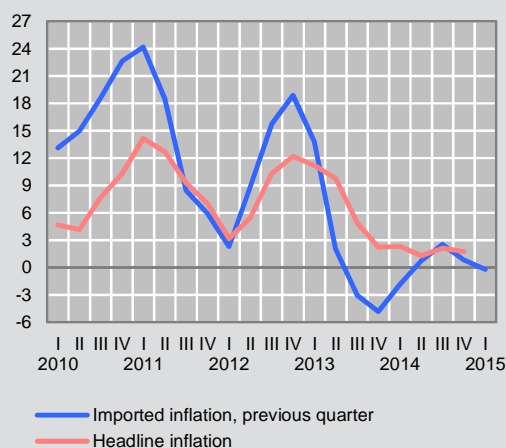
Sources: SORS and NBS calculation.

came about only in the category of animal products, primarily milk and eggs.

Prices of elements and materials incorporated in construction, which serve as an indicator of construction costs, were pared back by 0.4% in Q4, while accelerating to 4.6% in y-o-y terms in December.

In the course of Q4, pressures emanating from import inflation subsided significantly in light of the collapse in global oil prices. **Dinar-denominated import prices**² dipped by 4.2%, almost fully on account of lower oil prices. Still, the disinflationary impact of tumbling global oil prices on prices at home was partly offset by the dinar’s depreciation against the dollar. A disinflationary impact was also produced by world food prices, which continued down in Q4, whilst import prices of intermediate goods stagnated. Following three consecutive quarters of growth, estimated import prices stagnated in y-o-y terms in December (-0.2%), signalling the absence of inflationary pressures from this source in the next quarter.

Chart III.0.4 Domestic and imported inflation
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

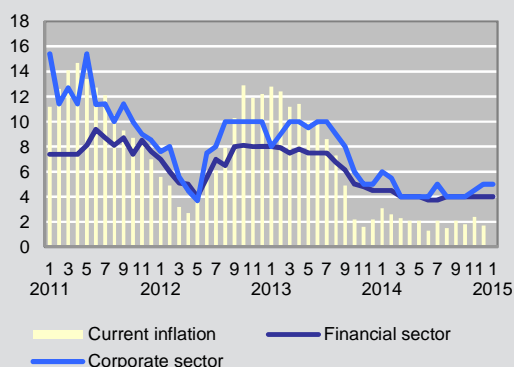
Inflation expectations

An extended period of low inflation and subdued expected inflationary pressures fed back into the stabilisation of short- and medium-term inflation expectations. For more than a year now, both the financial

¹ Producer prices in agricultural and fishing sectors.

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

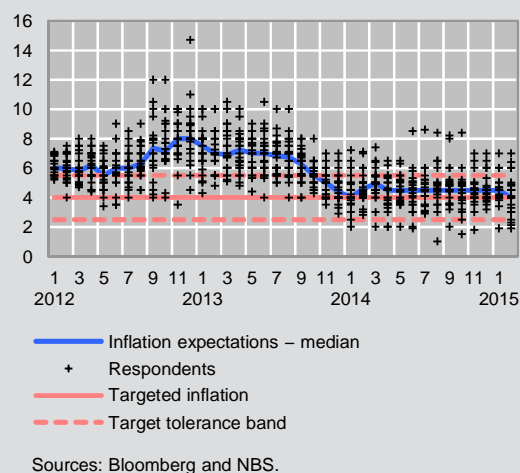
Chart III.0.5 Current inflation and one-year ahead inflation expectations*
(y-o-y rates, in %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Chart III.0.6 One-year ahead expected and targeted inflation – financial sector
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

and corporate sectors have expected one-year ahead inflation to move within the target band – the financial sector from October, and corporates from November 2013. Inflation expectations of these two sectors have been moving within the target band for the longest time on record.

According to the **Bloomberg** survey, **one-year** ahead inflation expectations of the financial sector stayed unchanged over the past ten months – they equalled 4.5%, only to slide towards the target level of 4.0% in February. The December and January surveys of the **Ninamedia**³ agency show that financial sector expectations were also at the target level (4.0%), as indicated by the previous three surveys of the Ipsos agency. In December, corporate sector expectations climbed to 5.0% from 4.0% – where they stayed as of August according to Ipsos surveys. They remained unchanged in January.

Medium-term, i.e. **two-year ahead** inflation expectations of the financial sector moved around the midpoint and returned from 3.9% in October to 4.0% in December, where they remained in January. In October, the corporate sector expected two-year ahead inflation at 4.0%, but raised its expectations to 5.0% in December, where it kept

them in January. Short-term inflation expectations treaded the same path.

The household sector perceived a 10.0% y-o-y inflation in January, but said it would fall to 8.0% over the year ahead. Qualitatively expressed inflation expectations of households show an increase in the number of respondents expecting prices to stay unchanged over the next year or expecting their moderate increase, compared to those respondents who expect significantly higher prices. Also, the number of those expecting a fall over the next year went up.

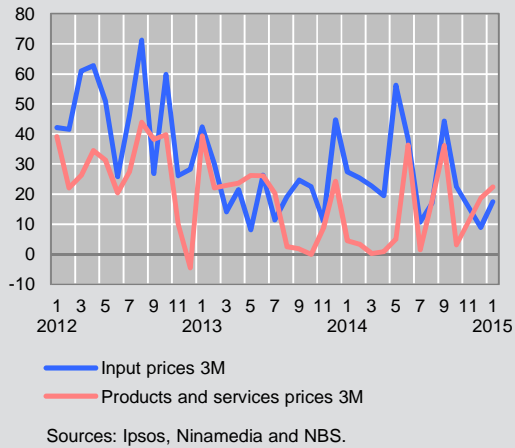
A protracted period of low inflation and subdued expected inflation pressures brought about a lower dispersion of answers of respondents of all sectors, compared to Q3 when the dispersion widened most probably over uncertainties as to the flood effects on inflation.

As the expected electricity price hike did not take place, the net percentage⁴ of enterprises expecting a rise in their input prices over the next three months was much smaller in December (8.9% vs. 44.3% in September). This was certainly due to a vigorous fall in global oil prices. The net percentage of enterprises expecting a rise in prices of

³ Ninamedia clipping d.o.o. Novi Sad has conducted a survey on expectations of economic entities since December 2014, in accordance with the methodology applied so far.

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.

Chart III.0.7 Expectations of enterprises regarding a change in prices of their inputs, products and services
 (net percentage, "+" = increase, "-" = decrease)



their products and services also declined, though to a lesser degree. As a result, it came at 18.7% in December and was after quite a while above the net percentage of enterprises expecting a rise in their input prices. In January, both net percentages were somewhat higher than in late 2014 – 17.4% for the expected rise in input prices and 22.4% for prices of products.

IV. Inflation determinants

1. Financial market trends

Turbulences in international markets hindered the inflow of capital into emerging economies, Serbia included. Together with other global and domestic factors, they heightened the depreciation pressures on the dinar. The NBS intervened in the FX market to alleviate excessive short-term volatility of the exchange rate, which partly reflected on reduced excess liquidity of banks and a temporary rise in interbank money market rates by the late year. Still, the interest rate rise did not feed into the cost of borrowing of the government and private sectors.

Interest rates

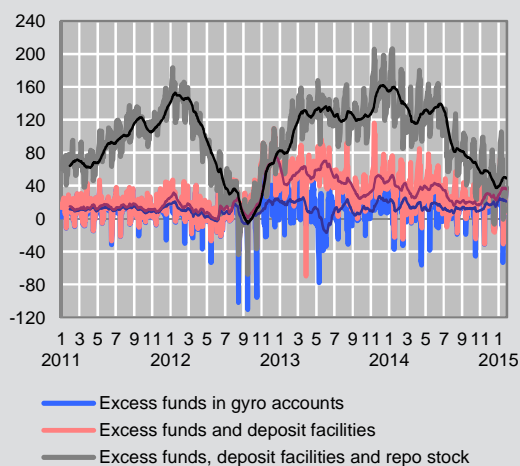
The average repo rate⁵ fell somewhat less than the key policy rate and stood at 6.2% at end-December. The rate was declining during most of Q4, that is until the second half of December, when it edged up reflecting a reduction in excess liquidity. However, the increase was only

temporary and in early 2015 the rate receded to its early-December levels.

A reduction in bank excess liquidity resulted in higher trading in the interbank overnight money market in Q4, with average daily volumes reaching RSD 4.0 bln – almost twice as much as in Q3. In the review period, BEONIA mirrored the movement in the key policy rate and was on a moderate decline until mid-December. During the last two weeks of December, as demand for dinars stepped up and banks showed preference for credit rather than deposit facilities, BEONIA temporarily drew closer to the upper bound of the NBS interest rate corridor. Driven by the rise in the second half of the month, average monthly BEONIA touched 7.4% in December, or 1.2 pp more than in November and 1.1 pp more than in September.

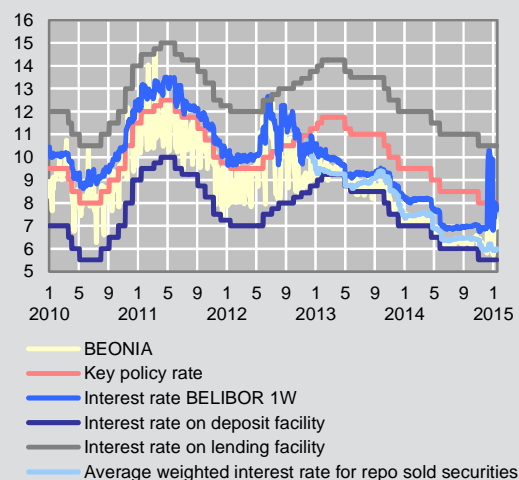
BELIBOR rates trended along a similar path. The rise was more pronounced for shorter-maturity rates. In December, average BELIBOR rates moved between 8.0% for the

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



Source: NBS.

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



Sources: Thomson Reuters and NBS.

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

shortest and 8.8% for the longest maturities, up by between 0.7 pp and 1.2 pp relative to September.

Trading volumes in the interbank money market expanded in January. Through most of the month, interest rates were on a downward path, but started up at the beginning of the new reserve requirement maintenance period.

In Q4, interest rates in the primary market of dinar government bonds recorded marginal changes in both directions, moving between 0.1 pp and 0.3 pp. Of longer maturities, rates were cut on one-year (to 8.0%) and three-year (to 9.7%) securities. A rise was seen only for seven-year securities (to 12.0%). The dinar yield curve lengthened further in October, when the first auction of ten-year securities closed at 13.0%.

Q4 saw lower performance at primary market auctions of government securities – 57.5%, down from 72.4% in Q3. This was due to the government's diminished need to borrow by selling dinar securities after having borrowed externally in Q3, but also because lower amount of securities were due for redemption until the end of the year. At the same time, due to increased aversion to investment in emerging markets, prompted by turbulences in international markets, foreign investors were less willing to purchase dinar securities than in Q3. Motivated by higher returns, they directed investment in longer-term securities (three, seven and ten years) and bought more than a half of the securities issue.

Interest rates on securities denominated in euros were on a decline throughout Q4. The steepest fall was recorded at December auctions when demand outstripped supply. Namely, rates on one-year securities fell by 0.7 pp and those on two- and three-year securities by 0.5 pp and 0.3 pp respectively. By late Q4, interest rates in this segment of the market moved between 2.5% for one-year and 5.5% for securities with a ten-year maturity.

Chart IV.1.4 Primary market of government dinar securities – performance ratio and foreign investor participation

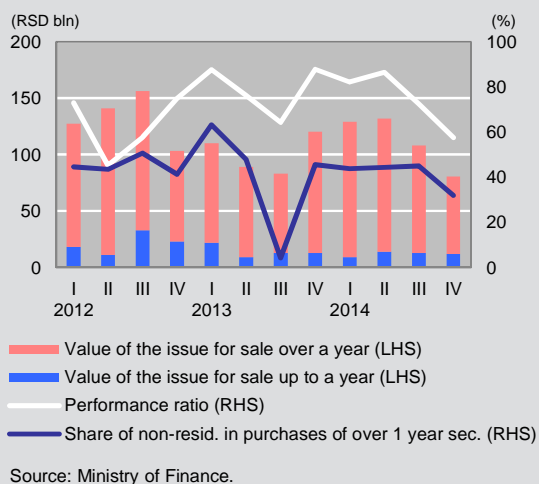


Chart IV.1.3 Yield curve in the interbank money market
(average values, p.a., in %)

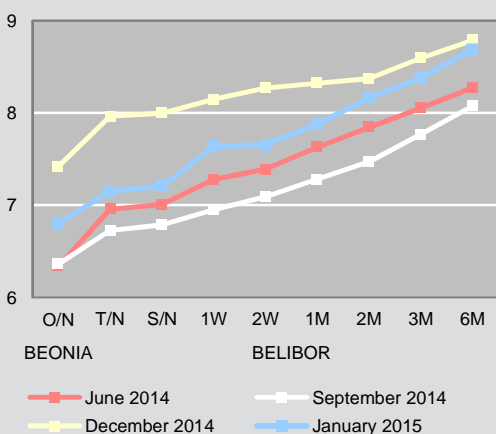
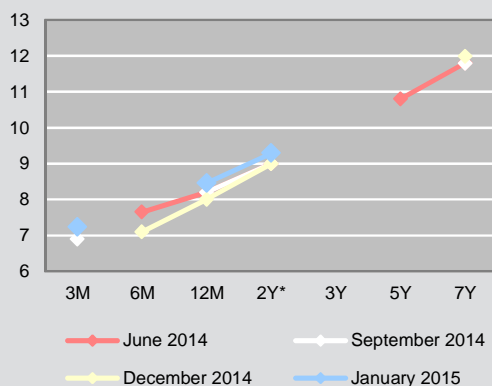


Chart IV.1.5 Interest rates in the primary market of government securities
(p.a., in %)



* Excluding coupon securities whose interest rate is linked to the NBS key policy rate.

The trading volume in the secondary market of government securities amounted to RSD 77.8 bln in Q4, down by RSD 14.0 bln from Q3. One- and three-year securities were most traded. Yield rates on securities traded in this market generally mirrored the trends in primary trading – by late Q4, they ranged from 6.9% for securities with the remaining life of seven months to 12.0% for seven-year securities.

The weighted average rate on new dinar loans reached 12.6% in December, down by 1.2 pp relative to September. At the same time, interest rates on dinar corporate loans fell (by 0.2 pp to 10.9%), while those on household loans went up (by 0.1 pp to 16.9%). Further, the share of corporate loans, which were less expensive than household loans, increased among new dinar loans (to 71.3% in December), which is why the decline in the average rate was sharper than in the rate on corporate loans.

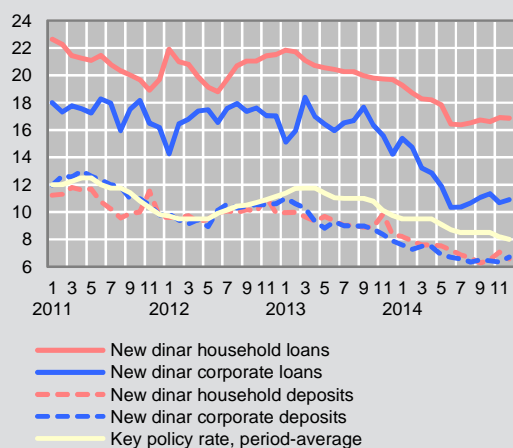
Despite an increase (by 0.2 pp to 10.6% in December), the interest rate on current assets loans remained lower than before the subsidised lending programme was launched. The decline in the dinar rate was prompted by a reduction in interest rates on other dinar loans, while the rates on less popular, investment loans went up. Rates on the most popular dinar household loans, i.e. cash and refinancing loans, stayed unchanged relative to September. At the same time, interest rates were raised on consumer and housing loans.

As banks cut the price of FX and FX-indexed loans, the weighted average rate on new euro and euro-indexed dinar loans fell in Q4 by 1.1 pp to 5.1% in December. The average price of corporate loans was pared back to 4.9%. Rates were lowered on all types of loans, but most on the predominant – current assets and investment loans. Borrowing on more favourable terms was also available to citizens in Q4, at the average rate of 6.9%. In contrast to dinar loans, rates on all FX household loans declined – to 4.7% on housing, 5.6% on consumer and 10.0% on other loans.

A drop in lending rates brought about the narrowing in the interest margin in Q4, which was expected by banks judging by the October bank lending survey. At the same time, the weighted average rate on new dinar deposits went up by 0.2 pp to 6.7% in December, while the average rate on euro deposits fell by 0.1 pp to 1.5%.

Neither this year did banks offer much more favourable terms on the occasion of the World Savings Day and no appreciable rise was noted for rates on household savings. The average rate on dinar savings touched 7.1% in November, and the rate on euro savings 1.8%. These rates fell to 6.6% and 1.7% in December, but remained somewhat higher relative to September. Q4 also saw an increase in the weighted average rate on dinar corporate deposits – by 0.2 pp to 6.7%, while the rate on euro deposits slipped by 0.4 pp to 1.2%.

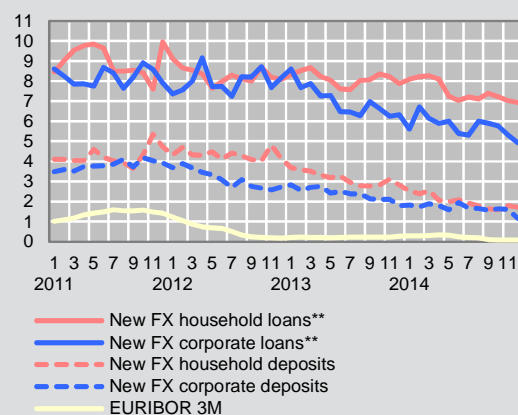
Chart IV.1.6 Interest rates on new dinar loans and new corporate and household deposits*
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 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.

Risk premium

In the closing quarter of 2014 and early 2015, risk premia of emerging economies showed greater volatility than in the prior period. This reflects the collapse in global oil prices, geopolitical tensions relating to the situation in Ukraine, changes in Fed's monetary policy and strengthening of the dollar.

All of the above led investors to re-examine their assessment of risks associated with investment in emerging economies. As a result, the average spread between the yield on dollar securities issued abroad by governments of emerging economies and the return on US government securities widened appreciably relative to end-Q3. EMBI Global gained 70 bp in Q4, whilst in mid-December, when hitting its quarterly peak, it overshot the end-Q3 figure by 144 bp. In January, financial markets were additionally shaken by the unexpected decision of the Swiss National Bank to abandon its cap of 1.20 francs per euro – as a result, EMBI Global edged up by additional 51 bp.

Besides, risk premia showed diverging movements across emerging economies. The risk premium precipitated up in countries dependent on oil exports, notably Venezuela and the Russian Federation, as well as in Ukraine due to

the current crisis. Risk premia of other high-yielding credit markets were also exceptionally volatile. However, these markets showed greater resilience to risk premium growth, notably European emerging markets. Most of them ended Q4 with a somewhat lower premium than a quarter before. Following temporary leaps in early October and mid-December, by end-year EMBI was weaker for Turkey (-31 bp), Poland (-9 bp), Hungary (-5 bp) and Romania (-4 bp). An upturn was seen in Serbia (12 bp) and Croatia (2 bp). As global uncertainties heightened in early January, risk premia of all European emerging economies first began to rise, and declined by late January relative to December for Hungary (-7 bp) and Serbia (-2 bp), but not for other countries, notably Croatia, whose risk premium rose by 34 bp.

EMBI for Serbia, at 310 bp in late January, was under the strongest sway of global factors. In January, Fitch affirmed Serbia's credit rating at B+ with a stable outlook, and Standard & Poor's affirmed the rating at BB- with a negative outlook. The rating was affirmed on account of the adoption of fiscal consolidation measures, further implementation of structural reforms and the expected conclusion of an arrangement with the IMF.

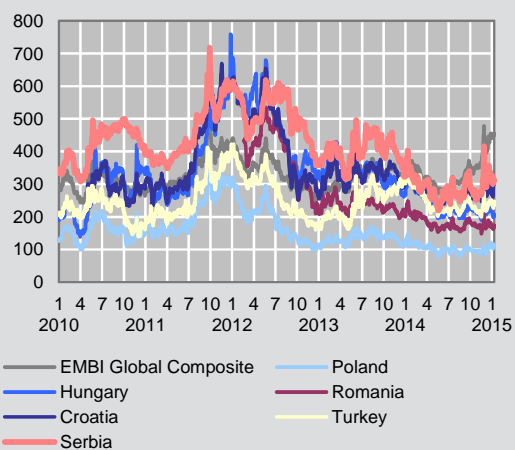
Foreign capital inflow

The current account deficit widened relative to Q3, notably due to income repatriation in late 2014. Capital inflows from FDI and portfolio investment did not suffice to cover the deficit.

Despite the FX inflows from FDI and portfolio investment, Q4 saw a net capital outflow, driven by the contraction in resident foreign liabilities arising from financial loans.

Preliminary data suggest a EUR 339.5 mln net inflow from **FDI** in Q4. A part of debt of foreign-owned enterprises was converted into equity. As a result, a EUR 623.9 mln net inflow was recorded in respect of investment in equity, and a EUR 278.4 mln net outflow from intercompany debt. Reinvested earnings declined by EUR 6.0 mln net.⁶ At the same time, net outflow from paid and collected dividends amounted to EUR 262.4 mln, and net outflow from interest on intercompany debt EUR 19.5 mln.

Chart IV.1.8 Risk premium indicator – EMBI by country (daily data, in bp)



Source: JP Morgan.

⁶ According to the IMF's BPM6, reinvested earnings and intercompany debt are included within FDIs. This change was explained in more detail in Text box 1 of the August 2014 Inflation Report.

Chart IV.1.9 Current account deficit and net capital inflow
(in EUR mln)

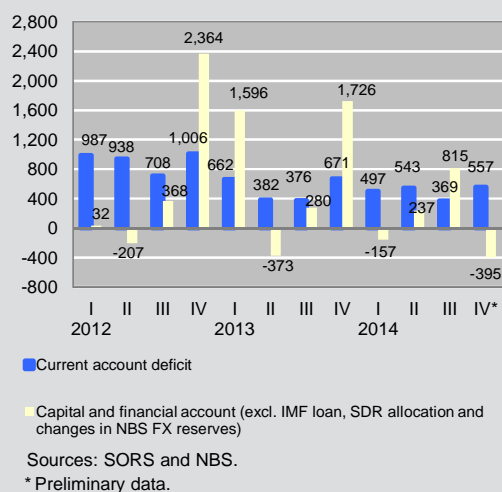
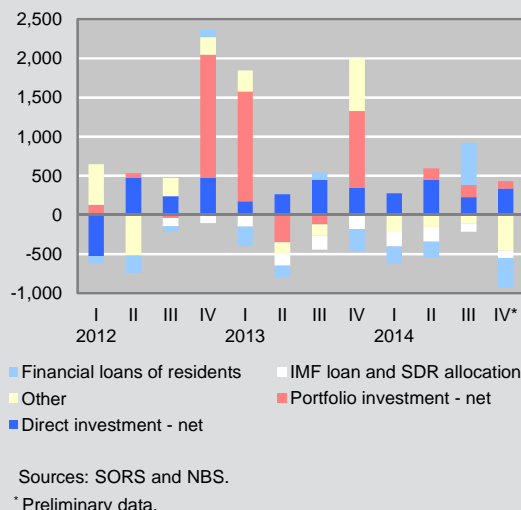


Chart IV.1.10 Structure of the financial account
(in EUR mln)



Net FDI inflow totalled EUR 1,288.7 mln in 2014, which is consistent with our projections. An inflow of similar magnitude (EUR 1.3 bln) is expected in 2015, mainly intended for investment in manufacturing, the financial sector and trade. Consistent implementation of structural reforms and fiscal consolidation, progress in the European integration process, recovery of the euro area and implementation of the announced bilateral cooperation projects should be the key factors in creating better conditions for higher FDI growth.

The turmoil in international markets caused increased foreign investor aversion to emerging economies. Non-residents invested less in government securities, feeding back into a smaller net inflow (EUR 90.2 mln) from **portfolio investment** relative to Q3. Since early 2014, net inflow from this source amounted to EUR 388.7 mln. In the course of Q4, portfolio investors were paid EUR 80.6 mln in respect of interest, whereby the amount of interest paid on these grounds reached EUR 379.2 mln in 2014.

As the closing quarter of 2014 was marked by more intensive external debt repayment by residents, the liabilities arising from **financial loans** declined by EUR 468.6 mln. The highest net debt repayments were made by banks – additional EUR 283.4 mln, while liabilities of enterprises under cross-border loans fell by EUR 193.4

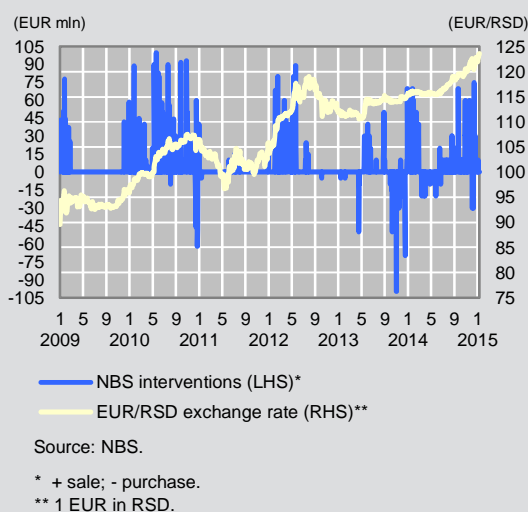
mln. In contrast, external liabilities of enterprises under trade loans grew by EUR 135.9 mln net. On account of liabilities due, the NBS paid out to the IMF EUR 98.8 mln in Q4, or EUR 567.4 mln in the entire 2014. It was only net government debt that climbed up – by EUR 107.0 mln. The servicing of credit liabilities due accounted for EUR 181.0 mln, while loans drawn were EUR 288.0 mln. The loans drawn included an IBRD loan intended for the Deposit Insurance Agency and EIB’s loans for Corridor X and the development of regional and municipal infrastructure.

Trends in the FX market and exchange rate

Depreciation pressures prevailed in Q4 and early this year, bolstered by global and domestic factors. In terms of end-of-period, the dinar lost 1.7% against the euro, or 2.4% in period-average terms. Further strengthening of the dollar against the euro gave rise to dinar’s weakening against the dollar by 5.9% in late December relative to end-Q3. In 2014, the dinar lapsed back by 5.2% vis-à-vis the euro.

Geopolitical tensions surrounding the Ukrainian crisis sent jitters through international markets in Q4 as well.

Chart IV.1.11 Movements in EUR/RSD exchange rate and NBS FX interventions

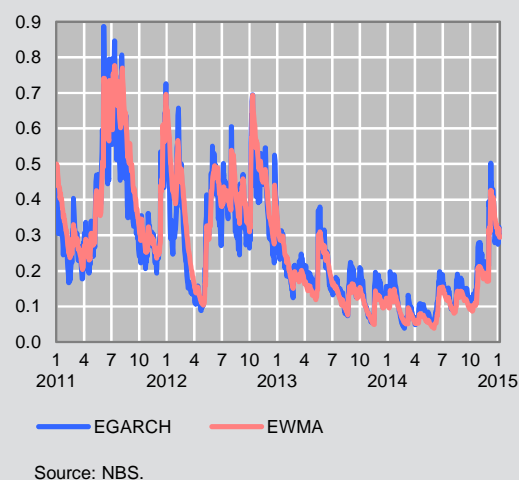


Tumbling oil prices and tightening of sanctions against the Russian Federation, along with depreciation of the ruble, adversely affected capital inflows and stepped up pressures on the majority of currencies of emerging economies, including the dinar. Serbia's risk premium, mirroring the regional dynamics, rose a tad relative to end-Q3. Sluggish recovery of the euro area, our main foreign trade partner, continued to bear down on exports and foreign currency inflows.

Demand for foreign currency in the domestic market increased markedly in Q4, partly due to higher payments of energy imports. In addition, pressures on the dinar heightened also reflecting dividend payments to foreign owners. Faced with a reduction in FX-indexed assets and seeking to maintain currency-matched assets and liabilities on their balance sheets, banks created demand for foreign currency during most of the period observed. They used a portion of the amount purchased to reduce their external liabilities. In contrast to the quarter before, enterprises were also net repaying their external debt. On the other hand, FX supply in the domestic market slightly increased on account of the inflow of FDIs and portfolio investment, whereas FX purchases in respect of exchange operations were below the level which is usual for that period of the year. Depreciation pressures subsided by

⁷ Excluding the NBS.

Chart IV.1.12 Short-term volatility of the RSD/EUR exchange rate (in %)



late December, reflecting the disbursement of several larger FX-indexed loans, but also the contraction in dinar liquidity of banks.

Trading volumes in the IFEM continued to recover – they were EUR 38.8 mln⁷ on average in Q4, up by EUR 14.1 mln from Q3. The highest average monthly value since June 2013 was observed in December (EUR 53.6 mln). Consistent with elevated trading volumes, the exchange rate succumbed to sharper volatility (measured by EWMA⁸ and EGARCH⁹).

To ease excessive short-term volatility of the exchange rate and without any intention to influence its trend, the NBS intervened in the IFEM in Q4 by selling EUR 765.0 mln net. It intervened mainly on the sale side. In the second half of December, it intervened twice on the purchase side. In the course of January, the NBS sold EUR 90.0 mln in the IFEM.

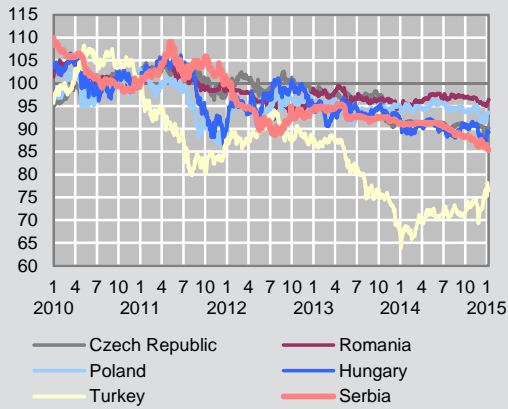
The NBS continued to organise three-month and two-week FX swap auctions. At three-month swap auctions, the NBS sold EUR 24.0 mln and bought the same amount, while at two-week actions it both sold and bought EUR 42.0 mln.

Depreciation pressures gained vigour in most countries of the region running similar exchange rate regimes.

⁸ EWMA – Exponentially Weighted Moving Average.

⁹ EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

Chart IV.1.13 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.

Relative to end-Q3, of the currencies observed, the Polish zloty weakened the most (2.0%). The Romanian leu and Hungarian forint depreciated by almost as much as the dinar – by 1.6% and 1.4% respectively. The Czech koruna weakened somewhat less 0.8%, whilst the Turkish lira was the only currency that notched up (2.5%).

Text box 1: The Swiss National Bank's decision to lift the cap on the franc's value against the euro

The unexpected decision by the Swiss National Bank (SNB) on 15 January 2015 to remove the minimum exchange rate for the Swiss franc against the euro sent foreign exchange and credit markets around the world into turmoil. This decision represents a move towards the tightening of the SNB's monetary policy, although the bank expressed its readiness to intervene in the FX market, should monetary conditions require easing. At the same time, the bank made a decision to cut interest rates hoping to discourage conversion of other currencies into the franc, i.e. alleviate appreciation pressures on its currency. Central bank also lowered the interest rate on sight deposit account balances that exceed a given exemption threshold by 0.5 pp, to -0.75%, in a bid to move the target range for the policy rate, the three-month Libor, further into negative territory, between -1.25% and -0.25%.

Back in September 2011, the SNB introduced the minimum exchange rate for the franc against the euro as a provisional measure, in an attempt to halt the rise of its currency – a traditional “safe haven” currency for investors – which occurred at a time of pronounced instability in the global financial market. Limiting the franc's value against the euro precluded further tightening of monetary conditions, ensuring that Swiss export-oriented market is shielded from the negative impacts of an overvalued currency, considering that the value of exports of goods and services exceeds 70% of Switzerland's GDP. This measure required the central bank to intervene in the FX market by selling francs, which led to an increase in FX reserves to approximately 80% of GDP.

In making the decision to lift the cap on the franc's value against the euro in January this year, the SNB was guided by the assessment that the overvaluation of the franc has in the meantime decreased and that the economy was now capable of adjusting to the current market conditions. The analysts view this decision in light of different monetary policies of leading central banks, the ECB and the Fed, which will only become more striking in the coming period. The ECB's decision to expand its purchases of securities to include government securities of euro area member states would have required the SNB to increase the scope of its interventions in the FX market, thereby inflating its FX reserves with the weakening euro. In such circumstances it was estimated that maintaining the minimum exchange rate for the franc against the euro would no longer be justified.

Global financial markets have responded intensely to these measures. On the day of the decision, the franc soared, ending the early trading nearly 40% higher against euro, only to level off at around 15% higher thereafter. It remains to be seen at which level the franc will stabilise in the coming period and how this will reflect on the competitiveness of the Swiss economy, primarily of the chemical and machine industry, as well as of watch manufacturing and tourism. The negative consequences of abandoning the cap on the franc's value against the euro on Swiss economy, which will probably stay in deflation, may be moderated by increased productivity, the recovery of the US market, a drop in global oil prices and quantitative easing in the euro area. However, most analysts have already revised down their projections of Switzerland's economic growth.

Considering that a part of the credit portfolio of banks in certain countries in Central and Eastern Europe is indexed to Swiss francs, the decision to end the policy of capping this currency against the euro ruffled the regional credit markets, as its sudden strengthening made the servicing of these loans significantly more expensive. The greatest exposure to the risk of changing value of the franc in these countries is suffered by their citizens, who were attracted by lower interest rates, especially on mortgage loans, prior to the 2008 financial crisis. However, there is a general consensus that no country in the region faces a systemic risk to the stability of its financial system, in contrast to the situation several years earlier when the global financial crisis was at its peak. The situation then was most serious in Hungary, where CHF-indexed household loans accounted for about 25% of GDP, since the majority of FX-indexed loans were denominated in francs (around 93%). Since then, the Hungarian authorities have implemented a set of measures, above all the mandatory

conversion of these loans into the forint at the rate more favourable than the market rate, almost entirely eliminating debt denominated in francs (and other foreign currencies). Costs of implementation of these measures were borne by the banks, as well as by the state and bank clients. However, the mandatory character of these measures and the ensuing credit market distortions came under criticism because of what ended up as the transfer of costs from banks to other loan users.

In this region today, Poland has the highest exposure to CHF loans, with mortgage loans in this currency accounting for about 8% of GDP. However, it is estimated that they pose no systemic risk as repayment of only 3% of all CHF loans is delayed, plus Polish banking system is among the strongest in Europe and its economy should record a 3.5% growth this year. Croatia comes second in terms of exposure in francs, where loans indexed to this currency account for around 7% of GDP, but Croatian economy is weaker than that of Poland. The Croatian authorities responded by “freezing” the Swiss franc’s rate on loans for one year at the level before the SNB’s decision to ban its minimum exchange rate of 1.20 Swiss francs to the euro, hence transferring incurred losses to banks. There is a significantly lower exposure in francs in Romania, Serbia and Slovenia, while it is negligible in the Czech Republic.

Even though there is no systemic risk to financial system stability, regulators in the countries of the region are seeking ways to alleviate the burden of loan repayment to debtors faced with a sudden increase in costs caused by the franc’s surge. Different models are being considered in cooperation with banks, which are very interested in resolving this issue, primarily in view of the depressed prices and low liquidity in the real estate market. Besides, it is believed that the requests for government intervention are premature and hasty and that all strengths and weaknesses of alternative models must be assessed carefully and over a sufficiently long period of time.

Household lending indexed to foreign currency, other than the euro, has been prohibited in Serbia since June 2011, since citizens continued to borrow in CHF regardless of the warnings issued by the central bank. Aware of the situation faced by some 22,000 citizens, in May 2013 the NBS put forward a recommendation to banks to enable their clients with CHF-indexed loans to pay lower instalments over the next three years. The purpose was to alleviate the loan repayment burden during the difficult period ahead, considering that the government was planning to implement fiscal consolidation measures, which would reflect on the citizens’ standard of living. Payment of the difference between each real and reduced instalment amount was to be postponed for three years and no interest was to be charged on the receivables deferred. In this way the citizens’ loan instalments would be lower by between 12% and 20% (depending on when the loan was taken), until fiscal consolidation measures yield full effect on the standard of living. Those who followed this recommendation are now less affected by the current CHF surge.

Today, CHF-indexed loans in Serbia account for around 3% of GDP, most of them being household loans, especially housing loans. Although there is no systemic risk and the banking system remains stable, together with representatives of the banking industry the NBS is considering different methods for solving this issue in order to help relieve the debt servicing burden for the citizens affected. To be more specific, several alternative modalities are on the table – from temporary reduction of instalments and moving a part of the burden to the end of the repayment period, loan conversion into euros and adjustment of interest rates on CHF-indexed loans with market interest rates, to the option to extend the loan repayment period. The result of the agreement between the NBS and the banks will be formulated as a decision which will be binding for banks. The long-term solution to this problem lies in putting in greater efforts to strengthen the economy and reduce dependence on foreign sources of financing and the high currency risk this entails. This is certainly going to be a complex process, but will be made easier by the already achieved low inflation, adjustment of the current account deficit of the balance of payments, as well as fiscal consolidation and structural reforms.

Stock exchange trends

By late December, BELEX15 (the index of the most liquid shares) and BELEXline (the general index) stood at 667.0 and 1,344.8 points respectively, up by 0.9% and 1.9% on end-September. Rising by 19.5% and 21.7% respectively at the annual level, these two indices were among the best performers in the region.

Total trading in shares of the Belgrade Stock Exchange (BSE) rose mildly (by RSD 0.2 bln) from Q3 – to RSD 3.4 bln in Q4. December experienced the highest trading volume (RSD 1.4 bln), reflecting mainly trading in the open market.

Foreign investor participation also increased – non-residents participated in more than a half (53.1%) of total trading in shares in Q4 and net bought domestic shares worth RSD 0.3 bln.

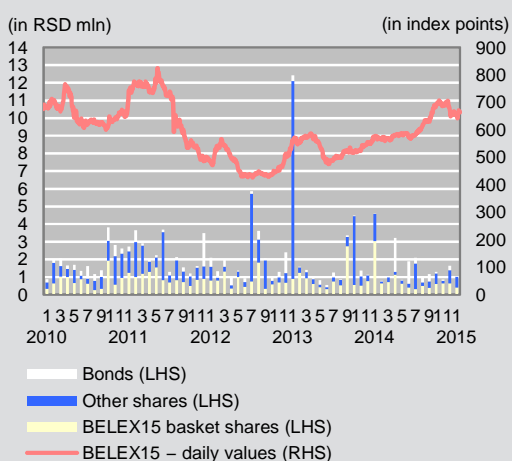
By contrast to shares, trading in frozen FX savings bonds dwindled further. Total trading in these bonds amounted to RSD 0.4 bln in Q4, with A2016-series bonds accounting for a larger share. On a downward path, the rates of return for this series arrived at 2.9% in late December. The rates of return picked up marginally for the series maturing this year – to 2.8% in late Q4.

In December, the City of Šabac issued municipal bonds through a public offering, which marks a positive step forward in the development of the domestic capital market, this issue being the first of the kind (so far, three local self-governments have issued bonds, but for pre-defined buyers). The issue worth RSD 400.0 mln was sold in entirety, at the fixed interest of 6.0%. The bonds are euro-indexed, with a seven-year term. Interest will be paid annually – as of the first year, and the principal as of the third year. In early 2015, the bonds were admitted to the BSE open market.

BSE market capitalisation expanded RSD 19.5 bln in Q4 to reach RSD 796.6 bln in late 2014. Of this, regulated market capitalisation was up RSD 12.8 bln to RSD 450.2 bln, and MTP¹⁰ capitalisation RSD 6.7 bln to RSD 346.4 bln. As a result, the share of market capitalisation in estimated GDP edged up 0.4 pp to 20.5% in late Q4.

Indices on the majority of stock exchanges in the region were on a downturn, most notably in Zagreb (9.0%) and Budapest (7.0%). Conversely, indices on Skopje and Sarajevo stock exchanges added 7.6% and 4.2% respectively.

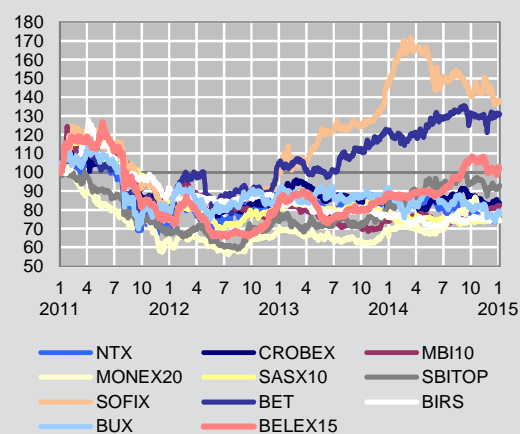
Chart IV.1.14 BELEX15 and Belgrade Stock Exchange turnover



Source: Belgrade Stock Exchange.

Chart IV.1.15 Stock exchange indices across the region

(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

¹⁰ 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.

2. Money and loans

In y-o-y terms, a rise in money supply decelerated further in Q4. At the same time, after quite a while, credit activity exited the negative y-o-y territory. However, as the subsidised lending programme came to an end, its positive effects on credit growth are fading, which the NBS tends to mitigate by lowering its reserve requirement ratios.

Monetary aggregates

In Q4, dinar reserve money gained 8.4% and 9.0% in nominal and real terms respectively. Due to changes in reserve requirement regulations, the balance of bank FX deposits with the NBS declined. As a result, total reserve money shifted down by 5.4% and 4.8% in nominal and real terms respectively. Y-o-y, dinar reserve money grew 5.8% in real terms and total reserve money fell by 6.2%.

Government spending from accounts at the NBS stepped up in late 2014 (in October, particularly in December) and gave the strongest boost to the creation of dinar reserve money in Q4 – by RSD 55.4 bln. Banks cut back on their investment in repo securities by additional RSD 37.5 bln,

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

	2014				Share in M3 Dec. 2014 (%)
	March	June	Sept.	Dec.*	
M3	1.9	3.5	4.4	6.8	100.0
FX deposits	0.4	0.2	1.7	5.1	67.0
M2	5.4	11.3	10.7	10.4	33.0
Time and savings dinar deposits	-7.9	-6.8	4.1	13.2	9.8
M1	12.6	20.4	13.7	9.2	23.1
Demand deposit	15.7	28.5	16.6	11.2	16.1
Currency in circulation	6.3	4.0	7.3	4.8	7.0

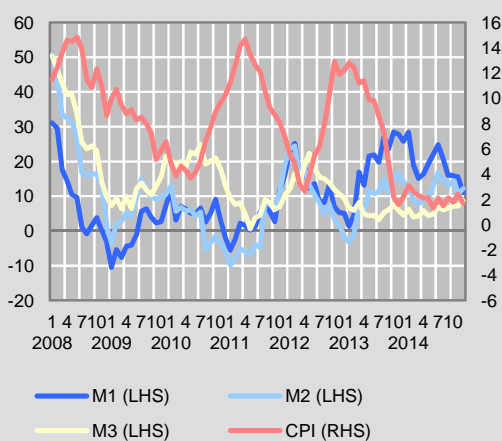
Source: NBS.

* Preliminary data.

which, coupled with FX payment transactions with Kosovo and Metohija (RSD 12.3 bln), generated liquidity as well. On the other hand, in Q4 the major part of liquidity was mopped up through NBS interventions in the IFEM (RSD 83.2 bln).

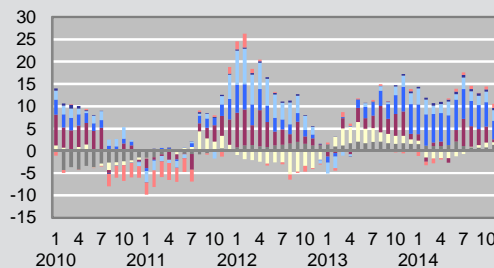
In terms of the structure of dinar reserve money, balances in bank giro accounts (RSD 14.9 bln) increased the most, whilst dinar allocations of required reserves expanded by

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



Sources: SORS and NBS.

Chart IV.2.2 Contribution to y-o-y growth in M2, by sector
(in pp)



- Other financial organisations
- Non-profit and other organisations
- Cash in circulation
- Households
- Companies
- Public enterprises
- Local authorities

Source: NBS.

RSD 10.4 bln after regulations on required reserves were amended to raise the share of dinar allocations. Following the seasonal dynamics, cash in circulation (RSD 7.0 bln) accelerated. A contraction was observed for balances in accounts of local authorities and excess deposits held by banks with the NBS – by RSD 3.2 bln and RSD 0.4 bln respectively.

The increase in money supply continued in Q4, though at a weaker pace than in previous quarters. M2 posted the sharpest real rise (5.3%), fostered by growing dinar savings and term deposits. At the same time, M1 picked up by 4.3%. Despite a decline, FX deposits expressed in dinar terms rebounded (due to dinar's weakening against the euro), inducing a 3.2% rise in M3. In y-o-y terms, deceleration in money supply growth, begun in August, continued throughout Q4. By late 2014, M1, M2 and M3 went up 9.2%, 10.4% and 6.8% in real terms respectively relative to end-2013. The creation of M3 was influenced primarily by lending to the private sector, government spending and the purchase of government securities by banks.

Sparked by the seasonal increase in December, growth in demand deposits outpaced the end-Q3 figure (RSD 8.1 bln) – mainly due to an upswing in balances in household and OFO accounts, whilst balances in corporate accounts were scaled down.

Balances in dinar savings and term deposit accounts climbed by RSD 12.3 bln, mainly reflecting rising balances in enterprise accounts, which is partly attributable to the intensified subsidised lending.

Relatively low household income and low deposit interest rates did not generate any major rise in household savings in the period surrounding the World Savings Day. In Q4, FX savings were up by EUR 33.8 mln, while dinar savings drifted down by RSD 1.8 bln. As a result, FX and dinar savings reached EUR 8.3 bln and RSD 38.1 bln by end-December respectively.

Total FX deposits were decreased by EUR 97.8 mln in Q4. But for household savings, a decline was noted for account balances of all other sectors, most notably enterprises and OFOs.

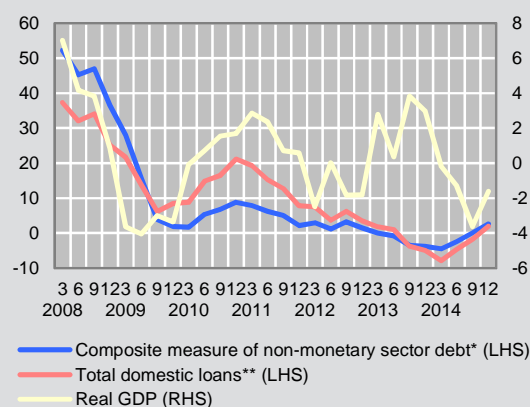
Loans

Lending activity continued up in Q4, though at a slower pace than in the previous quarter. Excluding the exchange rate effect¹¹, domestic lending was up by 1.4% in Q4 and its share in estimated GDP rose by 0.7 pp to 48.0% in December. As in the previous two quarters, subsidised loans added significantly to the growth.

As a result, after 15 months domestic lending activity exited the negative y-o-y territory in October and grew by 1.9% in December. At the same time, a y-o-y rise in corporate and household loans was 1.2% and 6.1% respectively. Excluding the receivables of delicensed banks from bank loan receivables, domestic lending activity has been growing y-o-y since September.

Excluding the exchange rate effect, corporate loans rose by 2.9% or RSD 24.9 bln, mainly in response to the extension of subsidised liquidity and current assets loans. Compared to earlier months, the disbursement of these loans slowed down in October and November, only to

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



Sources: NBS and SORS.

* As an indicator of total borrowing, it includes domestic loans to the private sector, public enterprises and local authorities, and enterprise cross-border borrowing.

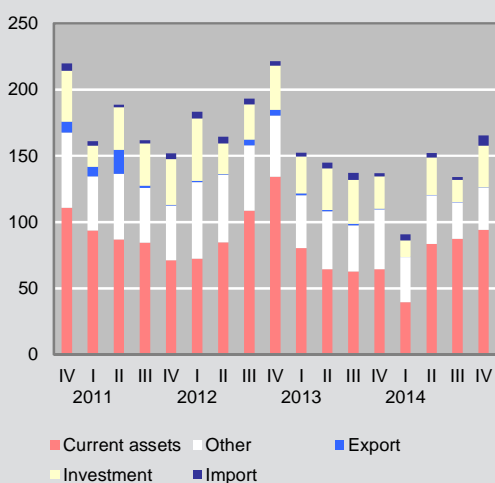
** Excluding the exchange rate effect.

¹¹ Calculated at the RSD/EUR exchange rate as at 31/08/2008, assuming that all FX and FX-indexed loans were approved in euros.

pick up in December before the winding down of the programme by late 2014. According to data of the Development Fund, subsidised loans worth RSD 45.4 bln were disbursed in Q4, or RSD 136.1 bln since the start of the programme. The disbursement of several larger loans to public enterprises was another driver of lending activity. In Q4 again, the major portion of new corporate loans (almost 60%) went to finance current assets. The disbursement of investment loans remained modest due to the ailing economy and absence of investment.

As indicated by the NBS January bank lending survey¹², banks tightened their corporate lending standards in Q4, though less than in Q3. Despite a further cut in costs of funding sources, standards were made more restrictive in light of gloomy expectations about future economic growth and the estimated risk regarding the collection of receivables and collateral. The terms of borrowing by enterprises were more favourable because of lower margins and the accompanying costs. At the same time, the bank criteria regarding collateral, the maximum amount of loan and repayment period were tightened.

Chart IV.2.4 Structure of new corporate loans (in RSD bln)



Source: NBS.

Loan demand of enterprises drifted up in Q4 as well, and pertained mainly to dinar loans, chiefly for the sake of financing current assets and debt restructuring. The same factors are likely to underpin the expected growth in loan demand in Q1 2015 as well.

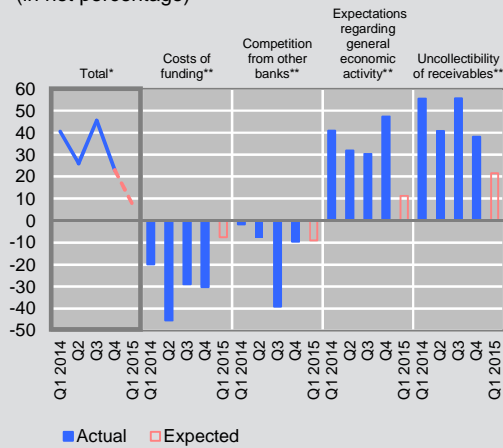
Excluding the exchange rate effect, household lending bounced back by RSD 1.2 bln or 0.6% in Q4. However, compared to previous quarters, the growth slowed down and may be correlated with the start of application of fiscal consolidation measures. As in the past, cash loans were predominant, consistent with expectations presented in the October bank lending survey. Contracted household income and the adverse situation in the real estate market resulted in modest disbursements of housing loans in Q4, whereas the least popular, consumer loans increased marginally. Household borrowing under costlier categories – revolving loans, credit cards and current account overdrafts, stayed at the similar levels as in the prior months.

According to the January bank lending survey, contrary to expectations, some banks tightened standards for household lending in Q4, driven by the same motives as for corporate lending. However, relaxation is expected in the next quarter. On the other hand, collateral requirements were eased and the accompanying costs reduced, and more favourable repayment terms were offered for FX loans. Household demand for loans increased in Q4 as well – notably for cash, refinancing and FX consumer loans. Besides, demand for housing loans decreased. The refinancing of current obligations was the main reason why citizens borrowed, while low household income and the adverse situation in the labour and real estate markets acted in the opposite direction. Banks expect an increase in demand in the coming period as well, assuming it will be driven by the need to refinance obligations.

Corporate and household dinar debt continued up – by late December, 31.2% of bank lending to these sectors was dinar-denominated, up by 0.9 pp on end-Q3. Owing to subsidised loans, the increase in dinarisation was higher in the corporate sector (by 1.4 pp to 25.0%). In the household sector, the share of dinar in total lending picked up by 0.4 pp to 41.0% in December.

¹² The NBS began conducting the survey in early 2014. Participation is voluntary and the response rate almost 100%.

Chart IV.2.5 Impact of individual factors on changes in standards for the extension of loans and credit lines to enterprises (in net percentage)

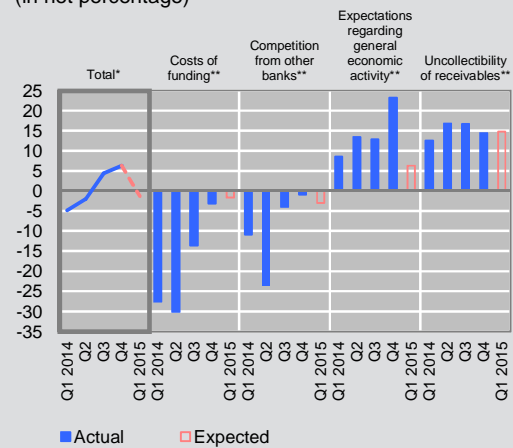


Source: NBS.

* Positive values indicate tightening of conditions and negative – easing, relative to the previous quarter.

** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of lending standards.

Chart IV.2.6 Impact of individual factors on changes in standards for the extension of loans and credit lines to households (in net percentage)



Source: NBS.

* Positive values indicate tightening of conditions and negative – easing, relative to the previous quarter.

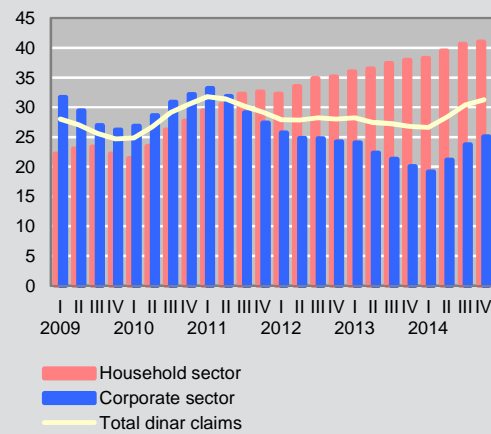
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of lending standards.

The share of NPLs in total loans (under the gross principle) fell by 0.5 pp from end-Q3 to 22.5% in November. The reduction was due to a mild rise in lending activity and the write-off and collection of a part of NPLs. In November, the share of NPLs dipped by 0.1 pp to 27.2% for the corporate sector, while it inched up by 0.1 pp to 10.3% for the household sector.

The decision of the Swiss National Bank to lift the cap on the franc’s value against the euro and the resulting appreciation of the franc will worsen the repayment burden for CHF indexed debt. The household sector will be hit most severely, notably in light of CHF-indexed housing loans. In November, household obligations under these loans came at RSD 96.8 bln, making up 28.8% of housing or 13.7% of total household loans.

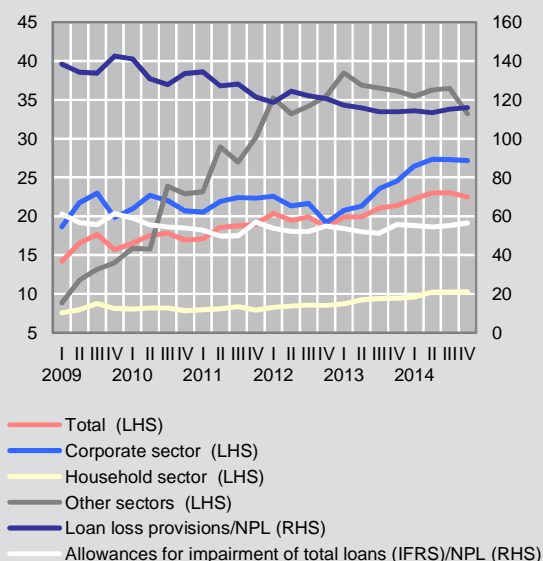
However, despite the high share of NPLs in total loans, the capital adequacy ratio of 19.4% indicates unimpaired stability of the domestic banking sector. Allowances for impairment stood at 56.7% of NPLs in November. At

Chart IV.2.7 Share of dinar in total bank claims on corporate and household sectors (in %)



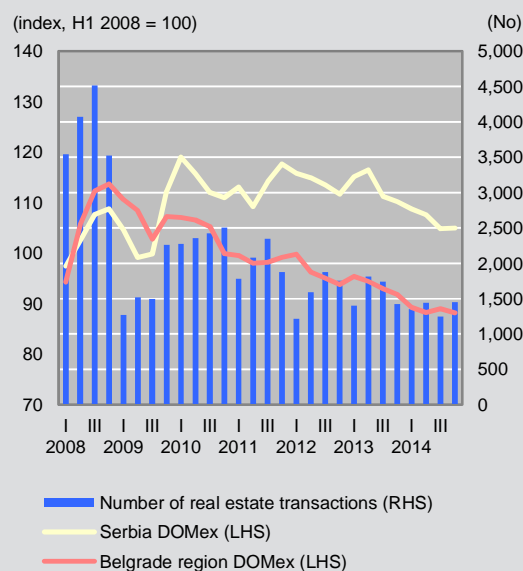
Source: NBS.

Chart IV.2.8 NPLs share in total loans, gross principle (%)



Source: NBS.

Chart IV.3.1 DOMex and real estate transactions



Source: National Mortgage Insurance Corporation.

115.9% in November, loan loss provisions¹³ fully covered the amount of gross NPLs.

3. Real estate market

Real estate prices stagnated in Q4, whilst trading volumes receded further. Improvement in regulations should herald positive trends in the real estate market in the coming period.

Measured by DOMex¹⁴, real estate prices stagnated in Q4, whilst a moderate drop in prices in Belgrade (0.9%) was offset by price growth in other regions of Serbia. At the year-level, in 2014 real estate prices slipped by 5.9% on average relative to 2013, at the average price of EUR 880.1 per square metre.

Real estate prices were declining throughout 2014, mainly reflecting dented demand, as signalled by the

concurrent drop in trading volumes. Though up by 16.4% in Q4, the number of real estate transactions turned 13.9% lower at the year-level. The number of sold properties in Serbia’s territory¹⁵ amounted to 5,492 in 2014 – the lowest since 2007 when the statistics were first available. As in the previous years, the largest number of sold properties was recorded for the Belgrade region (46.5%), followed by Vojvodina (26.3%).

Dampened demand for real estate was mainly due to low purchasing power. High unemployment, the start of application of fiscal austerity measures and uncertainties as to the capacity to repay a mortgage loan, are the reasons why households are increasingly reluctant to take on housing loans, as indicated by the results of the bank lending survey.

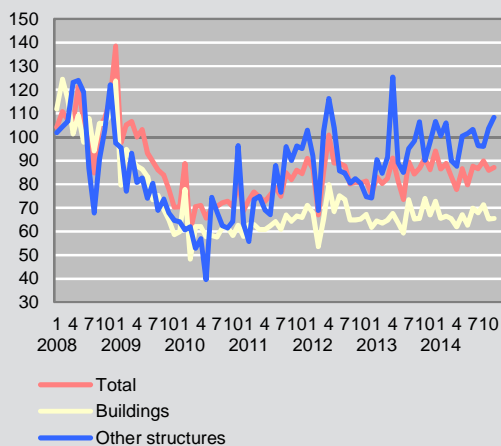
Dented demand dragged down the supply of new apartments in the domestic market. In the first three quarters of 2014, the number of newly constructed apartments in Serbia was by as much as two thirds lower

¹³ Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but serve to calculate bank capital. They are calculated on the group basis by assets classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100%, of receivables classified in A, B, C, D and E categories, respectively).

¹⁴ DOMex is published by the National Corporation for Insurance of Housing Loans and relates only to real estate purchased by insured loans. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror the trends in the real estate market, in light of high unemployment, plummeting wages and muted credit activity.

¹⁵ The number of real estate transactions and apartment prices per square meter also concern only the real estate purchased by insured loans.

Chart IV.3.2 Indices of the number of issued construction permits
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

than in the same period last year. In addition, the average number of issued permits for the construction of buildings and apartments fell by 6.2% and 16.6% s-a in Q4¹⁶ respectively. The bleak situation in apartment construction is also confirmed by the high share of NPLs in the construction industry – around 50% in Q4.

The real estate market is likely to improve in the near future owing to regulatory changes. The start of application of the new Law on Planning and Construction, which envisages electronic issuance of construction permits, should push down flat construction costs and spur investment. Moreover, full implementation of the Law on Mediation in Trade and Lease of Real Estate will enhance legal security and raise the quality of services in the real estate market.

4. Aggregate demand

The recovery of exports, elevated investment and government consumption lent an impetus to Q4 growth in aggregate demand (0.5% s-a), while further contraction in household consumption and dampened private investment produced a negative effect. Imports gathered further momentum in Q4, though at a weaker pace compared to exports, resulting in a positive contribution of net exports to aggregate demand.

A fall in aggregate demand in 2014 is estimated to have been fully determined by subdued domestic demand. Net exports gave a neutral contribution to aggregate demand as the slowdown in exports due to floods and muted external demand were offset by a slower rise in imports caused by fiscal consolidation measures.

Domestic demand

A moderate decline in **private consumption** continued into Q4 (0.2% s-a), as suggested by most indicators. Imports of consumer goods and trading volumes in green markets underperformed the Q3 figure (0.7% and 0.3% s-a respectively). A downturn was also posted for the number of overnight tourist stays, the volume of postal and telecommunications activities and the volume of services in passenger transport. Furthermore, data from the Household Consumption Survey reveal a relatively

Table IV.4.1 Investment indicators

	2013		2014		
	Q4	Q1	Q2	Q3	Q4
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Hours worked in construction	-1.1	4.0	-8.8	0.71	-17*
Industrial inventories	2.6	1.7	0.5	-3.0	-1.6
Industrial production of capital goods (physical volume)	-4.3	-7.0	-1.7	2.7	-1.8
Exports of equipment**	-6.7	20.7	-7.9	-3.2	-4.8
Imports of equipment**	0.4	-6.2	1.8	-1.6	0.6
Inventories of capital goods	-3.5	-8.2	0.0	-0.2	10.5
Industrial production of intermediate goods (physical volume)	0.2	-1.7	-6.0	2.7	-1.4
Exports of intermediate goods**	0.2	1.1	-0.9	-1.0	-1.2
Imports of intermediate goods**	-1.4	1.9	-5.0	-2.3	4.2
Inventories of intermediate goods	1.5	2.3	2.5	-0.4	-2.3
Industrial production of construction materials (physical volume)	-2.5	7.1	-6.0	4.5	4.6
Inventories of construction materials	-6.3	3.7	-3.7	-7.1	-3.8
Government investment***	-27.6	33.6	39.7	-35.2	5.7

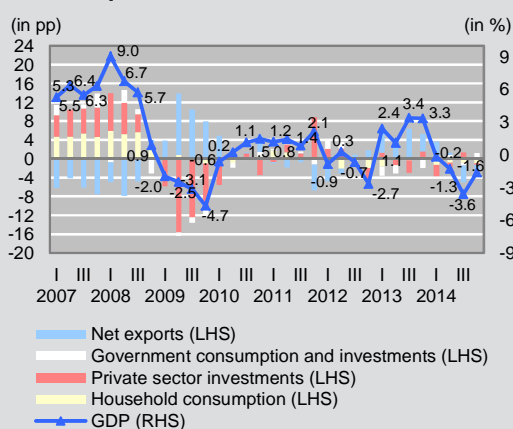
* SORS estimate.

** Exports and imports are denominated in euros.

*** Government investment spending is deflated by the industrial producer price index.

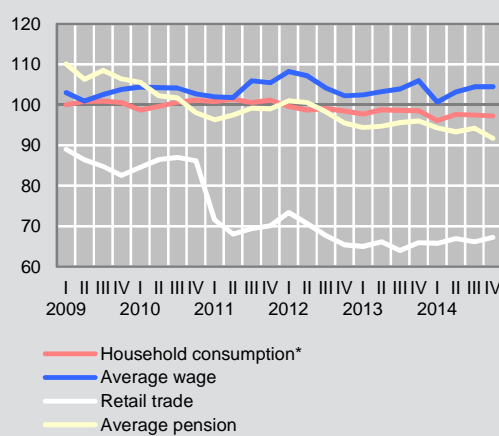
¹⁶ October and November.

Chart IV.4.1 Contribution to y-o-y GDP growth rate – expenditure side



Sources: SORS and NBS calculation.
Note: NBS estimate for Q4 2014.

Chart IV.4.2 Household consumption
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.
* NBS estimates for Q4 2014.

strong s-a decline in consumption in the first three quarters of 2014, which is expected in Q4 as well due to a cut in public sector wages and pensions. Conversely, a 1.6% s-a rise in retail trade volumes in Q4 may be put down to better tax discipline as indicated by VAT receipts which rose briskly by 8.7% s-a. In y-o-y terms, a decline was recorded for household consumption for the fourth consecutive quarter – 1.3% in Q4.

Household consumption slackened in Q4 also in light of other main sources of consumption. Real wage and pension bill and remittances went down and the extension of loans for current consumption (consumer and cash loans) lost vigour, which was partly compensated for by a lower amount of new savings deposits.

Private investment is also estimated to have abated in Q4 (2.2% s-a), whilst its y-o-y decline decelerated to 4.9%. A cut-back in investment is confirmed primarily by construction indicators – a decline in the number of issued construction permits and effective hours worked by 1.7% s-a each. By contrast, a mild increase in equipment imports (0.8% s-a), bolstered FDI inflows and a further rise in the production of construction material signal possible recovery of private investment in the coming period.

Uncertainties as to economic prospects, insufficient liquidity and the need of debt restructuring make

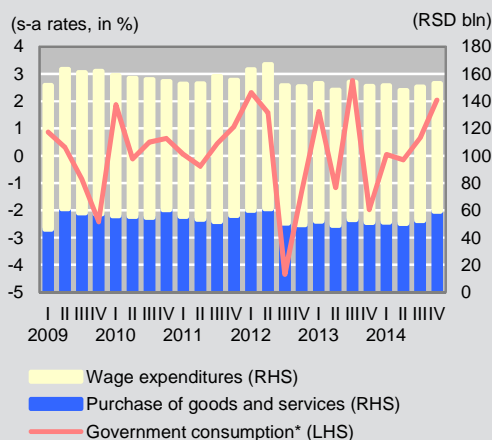
enterprises continue to opt predominantly for shorter-term borrowing, which is why the extension of investment loans remained modest in the quarter reviewed.

Up by 2.0% s-a and 3.2% y-o-y, **government consumption** spurred aggregate demand in Q4. The rise was prompted by greater outlays for the purchase of goods and services (13.2% s-a). On the other hand, outlays for public sector wages plummeted on the back of austerity measures (4.6% s-a). **Government investment** posted a moderate rise (5.7% s-a), mainly due to payments under projects initiated earlier, as indicated by three times higher amount of consolidated capital expenditure of the government in December, relative to average monthly amounts throughout the year. Government investment grew in y-o-y terms as well – by 25.4%.

Net external demand

Following a decline in Q3, real exports of goods and services went up by 2.8% s-a in Q4, mainly owing to a strong upswing in exports of agricultural commodities. With imports of goods and services also rising (1.3% s-a), though at a slower pace, net exports gave a positive contribution to total demand in Q4. Y-o-y, the decline in exports of goods and services slowed down considerably (from 5.7% in Q3 to 1.0% in Q4), while imports continued on a moderate growth path (2.1%), which

Chart IV.4.3 Government consumption
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q4 2014.

resulted in much lower negative contribution of net exports to total demand in Q4 (1.6 pp.).

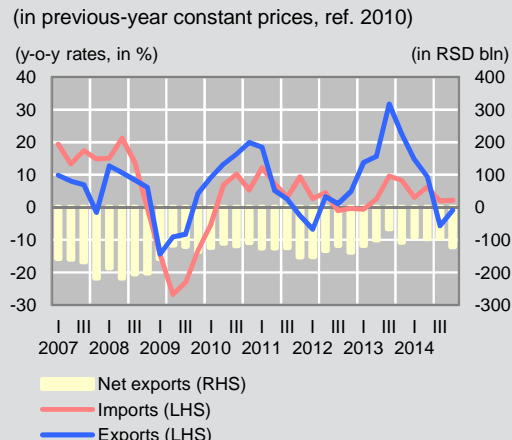
Leading indicator of external demand for our exports¹⁷ recorded continuous monthly rise in Q4, moving above its long-term average. Fresh impetus to exports in the coming period is also likely from improved external competitiveness due to the real depreciation of the effective exchange rate of the dinar by 3.4% in Q4 and lower unit labour costs in industry.

Euro-denominated commodity exports perked up in Q4, rising by 4.4% s-a on a quarter earlier¹⁸, partly owing to an increase in export prices. The rebound was driven chiefly by the rise in exports of agricultural commodities which reached a sizeable 42.1% s-a, tobacco and tobacco products (63.9% s-a) and an upturn in base metals exports (17.2% s-a). Furthermore, in terms of the impact on total exports, rallying motor vehicle exports (accounting for a major share in the total) featured significantly, and so did the exports of rubber and plastic products.

A strong growth in exports of agricultural commodities was driven by record high corn yields in the current agricultural season and estimated market surplus of some 3 million tons. Reaching 1.2 mln tons in Q4 2014, corn exports doubled y-o-y. Wheat exports contracted from Q3, mainly because domestic export price was higher than those in the region. Apart from cereal exports, which

¹⁷ 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.

Chart IV.4.4 Exports and imports of goods and services
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
Note: NBS estimate for Q4 2014.

expanded by around EUR 100 mln q-o-q, fruit and vegetable exports were also significant.

Motor vehicle exports climbed by 3.3% s-a on the back of a rebound in production and exports of Fiat Automobiles Serbia, which recorded a continuous growth on a monthly basis in Q4. The company's total exports in 2014 plunged by EUR 150 mln from a year earlier.

On the other hand, some former major export contributors continued their decline in Q4. This primarily concerns chemical industry, whose physical volume of production shrunk considerably in the last three quarters. Pharmaceutical products, electrical equipment and clothing also recorded lower export figures compared to the previous quarter.

Exports of petroleum products shrunk by 14.3% s-a in Q4. However, lower exports value can be correlated with the drop in global oil price, rather than a decrease in exports quantity, given the expansion of physical volume of production and a decrease in inventories in this branch of industry.

Further shrinking of imports of intermediate goods (1.5% s-a) in Q4 was a major factor behind the decline of euro-denominated commodity imports (1.5% s-a). In addition, fiscal consolidation measures continued to weigh down consumer goods imports, which stood at 0.8% s-a in Q4.

¹⁸ For a more detailed analysis of commodity trade in 2014, see Box 2 on p 32.

Chart IV.4.5 External demand and Serbian exports

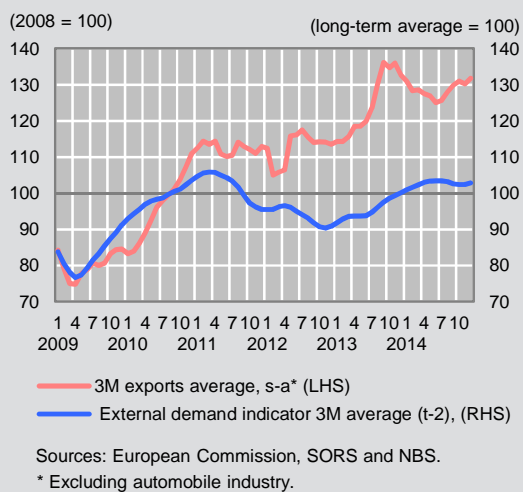
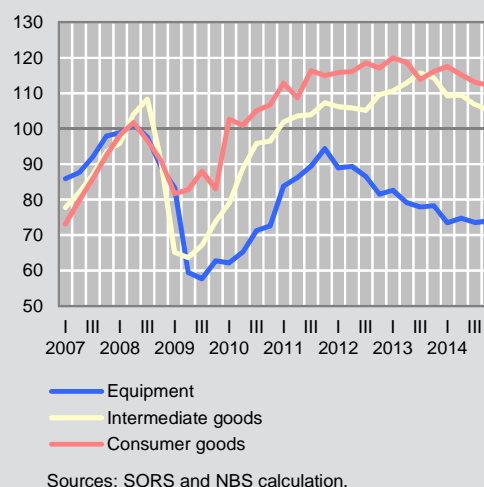


Chart IV.4.6 Imports by key components
(s-a, H1 2008 = 100)

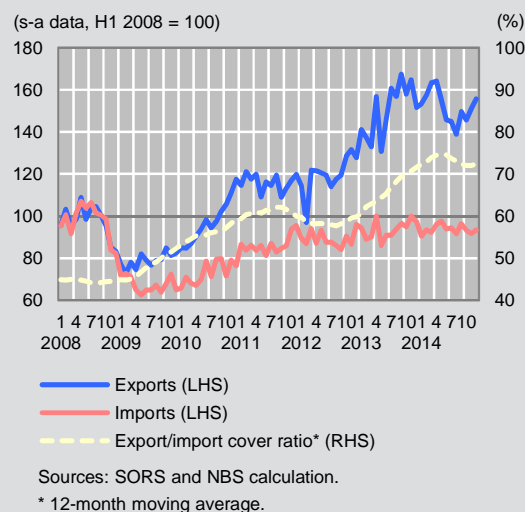


On the other hand, a mild increment in equipment imports (0.6% s-a) is encouraging, signalling possible investment upturn in the period ahead.

Observed by economic destination of the EU, the largest drop in imports in Q4 was recorded for energy (12.0% s-a), chiefly due to the lower value of oil imports following a drop in oil prices in the global market. Furthermore, gradual rehabilitation of production facilities in energy and mining led to reduced imports of electrical energy and coal used for electricity generation. A decline in imports was also recorded for capital goods and durable and non-durable consumer goods. In Q4, only imports of intermediate goods went up.

In December 2014, commodity export/import cover ratio¹⁹ stood at 72.4%, unchanged from September, but gaining some 0.8 pp on end-2013. At end-2014, commodity exports were 55% above and imports 6.5% below their pre-crisis levels²⁰.

Chart IV.4.7 Commodity trade in euros



¹⁹ 12-month moving average.

²⁰ H1 2008.

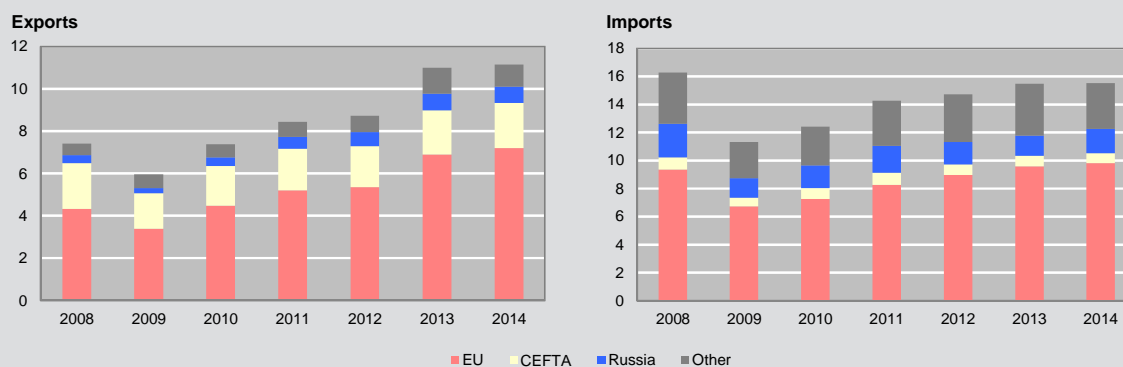
Text box 2: Dynamics and structure of Serbian trade in goods in 2014

Positive trends in Serbia's foreign trade in goods¹ continued into 2014. Still, unlike 2013, when earlier investments in automobile and oil industry reached their full effect on exports, developments in 2014 were largely aggravated by floods, so net exports had a significantly weaker effect on the growth in aggregate demand. Serbia's total exports of goods in 2014 amounted to EUR 11.2 bln, up by EUR 160 mln, y-o-y. The highest increase was recorded in food exports (EUR 210 mln), primarily cereals, followed by a rise in exports of meat and meat products, fruit and vegetables and dairy products, owing to a better agricultural season and increased exports to Russia. Despite the underutilisation of capacities in the Smederevo steel plant, the volume of exports of iron and steel increased when compared to 2013 (by EUR 63 mln), while the value of exports of non-ferrous metals declined, partly due to a drop in their prices in the global market. Dampened activity in domestic chemical industry contributed to the weakening of both imports and exports of chemical products. Positive effects of earlier FDIs into manufacturing industry are reflected in the continued rise in exports of electrical machinery and equipment, tobacco, paper and board packaging, clothes, footwear and textile products.

At EUR 1.5 bln, motor vehicles remained the chief export product of Serbia in 2014. This is, however, down by approximately EUR 100 mln y-o-y, due to difficulties in selling these products in foreign markets amid tough international competition. Imports of automobile parts have also dipped, whereas weak aggregate demand and limited purchasing power contributed negatively to lower imports of automobiles. Even though exports of the leading individual producer, Fiat, decreased, exports of other companies operating in this area, whose production is almost exclusively aimed at foreign markets, keep increasing.

Trends in foreign trade in the energy sector were divergent. On the one hand, May floods caused electricity exports to practically halt in H2, so 2014 saw exports falling by EUR 143 mln from the previous year. For the very same reason, electricity imports increased in H2, as did the imports of coal for generation of electricity. On the other hand, exports of petroleum products increased y-o-y (around EUR 30 mln), while imports decreased notably (by around EUR 100 mln), owing to modernisation of the capacities in oil industry. The slackened activity in chemical and metal processing industries was the main contributor to lower imports of natural gas, but also of inputs for chemical industry. Still, given the significant share of energy in total imports (14.0%), and its much lower share in total exports (3.7%), the foreign trade balance of the energy sector was negative, measuring around EUR 1.8 bln.

Chart O.2.1 **Geographic breakdown of Serbia's trade in goods with foreign trade partners**
(annual amounts in EUR bln)



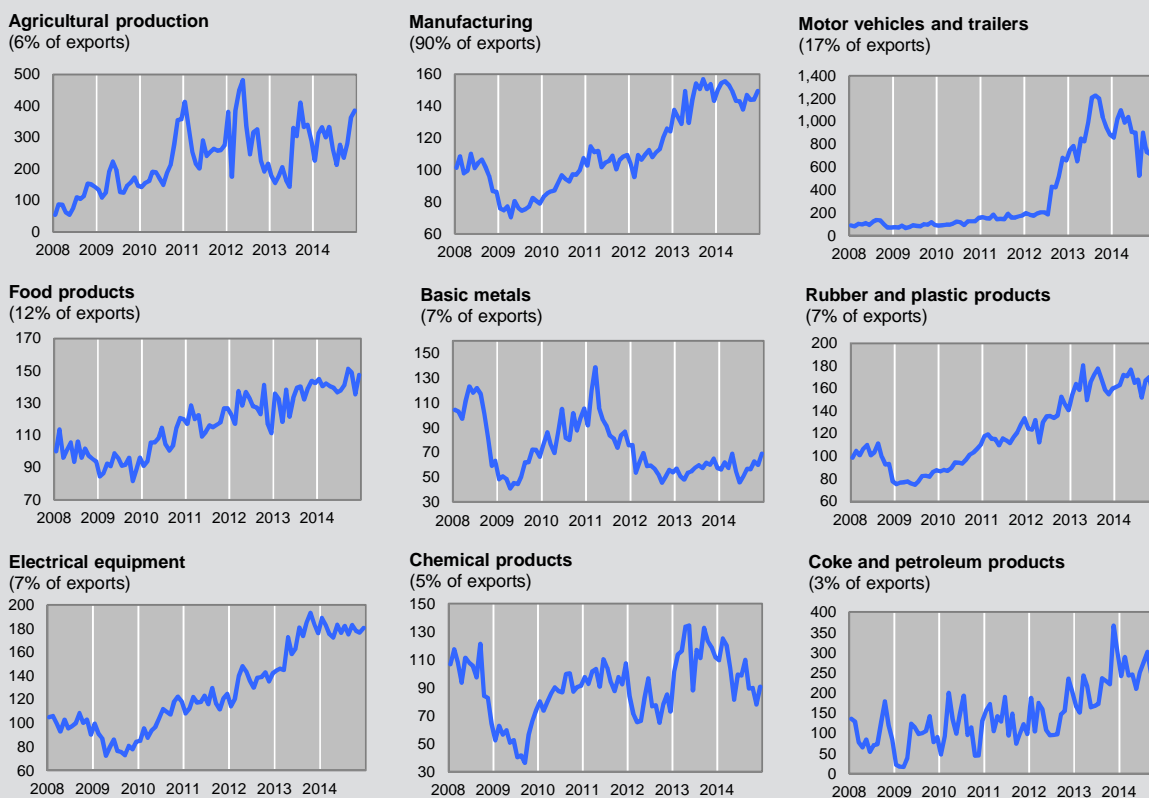
As in the previous years, the EU remained our largest export market, where around 65% of total exports of goods were sold in 2014 (EUR 7.2 bln). On the other hand, the highest proportion of goods was imported from the EU (EUR 9.8 bln), resulting in a negative trade balance in 2014, in the amount of EUR 2.6 bln. Apart from the EU, other

¹ According to the methodology of foreign trade statistics

significant foreign trade partners are CEFTA countries (accounting for around 20% of total exports of goods), with which Serbia has for years been recording a positive balance of trade in goods. In 2014, total exports of goods to these countries stood at EUR 2.1 bln, while imports were around EUR 700 mln, resulting in the surplus in trade in goods of EUR 1.4 bln.

Even though the EU represents our largest foreign trade partner, Serbian exports to Russia have been growing over the last few years, owing to the possibility of duty-free exports of the largest number of products. Russia has been the fourth largest export market for Serbia since 2013. In 2014, our exports to Russia came at EUR 774.5 mln, which is a slowdown in the multiyear upward trend in our exports to this country. Food products accounted for the largest share (28.9%) of Serbian exports to Russia in 2014, which is an increase in share of nearly 13 pp y-o-y. Pork recorded the highest increase in exports, followed by vegetables and fruit, primarily apples, dairy products, namely cheese, and meat products. Food exports rose additionally in the wake of Russia’s decision to impose embargo on imports of food and agricultural products from the EU, the USA, Norway, Canada and Australia. Still, given the size of the Russian market and its demands for food imports², the increase of Serbian exports to the Russian market is marginal. On the other hand, majority of other categories of goods exported to Russia (non-ferrous metals, rubber products, cork and wood products, textile products, furniture, clothes and medicinal and pharmaceutical products) recorded lower exports compared to 2013 which may in part be attributed to the weakening of the ruble in 2014 and the consequent weakening of demand in the Russian market.

Chart O.2.2. Trade in goods by key industries
(s-a indices, 2008 = 100)



Sources: SORS and NBS calculation.

² According to the International Trade Centre data, based on the calculations of the Customs Tax Service of Russia, Russian imports of these products totalled EUR 25.7 bln, of which EUR 8.9 bln from the EU and EUR 1.0 bln from the USA.

Contrary to exports, imports from Russia are much less diversified, since three quarters of Serbian imports from Russia, equalling EUR 1.8 bln in 2014, involved oil and gas. Still, energy dependence of Serbia has been mildly reduced over the last few years, owing to investments in the oil industry, which contributed to increased use of oil from domestic sources. Further on, the completion and launching of the Banatski Dvor UGS facility, boasting the capacity of 450 mln cubic metres, reduced Serbia's exposure to possible disruptions in gas supply, given that at full capacity, gas consumption is secured for around 50 days.

As regards the outlook for Serbian trade in goods, we expect that the trade deficit will continue shrinking on account of further growth in exports of the manufacturing industry (food, oil, electrical equipment and base metal industry), owing to the recovery of our key foreign trade partners and expected increased external competitiveness. Positive effects are also expected from the restoration of flood damages in the energy sector.

In addition, positive contribution to trade in goods and the overall foreign trade balance in the medium term will also come from the effect of the adopted fiscal consolidation measures, through reduced consumption and imports of consumer goods, as well as from the drop in the world price of crude oil which will contribute to a decline in the value of energy imports.

5. Economic activity

Economic activity in 2014 was predominantly affected by the May flooding, which caused most damage to mining and energy sectors, but also by slower than expected recovery of Serbia’s main foreign trade partners. Still, Q4 saw a gradual recovery of industrial production, which greatly contributed to the growth of GDP by 0.5% s-a. Y-o-y decline decelerated (1.6%) due to rising activity in agriculture and information and communications, the recovery of construction and trade, as well as a smaller decline in industrial production.

The process of gradually normalising production in the mining and energy sectors had an effect on the recovery of the overall industry in Q4, which also contributed to the growth of quarterly GDP (0.5% s-a). In addition, construction and most service sectors recorded increased activity. Economic activity measured by NAVA also rose in Q4, to a slightly greater extent, amounting to 0.7% s-a. Compared to the pre-crisis period²¹, GDP and NAVA were 2.2% below their pre-crisis level in Q4.

Judging by the 1.6% s-a increase in the physical volume of industrial production in Q4, it seems that, after four quarters, it has stopped declining. Recovery was recorded for all three sectors of industry. The mining sector, which was heavily affected by the flooding, has seen an increase in physical volume by 4.6% s-a – after the rehabilitation

Table IV.5.1 Annual GDP growth and contributions

	2012		2013		2014*	
	%	pp	%	pp	%	pp
GDP	-1.0	-1.0	2.6	2.6	-1.8	-1.8
Agriculture	-17.3	-1.5	20.9	1.5	1.5	0.1
Industry	5.9	1.1	6.4	1.2	-5.5	-1.1
- Manufacturing	7.7	1.0	5.7	0.8	-1.4	-0.2
- Mining and energy	0.4	0.0	8.8	0.4	-19.0	-0.9
Construction	-9.8	-0.5	-3.9	-0.2	-0.2	0.0
Services	0.4	0.2	0.2	0.1	-1.4	-0.7
Net taxes	-2.2	-0.4	-1.3	-0.2	-1.1	-0.2

Sources: SORS and NBS calculation.

* NBS estimate.

of the coal mine Veliki Crljeni in Q3, production was partially restored in the largest coal mine in the Kolubara basin, Tamnava – Zapadno polje. Higher output in mining led to increased production of electricity, gas, steam and air conditioning supply (7.1% s-a), which was, in addition to the gradual restoration of thermoelectric power plant production, supported by the rehabilitation of the Đerdap 2 hydroelectric power plant after the adverse weather conditions in September.

Physical volume of production in manufacturing rose by 1.2% s-a in Q4, greatly owing to the upturn in production

Chart IV.5.1 Economic activity indicators
(s-a, H1 2008 = 100)

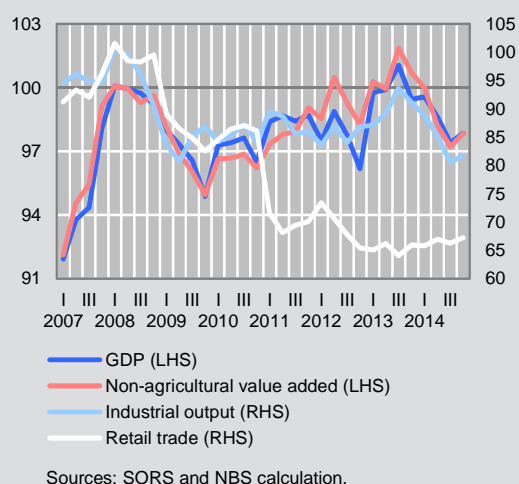
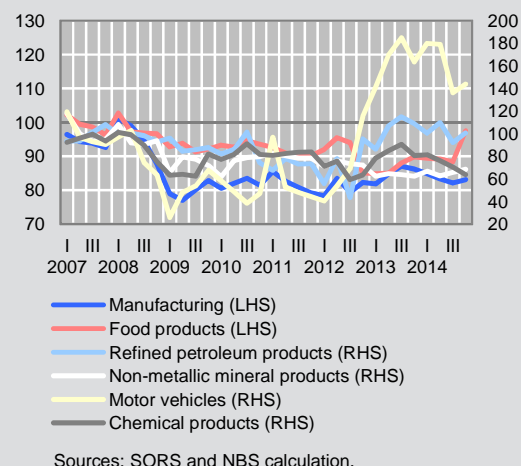


Chart IV.5.2 Physical volume of production by branches of manufacturing industry
(s-a, H1 2008 = 100)



²¹ H1 2008.

of petroleum products. However, the significant improvement in production in this area is partially due to the low base, since production in Pančevo refinery was halted in September because of the planned overhaul. Increased physical volume was also recorded for production of machinery and equipment, while a good agricultural season and exports to the Russian market contributed to the expansion of the physical volume of production in food industry. Mild growth in the production of base metals, construction materials and furniture continued and, after two quarters, recovery was recorded for the automobile industry as well.

Physical volume of production in certain export-oriented branches continued falling, which is indicative of continued low export demand. Production decreased the most in the pharmaceutical industry and the production of computers and computer equipment. For the third consecutive quarter, the physical volume of production in the chemical industry continued shrinking, since the largest enterprises in this area are in the process of restructuring and ownership transformation. Similarly, physical volume of production of electrical equipment, rubber, plastic and clothes continued to contract.

In contrast to indicators in industry which point to a recovery in Q4, the number of building construction permits, which indicates the level of construction activity, continued falling y-o-y in October and November. On the

other hand, production of construction materials continued to expand, which could signal a slight recovery in this area in Q4. Relative to the previous quarter, retail trade turnover inched up by 1.6% s-a.

According to a preliminary assessment of the Serbian Statistical Office, GDP fell by 1.6% y-o-y in Q4, signifying a slowdown from the previous quarter. This contraction is primarily the consequence of the continuing slump in industrial production (8.5% y-o-y), whose movement is still affected by the floods. On the other hand, GDP drop was moderated by an upturn in trade and transport (1.8% y-o-y) and construction (2.1% y-o-y), ongoing growth in agriculture (1.4% y-o-y) and information and communications sectors (3.2% y-o-y).

Physical volume of industrial production shrunk by 8.5% y-o-y in Q4, but the decline has decelerated in all industrial sectors. The most drastic fall of as much as 27.5% y-o-y was recorded for electricity, gas, steam and air conditioning supply, since production capacities which are usually the most active in Q4 have not yet been fully restored. The situation is similar in the mining sector, where physical volume of production went down by 23.8% y-o-y. The physical volume of production in the manufacturing industry edged down by 1.2% y-o-y in Q4.

GDP fall in 2014 is estimated at around 1.8%. Industrial activity contracted the most, as its movement was under

Chart IV.5.3 Physical volume of production in energy and mining
(s-a, H1 2008=100)

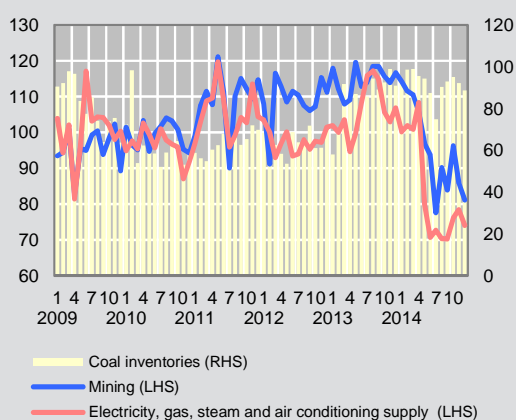
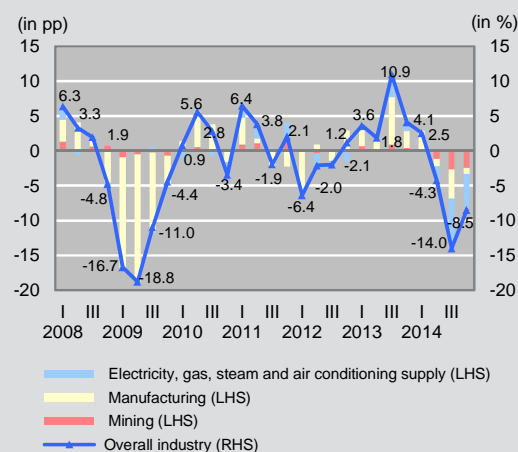


Chart IV.5.4 Contributions to y-o-y growth of the physical volume of industrial production



the heavy influence of the May floods throughout most of the year (-1.1 pp contribution to GDP). On the other hand, positive contribution to GDP in 2014 came from increased activity in transport (0.5 pp), information and communications and agriculture (0.1 pp each).

According to the estimates of the Serbian Statistical Office, the physical volume of agricultural production rose by 1.5% in 2014. This was largely on the back of increased production of most major crops, which also led to a drop in their prices. Owing to lower prices of primary agricultural commodities, livestock breeding costs also declined, creating a positive incentive for increased livestock production. This is confirmed by livestock breeding indicators – higher sales and purchases of livestock and dairy products and meat production in slaughterhouses in the first eleven months of 2014.

Movements of indicators available in the first three quarters were indicative of a slight downturn in construction activity – value of completed construction work dropped by 4.1% y-o-y, while the number of working hours on construction sites shrunk by 6.1% y-o-y.

The most significant positive contribution to GDP in 2014 was provided by increased activity in the transport sector, where the physical volume of services jumped by 22.8% y-o-y in the first three quarters. The key reason behind this was the surge in the physical volume of services in air traffic by 65.5% y-o-y. The growth of physical volume of telecommunications services by 4.9% y-o-y in the first three quarters also points to a positive contribution of the information and communications sector to the movement of GDP. Although retail trade turnover recorded a real growth by 2.6%, falling wholesale turnover led to an overall decline in trade activity in 2014. Continued implementation of fiscal consolidation measures should result in decreased activity in other service sectors, so their contribution to the movements of GDP is expected to be negative across the board (around 0.7 pp).

6. Labour market developments

Real wages in the private sector continued rising during Q4, while the implementation of fiscal consolidation measures contributed to the decline in real wages in the public sector. The recovery of industrial activity and increased productivity helped

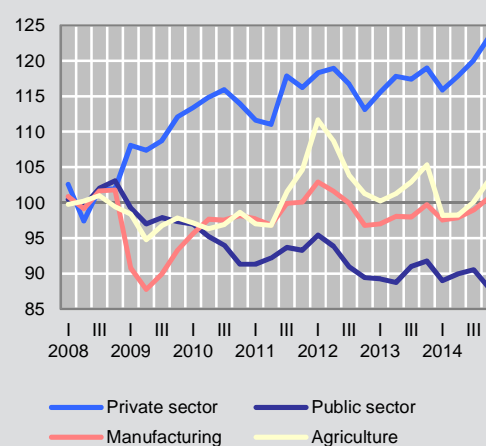
reduce unit labour costs. The labour market conditions kept improving, while unemployment fell further and informal employment rose.

Wages and labour productivity

Real net wage increased in Q4, with wages rising in the private sector (2.7% s-a), and decreasing in the public sector (2.9% s-a) thanks to the implementation of fiscal consolidation measures. As a result, real wages in the private sector continued up on a significantly higher level (23.4%) compared to the pre-crisis period, while public sector wages were 12.1% down from their pre-crisis levels²².

The steepest increase in real wages in Q4 was registered in those industries which recorded an increase in activity – transport, agricultural sector, professional, innovative and technical activities, as well as in the financial sector. The majority of these industries also saw a drop in employment. Industry-wise, the drop in real wages was recorded in mining and energy, while a mild growth in wages was registered in the manufacturing industry. Contrary to the previous quarter, real wages declined in construction and information and communications, while in industries with a large public sector employment share, such as education, healthcare protection and public administration, real wages continued on a downward path.

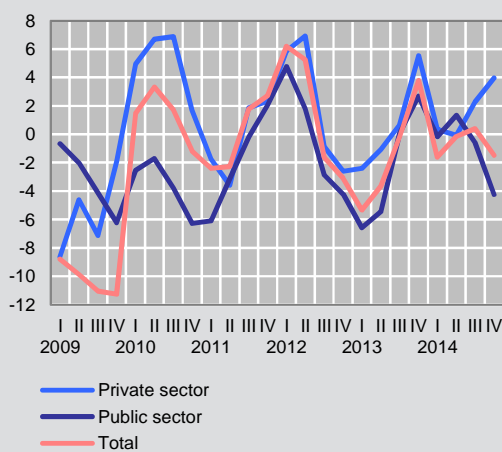
Chart IV.6.1 Real net wages (s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

²² H1 2008.

Chart IV.6.2 Real net wage movements
(y-o-y growth, in %)



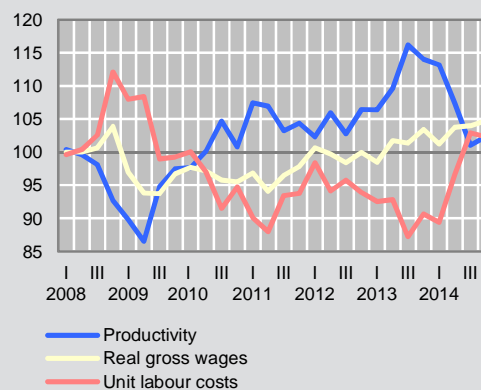
Sources: SORS and NBS calculation.

During Q4, real net wage bill in the private sector rose y-o-y (4.0%), primarily owing to the increase in information and communications. On the other hand, following the November cut in wages of 10%, the public sector recorded a y-o-y drop in the real net wage bill (4.2%).

In Q4, the cut in wages had an impact on a decrease in the real net wage bill (2.8% s-a) in the public sector. However, real wages in the private sector continued growing, and this growth came at 5.0% s-a in Q4. The average nominal take-home wage in Serbia measured RSD 46,359 in Q4, up by 3.2% from Q3, that is, by 0.4% y-o-y.

Consistent with expectations stated in the last report, Q4 witnessed a rise in the industrial labour productivity, owing to the growth in activity, while employment remained relatively unchanged. The increment of productivity exceeded the growth of real gross wages, which **drove unit labours costs down** by 0.6% s-a, and their gradual return to the pre-crisis level. The manufacturing industry, which produces the largest portion of tradable goods, experienced a modest growth in unit labour costs (0.9% s-a), as real wages in manufacturing rose more than in other industrial sectors.

Chart IV.6.3 Movements in productivity, real gross wages and unit labour costs in industry
(s-a, H1 2008 = 100)



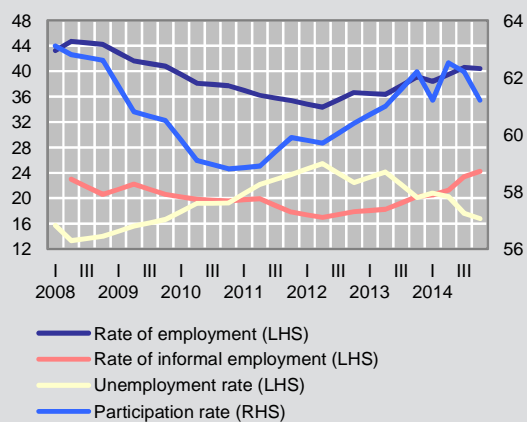
Sources: SORS and NBS calculation.

Employment

Labour Force Survey data show an improvement in the labour market during Q4. The unemployment rate continued declining and came at 16.8%, down by 3.3 pp from the end of 2013. Employment rate practically stagnated in Q4 (decline of 0.2 pp), while coming up by 1.3 pp from the end of 2013. Formal employment kept declining in Q4, whereas informal employment went up. Participation rate in Q4 dipped by 1.0 pp, which can partly be attributed to retirement prior to the adoption of amendments to the Law on Pension and Disability Insurance whereby the retirement age was increased.

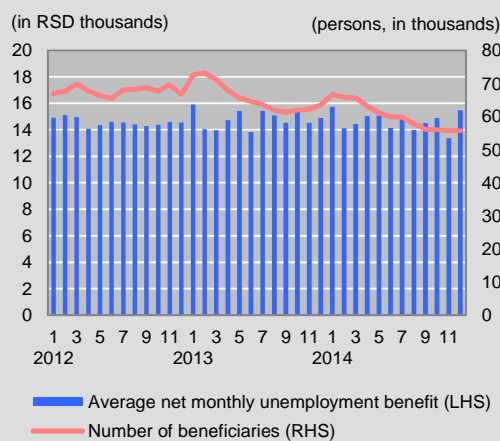
The strongest employment growth in Q4 was registered in the manufacturing industry, which corresponds to the growth in economic activity of this sector during the period observed. Increase in employment was also recorded in other sectors that witnessed growth in activity (construction and agriculture), as well as in arts, entertainment and recreation. On the other hand, the number of employees fell in mining, energy and the majority of the service sectors, and most notably in public administration and administrative activities, which is a consequence of the natural outflow of employees stemming from the ban on new employment.

Chart IV.6.4 Labour market indicators under the Labour Force Survey
(in %)



Source: SORS.

Chart IV.6.5 Average monthly unemployment benefit



Source: National Employment Service.

Increase in the number of part-time workers lasted into Q4, while the number of full-time employed declined. Following a marked fall in Q3, the youth unemployment rate remained almost unchanged in Q4 (41.9%). The share of long-term unemployment in total unemployment recorded a slight decline (0.5 pp), coming at 66.5% in Q4.

According to RAD research²³, the number of employed rose modestly in Q4. At the same time, the number of employed in the private sector went up (1,157 persons), while the reduction in employment in the public sector continued (1,110 persons). Observed by industry, mining witnessed the sharpest increase in employment owing to additional engagement of workers for rehabilitation of coal mines. Employment in trade and education climbed substantially, while manufacturing, construction and information and communications saw a slight rise. On the other hand, the number of employed dipped in the sectors of transport, finance, administrative activities and public administration.

The National Employment Service data show that the number of unemployed continued down for the third quarter, totalling 741,906 persons at the end of 2014. The sharpest fall in the number of unemployed occurred in professions pertaining to industry (mechanical engineering and metal processing, textile and leather

industry, electrical engineering, chemistry and non-metals) and agriculture, while a higher number of unemployed was registered in healthcare, pharmacy and social protection. In Q4, first time job seekers secured employment with fewer obstacles. This is also reflected in the fact that the number of such persons declined by 5,068, according to the labour market data. Also, the number of unemployed with previous job experience dropped by 1,575.

A continuous decline in the number of beneficiaries of the unemployment benefits, lasting since January 2014, continued into Q4. Last year, that number fell by 7,847 persons in total, coming at 55,735 persons in December, thus hitting its lowest level in the last three years. The reduction in the number of these beneficiaries is considered to be a positive development, as funds intended for labour market incentives may now be re-allocated to implementation of measures of active employment policy (self-employment incentives, public construction works, job fairs, training and retraining) which contribute more to higher employment.

Winding up of the privatisation process for enterprises under restructuring could, to a certain extent, increase unemployment this year, after the shutdown of enterprises without the prospect of continuing as a going concern.

²³ RAD researches are conducted twice a year, in March and September, while data referring to other months are calculated based on estimates.

Table IV.6.1 Employment and unemployment trends
(in thousands)

	2014			
	Q1	Q2	Q3	Q4
Formal employment	1,690.4	1,704.3	1,704.9	1,705.0
Farmers (according to LFS)	423.4	449.9	454.2	450.5
Total employment	2,113.9	2,154.1	2,159.1	2,155.5
Total unemployment	790.5	773.4	748.5	741.9
First time job seekers	271.1	264.9	261.4	256.3
Workers with previous job experience	519.4	508.4	487.2	485.6

Sources: SORS and National Employment Service.

Still, adoption of the new Labour Law increases the flexibility of the labour market, creating better employment prospects for workers who could lose their jobs in this way. This particularly relates to changes in regulations addressing calculation of redundancy payments and years of service. These changes reduce costs to employers when engaging workers with more years of service, who, by and large, account for a large share of those employed in enterprises under restructuring.

7. International environment

The growth of the economic activity in the USA continued in Q4, while the growth in the euro area, although higher than in Q3, remained sluggish. Financial sanctions, sharp decline of world oil prices and ruble depreciation dampened the Russian economic activity, whose negative effects could spill over to the euro area and Central and Eastern Europe.

Facing the threat of deflation, the ECB introduced QE programme, while the Fed ended it, announcing that it might start increasing the key interest rate this year. The ECB and the Fed will continue implementing different monetary policies, and this is likely to cause further strengthening of the dollar in the coming period. Such expectations prompted the central bank of Switzerland to lift the cap on the minimum foreign exchange rate of the franc against the euro, thereby sending shock waves across global financial markets.

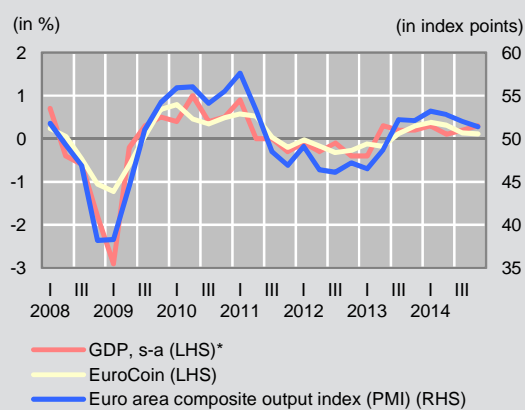
²⁴ Above 50%.

Economic activity

The euro area's GDP continued its mild growth in Q3 (0.2% s-a), primarily owing to growth in household consumption (0.5% s-a). This is an encouraging result, given that the problems facing the euro area economies (high unemployment, deflationary pressures and fiscal consolidation) affect this particular component of GDP the most. Following a drop in Q2, Germany and France recorded GDP growth (0.1% s-a and 0.3% s-a respectively) in Q3, Italy experienced a softer fall (0.2% in Q2 vs. 0.1% s-a in Q3), while Spain saw further relatively strong growth (0.5% s-a).

Based on the movements of leading indicators, GDP is expected to continue its growth in Q4 following the dynamics similar to that recorded in Q3. For the eighteenth month, *PMI Composite* was in the expansion zone²⁴ in December (51.4 points), with better results recorded in the service sectors than in the production sectors. The continuation of expansion is also indicated by the trends of the European Commission's indicator (*Economic Sentiment Indicator – ESI*), which, on average, hovered above its long-term level (100.7 points)²⁵, as well as above the trend of the *EuroCoin*, which ended its five-month decline in December. According to the estimate of *Consensus Forecast*, mild growth of economic activity (0.1% s-a) is expected in

Chart IV.7.1 Movements in GDP and economic activity indicators of the euro area
(quarterly rates)



Sources: Eurostat, Markit Group and Banca d'Italia.

* Preliminary estimate for Q4 2014.

²⁵ 100 points bound represent the long-term average, so the values above this bound indicate the expansion of economic activity.

Germany, France and Italy, while Spain should maintain its growth rate of 0.5% s-a.

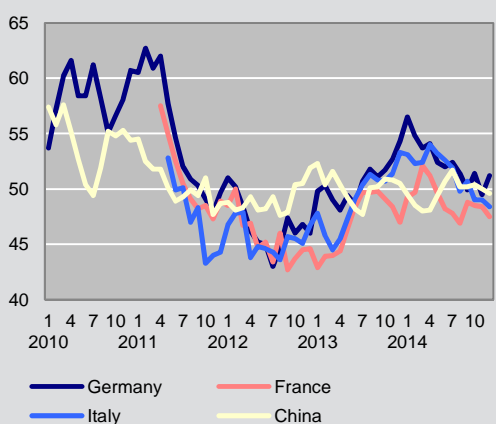
According to the estimates of Consensus Forecast and the IMF, after two consecutive years of fall, the euro area’s GDP recorded growth of 0.8% in 2014, owing to the recovery of household consumption and private investment. The growth is expected to accelerate in 2015 (1.1%), owing to stronger external demand following the recovery in the USA and the UK, the euro depreciation against the dollar and the drop in the world oil prices. Further on, lower oil and other energy prices will lead to an increase in disposable household income and higher consumption. Also, growth in credit activity and investment should be supported by increased confidence in the financial sector, in the wake of published results of the stress-tests and AQRs, and the injection of additional liquidity through the new ECB measures.

Still, the economy could slow down due to the risks regarding the development of the situation in Russia and Ukraine, further developments in Greece, as well as stronger disinflationary pressures. Under such conditions, improvement of the situation in the labour market will decelerate, weighing down the slow recovery in household consumption. Unemployment in the euro area measured 11.4% in December, which is a decline of 0.1 pp from September.

According to the January *Consensus Forecast*, economic growth in **Central and Eastern Europe** measured 1.5% in 2014, up by 0.1 pp from October. The largest growth is expected in the countries of Central Europe (3.0%) which are heavily reliant on the economic recovery of the euro area. South-East European countries are expected to record lower growth (1.4%) due to weak domestic demand caused by high unemployment and low credit activity. In 2014, Turkey recorded slower growth, as negative effects on domestic demand exerted by the depreciation of the lira from the beginning of the year (lower final consumption and credit activity) surpassed the positive effects on net exports.

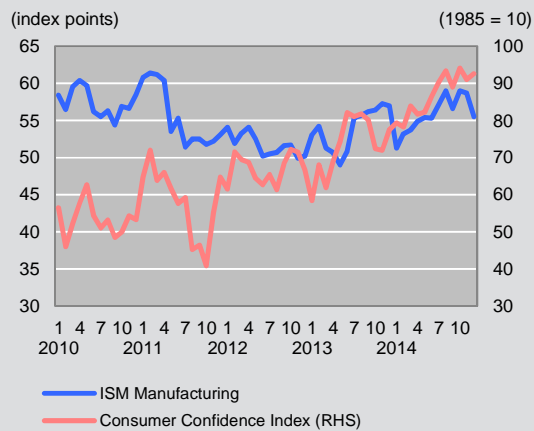
The outlook of growth in Central and Eastern Europe in 2015 was revised down in January (1.2%) by 0.8 pp, compared to October (2.0%) because of persistent uncertainties regarding the Ukraine crisis and the collapse of world oil prices. GDP growth is expected in most countries, while fall is expected in Ukraine and Russia only. The economic situation in Russia is more complex, as the country is facing a number of negative shocks simultaneously. Financial sanctions have restricted international sources of funding for Russian companies and have also brought about difficulties in refinancing of obligations as they fall due. Further on, the capital outflow generated depreciation pressures, which have been additionally built up by the reduced inflow of export

Chart IV.7.2. **PMI Manufacturing for selected countries**
(index points)



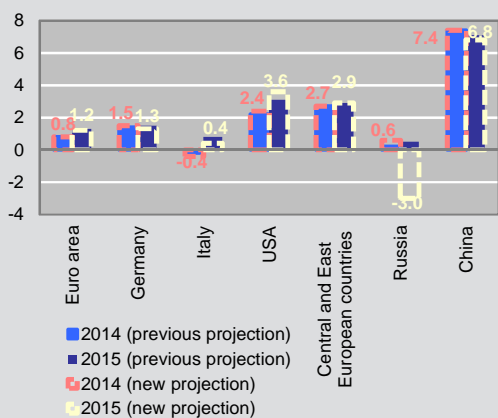
Source: Markit Group.

Chart IV.7.3. **Leading economic indicators in the United States**



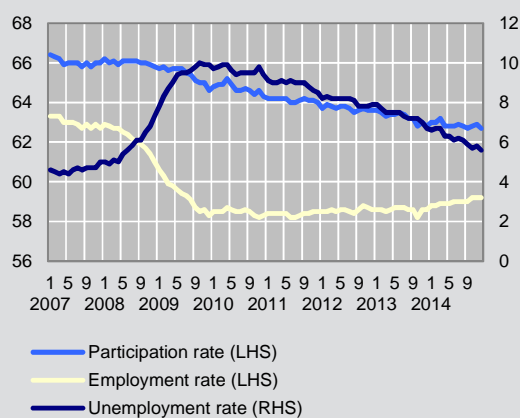
Source: Institute for Supply Management, The Conference Board.

Chart IV.7.4 Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF (%)



Sources: IMF WEO (October 2014) and IMF WEO Update (January 2015).

Chart IV.7.5 US labour market (monthly rates, in %)



Source: Bureau of Labor Statistics.

revenues, following the collapse of oil prices²⁶. Should the oil price remain at its current, low level, GDP is likely to decline significantly in 2015.

GDP growth in the **USA** has accelerated (from 1.15% s-a in Q2 to 1.25% s-a in Q3), which confirms that the US economy is on the course of a steady recovery. Positive contribution of household consumption and private investment to GDP growth lasted into Q3. In contrast to Q2, the positive contribution also came from net exports, owing to an increase in exports and a decrease in imports. The leading indicator of economic activity in the manufacturing sector, *ISM Manufacturing*, reached the level of 55.1% in December, and has been resting in the expansion zone²⁷ since November 2012. In addition, economic expectations have also improved, as measured by the *Consumer Confidence Index*, which continued rising in Q4. According to the preliminary estimate, GDP growth in Q4 (0.7% s-a) is slower than in Q3, thanks to an increase in imports and slackened growth in private investment.

The accelerated economic growth contributed to further improvement of conditions in the labour market. Unemployment declined by an additional 0.3 pp in Q4 and measured 5.6% in December, while non-farm payroll employment rose further to the average of 324,000 per month. According to the January *Consensus Forecast*,

due to the higher-than-expected growth of GDP in Q3, the economic growth outlook in 2014 was revised upward by 0.2 pp to 2.4%, which corresponds to the IMF projection. According to *Consensus Forecast*, GDP growth in 2015 is expected to accelerate to 3.2%, i.e. to 3.6% as suggested by the IMF forecast.

In Q4, **China's** economic growth kept its level from the previous quarter, measuring 7.3% y-o-y. Industrial output increased 7.9% y-o-y in December, which is practically unchanged when compared to 8.0% y-o-y recorded in September, while *PMI Manufacturing* slid below 50 points in December, for the first time since May. At 7.4%, GDP growth in 2014 was below the expected, and is the lowest growth in the last 24 years. According to the latest IMF forecast, growth should additionally drop in 2015, down to 6.8%.

Inflation movements

The long-drawn-out period of extremely low inflation is making the economic recovery of the **euro area** even more difficult. In December, for the first time since 2009, inflation slid into the negative zone (-0.2% y-o-y). As the December drop in prices was largely driven by the collapse of world oil prices, the circumstances in the euro area are not yet classified as a typical deflation, i.e. as a

²⁶ Revenues from exports of oil make up around 50% of the total exports revenues of Russia.

²⁷ Above 50%.

easing. The expanded asset purchase programme, which is to be implemented by the ECB between March 2015 and end-September 2016 at the earliest, will entail monthly purchases of private and government securities in the value of EUR 60.0 bln. In this way, over EUR 1.100 bln will be injected into the system.

Investors' expectations that the ECB will expand its purchases to include government securities has helped move the two-year yield on government securities into the negative zone in many euro area member states. Those expectations also reflected on long-term yields. After falling in August for the first time below 100 bp, the yield on German ten-year bonds recorded new historic lows in Q4, followed by yields on securities of other member states. The exception were yields on Greek ten-year bonds, which rose by 280 bp due to political uncertainties in light of the January parliamentary elections. Surprisingly, yields on US government securities fell as well, although to a lesser extent than in Germany, so the difference in yields still increased and amounted to almost 170 bp at the end of the year.

The majority of central banks in **Central and Eastern Europe** eased their monetary policy or kept it unchanged during Q4. For instance, the central banks of Poland and Romania cut their main refinancing rates by 50 bp and 25 bp, respectively, due to decelerated economic growth and inflation target undershooting. The Romanian central

bank opted for another reduction by 25 bp in January, while the central bank of Turkey trimmed its rate by 50 bp. The Czech Republic and Hungary did not change their policy rates. But Russia did, by as much as 900 bp – to 17%, faced with plummeting global oil prices and the limited access of many Russian companies to the international capital market (because of US and EU sanctions), leading to a staggering fall in the value of the ruble (28.4% relative to USD in Q4). The ruble began growing in strength in mid-December due to interventions in the FX market, but this was only temporary. By end-December it started dropping again, a trend that continued into this year. The central bank of Russia defied expectations at the end of January by lowering its policy rate to 15.0%. Fitch and Standard & Poor's downgraded Russia's credit rating to non-investment grade. It is estimated that Russia might not achieve economic growth by 2017. The reliance of Russian economy on the movements of energy prices is indicated by the fact that energy makes up around 70% of Russian exports and approximately 50% of government budgetary revenues.

Positive movements in the real sector encouraged the Fed to end its quantitative easing in November 2014. Thus, after three rounds of quantitative easing, the Fed increased the balance in its account to a record USD 4,500 bln, from less than USD 1,000 bln in 2007. The Fed will not start selling purchased securities before increasing its

Chart IV.7.7 Policy rates across selected countries
(annual level, in %)

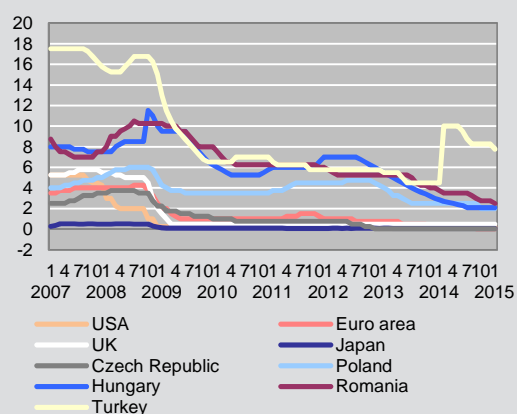
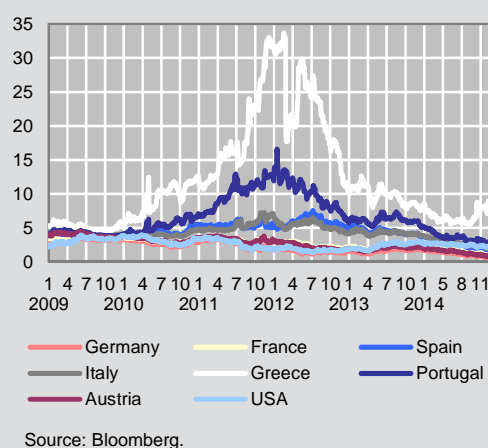


Chart IV.7.8 Yield on 10-year bonds of selected countries
(daily data, in %)



policy rate. In line with the December announcement, it will wait for a few more meetings prior to making the decision to start increasing the policy rate, which will depend on the real sector movements and inflation. Market assessment suggests that this will happen in mid-2015, although it might be postponed, primarily towards the second half of the year due to the oil price collapse.

Financial and commodity markets

The strengthening of the dollar was the main feature of financial market movements in Q4 which greatly determined movements in commodity markets as well. On the other hand, commodity market movements were characterised by the falling price of oil, which reflected on increased financial market instability.

The dollar grew stronger relative to major world currencies due to the diverging monetary policies of the Fed, on the one hand, and of the ECB and the Bank of Japan, on the other. End-of-period, the dollar strengthened against the euro by 4.4% in Q4. Its appreciation accelerated in January (7.2%), owing much to the ECB’s plans for new stimulus measures and to the uncertainty over the outcome of Greek parliamentary elections.

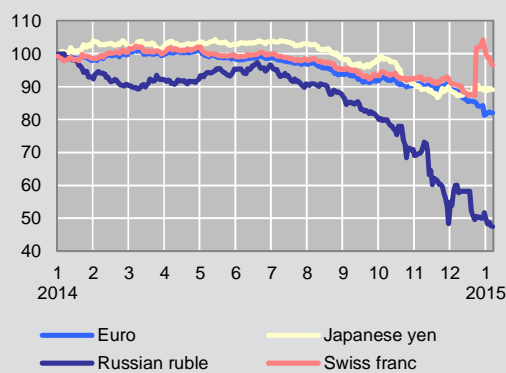
Movements in commodity markets were marked by the continuing slump in oil prices which grew even more

severe than in the previous quarter: relative to September, the average Brent crude oil spot price was 36.0% lower in December and 40.2% at end-of-period.³⁰ It fell below USD 50 per barrel in January this year, reaching its lowest level since 2009. In other words, oil prices were more than halved compared to mid-2014. The decline in oil prices was caused primarily by a significant boost in US oil production from oil shale, the strengthening of the dollar and the unwillingness of OPEC member countries to cut back on production. The unexpected intensity of the price drop is causing strong deflationary pressures in most countries.

Uncertainty over further movements in oil price and its effect on the Russian economy and monetary policies of major central banks as well as over the outcome of Greek elections reflected on increased financial market instability. This was indicated by the VIX, Wall Street’s “fear gauge”, which was higher in Q4 and January 2015 and noticeably more unstable than in the previous period. High uncertainty was also signalled by the EM-VXY index which tracks short-term volatility in emerging market currencies.

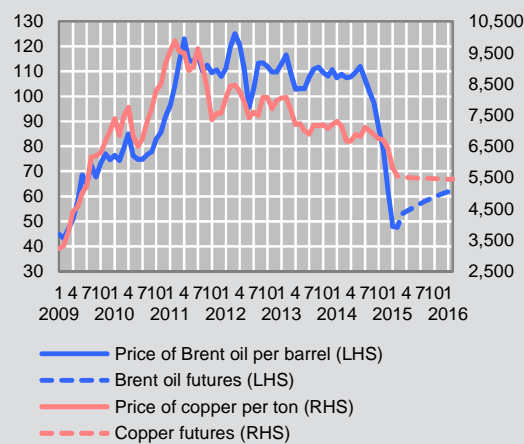
Strengthening of the dollar and increasing signals that the Fed would start raising interest rates this year led to a further fall in the price of gold in early Q4, since this precious metal struggles to compete with higher-yielding assets. However, demand for gold and its price started growing in November, primarily due to increased

Chart IV.7.9 Exchange rates of selected national currencies against the dollar*
(daily data, 31 December 2013 = 100)



Source: NBS.
* Growth indicates appreciation.

Chart IV.7.10 Oil and copper price movements
(average monthly prices, in USD)



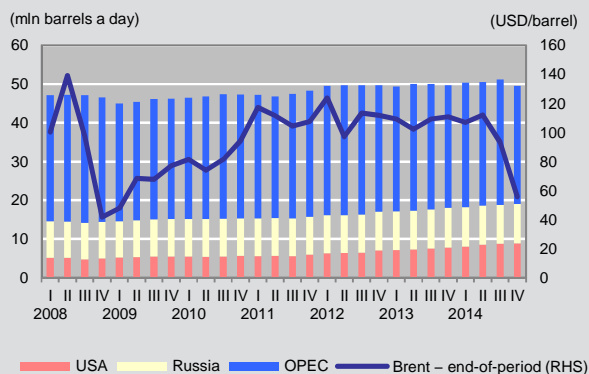
Source: Bloomberg.

³⁰ See Box 3 on page 47.

Text box 3: Macroeconomic effects of falling oil prices, globally and on Serbia

The financial crisis brought about a sharp drop in the price of oil in the global market¹. Following this plunge, the price recovered and was relatively stable from 2011, hovering around USD 110 per barrel. A renewed fall came about in late June 2014, causing prices to fall approximately 55% by late January 2015 (Chart O.3.1). The main reasons for the latest slump in oil prices were structural changes of global supply and demand, as well as the decision of OPEC member countries not to cut back on production. The development of unconventional oil extraction technologies (from oil shale and oil sands) and the production of biofuels in recent years significantly boosted oil supply in the world market. The USA is at the forefront of these technologies – its oil production expanded by about 70% between 2008 and 2014, decreasing the country’s dependence on oil imports. At the same time, anticipation of lower demand against estimates of slowing global economic growth was additionally raised by increasingly efficient oil use and its falling share in total energy consumption. Lower demand meant lower revenues for oil exporting countries, which decided to change their strategy and maintain production levels rather than adjusting supply to prop up prices.

Chart O.3.1 Crude oil production and prices



Sources: US Department of Energy, Bloomberg.

While this is estimated to have a positive impact on global economic growth, individual countries will be affected differently, depending on whether they are net exporters or net importers of oil and on how sustainable these low prices are in the medium term. Declining export revenue and a slowdown of economic activity were detected in net oil-exporting countries, which could negatively influence the sustainability of their public finances. These issues are additionally intensified in those developing economies which are heavily reliant on oil production and exports. On the other hand, in net oil-importing countries, in addition to positively affecting the terms of trade, low oil prices should also lead to lower production costs as well², and incentivise investment and demand. These lower oil prices will also increase real disposable income of households (as less money is allocated in purchase of petroleum products), which should increase private consumption, especially if oil prices are expected to stay low in the long run. Falling oil prices should also reduce inflationary pressures, possibly encouraging central banks to further ease monetary policy and stimulate economic growth.

Since Serbia is a net importer of crude oil and natural gas, lower global prices of these raw materials should positively affect its foreign trade balance. Also, the share of petroleum products in overall production costs is relatively high (10-30%, depending on the sector) and their reduced prices could spur enterprises to invest in projects earlier considered unprofitable. Moreover, higher disposable income of households and the government should moderate short-term negative effects of fiscal consolidation measures on final consumption. However, in the current conditions of high unemployment and substantial household and public debt, it is reasonable to expect that a part of disposable income will be used for saving and repayment of debt. In addition to the effects on economic activity, reduced global oil prices should lead to lower inflation as well – directly, because of cheaper petroleum products and indirectly, because of lower production costs and lower inflation expectations. On the other hand, the disinflationary pressures stemming from lower oil prices will be moderated to the extent excess disposable income is spent on other goods. However, it is quite difficult to predict accurately

¹ From end-June to end-December 2008, the price of Brent crude declined by 70%.

² The fall in oil prices usually leads to a decrease in the price of natural gas, another fuel important for industrial production.

the effects of reduced oil prices on economic activity and inflation, precisely due to many indirect factors whose intensity is hard to assess in advance.

In Serbia, the current decline in oil prices in the world market is expected to have the highest impact on the current account of the balance of payments. Namely, following the modernisation of its oil refineries, Serbia increased the volume of crude oil processing from domestic sources, partially substituted petroleum product imports and began exporting petroleum products to neighbouring countries, positively affecting the current account of the balance of payments. During 2014, local oil industry helped reduce the current account deficit by approximately 0.6 pp of GDP, owing to an increase in petroleum product exports and a drop in crude oil and natural gas imports, with similar foreign trade trends expected in 2015. Despite the rising physical volume of imports brought about by increased processing demands, lower prices of crude oil are expected to reduce the value of imports in euro terms. The value of imports is also expected to drop, as imports of higher-quality petroleum products have been substituted with domestic production, following the modernisation of processing capacities. Shrinking oil prices will reduce the value of petroleum product exports, even though the domestic oil industry investments in the regional sales network have boosted their physical volume. Further on, the value of natural gas imports is likely to go up as the planned quantities for imports rise, driven by the growing needs of the domestic industry.

In order to determine the effect of current oil price trends on the reduction of external imbalance in 2015, a comparison was drawn between 2014 global oil market conditions and the current trends. Apart from global market prices, crude oil prices in Serbia are also significantly influenced by the euro to dollar trend, as euro depreciation against the dollar mitigates the effects of falling dollar prices of oil. To approximate conditions in the domestic oil market, we used data from the energy balance of the Republic of Serbia for 2015, adjusted in accordance with the business plans of NIS (Petroleum Industry of Serbia), while the Consensus Forecast and oil futures prices were used as external assumptions. The average price of Brent crude in 2014 measured USD 98.9 per barrel, and based on the futures trend, our estimate is that it will move around USD 50 per barrel in 2015. The average dollar to euro rate, at 1.32 in 2014, now stands at 1.14. According to the January Consensus Forecast, it will equal 1.16 by end of 2015, so we took 1.15 as our estimate of the average rate. It follows that the current account deficit reduction will come at approximately EUR 491 mln, i.e. around 1.5 pp of GDP. Given that persistent uncertainties in the commodities and financial markets, lasting since mid-2014, may cause significant deviation from the assumptions underlying the projection, we analysed other possible scenarios, using different assumptions for crude oil prices and dollar to euro rate (Table O.3.1). Depending on the assumptions used, the impact on the current account deficit is estimated to be between 1.2 and 1.8 pp of GDP.

Tables O.3.1 Effects of changes in external assumptions on current account deficit in 2015

Crude oil price (USD/barrel)	60	50	40
EUR/USD exchange rate	1,20	1,15	1,10
Exports and imports (in thousands of tonnes)			
Exports of petroleum products	615	615	615
Imports of crude oil	1,956	1,956	1,956
Imports of petroleum products	587	587	587
Imports of natural gas	1,341	1,341	1,341
Exports and imports (increase in EUR mln)			
Exports of petroleum products	-98	-126	-157
Imports of crude oil	-106	-200	-304
Imports of petroleum products	-295	-326	-359
Imports of natural gas	-85	-91	-98
Net exports	388	491	603
Effects on a reduction in current account deficit			
(in pp of GDP)	1,2	1,5	1,8

Sources: Energy balance of the Republic of Serbia for 2015 and NBS estimate.

V. Inflation projection

Y-o-y inflation is expected to return within the target tolerance band around mid-year and to stay within the band thereafter. Such movements in inflation will be driven by the expected adjustment in administered prices, the effects of past depreciation of the dinar and the gradual waning of the disinflationary pressures generated by the primary agricultural commodity prices. Working in the opposite direction will be low aggregate demand, its disinflationary effects reinforced by additional fiscal consolidation measures. The risks to the inflation projection are associated primarily with developments in the international environment, including prices of primary commodities, and with the movement of administered prices at home.

GDP will receive headwinds from additional fiscal consolidation measures and will most probably contract this year again – by around 0.5%. Recovery is expected from 2016 onwards.

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

Consistent with the expectations stated in the November *Report*, y-o-y inflation continued to move below the lower bound of the target tolerance band (2.5%) in Q4 and amounted to 1.7% in December. Q-o-q, inflation fell by 0.6%, driven chiefly by the lower prices of unprocessed food, petroleum products and cigarettes. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has also been undershooting the target tolerance band since August, trended closer to the lower bound of the target and settled at 2.3% y-o-y at end-2014.

The undershooting of the inflation target tolerance band, which marked most of 2014, can be put down primarily to factors with a temporary effect – the unusually small growth in administered prices (1.1% in 2014 as a whole)³¹, the decline in primary commodity prices and the collapse of global oil prices.

Extended period of low inflation and anticipation of weak inflationary pressures in the period ahead have helped stabilise short- and medium-term inflation expectations. One-year ahead inflation expectations of the financial sector and businesses have been within the target band for more than a year now. Two year-ahead inflation expectations of both sectors are also within the target band.

After relative stability in October, the dinar came under depreciation pressures which lasted through most of the period November 2014 – January 2015, reflecting the interplay of global and local factors. The precipitous decline in oil prices and the tightening of sanctions against Russia, which led to the weakening of the Russian ruble, exerted a negative impact on capital inflows and reinforced the pressure on the currencies of emerging markets. At the same time, the demand for foreign exchange in the domestic market gathered traction in Q4,

³¹ Due to the need for gradual removal of price disparities, this growth averaged 10% in the past several years.

fuelled by the buoyed energy imports, news on halting the South Stream project, dividend payments to parent companies abroad and net foreign debt repayment by corporates and banks, but supply did not follow along. The NBS intervened in the IFEM by selling at the time EUR 765.0 mln net.

Based on our estimates, consolidated budget deficit (including “below-the-line“ transactions) in 2014 came at 6.6% of GDP. Of this amount, 3.0 pp related to interest payments. The measures already taken, such as the cut in pensions and public sector wages, and the expected rightsizing of the public sector should pave the way for a smaller deficit this year – a deficit below 6.0% of GDP.

According to NBS estimates, GDP gained 0.5% s-a in Q4, i.e. slowed its decline to 1.6% y-o-y. This, on the one hand, came as a result of faster growth in exports than in imports, and on the other, as a result of stagnating domestic demand – the fall in household consumption and investment was offset by higher government consumption. In terms of production performance, the largest positive contribution to GDP came from the sector of industry. Even though the economic downturn in 2014 was primarily due to the damage inflicted on the sectors of energy and mining by the May flooding, industrial production recorded a recovery in Q4, reflecting not only

a pick-up in activity of the manufacturing industry, but also a rise in production of these two sectors.

The negative output gap³² is still wide. Its size indicates that the disinflationary pressures generated by aggregate demand will remain strong in the medium term. In the short term, these pressures will be strengthened further by the implementation of fiscal consolidation measures.

Based on PMI Composite³³ and Economic Sentiment Indicator, after a mild pick-up in Q3, economic activity of the euro area continued to grow in Q4 at a similar pace. Sluggish recovery of the euro area and the risk of a protracted period of low inflation led the ECB to extend in January its asset purchase programme launched in Q4 so as to include sovereign securities of the bloc's member states. The Fed, by contrast, ended its QE in November, encouraged by positive developments in the real sector, and is likely to start raising its interest rate in the course of this year.

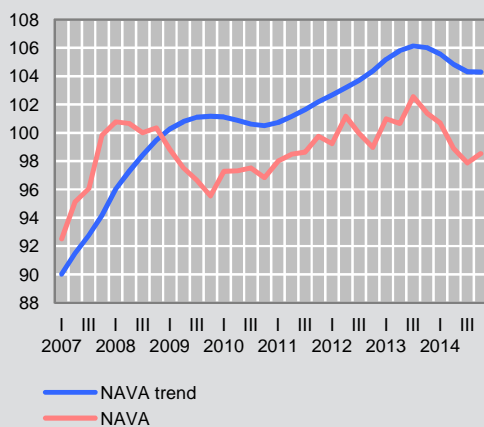
Inflation projection assumptions

External assumptions

The assumption for the euro area's GDP growth in 2015 has been revised slightly down from the November projection – to 1.1%, while the assumption for 2016 stands at 1.6%.³⁴ To achieve these growth rates, domestic demand in the euro area should be supported by additional monetary policy measures, improvement in financial conditions, progress in the implementation of fiscal consolidation and structural reforms, and significantly lower energy prices, which would have a positive effect on real disposable income. At the same time, the euro area is faced with high unemployment, considerable unutilised capacities and the need for balance sheet adjustment in public and private sectors alike.

For the first time since 2009, the euro area inflation entered the negative territory in December (-0.2% y-o-y), led mainly by the plummeting global oil prices. Inflation expectations also dropped and are, based on the majority of indicators, at their record lows. Still, given the unconventional measures taken by the ECB and the additional measures announced, we expect moderate price growth in the euro area in 2015 and 2016. Consistent with the announcements of ECB officials, the

Chart V.0.1 Output gap
(Q3 2008 = 100)



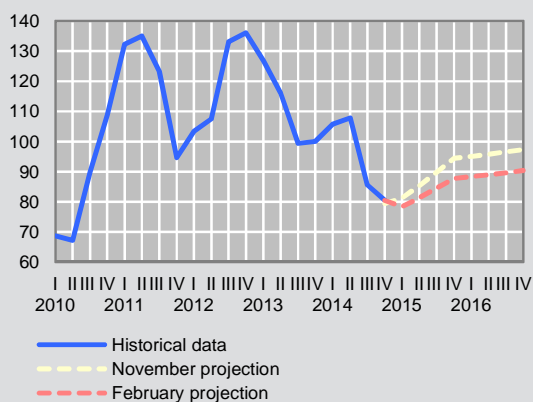
Sources: SORS and NBS calculation.

³² 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 potential output.

³³ In December, this indicator was in the zone of expansion (above 50 points) for the eighteenth month in a row.

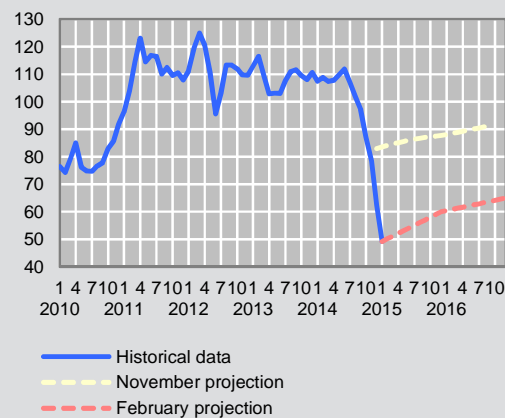
³⁴ The assumption for the euro area's GDP growth in 2015 and 2016 is consistent with the latest Consensus Forecast.

Chart V.0.2 Assumption for international prices of primary agricultural commodities (Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.3 Assumption for Brent oil prices (USD/barrel)



Sources: Bloomberg and NBS.

markets expect no change in the ECB’s main refinancing rate in the coming twelve months either (Consensus Forecast).

As suggested by the current commodity futures, after last year’s slump, primary commodity prices are likely to rise somewhat in the coming period.

Following a steep fall from mid-May to October, international prices of primary agricultural commodities³⁵ recorded growth in the last two months of 2014. We expect this growth to continue in 2015. However, consistent with the movement in futures and the strengthening of the dollar, this growth (around 10%) is assumed to be considerably lower than in the November projection. Despite the growth, these prices are bound to stay at a relatively low level compared to the years before. No major increase is expected in 2016 either.

Given their current movements, the assumption for oil prices³⁶ has been revised significantly down relative to the November projection. That is to say, oil prices are expected to end this year slightly above their current level and to rise moderately in 2016. This assumption is in line with the movement in oil futures.

Table V.0.1 Projection assumptions

(changes relative to the previous projection are given in brackets)

	2015	2016		
External assumptions				
EU inflation (Q4 to Q4)	0.5%	(-0.5)	13%	(-)
ECB policy rate (year-end)	0.05%	(-)	0.05%	(-)
Euro area GDP growth	1.1%	(-0.1)	16%	(-)
International prices of primary agricult. commodities (Q4 to Q4)*	10.0%	(-9.0)	3.0%	(-)
Brent oil price per barrel (year-end, USD)	60.0	(-28)	65.0	(-)
Internal assumptions				
Administered prices (Dec to Dec)	7.0%	(-3.4)	7.0%	(-)
Trends				
Appreciation trend of the real exchange rate (average)	15%	(-0.1)	16%	(-)
Real interest rate trend (average)	2.9%	(-0.1)	2.8%	(-)

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

³⁵ Measured by the composite index which comprises dollar prices of wheat, corn and soybean in the benchmark commodity markets.

³⁶ Brent oil.

Internal assumptions

Consistent with the expected movements in international prices of primary agricultural commodities, the projection assumes their local counterparts will also go up this year (though somewhat more than the international prices due to the dinar's recent losses against the dollar) and rise moderately in the next year as well.

After extremely weak growth in 2014, administered prices are projected to rise this year by around 7.0%. Due to the collapse of global oil prices which are an important element in determining the level of some administered prices in Serbia (prices of utilities, public transportation, and in part of natural gas), this rise is now weaker than anticipated earlier. An important factor for the realisation of the assumed administered price growth is the announced adjustment of electricity prices which are projected to go up by 15% in Q2 this year. In light of the need to continue with the removal of price disparities, we expect the administered price growth in 2016 will be faster than that of other prices, reaching again around 7%.

Another assumption underlying the projection is the appreciation trend of the real exchange rate typical for transition countries and conditioned by the removal of price disparities, mainly in the area of administered prices. This trend is slightly slower than in the November projection because of the smaller-than-anticipated administered price growth and slow convergence of income levels in Serbia to those in the euro area.

We have also assumed, consistent with the announcements from the Government, continued fiscal consolidation in the coming period that will put public finance on a sustainable footing and stabilise public debt by 2017 and then send it on a downward path. The projection also envisages that a new arrangement will be agreed with the IMF.

Projection

Inflation projection

Under the central projection, y-o-y inflation will return within the target tolerance band ($4.0 \pm 1.5\%$) around mid-year. It will trend closer to the target by December and

then continue to revolve around the target until the end of the projection horizon.

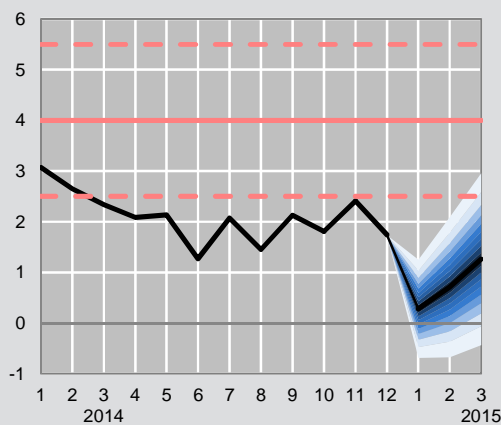
Short-term inflation projection

Under the short-term inflation projection, i.e. projection for Q1 2015, y-o-y inflation will continue to move below the lower bound of the target tolerance band. Because of the high last year's base resulting from the increase in the VAT rate, y-o-y inflation is likely to hit its new 50-year low in January. For the first time ever, administered prices will record a y-o-y fall.

At quarterly level, consumer prices are expected to increase in Q1, led primarily by the seasonally-induced rise in fruit and vegetable prices. This expectation is also supported by the available market data. On the other hand, the on-going slump in global oil prices is bound to reflect on the domestic prices of petroleum products (though less strongly due to the dinar's weakening vis-à-vis the dollar).

Y-o-y core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been moving below the lower bound of the target tolerance band since August, is expected to return within the target band in Q1. Looking at Q1 alone, core inflation growth will be smaller than in the previous quarter. A positive contribution is expected

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



Source: NBS.

from the pass-through effect of the dinar’s depreciation in Q4.

Medium-term inflation projection

Inflation’s return towards the target in 2015 will be driven primarily by administered and non-food prices, and in the second half of the year by food prices as well (excluding fruit and vegetable prices).

Given that the increase in electricity prices is envisaged to take place in April, it may reasonably be expected that the y-o-y growth in administered prices will accelerate from that month onwards. And though their contribution to inflation in 2015 (around 1.5 pp) is expected to be smaller than in the previous years, administered prices are likely to be the main driving force behind inflation growth.

Another important contributor to the inflation’s rise towards the target will be the non-food prices, whose movements are also affected by the exchange rate of the dinar. Though the short-term effect of the exchange rate pass-through to prices is significantly weaker than before, past depreciation of the dinar is expected to give some impetus to the non-food inflation growth. This effect may work its way through higher prices of imported products and non-food products with high import content. Still, the intensity of the exchange rate pass-through will depend on the importers/producers’ ability to command higher prices against the backdrop of depressed domestic demand. An alternative solution, for those who can afford it, would be to lower their margins. The pressure on import prices in Serbia is likely to be additionally constrained by the very low inflation abroad, especially in the euro area which is our key trade partner.

Within food prices, two different trends are expected in the coming period. The y-o-y growth in fruit and vegetable prices should step up in H1 and slow down in H2, while other food prices should be moving in just the opposite direction. Namely, fruit and vegetable prices are expected to lose pace once the new agricultural season kicks in, given that their robust growth last year was triggered by one-off factors such as the low base in 2013 and the May flooding. As regards other food prices, their movement is to a large degree linked to the movement in prices of primary agricultural commodities as key inputs

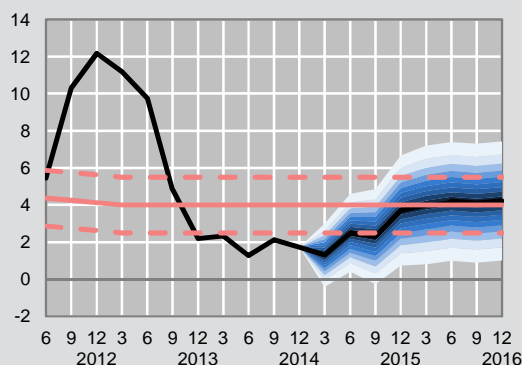
in the production of food. The costs in food production remain low, but with the expected further growth in primary agricultural commodity prices, a rise in food inflation on this account also appears likely. This rise is expected in H2.

Low domestic demand continues to be the main disinflationary factor in the medium term. Its effect will be reinforced by the fiscal consolidation measures that will weigh down on government and household consumption. The disinflationary effect of domestic demand could be moderated to a degree by the increase in external demand if the euro area continues to recover, as well as if the depreciation of the dinar leads to improved price competitiveness of our exports.

The risks to the projected inflation path are associated primarily with developments in the international environment, including prices of primary commodities, and with the movement of administered prices at home.

The international environment is plagued by uncertainties over the evolution of the geopolitical situation, the pace of recovery of the euro area and the effects of divergent monetary policies of the world’s major central banks

Chart V.0.5 Inflation projection
(y-o-y, in %)



Source: NBS.

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%.

(notably the Fed and the ECB) on the financial markets of emerging economies.

At this point, it is impossible to be sure in which direction the effects from the international environment will work. The current geopolitical tensions and the normalisation of the Fed's monetary policy could result in more volatile capital flows to emerging market economies, Serbia included. An increase in investor risk aversion in the global financial markets would probably dampen capital inflows, push up the country risk premium and consequently, put pressures on domestic prices. A factor that could work in the opposite direction is the most recent ECB's decision to embark on a large-scale quantitative easing programme. Moreover, if despite monetary stimulus from the ECB, the euro area recovery turns out to be slower than expected (e.g. because of the possible further tightening of geopolitical tensions), Serbia's negative output gap could widen still further, leading to stronger disinflationary pressures from aggregate demand.

The projection assumes that the prices of primary commodities (oil and primary agricultural commodities) will rise to some degree. Still, deviations from this assumption are possible in either direction and would no doubt steer inflation away from the projected path.

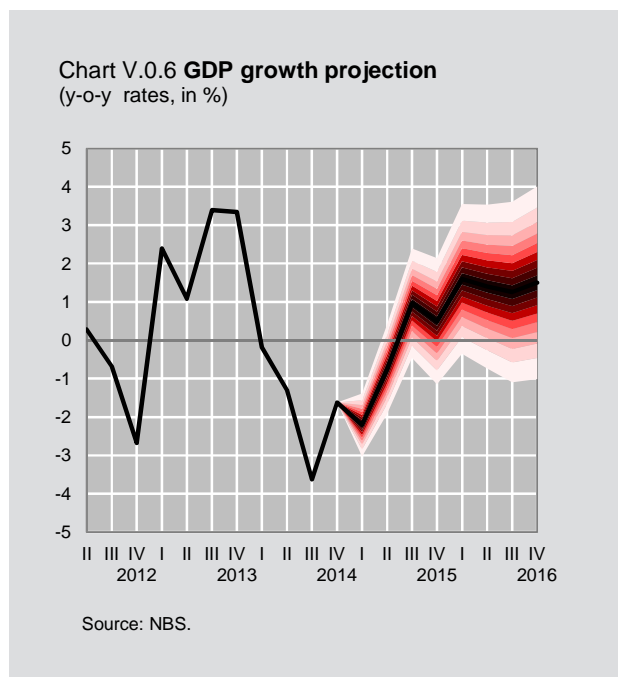
The same goes for administered prices as the lack of a transparent mechanism and schedule of administered price revisions makes the first- and second-round (through impact on other prices) effects of these revisions on inflation less predictable.

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

Looking ahead, monetary policy easing will depend primarily on the assessment of the potential impact of developments in the international environment on capital flows and Serbia's risk premium, as well as on the movement in international and domestic prices of primary commodities and their effect on other prices. Additional fiscal consolidation measures, both taken and announced, have lessened the balance of internal risks.

GDP projection

Fiscal consolidation is most likely to cause a mild fall in GDP this year (around 0.5%), but as the negative effects of fiscal consolidation on GDP are, as a rule, short-term,



the recovery of economic activity is expected from 2016 onwards.

On the expenditure side, GDP fall in 2015 will be attributable to smaller final government and household consumption tamped down by continuing fiscal consolidation. Still, consistent implementation of fiscal consolidation measures and structural reforms should help increase investments and net exports. As a result, investments and net exports are expected to provide a positive contribution to this year's GDP. The positive contribution of net exports will also stem from the expected stronger recovery of external demand in the coming period, and in part, from the fall in imports amid reduced final consumption.

On the production side, weaker final consumption is expected to mute activity, notably in the services sectors which are set to be the strongest negative contributors to this year's GDP. Negative contribution will probably come from manufacturing as well, given the languid recovery of the euro area. However, assuming full normalisation of production in the sectors of mining and energy around mid-2015 – after significant flood damages last year – the contribution of overall industry should be positive. We also expect the construction industry to record growth for the first time in three years.

The recovery of economic activity in 2016 should be led by investments. Positive contributions are also expected

from net exports and the recovery of household consumption. As the budget deficit reduction is expected to proceed, government consumption is poised for yet another yearly fall.

The risks to GDP projection are associated mainly with the pace of economic recovery of the euro area, i.e. Serbia’s key foreign trade partner. Even though the sustained low level of oil prices and unconventional ECB measures could help accelerate the euro area’s recovery, this acceleration could be completely annulled by the tightening of the current geopolitical tensions. As regards internal factors, risks are associated with a potentially higher-than-estimated negative short-term impact of fiscal consolidation and structural reforms on GDP. To be more precise, if the pace and intensity of fiscal consolidation and structural reforms turn out slower and weaker than initially announced, the country’s risk premium and the depreciation pressures will probably rise, causing indirectly a sharper real fall in domestic consumption, while in the opposite scenario, GDP will be affected through a greater direct negative effect on domestic demand. At the same time, the possibility that the implementation of fiscal consolidation measures and structural reforms will result in a faster-than-expected economic recovery cannot be excluded either. And here, we are referring primarily to the potential positive short-term effects of resumed production at the Smederevo steel plant and the on-going privatisation and bankruptcy proceedings.

Table V.0.2 Projections of key macroeconomic indicators for Serbia

	2015		2016	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	3.4	-	4.0	-
European Commission	3.5	3.2	4.4	4.3
Consensus Forecast	4.6	3.1	-	4.0
GDP (%)				
IMF	10	-	15	-
European Commission	0.0	-0.3	1.1	1.2
Consensus Forecast	15	0.1	-	1.8
Current account deficit (% of GDP)				
IMF	5.1	-	4.1	-
European Commission	4.8	5.3	4.7	5.4
Consensus Forecast*	4.9	5.7	-	5.4

Sources: IMF WEO (October 2014), European Commission (Autumn forecast 2014 and Winter forecast 2015) and Consensus Forecast (October 2014 and January 2015).

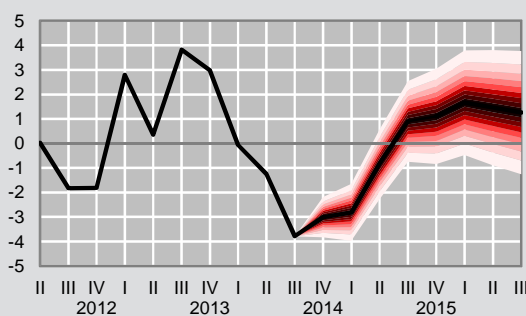
* Calculated based on the NBS projection of dollar GDP in November 2014 and January 2015.

Comparison of projections and their outcome

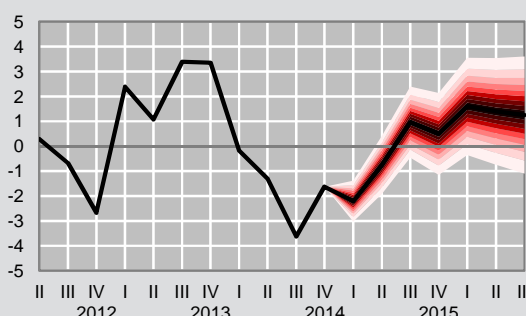
Our new inflation projection has not been changed from the projection published in the November *Report*. Inflation outturn in Q4 is in line with the expectations

Chart V.0.7 Current vs. previous GDP growth projection

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



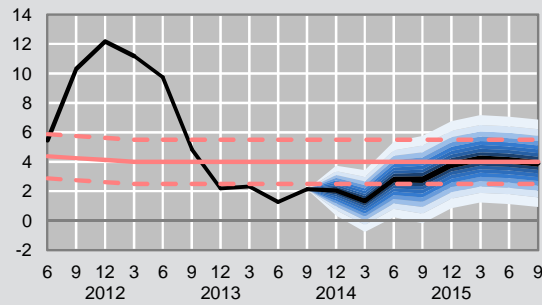
February projection
(y-o-y rates, in %)



Source: NBS.

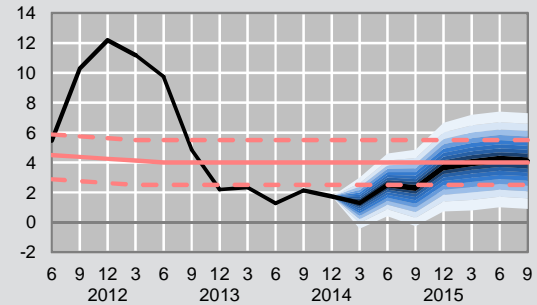
Chart V.0.8 Current vs. previous inflation projection

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



Source: NBS.

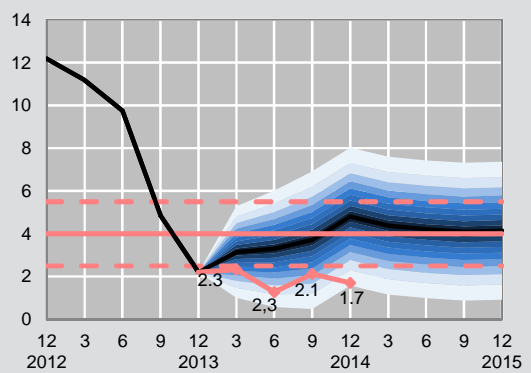
February projection
(y-o-y rates, in %)



stated in November and the assessment of the intensity of inflation factors in the period ahead is also the same as assumed in the previous *Report*.

During the last year, y-o-y inflation was moving below the central projection from the February 2014 *Inflation Report*. Inflation deviated from the central projection mainly under the impact of a smaller-than-anticipated increase in administered prices (1.4 pp lesser contribution to inflation) and a sharp fall in prices of oil and primary agricultural commodities.

Chart V.0.9 Achievement of February 2014 inflation projection
(y-o-y rates, in %)



Source: NBS.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014
EXTERNAL LIQUIDITY INDICATORS (in %)													
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.5	7.0	6.7	7.2	6.6 ²⁾
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	193.0	299.6	242.6	289.8	278.1	283.2	312.4	29.8
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	30.6	30.0	32.5	29.8
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.5	13.1	13.4	12.7	13.6	10.6	17.5
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.4	37.5	36.2	32.9	30.3	30.2	24.0	41.1
EXTERNAL SOLVENCY INDICATORS (in %)													
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.2	75.2	74.9	78.9	78.3
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.4	12.0	14.2	11.3	11.0	10.6	10.4	
External debt/exports of goods and services	234.9	205.7	214.2	219.1	277.0	246.9	216.4	223.0	184.5	177.9	172.5	182.5	180.2
FINANCIAL RISK EXPOSURE INDICATORS (in %)													
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	335.3	293.1	310.8	278.0
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	192.8	191.8	199.8	195.7
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP													
	70.8	77.4	80.2	82.6	69.0	79.8	82.7	89.9	92.7	97.4	98.9	99.3	96.1 ²⁾
MEMORANDUM (in EUR million)													
GDP (in EUR million) ¹⁾	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	7,644	8,317	8,401	8,869
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,764	25,650	25,310	26,361	26,030
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,178	4,159	4,591	1,001	1,105	902	1,553
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	10,428	10,125	10,878	9,907
Short-term debt ³⁾	951	968	1,044	1,832	1,843	1,752	601	455	197	141	155	129	110
Current account balance	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,640	-2,092	-540	-496	-508	-557 ²⁾
CREDIT RATING (change of rating and outlook)													
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014			
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan			
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB-/stable		BB	BB- /stable	BB- /negative				
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+			
Moody's											B1/stable		

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during 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 (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to London Club creditors) to exports of goods and services during period under review.

External debt/GDP (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.

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

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

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

¹⁾ According to ESA 2010.

²⁾ NBS estimate.

³⁾ At original maturity.

Notes:

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

2. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM 6. Data for 2005 and 2006 are shown according to BPM 5.

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

4. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 455.0 mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 859.6 mln, of which EUR 382.0 mln relates to domestic banks and EUR 477.6 mln to domestic enterprises).

5. External debt repayment does not include: short-term debt repayment and advance debt repayment.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014
Real GDP growth (in %) ¹⁾	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-0.2	-1.3	-3.6	-1.6
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	2.2	2.3	1.3	2.1	1.7
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	10,428	10,125	10,878	9,907
Exports (in EUR million) ³⁾	5,329	6,948	8,114	9,577	8,041	9,521	11,147	11,498	13,963	3,305	3,654	3,709	3,783 ⁶⁾
- growth rate in % compared to a year earlier	19.1	30.4	-	18.0	-16.0	18.4	17.1	3.2	21.4	16.0	7.3	-5.5	0,0 ⁶⁾
Imports (in EUR million) ³⁾	9,612	11,970	15,503	18,267	13,098	14,243	16,497	16,993	17,796	4,139	4,576	4,640	4,741 ⁶⁾
- growth rate in % compared to a year earlier	0.7	24.5	-	17.8	-28.3	8.7	15.8	3.0	4.7	3.3	4.6	1.5	-2.1 ⁶⁾
Current account balance ³⁾ (in EUR million)	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,640	-2,092	-497	-543	-369	-557 ⁶⁾
as % of GDP	-8.4	-9.6	-18.1	-21.2	-5.8	-7.0	-9.9	-11.5	-6.1	-6.5	-6.5	-4.4	-6.3 ⁶⁾
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	20.8	20.3	17.6	16.8
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	361.4	388.7	381.4	385.7
RS budget deficit/surplus (in % of GDP)	0.5	-1.7	-1.6	-1.9	-3.1	-3.3	-3.9	-5.4	-4.5	-8.1	-4.7	-2.4	-3.4
Consolidated fiscal result (in % of GDP) ⁴⁾	1.1	-1.4	-1.9	-2.7	-4.3	-4.7	-4.8	-7.1	-5.5	-7.7	-5.7	-3.8	-9.1
RS public debt, (external + internal, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	60.8	61.6	67.9	70.9
RSD/USD exchange rate (average, in the period)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	84.47	84.30	88.53	96.29
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	83.89	84.85	93.62	99.46
RSD/EUR exchange rate (average, in the period)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	115.75	115.58	117.37	120.31
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	115.38	115.79	118.85	120.96
MEMORANDUM:													
GDP (in EUR million) ⁵⁾	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	7,644	8,317	8,401	8,869

¹⁾ At constant prices of previous year.

²⁾ Retail prices until 2006.

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

⁴⁾ As of 2008 includes below-the-line items (incl. payment of called guarantees and bank recapitalisations), in line with IMF methodology.

⁵⁾ According to ESA 2010.

⁶⁾ NBS preliminary data

Notes:

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

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Executive Board meetings and changes in the key policy rate

2014

Date	Key policy rate (p.a, in %)	Change (in basis points)
16 January	9.50	0
13 February	9.50	0
6 March	9.50	0
17 April	9.50	0
8 May	9.00	-50
12 June	8.50	-50
10 July	8.50	0
7 August	8.50	0
11 September	8.50	0
16 October	8.50	0
13 November	8.00	-50
11 December	8.00	0

2015

Date	Key policy rate (p.a, in %)	Change (in basis points)
15 January	8.00	0
12 February	8.00	0
12 March		
9 April		
11 May		
11 June		
9 July		
13 August		
10 September		
15 October		
12 November		
10 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 December 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 8%.

In making the decision, the Executive Board was guided by the fact that y-o-y inflation is still moving below the lower bound of the target tolerance band. However, while dented aggregate demand and low inflation in the international environment generate disinflationary pressures in the long run, the falling prices of primary agricultural commodities and unadjusted administered prices have a temporary disinflationary effect and have made the strongest influence on the movement of inflation below the lower bound of the target ($4\pm 1.5\%$).

The Executive Board judges that the monetary policy measures undertaken so far, gradual waning of disinflationary effects of low food production costs, and the expected administered price adjustment will contribute to inflation's return within the target band by mid-2015.

Furthermore, the Executive Board is aware of persistent uncertainties coming from the international environment associated with the impact of geopolitical factors, monetary policy moves of the world's leading economies, as well as the pace of economic recovery of our major trade partners.

The Executive Board expects that fiscal consolidation envisaged by the 2015 budget will mitigate the negative impact of risks emanating from the international environment and have a positive bearing on the country's risk premium, which will all contribute to keeping inflation low and stable.

The next rate-setting meeting of the Executive Board is scheduled for 15 January 2015.

Press release from Executive Board meeting held on 15 January 2015

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 8 percent.

In making this decision, the Executive Board was guided by the fact that y-o-y inflation continues to move below the lower bound of the target tolerance band, reflecting largely the factors with a temporary disinflationary effect, such as low prices of primary agricultural commodities, a sharp fall in oil prices and weak administered price growth. Y-o-y core inflation, which measured 2.3% last December, approached the lower bound of the target tolerance band, attesting to the short-term disinflationary effect of the said factors.

In the Executive Board's best collective judgement, inflation will return within the target tolerance band ($4\pm 1.5\%$) around mid-year as a result of past monetary policy measures, gradual weakening of the disinflationary effect of low food production costs and the anticipated adjustment of administered prices. Depressed domestic demand and low euro area inflation will help keep domestic inflation low and stable in the medium run.

The Executive Board stated that the risks from the international environment, which have heightened investor risk aversion to emerging markets, persist and that international capital flows in the coming period will depend on the character of monetary policies pursued by the leading central banks, notably the Fed and the ECB, as well as on geopolitical events.

The Executive Board concurred that the implementation of fiscal consolidation measures and structural reforms in Serbia, on the other hand, will contribute to the reduction of internal and external imbalances and lesser sensitivity to developments in the international environment, as well as to maintaining the country's macroeconomic stability.

The next rate-setting meeting will be held on 12 February.

Press release from Executive Board meeting held on 12 February 2015

At its meeting today, the Executive Board decided to keep the key policy rate at 8 percent.

The Executive Board asserted that y-o-y inflation continues to move below the lower bound of the target tolerance band, which is mainly due to factors with a temporary disinflationary effect such as the unexpectedly small growth in administered prices, the collapse of oil prices and low prices of primary agricultural commodities. Also, the Executive Board acknowledged the on-going geopolitical tensions and volatility in the international commodity and financial markets, which may result in increased investors' risk aversion, slower capital flows and a more uncertain effect of monetary policy measures of advanced economies, notably those of the ECB, on the economic recovery of our key trade partners.

The Executive Board concluded that the adverse effects of floods are gradually wearing off, as indicated by the recovery of economic activity, notably in the industry and construction sectors.

The factors determining the Board's decision to keep the key policy rate unchanged will be discussed at the presentation of the February Inflation Report, adopted by the Executive Board at its meeting today.

The next rate-setting meeting will take place on 12 March.

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