National Bank of Serbia

2017

February

INFLATION REPORT

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Introductory note

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

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

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

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

The February *Inflation Report* was considered and adopted by the NBS Executive Board at its meeting of 14 February 2017.

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

ABBREVIATIONS

bln – billion
bp – basis point
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
EU – European Union
FAO – UN Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
FOMC – Federal Open Market Committee
GDP – gross domestic product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NPLs – non-performing loans
OFO – other financial organisation
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
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Inflationary pressures remained subdued in the last quarter of 2016. Looking at domestic factors, the key contributors to weak inflationary pressures were the effects of fiscal consolidation, relative stability of the exchange rate and low inflation expectations of the financial and corporate sectors. While global oil prices regained some ground, encouraging a modest inflation rise in the euro area, the impact of prices from the international environment stayed relatively weak. Quarter-on-quarter, price growth of 0.5% was determined by an increase in prices of electricity and petroleum products, a seasonal rise in prices of travel packages, clothes and footwear and, on the other hand, by lower prices of unprocessed food. Consistent with our expectations stated in the November *Report*, year-on-year inflation rose in the fourth quarter as a result of the low base effect and the above increase in prices of electricity and petroleum products, equalling 1.6% in December.

In the fourth quarter, year-on-year inflation moved in line with the expectations stated in the November Report and equalled 1.6% in December.

In the period since the November *Report*, euro area growth prospects for this year improved, which should have a positive impact on Serbia. On the demand side, better economic prospects are also supported by a gradual recovery of the labour market and, on the supply side, by the still relatively low energy prices and low lending rates amid continuing monetary expansion of the European Central Bank. As the Federal Reserve decided to continue the policy normalisation in December, while the European Central Bank decided to extend its quantitative easing programme until end-2017, monetary policies of leading central banks diverged further, adding to the uncertainty regarding their possible impact on global capital flows. Uncertainty in the international commodity market was associated with movements in oil prices which rose after leading global producers reached agreement on production caps.

In the period since the November Report, developments in the international environment were marked by more favourable growth prospects of the euro area and most of our other significant foreign trade partners in 2017, a rise in global prices of oil and increasingly diverging monetary policies of leading central banks.

In the period since the November *Report*, the Executive Board kept the key policy rate on hold at 4.0%, in consideration of the inflation outlook, the effects of past monetary easing and the lowering of the inflation target

The Executive Board cut the key policy rate in July and kept it on hold in the coming months.

to 3.0 ± 1.5% as of 2017. Additionally, uncertainty in the international commodity and financial markets, mostly regarding movements in global oil prices and the pace of Federal Reserve's policy normalisation, mandated caution in the conduct of monetary policy in the period under review. It was assessed that better macroeconomic prospects at home, supported by the implementation of fiscal consolidation and structural reforms and the narrowing of external imbalances, together with economic growth driven mostly by investment and exports, would be the key factor to mitigate the risks from the international environment.

Though foreign investor sentiment with regard to portfolio investment in emerging economies wavered in the fourth quarter, the dinar remained relatively stable against the euro.

The sentiment with regard to portfolio investment in emerging economies improved at the start of the fourth quarter, but subsided as it became increasingly probable that the pace of Federal Reserve's policy rate hikes would be faster than expected. This reflected on foreign investors' behaviour in the market of dinar government securities and in the domestic foreign exchange market. Still, the exchange rate of the dinar was relatively stable due to a further narrowing of external and internal imbalances, positive assessment of Serbia's performance under the stand-by arrangement with the International Monetary Fund and the country's raised credit rating outlook. A contribution to exchange rate stability was also provided by the National Bank of Serbia through both foreign exchange purchase and sale interventions in order to prevent excessive short-term volatility of the exchange rate.

Interest rates on new loans to the private sector subsided further in the fourth quarter.

Past monetary easing, low euro area interest rates, further narrowing of internal and external imbalances and increased interbank competition led to a further fall in rates on new loans to corporates and households (by 0.5 percentage points each) in December relative to September. As a result of the above factors and the acceleration in economic activity, lending activity increased to 1.9% year-on-year in December (according to preliminary data, exchange rate effect excluded). Additionally, the share of non-performing loans in total loans dropped to its lowest level (17.0%) since January 2011, as banks intensified their efforts to resolve the issue of non-performing loans.

The planned structural fiscal adjustment of around 4% of GDP and the reduction of the share of public debt in GDP were achieved in 2016, a year earlier than planned, thanks to the results of fiscal consolidation.

The three-year objectives under the fiscal consolidation programme relating to the volume of structural adjustment of the fiscal deficit and the share of public debt in GDP were achieved in 2016, a year earlier than planned. The key contribution to the substantial narrowing of fiscal imbalances came from austerity measures on the expenditure side of the budget, but a notable contribution in 2016 also came from rising

income, mostly as a result of improved tax collection and accelerated economic growth. The consolidated budget deficit in 2016 measured 1.4% of GDP, well below the quantitative criterion of 2.1% of GDP set for the sixth review of the arrangement with the International Monetary Fund. At the same time, interest expenses excluded, a surplus of 1.8% of GDP was recorded at general government level. As a result of strong fiscal efforts, the share of public debt in GDP decreased in 2016, and is expected to trend further down in the coming years.

External imbalances narrowed further, with current account deficit fully covered by the net inflow of foreign direct investment.

As exports of goods and services grew much faster than imports in 2016, the deficit in the trade of goods and services was 21% down from a year earlier and the current account deficit narrowed by around 13%. Thanks to an improved business environment and structural reforms, net inflow of foreign direct investment in 2016 of close to EUR 1.9 billion (5.4% of GDP) exceeded its 2015 level and, for the second year in a row, was more than sufficient to cover the current account deficit.

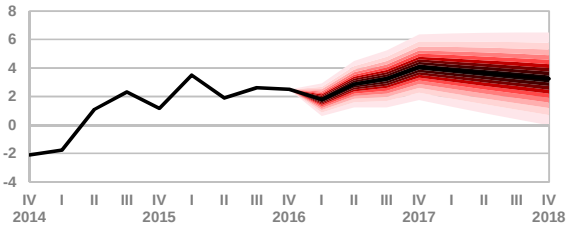
Consistent with our expectations stated in the November Report, gross domestic product is estimated to have increased by 2.7% in 2016 due to a positive contribution of all production sectors and the majority of service sectors.

According to our estimate, gross domestic product increased by 2.5% in the fourth quarter of 2016. As a result, Serbia's gross domestic product growth in 2016 measured 2.7%. Besides agriculture, the key positive contribution came from the manufacturing industry which had been recording growth for an extended period of time supported by the activation of earlier investments and the rise in domestic and external demand. Construction and the majority of service sectors also gave a positive contribution. Based on our estimate, GDP growth was driven by investment and exports on the expenditure side. Household consumption also provided a positive contribution, mostly thanks to an improved labour market situation.

Economic activity should accelerate to around 3.0% this year and around 3.5% in 2018.

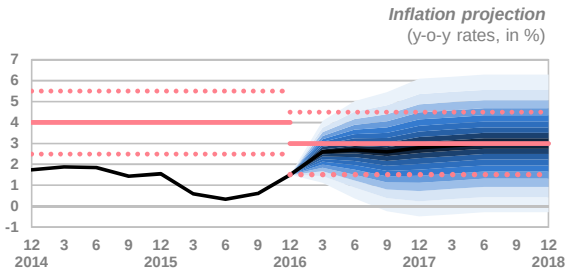
According to our estimate, economic growth will accelerate to 3.0% this and 3.5% next year. On the expenditure side, GDP growth in the period ahead will continue to be led primarily by investment and exports based on continued effective implementation of infrastructural projects and an improved investment ambience. A positive, gradually rising contribution is also expected from final consumption. This will be supported by the anticipated rise in employment and private sector wages and, to a degree, also by the increase in public sector wages and pensions.

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



According to our latest projection, year-on-year inflation will move within the target tolerance band (3.0% ± 1.5 percentage points) from the start of 2017.

Year-on-year inflation should enter the target tolerance band in early 2017 (3.0 ± 1.5%) and remain relatively stable therein until the end of the projection horizon, i.e.



end-2018. Such inflation movements will reflect primarily the low base effect from fruit and vegetable prices, gradual increase in domestic aggregate demand and inflation abroad (notably the euro area), while low costs of inputs in food production, and the high base for petroleum product prices from March onwards, will continue to hold inflation back for a period of time. The risks to the projected inflation path are symmetric, mostly associated with future developments in international commodity and financial markets and, to a certain degree, with administered price growth at home.

The new inflation projection is slightly higher, due primarily to the upward revision of assumptions regarding global oil price movements in late 2016 and 2017.

The new inflation projection for 2017 is slightly higher than the one published in the November *Report*, particularly with regard to the first quarter. Like in other countries, this is due to the fact that global oil price growth in late 2016 turned out faster, and the assumptions for 2017 growth higher, than assumed in November.

The monetary policy stance in the period ahead will continue to depend primarily on developments in the international environment.

Looking ahead, monetary policy decisions of the National Bank of Serbia will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, notably those coming from the international environment. Accordingly, the National Bank of Serbia will continue to closely monitor and assess movements in the domestic market and in the international environment, including both the international financial market and the market of primary commodities. As before, the National Bank of Serbia will use all available instruments to make sure inflation remains low and stable over the medium term which, together with the preservation of financial stability, will contribute to sustainable economic growth.

II. Monetary policy since the November *Report*

Since the November Inflation Report, the NBS Executive Board has kept the key policy rate (4%) on hold, in consideration of the inflation outlook, the effects of past monetary easing and the lowering of the inflation target to 3.0 ± 1.5% as of early 2017. As assessed by the Executive Board, inflation will stay low and stable, moving within the target band as of early 2017, on account of the recovery of global oil prices, rising demand at home and higher inflation abroad. On the other hand, relatively low costs in food production are likely to produce disinflationary effects for some time yet.

Monetary policy caution in the period observed was mandated by uncertainties in the international commodity and financial markets, most notably in terms of global oil price movements and the pace of normalisation of the Fed's monetary policy. As originally assessed by the Executive Board, risks from the international environment would be mitigated not only by the ECB's monetary accommodation, but primarily by better macroeconomic prospects of our economy (reflecting the results of fiscal consolidation and structural reforms), the narrowing in external imbalances and growth led by investment and exports.

Since the November *Report*, monetary policy decisions were made in consideration of the new inflation target of 3.0%±1.5 pp as of 2017. The decision on target revision was adopted jointly with the Government in light of the achieved and maintained price stability over the past three years, significant improvement in Serbia's macroeconomic fundamentals and prospects, and the fact that corporate and financial sector inflation expectations were anchored to levels close to the new target.

The decisions on monetary policy in the period observed were based on the November inflation projection, which was somewhat lower than the previous (August) one, notably after the downward revision of assumed movements in global prices of primary agricultural products and lower than expected administered price growth. As envisaged by the November projection, inflation was to stay low and stable, moving within the new target band as of early 2017, until the end of the projection horizon. The risks to the inflation projection pertained primarily to future movements in the global commodity and financial markets, including, to an extent, administered price growth in 2017. In regard to economic activity, owing to an excellent agricultural season, November saw a new upward revision of the GDP growth rate for 2016 – to 2.7% (it stayed unchanged for 2017 at 3.0%).

In light of such inflation and GDP projections and new information on developments at home and abroad, the NBS Executive Board did not change the key policy rate (4.0%) since November. Relying on the February inflation projection, it did not change the rate in February either. Its decisions to keep the degree of monetary accommodation were based on expected movements in inflation and its key factors, the effects of past monetary policy easing and the downward revision of the inflation target as of 2017.

The Executive Board was of the opinion that inflation would remain low and stable, and move within the new target band as of early 2017, reflecting a gradual rise in global oil prices following the announcements and subsequent agreement of the leading world producers to limit production, which, given the low base effect for petroleum product prices, was likely to fuel a steady rise in y-o-y inflation in the period ahead. The Executive Board also expected that elevated domestic demand and the gradual recovery of inflation abroad, notably in the euro area (our most important foreign trade partner)

would have the same effect. On the other hand, it was also assumed that relatively low food production costs would continue to generate disinflationary pressures for some time yet.

Monetary policy caution in the period observed was mandated also by uncertainties in the international commodity and financial markets, notably in view of movements in global prices of oil and other primary commodities. Also, it is generally difficult to predict global liquidity and capital flows in an environment of diverging monetary policies of the two leading central banks – the Fed and ECB. Moreover, given the announced economic policy measures, notably fiscal incentives, including moderate upward revisions of the expected growth of the US economy and inflation, we may anticipate faster than expected normalisation of the Fed's monetary policy. Still, the pace of normalisation of the Fed's monetary policy remains uncertain, particularly as the expected strengthening of the dollar, through its impact on inflation and economic activity, could slow down the pace of policy rate hikes by the Fed.

In contrast, the ECB will pursue accommodative monetary policy given that the quantitative easing programme will be in place at least until late 2017, mitigating the negative effects of normalisation of the Fed's monetary policy. The ECB's decisions are particularly important for Serbia given its much stronger financial and trade links to euro area countries. Long-term, even more important for mitigation of external risks are structural improvements and the narrowing in internal and external imbalances that Serbia has attained. As assessed by the Executive Board, the results achieved, along with economic growth led largely by investments and exports, contributed to better macroeconomic prospects of our economy and its greater resilience to potential adverse impacts from the international environment.

III. Inflation movements

Low inflationary pressures continued into Q4 2016. Y-o-y inflation rose from 0.6% in September to 1.6% in December reflecting the low base effect and higher prices of electricity and petroleum products. The domestic factors lying at the core of subdued inflationary pressures came as a result of fiscal consolidation, relative stability of the exchange rate and low financial and corporate sector expectations. Despite partial recovery in global oil prices, which fuelled a moderate rise in euro area inflation, the impact of prices from the international environment remains relatively weak.

At the quarter level, the 0.5% price growth was led by higher prices of electricity and petroleum products and the seasonal rise in prices of travel packages, clothes and footwear. Unprocessed food prices worked in the opposite direction.

Inflation movements in Q4

Consistent with expectations from the November *Report*, inflationary pressures remained low in Q4. Y-o-y inflation rose to 1.5% in October and stayed around that level in the following two months. It arrived at 1.6% in December, with a negative contribution provided by fruit and vegetable prices, and the strongest positive contribution by non-food products and services and administered prices. Prices of petroleum products were a positive contributor to headline inflation in December, on account of the low base and rising global oil prices in Q4.

At the quarter level, consumer prices added 0.5% in Q4, somewhat less than expected in November, mainly owing to unprocessed food prices, i.e. a larger than expected drop in fruit and fresh meat prices and a smaller than seasonal increase in vegetable prices.

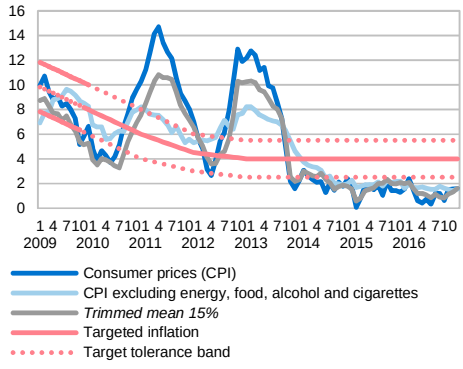
The impact of food prices on quarterly inflation remained negative in Q4 (contributing -0.3 pp to inflation), reflecting a drop in unprocessed food prices (3.0%). Within **unprocessed food**, the main negative contribution came from prices of fresh fruit (down by 22.4%, contribution: -0.45 pp) and fresh meat (down by 4.7%, contribution: -0.2 pp). An 8.2% rise in fresh vegetable prices (contribution: 0.3 pp) worked in the opposite direction. At the same time, **processed food** prices stagnated in Q4.

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

	Share in CPI	2016			
		I	II	III	IV
Consumer prices (CPI)	100.0	0.4	0.5	0.2	0.5
Unprocessed food	11.6	5.5	-0.6	-2.1	-3.0
Processed food	20.5	0.9	-0.3	0.4	0.0
Industrial products excluding food and energy	28.7	-0.2	0.5	1.0	0.6
Energy	15.5	-1.4	1.7	0.2	2.8
Services	23.7	-0.5	1.1	0.2	0.8
Core inflation indicators					
CPI excluding energy	84.5	0.7	0.3	0.2	0.0
CPI excluding energy and unprocessed food	72.9	0.0	0.5	0.6	0.5
CPI excluding energy, food, alcohol and cigarettes	45.1	-0.4	0.9	0.3	0.8
Administered prices	18.7	0.1	-0.4	1.4	1.1

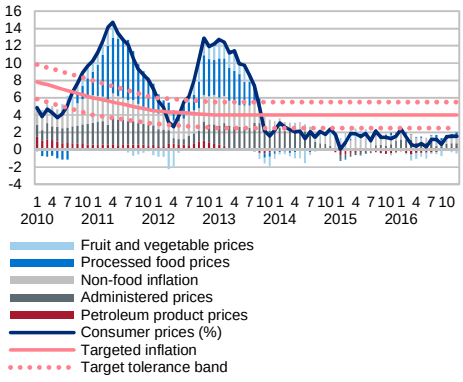
Sources: SORS and NBS calculation.

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



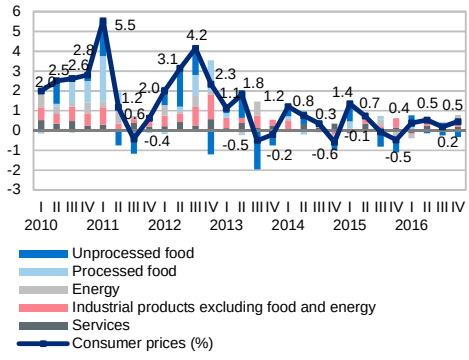
Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

Energy provided the strongest positive contribution to inflation (0.4 pp). Price growth in this group (2.8%) was led by the electricity price hike in October (3.8%, contribution: 0.2 pp) and higher prices of petroleum products. Owing to the low base and rising global oil prices (exceeding USD 55 per barrel late last year), **petroleum product** prices in the domestic market also went up in Q4 (2.8%, contribution: 0.1 pp). A positive impulse also came from prices of firewood and coal for heating, which normally record growth during the winter season.

Services prices posted moderate growth in Q4 (0.8%, contribution: 0.2 pp), with the seasonal rise in travel package prices as the main positive contributor (14.3%, contribution: 0.15 pp). A rise in prices of vehicle maintenance and repair services, also impacted, albeit to a lesser extent, the growth in prices of this group.

Prices of industrial products excluding food and energy rose by 0.6% in Q4 (contribution: 0.2 pp), led mainly by the seasonal increase in clothes and footwear prices (2.4%, contribution: 0.1 pp).

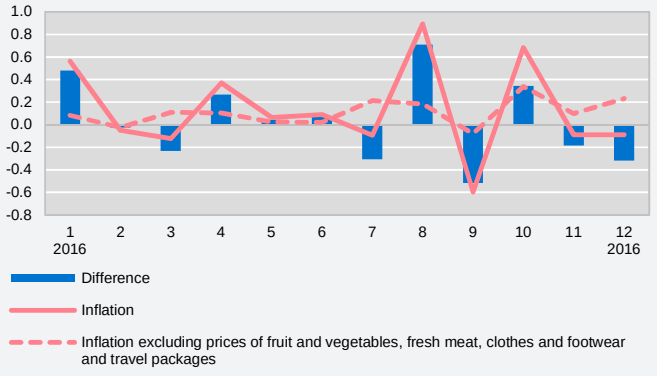
Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) rose to 0.8% in Q4, reflecting mainly the seasonal rise in prices of travel packages, clothes and footwear. Y-o-y, core inflation moved around 1.5% in Q4, where it ended 2016.

Administered prices grew by 1.1% (contribution: 0.2 pp) in Q4, almost fully on account of the electricity price hike in October. Still, y-o-y administered price growth came at 2.2% at end-Q4, much like in late Q3 (contribution: 0.4 pp). Though the increase in electricity prices was factored into the October calculation of y-o-y inflation, the December 2015 rise in cigarette prices dropped out from the December calculation.

Text box 1: Impact of seasonal factors on inflation in Serbia

Seasonal factors play an important role in explaining inflation movements during a year. Prices of some products and services included in the consumer basket display seasonal volatility – they rise or fall almost each year in the same months. A typical example are fruit and vegetable prices, as well as prices of fresh meat, clothes and footwear and travel packages, which make up 15.5% of the consumer basket for CPI calculation in Serbia. Knowing the seasonal trends of these prices is important as the assessment of strength of inflationary or deflationary pressures in an economy could otherwise be flawed.

Chart O.1.1 **Headline inflation and inflation excluding components with seasonal volatility in 2016**
(monthly rates, in %)



Sources: SORS and NBS calculation.

Fruit and vegetable prices are usually on the rise from January to May, when the supply is comparatively smaller, only to decline in H2, with the approaching of a new agricultural season. At the same time, the behaviour of fruit and vegetable prices differs. For instance, vegetable prices start to decline in June, i.e. one month earlier than fruit prices, and rise from September to November. On the other hand, fruit prices decline from July to December, primarily due to a new agricultural season, but also due to imports of comparatively cheaper tropical fruit.[1] In general, fruit and vegetable prices display high monthly volatility, exceeding at times even 10%. However, average monthly price changes during a year are much smaller, and have particularly diminished over the past four years, equalling 0.2% for fruit and 0.3% for vegetables. This is the result, among other things, of the liberalisation of imports and increasing production in greenhouses, which ensures greater supply throughout the year and mitigates the seasonal effect.

Chart O.1.2 **Average monthly changes in prices of products and services with a pronounced seasonal effect in 2007−2016***
(in %)

Sources: SORS and NBS calculation.
* Except for travel packages, where data are available for 2012−2016.

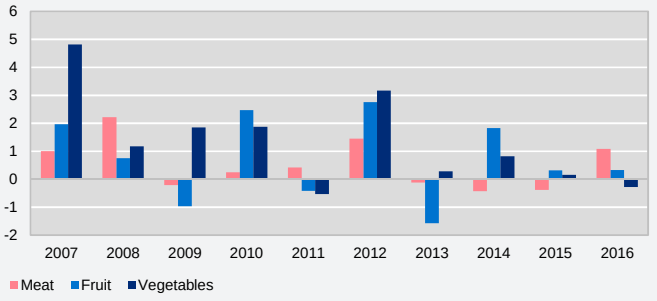
Fresh meat prices usually rise in summer months, i.e. from May to September, with the ending of the preceding production cycle and before the next one has reached its peak. Seasonal factors then continue into the following two quarters, when meat prices first record a decline and then flatline. In addition to seasonal factors, market shocks or external factors can also affect meat prices. This last occurred in July and August 2016 – prices of fresh pork increased more than seasonally expected, mirroring rising pork prices in the world market. Following this, there was an increase in prices of chicken (probably as households partially substituted their pork consumption with chicken consumption). Monthly volatility is weaker for meat than fruit and vegetable prices, rarely exceeding 5%, while average monthly changes during a year are somewhat greater, measuring 0.5% in the last ten years.

[1] With the exception of September when they record a moderate rise.

Whether an agricultural season is better or worse than average also affects fruit, vegetable and meat prices, and may increase or diminish seasonal volatility of prices of these product groups. Broken down by year (Chart O.1.3), the drought effect was visible in 2007 and 2012, and the flood effect in 2014.

Prices of clothes and footwear increase in the early winter and summer season, i.e. in Q2 and Q4, and fall in Q1 and Q3. Monthly price volatility is relatively small, rarely exceeding 1.5%. In the course of a year, the average monthly price change has been 0.2% in the past ten years.

Chart O.1.3 **Average monthly price changes by year**
(in %)



Sources: SORS and NBS calculation.

Prices of travel packages show the highest monthly price volatility, reaching close to 30% in the summer season. In general, these prices rise from June to August, in April and October, and decline in January, March and September. In each of the past five years, the average monthly change of travel package prices equalled 2.9%.

Excise duties on cigarettes also have a seasonal effect on inflation in Serbia. In accordance with the Excise Tax Law, they are raised each January and July, with the aim of bringing the minimum excise to EU levels by 2020. The minimum excise on cigarettes is determined as the sum of the ad valorem excise on the weighted average retail price of cigarettes[2] and the specific excise. The ad valorem excise equals 33% of the retail price of cigarettes, while the specific excise is determined in the dinar amount, which is raised each half a year and further adjusted to the inflation rate in the prior period. In January this year, the minimum excise was raised by around 4% (in respect of both the specific and ad valorem excise). In 2017, there will be no increase in the specific excise on account of adjustment to the inflation rate as inflation in 2016 was under 2%.[3]

Solid fuel prices also post seasonal growth in the period prior to and during the heating season. Hence, wood and coal prices increase mainly in autumn and winter months. Although the average annual growth in these prices most often does not exceed 1%, it declined further in the past four years, measuring around 0.2%.

The impact of seasonal factors on inflation is evident primarily in monthly (and quarterly) inflation rates (particularly against the background of especially low inflationary pressures, with prices of other products and services displaying relatively small volatility), and much less in y-o-y rates. Y-o-y inflation rates measure price changes in the current month relative to the same month a year before. As seasonal effects are usually always evident in the same months of a year, they are significantly offset in the calculation of y-o-y rates. In case of deviation from seasonal movements, i.e. when a season "moves" to another month or price growth is higher (smaller) than seasonal, the so-called core effect on y-o-y inflation is evident.

Given that the inflation target is determined as a y-o-y rate, inflation targeters, including the NBS, make their monetary policy decisions primarily in view of the expected future movements in y-o-y inflation. Still, the season for the above groups of products and services is factored into short-term inflation projections (for the following quarter). The NBS informs the public accordingly, considering the possible impact of seasonal factors on inflation expectations, particularly of households. According to the latest short-term inflation projection, the strongest impact on Q1 price growth will indeed be provided by the seasonal rise in prices of fruit and vegetables and solid fuel, and an increase in cigarette excise duties. At the same time, a seasonal decline in prices of fresh meat and travel packages is likely to work in the opposite direction.

[2] Total value of cigarettes marketed at retail prices divided by the total quantity of cigarettes marketed in the Republic of Serbia in the previous half a year.

[3] Starting from this year, adjustments to inflation will be carried out only if consumer price growth exceeds 2% in the previous calendar year, by the difference amount.

Producer and external prices

A y-o-y rise in producer and external prices in Q4 reflects the low base, as well as Q4 growth in these prices.

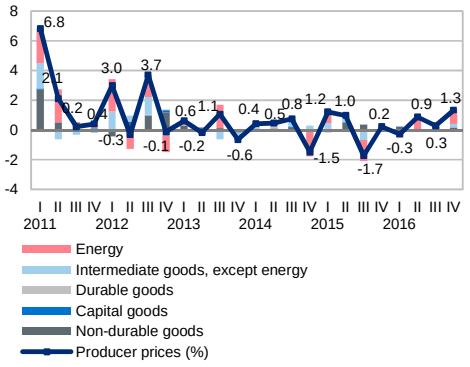
Industrial producer prices in the domestic market picked up from 0.3% in Q3 to 1.3% in Q4. The rise reflects higher producer prices in the energy and mining sectors, i.e. exploitation of crude oil and natural gas, production of petroleum products and base metals, as well as electricity, gas and steam supply. In contrast, producer prices declined in the production of computers, electronic, optical, food and metal products. Growth in industrial producer prices accelerated in y-o-y terms as well, from 1.3% in September to 2.0% in December 2016.

Following a Q3 drop, **agricultural producer prices** gained 6.3% in Q4. The rise was the most notable in the production of industrial plants, wheat and fruit, whereas the producer prices of vegetables, corn and poultry headed down. In y-o-y terms, following a five-month decline, agricultural producer prices moved up in Q4, adding 3.0% in December.

The growth in **prices of elements and materials incorporated in construction** was lower than in Q3, coming at 0.3%. Y-o-y, it sped up from 1.6% in September to 2.4% in December.

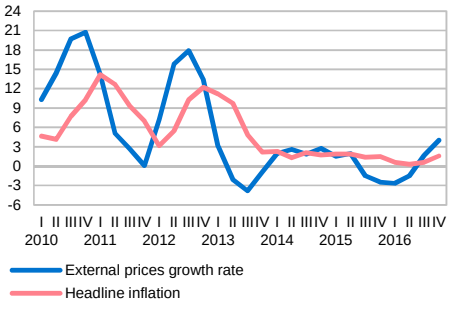
The rise in **external prices** expressed in dinars[1] continued into Q4, though at a somewhat faster pace than in Q3 (1.7% vs. 0.8%). Rising global oil prices provided the main contribution. World food prices, measured by the FAO index, also went up, reflecting higher prices of sugar, milk and dairy products, vegetable oil and meat, i.e. all the observed food categories apart from cereals. The growth in external prices was affected, to a lesser degree, by higher prices of German exports (used to approximate external prices of equipment and intermediate goods) and higher euro area consumer prices (used to approximate prices of imported services). An impulse also came from nominal depreciation of the euro against the dollar and, to a smaller extent, depreciation of the dinar against the euro over the past year. In y-o-y terms, external prices expressed in dinars picked up to 4.0% in Q4.

Chart III.0.4 **Contribution to quarterly producer price growth**
(in pp)



Sources: SORS and NBS calculation.

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



Sources: Destatis, FAO, Bloomberg and NBS calculation.

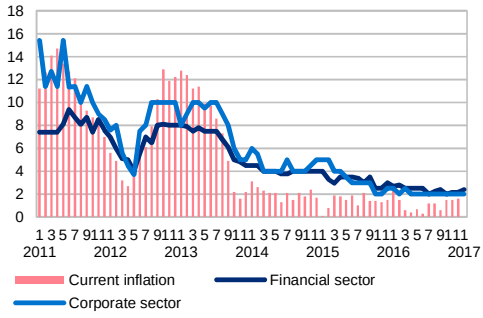
Table III.0.2 **Price growth indicators**
(y-o-y rates, in %)

	2015		2016	
	March	June	Sep.	Dec.
Consumer prices	0.6	0.3	0.6	1.6
Domestic industrial producer prices	-1.5	-1.6	0.2	2.2
Agricultural producer prices	-0.4	-0.4	-3.0	3.0
Prices of elements and materials incorporated in construction	-1.5	-1.0	1.6	2.4

Sources: SORS and NBS calculation.

[1] The weighted average of the world oil and food price index, euro area consumer prices and export prices of Germany, one of our main trade partners, is used as an indicator of external prices.

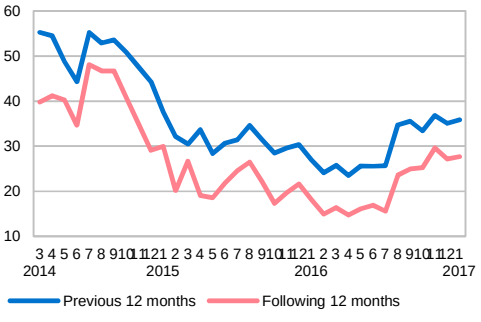
Chart III.0.6 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



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.

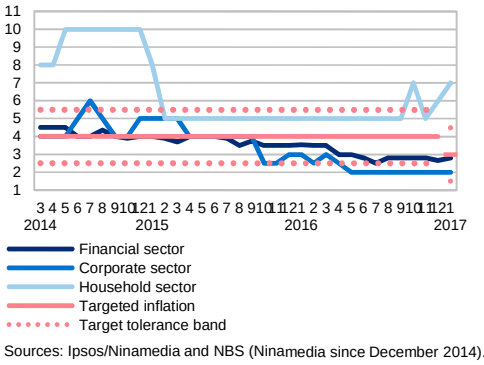
Chart III.0.7 **Household perceived and expected inflation**
(in index points)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

* The survey was not conducted in November 2014.

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



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

* The survey was not conducted in November 2014.

Inflation expectations

A prolonged period of relatively low and stable inflation expectations indicates that economic agents expect price stability to be preserved both one-year ahead and in the medium run.

According to the **Bloomberg** survey, **one-year ahead** inflation expectations of the financial sector have been within the target band since October 2013. In November 2016, following the announcement of the new target, this sector lowered its expectations to 2.4%, but raised them gradually in the subsequent months – to 2.7% in February. As indicated by the **Ninamedia** survey,[2] financial sector expectations are lower, moving within the 2.2–2.4% range in the November–January period. Corporate sector expectations are even lower – at 2.0% since April last year. Low and stable corporate expectations are underpinned by the preserved price stability and relative stability of the exchange rate, as well as by reduced cost-push pressures due to the still relatively low prices of oil and other primary commodities, as well as lower rates both on new and current loans.

Having stayed firmly at 5.0% for nearly a year, household expectations varied as of August (from 6.0% to 7.4%), only to return to 5.0% in January. Although the results of the qualitative household survey[3] indicate a rise both in perceived and expected inflation in Q4, expected inflation remains lower than perceived inflation, which means that one part of the population, who feel that prices increased in the past twelve months, do not expect the trend to continue over the next twelve months.

The financial sector expects **two-year ahead inflation** to move within the target tolerance band. Since August 2016, it has placed its expectations at around 2.8%. Since May 2016, corporates have anticipated medium-term inflation at 2.0%. Over the past several months, two-year ahead household expectations have been moving between 5.0% and 7.0%.

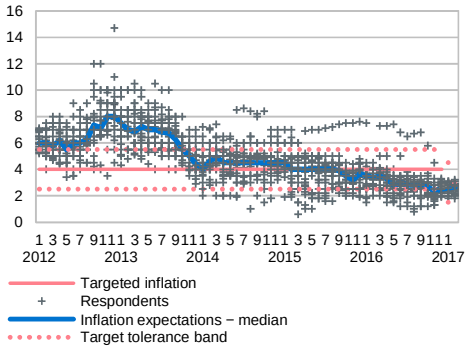
The dispersion of financial sector responses, the lowest among all sectors both according to Bloomberg and Ninamedia surveys, slipped further. The dispersion of corporate sector responses also declined. It is the highest, though relatively stable, among households.

[2] Ninamedia has been conducting a survey on expectations of economic agents since December 2014.

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

In Q4, the net percentage (NP) of enterprises expecting an increase in prices of their products over the next three months shrank further (from 4.5% to 0%), while the net percentage of enterprises expecting a rise in prices of inputs went up (from 1.0% to 13.6%). The majority of enterprises still do not expect a change in prices of inputs or prices of their products (84.9% and 87.2% respectively).

Chart III.0.9 **Targeted inflation and one-year ahead inflation expectations – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

IV. Inflation determinants

1. Financial market trends

Past monetary policy easing and further narrowing in internal and external imbalances continued to positively impact the cost of government and private sector borrowing in Q4. The private sector cost declined also on account of low interest rates in the international environment and enhanced bank competition.

Owing to further narrowing in external and internal imbalances, a positive assessment of the IMF concerning the implementation of the stand-by arrangement and improved credit rating outlook of the country, the exchange rate was relatively stable, despite the varying foreign investor sentiment regarding investment in securities of emerging economies, Serbia included. In an effort to ease excessive short-term volatility of the exchange rate, the NBS purchased EUR 185.0 mln net.

Interest rates

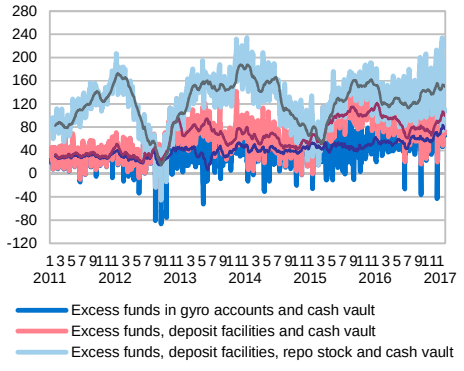
The average repo rate[4] declined a tad in Q4 (by 0.1 pp) and touched 2.9% in late December. Rates in the interbank money market remained stable in Q4, displaying minimum volatility.

Unchanged from September, BEONIA averaged 2.8% in December. Trading volumes in the interbank overnight money market contracted each month, equalling RSD 3.1 bln on average in December, down by RSD 0.9 bln from September.

Average monthly BELIBOR rates stayed broadly flat through Q4. In December they moved between 3.0% for the shortest and 3.6% for six-month maturity.

In January, trading volumes in the interbank money market contracted further, while average monthly rates remained broadly stable.

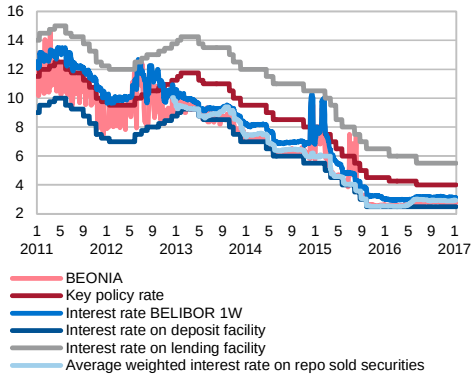
Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bln)



Source: NBS.

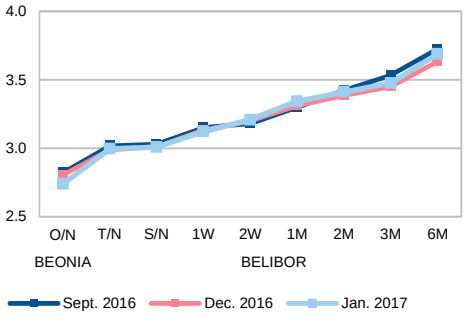
[4] The rate achieved at repo auctions weighted by the amount of sold securities.

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



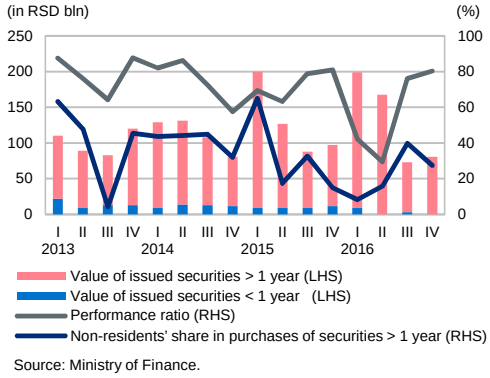
Sources: Thomson Reuters and NBS.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

The improved fiscal position and the consequently reduced government's need to borrow[5], along with past monetary policy easing, spurred a further fall in interest rates on dinar government securities in Q4. Rates on one-year securities fell by 0.1 pp to 3.5%, and those on three- and seven-year securities by 0.3 pp to 4.7% and 5.6% respectively. The fall in longer-maturity rates was aided by foreign investors who were, as before, more inclined to the longest-maturity assets. Government securities were attractive also owing to further improvement in Serbia's macroeconomic fundamentals, as confirmed by positive assessments of the IMF concerning the implementation of the stand-by arrangement, and improvement in the country's credit rating outlook by Standard & Poor's.

In contrast, expectations of faster normalisation of the Fed's monetary policy prompted a moderate rise in interest rates in the government securities market in January.

The rates at auctions of one-year (0.8%) and two-year (1.1%) euro-denominated government securities stayed broadly flat from Q3, while the rate on three-year securities (1.65%) lost 0.9 pp from the last auction in June. Following more than five years, an auction of 15-year securities was held in October. All securities on offer were sold at 4.2%, down by 1.7 pp compared to the previous auction.

Total trading volumes in the secondary market of government securities expanded to RSD 116.2 bln in Q4 (up by RSD 25.6 bln), reflecting higher non-resident participation on the sale side, primarily in view of expectations of faster normalisation of the Fed's monetary policy. In December, the rates of return ranged from 3.4% for the remaining one-month to 5.75% for the remaining 78-month maturity.

In December, the EBRD issued and sold a three-year dinar bond at a floating rate (0.4 pp + 3M BELIBOR). The dinar proceeds will be on-lent to local enterprises. The EBRD is the first international financial institution issuing dinar securities in the domestic market.

Past monetary policy easing, low interest rates in the euro area, improved macroeconomic fundamentals and enhanced bank competition helped further lower the cost of private sector borrowing in Q4.

[5] The general government deficit was RSD 51.7 bln in 2016, whereas the quantitative performance criterion under the arrangement with the IMF permits a RSD 112.0 bln deficit for 2016.

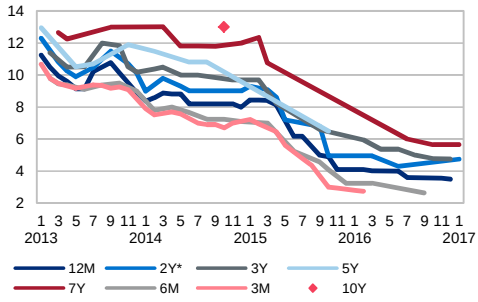
The average price of corporate loans was 5.4% in December, down by 0.5 pp from end-September. The reduction was aided by falling rates on current assets loans (by 0.9 pp to 4.9%) and other loans (by 0.6 pp to 6.0%). The price of investment loans stayed flat at 5.8% in December. The weighted average rate on dinar household loans also fell by 0.5 pp in Q4 and reached 10.8% in December. Down by the same amount, the rates on cash and refinancing loans arrived at 11.2%. Rates on consumer and housing loans (including apartment refurbishment loans) also dropped – to 7.0%. Some banks began to approve dinar housing loans at a rate below 5%, with a repayment term longer than 20 years. This reflected on the weighted average rate on new dinar housing loans extended in November (5.5%). In contrast, the price of other loans rose by 0.5 pp to 10.1%.

The weighted average rate on new dinar corporate and household loans fell by 0.2 pp from September to 8.5% in December. The decline was smaller than for rates on corporate and household loans each owing to a higher share of dinar household loans (generally costlier than corporate loans) in September.

The weighted average rate on new euro and dinar euro-indexed corporate and household loans slid by 0.3 pp in Q4 to 3.2% in December. The average rate on corporate loans fell to the same degree and reached 3.1% in December. Rates on all types of corporate loans declined, moving between 2.5% for import and 3.4% for investment loans. Current assets loans, as the most popular category, were approved at 3.0% in December, down by 0.3 pp from September. The average rate on household loans also fell by 0.3 pp to 4.4% in Q4, mirroring a decline in rates on housing loans (by 0.2 pp to 3.1% in December). Similarly to dinar loans, the rates on consumer and cash loans also dropped (to 5.3% and 3.5% respectively). It was only the price of other loans that went up (by 0.6 pp to 7.0%).

As in the previous several years, in 2016 banks did not offer much more favourable terms on the occasion of the World Savings Day, which is why there was no appreciable rise in household deposit rates in November. In Q4, rates on dinar household deposits lost 0.1 pp and those on FX deposits gained 0.1 pp, equalling 3.0% and 0.6% in December respectively. At the same time, rates on dinar corporate deposits were up by 0.3 pp to 2.9%, while the rate on FX deposits dipped 0.1 pp to 0.4% in December.

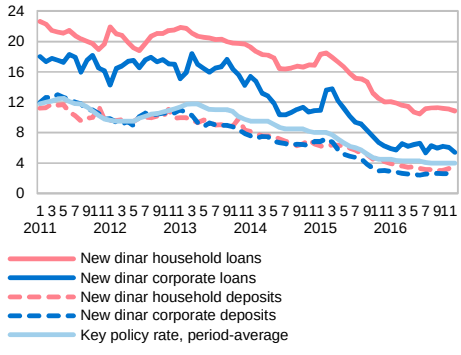
Chart IV.1.5. **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities with the rate linked to the NBS key policy rate.

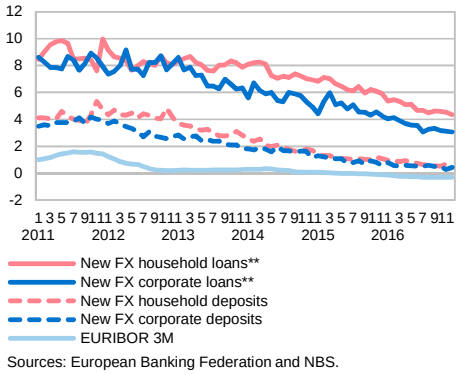
Chart IV.1.6 **Interest rates on dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on FX loans and deposits of corporates and households***
(weighted average values, p.a., in %)

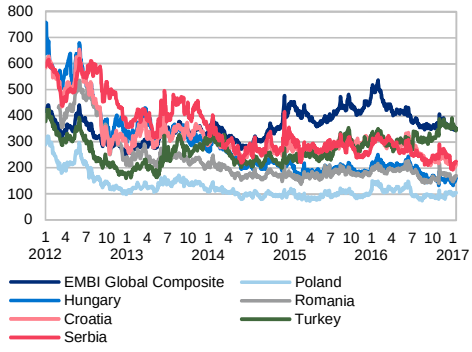


Sources: European Banking Federation and NBS.

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

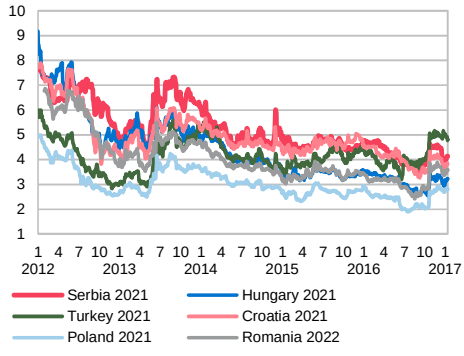
** Euro and euro-indexed.

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



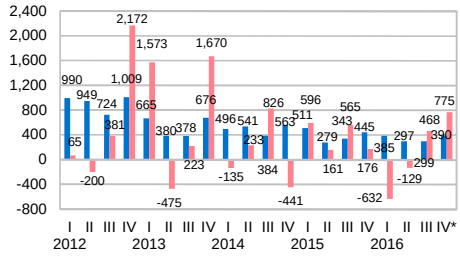
Source: JP Morgan.

Chart IV.1.9 **Yields on eurobonds of countries in the region**
(in %)



Source: Bloomberg.

Chart IV.1.10 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Risk premium

Measured by EMBI, Serbia's risk premium gained 24 bp in Q4. Until late January, it fell by the same amount to 225 bp. By mid-January, it even dropped to 194 bp, its lowest level since October 2007. EMBI Global mirrored the trend, edging up 5 bp in Q4, only to fall by 13 bp to 352 bp in January. Risk premia across the region recorded similar movements – they moved up in Q4 and headed down in January.

Serbia's risk premium, i.e. the difference in yields on Serbia's dollar eurobonds and US treasury securities, was under the impact of both global and domestic factors. Expectations of somewhat faster economic growth and inflation in the US drove up the rates of return on US long-term treasury securities in Q4. At the same time, the probability that the normalisation of the Fed's monetary policy would be faster than anticipated pushed up the rates of return on long-term government securities of emerging economies. As a result, Q4 saw an increase in the spread between these rates and those on US treasury securities, measured by EMBI. At the turn of 2017, as the situation in the international financial market calmed down somewhat, the rates of return on government securities of emerging economies declined, driving down the risk premia. The domestic factors impacting the fall in Serbia's risk premium included further narrowing in internal and external imbalances and the continuation of economic growth, led by investment and exports.

Positive macroeconomic performance and outlook were confirmed by the IMF's December decision on the successful conclusion of the sixth review of the stand-by arrangement. Besides, in December Standard & Poor's improved Serbia's outlook and affirmed its credit rating at BB-, stating the decision was underpinned by the results of fiscal consolidation and structural reforms, acceleration of investment-led economic growth and the narrowing in external imbalances aided by the vigorous growth in exports.

Foreign capital inflow

Foreign trade imbalances narrowed further. Q4 saw a relatively low current account deficit. At the same time, the inflow in the financial account was more than sufficient to cover the deficit, adding to relative stability of the dinar. As before, most of the capital inflow in Q4 was in the form of FDI. A smaller inflow was registered in respect of rising resident credit liabilities.

According to preliminary data, Q4 saw a net **FDI** inflow worth EUR 481.3 mln. The FDI inflow recorded in 2016 (EUR 1,857.2 mln) exceeded that from 2015, attesting to an improved investment climate in Serbia.

The 2016 FDI inflow covered 135.5% of the current account deficit. Investments were diversified across a variety of projects in different industries. The largest amounts were channelled to manufacturing, the financial sector, construction, trade, real estate business, telecommunications and transport. Positive trends are likely to continue into 2017.

A net capital outflow in respect of **portfolio investment** (EUR 232.3 mln) in Q4 resulted from the sale of government securities in the secondary market by foreign investors who, since the start of normalisation of the Fed's monetary policy, have been reducing their exposure to emerging markets. A contribution was also provided by early repayment of a portion of debt to London Club creditors. Furthermore, residents stepped up their investment in foreign securities in the international market. An outflow was registered also in respect of resident investment in EBRD dinar bonds, issued in the domestic market for the purpose of dinar lending to the Serbian economy.

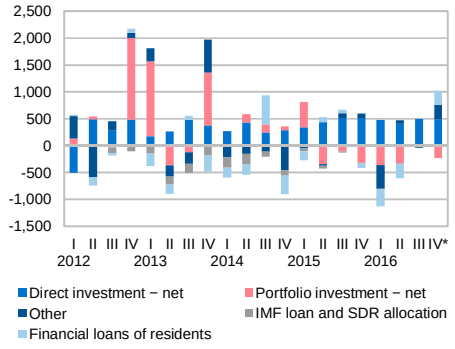
In Q4 residents borrowed EUR 261.3 mln net in respect of **financial loans**. Of this, government (EUR 344.9 mln) and bank (EUR 96.3 mln) borrowing went up, whilst enterprises repaid EUR 179.9 mln to foreign creditors. Since the beginning of the year, government borrowing increased by EUR 298.7 mln. In the year as a whole, banks repaid EUR 280.1 mln net, a third less than in 2015. Total debt repayment of enterprises in respect of cross-border loans was EUR 322.9 mln.

Trends in the FX market and exchange rate

In Q4 the dinar was broadly stable vis-à-vis the euro relative to end-Q3 (it weakened 0.1% end-of-period). It, however, lost 6.2% against the dollar, as a result of the euro's depreciation against the dollar in Q4.

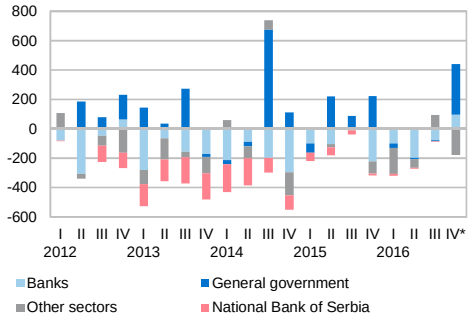
The first half of Q4 was marked by appreciation pressures on the dinar, reflecting mainly weaker than usual FX demand of local enterprises and elevated non-resident investment in government securities in October. Domestic enterprises' dented demand was partly due to higher exports, which continued up in Q4, i.e. stayed at a

Chart IV.1.11 **Structure of the financial account**
(in EUR mln)



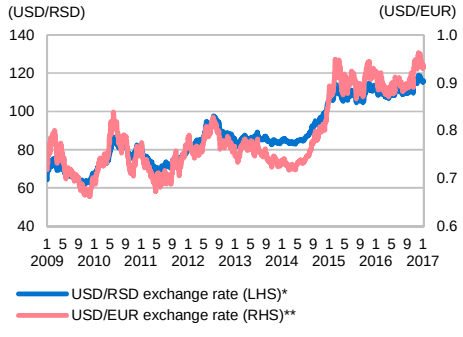
Sources: SORS and NBS.
* Preliminary data.

Chart IV.1.12 **Financial loans of residents – change in net borrowing**
(in EUR mln)



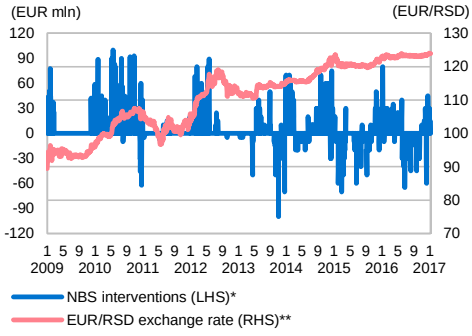
Source: NBS.
* Preliminary data.

Chart IV.1.13 **Movements in RSD/USD and EUR/USD exchange rates**



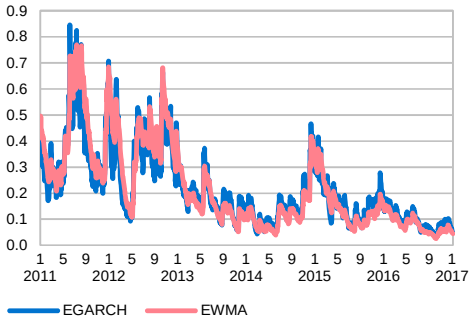
Source: NBS.
* 1 USD in RSD.
** 1 USD in EUR.

Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**



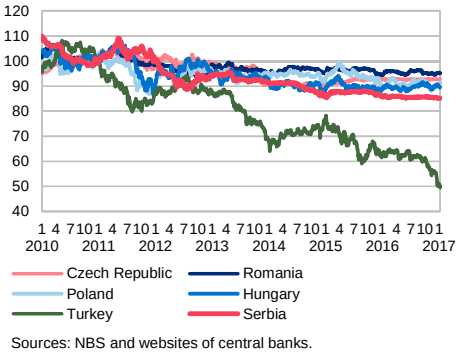
Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

Chart IV.1.15 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

Chart IV.1.16 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



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

high level of over EUR 1.0 bln a month. Though the purchase of foreign cash under exchange transactions was somewhat lower than in Q3, this was neutralised by an increase in banks' net assets indexed to the currency clause.[6]

The dinar strengthened in Q4 also in response to more favourable macroeconomic prospects, further narrowing in internal and external imbalances, a positive assessment following the conclusion of the sixth review of the arrangement with the IMF, improvement in the country's credit rating outlook by Standard & Poor's, all of which contributes to enhanced non-residents' confidence concerning long-term investment in Serbia.

On the other hand, expecting the Fed to raise its rate in December, foreign investors continued to reduce their portfolios of government securities, which, along with FX purchases on account of energy imports, fuelled depreciation pressures on the dinar in December (which continued into January).

To ease excessive short-term volatility of the exchange rate, in the past four months the NBS intervened in the IFEM in both directions. In October and November it responded primarily on the purchase side, and in December and January on the sale side. In Q4 it bought EUR 185.0 mln net (it bought EUR 295.0 mln and sold EUR 110.0 mln), and sold EUR 160 mln net at the year-level. In January it sold EUR 225.0 mln.

Following a reduction in the previous two quarters, trading volumes in the IFEM averaged EUR 20.7 mln a day in Q4, up by EUR 1.9 mln from Q3.[7] Average daily trading volumes were the highest in December (EUR 28.3 mln). Measured by EWMA[8] and EGARCH[9], volatility of the dinar against the euro stayed exceptionally low.

The volume of transactions at regular FX swap auctions organised by the NBS in Q4 was smaller than in Q3. The NBS bought and sold EUR 36.0 mln at three-month and EUR 18.0 mln at two-week auctions. Following a break in August and September, in Q4 banks engaged anew in interbank swaps. Compared to Q3, the volume of these transactions increased three times, to EUR 32.7 mln.

[6] In an effort to match their FX positions, banks increase their FX supply in the market.

[7] Excluding the NBS.

[8] EWMA – Exponentially Weighted Moving Average.

[9] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

The majority of currencies of countries in the region running similar exchange rate regimes weakened against the euro in Q4. The Turkish lira depreciated the most (9.0%), followed by the Polish zloty (2.5%) and Romanian leu (2.0%). The Hungarian forint weakened the least (0.6%). The Czech koruna stayed unchanged vs. the euro as the Czech central bank intervened on the purchase side.

Stock exchange trends

Share prices continued up in Q4, aiding further recovery of indices of the Belgrade Stock Exchange (BSE). In late December, BELEX15 stood at 717.4 and BELEXline at 1,569.4 index points, up by 12.7% and 9.1% respectively relative to end-September. Owing primarily to Q4 growth, these indices picked up by 11.4% and 13.7% at the year-level respectively.

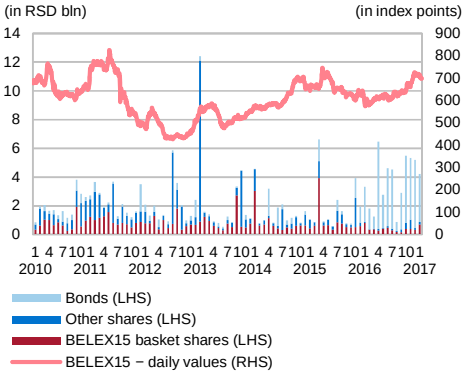
Trading in shares amounted to RSD 2.3 bln, of which trading in BELEX15 shares accounted for somewhat less than a half. Foreign investor participation in total trading of shares was RSD 0.8 bln – at the quarter level, RSD 213.5 mln net were sold, reflecting the net sale in October.

As in the previous quarters of 2016, in Q4 the major portion of stock exchange trading (around 85%) concerned trading in long-term RS bonds, which amounted to RSD 13.6 bln.[10] Transactions with foreign investors made up around 12%. No trading in municipal bonds was recorded in this quarter either.

December saw a new step towards the development of the Serbian capital market and further support to the dinarisation process (being one of the NBS's strategic objective) when the EBRD issued the first dinar securities in Serbia. The bonds were admitted to the BSE listing.

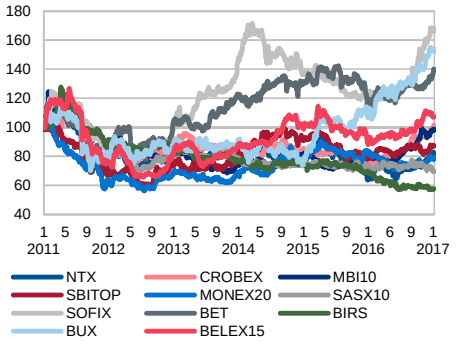
BSE market capitalisation was RSD 592.4 bln at end-December, up by RSD 7.0 bln from end-September. Regulated market capitalisation expanded RSD 23.5 bln, while MTP[11] capitalisation contracted by RSD 16.5 bln after the exclusion of some issuers from this segment. The share of market capitalisation in estimated GDP rose slightly compared to Q3 and came at 14.3% in late Q4.

Chart IV.1.17 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

Chart IV.1.18 **Stock exchange indices across the region**
(in index points, normalised, 31 December 2010 = 100)



Sources: BSE and websites of regional stock exchanges.

[10] In November 2015, trading in government long-term bonds on the BSE was enabled.

[11] 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.

The majority of indices in the region also edged up in Q4. The strongest rise was posted by Sofia (16.2%) and Budapest (15.7%) indices, whilst Banjaluka (2.6%), Ljubljana (3.3%) and Sarajevo (4.5%) indices headed down.

2. Money and loans

As usual for this part of the year, the money supply increased strongly in Q4, and was more pronounced in the dinar component. Household lending continued up, followed by a rise in new housing loans. On the other hand, strenuous efforts to clean up balance sheets from NPLs led to a temporary drop in bank receivables from corporates, as this creates space for new lending.

Monetary aggregates

The dinar reserve money gained 14.5% in nominal and 14.0% in real terms in Q4. As in previous years, bank deposits held with the NBS at year-end were higher than mandatory under FX reserve requirement. This contributed to an increase in the total reserve money of 15.1% in nominal and of 14.6% in real terms in Q4. Y-o-y, however, real decline in the reserve money slowed down further, to –2.2% for dinar reserve money and to –3.2% for total reserve money.

Bank investment in repo securities shrank by RSD 31.2 bln in Q4, and made the single largest contribution to dinar reserve money growth. Higher dinar liquidity of banks also stemmed from the NBS FX net purchases in the IFEM (RSD 15.4 bln) and FX payment transactions with Kosovo and Metohija (RSD 14.5 bln). Despite the seasonally higher spending from dinar accounts with the NBS, the government bought FX from the NBS in order to settle its FX liabilities, hence contributing RSD 7.7 bln to reserve money withdrawal in Q4.

Following the usual seasonal dynamics, all deposit categories rose strongly, and so did the broader monetary aggregates, which continued rising in Q4. This increase was more pronounced for dinar deposits, with M1 and M2 rising in real terms by 8.7% and 10.6%, respectively, which, coupled with a rise in FX deposits, pushed M3 up by 4.7% in real terms.

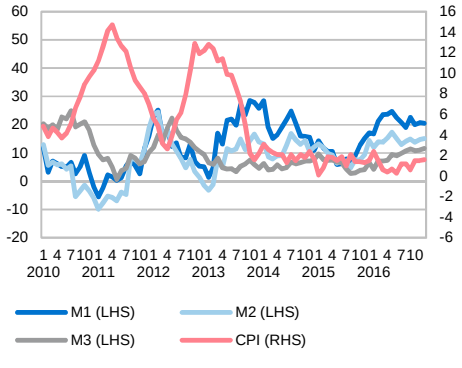
With an increase of RSD 37.1 bln, dinar demand deposits rose the most in Q4. This increase was almost entirely recorded in current accounts of households and in accounts of enterprises primarily belonging to the sector of trade, and to a lesser extent to the construction and energy sectors. For an extended period of time growth has been stronger in dinar deposits with shorter maturities,

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

	2015	2016			Share in M3 Dec. 2016 (%)
	March	June	Sep.	Dec.	
M3	6.6	8.7	10.8	9.8	100.0
FX deposits	3.6	5.8	9.0	7.9	63.2
M2	13.1	14.8	14.3	13.2	36.8
Time and savings dinar deposits	-9.5	-3.5	-4.9	-0.5	9.1
M1	22.8	22.1	21.9	18.6	27.7
Demand deposit	26.3	24.8	24.7	21.1	20.4
Currency in circulation	14.2	15.1	14.6	12.1	7.2

Source: NBS.

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



Sources: SORS and NBS.

which can be linked to the recovery of economic activity and, in part, to the curbing of the grey economy.

Mostly due to higher deposit balances in enterprise accounts at year-end, saving and term deposits gained RSD 29.4 bln in Q4. Higher deposit balances were posted in accounts of enterprises across almost all industries and particularly of those engaged in trade, as was also the case with deposits of shorter maturities. This can be partly ascribed to intensified lending to these companies. Dinar deposits of other sectors, of both shorter and longer maturities, did not change significantly.

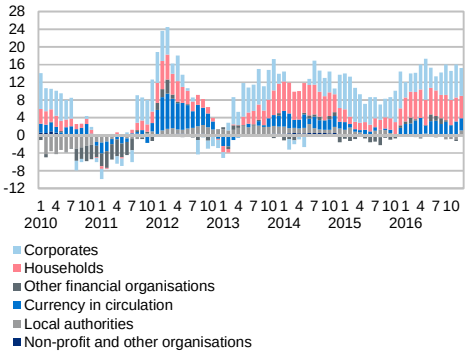
The rise in savings and term deposits is still propelled by dinar household savings which climbed by RSD 1.4 bln in Q4, reaching its new all-time peak at year-end – RSD 50.4 bln. It was 11.0% higher than at end-2015, while its share in total household savings rose to 4.5%. An extended period of low and stable inflation, relative stability of the exchange rate, more favourable interest rates and preferential tax treatment of the dinar relative to FX savings spurred the rise in dinar savings. FX household savings also rose further in Q4, by EUR 126.1 mln, and its increase at the level of 2016 measured EUR 334.3 mln, reaching EUR 8.7 bln in December. Besides household savings, FX deposits of corporates also went up significantly (by EUR 106.7 mln in Q4 and EUR 408.3 mln in 2016), largely as a result of good export performance. FX deposits of the majority of other sectors also rose a tad.

In y-o-y terms, the growth in the money supply slowed down in Q4, but still posted relatively strong growth, M1 in particular. In December, M1 was by 18.6% higher in real terms.

Loans

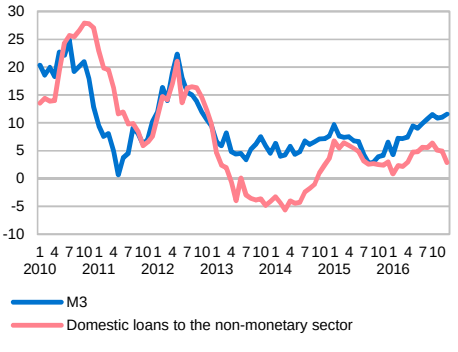
According to the preliminary data,[12] y-o-y growth of domestic loans equalled 1.9% in December, excluding the exchange rate effect.[13] Household loans rose by 10.1% y-o-y in December, while corporate loans drifted down by 3.8% from a year ago. This is a consequence of the expected step up in banks' activities on resolving NPLs. Excluding the effect of writing-off RSD 42 bln worth of corporate loans in 2016, and early loan repayment by a public enterprise to domestic banks in October covered by a cross-border loan, the y-o-y rise of corporate loans equalled around 1.5% in December.

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



Source: NBS.

Chart IV.2.3 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)

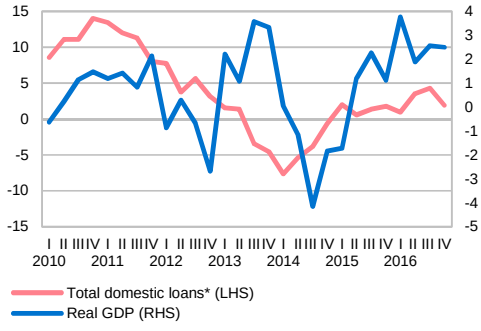


Source: NBS.

[12] According to the pre-closing entries.

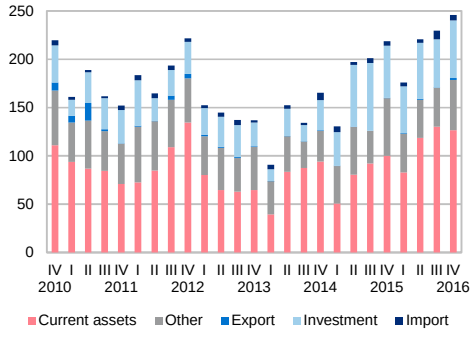
[13] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

Chart IV.2.4 **Lending activity and GDP**
(y-o-y rates, in %)



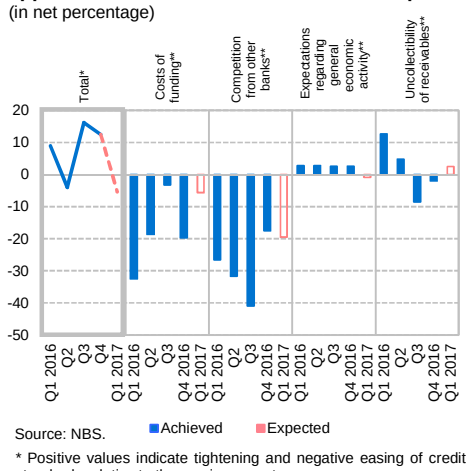
Sources: NBS and SORS.
* Excluding the exchange rate effect.

Chart IV.2.5 **Structure of new corporate loans**
(in RSD bln)



Source: NBS.

Chart IV.2.6 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)



Source: NBS.
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

At end-2016, the share of domestic loans in the estimated GDP equalled 47.3%, down by 0.5 pp from end-2015 due to a faster growth in nominal GDP.

Throughout 2016, credit activity was further assuaged by a pickup in economic activity, past monetary policy easing through which the NBS helped slash interest rates on dinar loans, lower interest rates in the international money market which reflected on a drop in interest rates on FX and FX-indexed loans, and increased interbank competition. On the other hand, the write-off and sale of NPLs worked in the opposite direction. As a result, positive effects are likely from this factor in the period ahead, since the unburdening of banks' balance sheets from distressed assets creates space for new lending.

The preliminary data indicate that corporate loans declined by 2.5% or RSD 28.2 bln in Q4, excluding the exchange rate effect. Although corporate loans usually rise the most in the final quarter, those receivables subdued in Q4 2016, mostly due to the said specific factors at play – banks' activities on resolving NPLs through write-off and assignment of NPLs to entities outside the banking sector and early loan repayment by a public enterprise to domestic banks in October covered by a cross-border loan.

On the other hand, total new lending to the corporate sector in Q4 (RSD 246.0 bln) went up by 12.5% from the same period last year, while in yearly terms, 2016 saw a rise of 16.6% in new corporate loans vis-à-vis 2015. Like before, corporate loan demand continued to be largely driven by the need to finance current assets and restructure debts, and hence current assets loans accounted for over a half of new corporate loans (around 53%). Investment loans kept their relatively high share in new loans (around 25%), confirming increased reliance on loans for investment financing. Thanks to a recovery in investment lending, this loan category made up around a third (33.1% in December) of corporate loan receivables. Observed by activity, during Q4, lending was primarily directed to trade companies, and partly to construction, agriculture and transport.

According to the results of the January bank lending survey,[14] in Q4 several banks tightened credit standards for large enterprises, while standards for SMEs were additionally eased, and are expected to be further eased in Q1 2017. As before, lower costs of funding and interbank

[14] The NBS has conducted the survey since early 2014. Participation is voluntary and the response rate almost 100%.

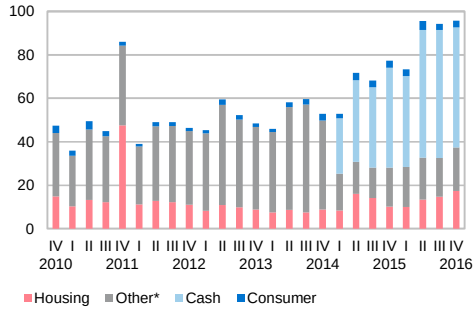
competition worked towards the easing of standards, and for the second consecutive quarter, so did the reduction in NPLs. Terms of borrowing were more favourable for corporates in Q4 due to lower margins and associated costs and extension of loan maturity, while the requirements regarding collateral and maximum loan amount were tightened. Also, corporate loan demand continued up, driven by the need to finance current assets and restructure debt, and to a degree, by investment financing. These same factors should act as the main drivers of growth in loan demand that is expected to last into Q1 2017.

Household lending continued rising, yet at a slower pace than in the previous two quarters, and according to the preliminary data, excluding the exchange rate effect, it went up by 1.7% or RSD 13.6 bln in Q4. This rise was still dominantly supported by cash loans (including refinancing loans), but also elevated housing lending.

The volume of new household loans in Q4 (RSD 95.8 bln) was by 23.8% higher than in the same period last year, or, observed at year level, by 33.0% and equalled RSD 358.9 bln. Cash loans made up around 60% of new household loans and were almost entirely dinar-denominated (over 99%); of this, around 70% were loans with a repayment period of over five years. Propped up by more favourable trends in the real estate market that prevailed since the start of 2016, housing loans continued up – the amount of newly approved housing loans in Q4 was 18.2% higher than in Q3, and increased by 70.6% from the same period in 2015. Although most of these loans were FX-denominated, November witnessed the first dinar housing loan at an interest rate of below 5% and maturity period of over 20 years. Borrowing under credit cards and current account overdrafts more or less kept the levels recorded in Q3.

According to the results of the January bank lending survey, credit standards for households were slightly eased in Q4, and a large number of banks expect further easing in Q1 2017. Standards were eased under the sway of interbank competition and greater readiness to assume risk, and to some extent, by cheaper sources of funding, positive expectations regarding economic activity and more favourable prospects in the real estate market. Households were offered longer loan repayment periods, interest margins were additionally trimmed, and some banks reduced associated costs as well. In line with expectations, household demand continued rising, with the greatest demand registered for dinar cash loans, refinancing loans and FX-indexed housing loans, which were the loan categories in respect of which standards

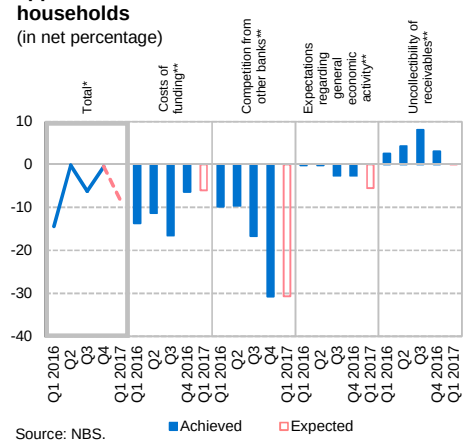
Chart IV.2.7 **Structure of new household loans**
(in RSD bln)



Source: NBS.

* Until December 2014, the 'Other loans' category included both cash and other loans.

Chart IV.2.8 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)

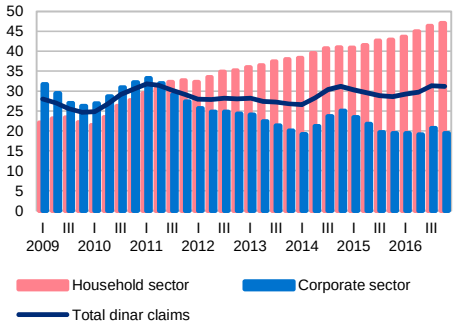


Source: NBS.

* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

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

Chart IV.2.9 **Share of dinar in total bank receivables from corporate and household sectors**
(in %)



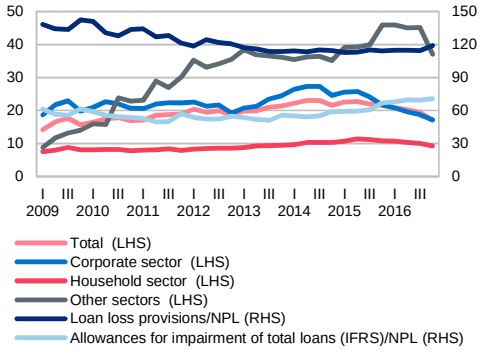
Source: NBS.

were significantly eased. This rise in demand was propelled primarily by real estate purchase and the need to refinance the current obligations, and to an extent, by a rise in private sector wages. These same factors should remain key drivers of household demand in Q1 2017 as well.

At end-December, 31.2% of corporate and household loans were denominated in dinars, up by 2.6 pp from end-2015. As households dominantly borrowed mostly in dinars, around 72% of new household loans in Q4 were denominated in dinars. This led to a further increase in the dinarisation of household loans, by 4.2 pp from the start of the year to 47.0% in December. The share of the dinar in total corporate loans equalled 19.4% in December, rising a tad from end-2015 (0.1 pp), yet dropped from Q3, mainly due to the write-off of dinar receivables.

The implementation of the NPL Resolution Strategy continues to yield good results.[15] According to the results of the recent bank lending surveys, the lower level of corporate NPLs has worked towards the easing of credit standards. The share of NPLs in total loans, on a gross basis, decreased further in Q4, and according to the preliminary data it came at 17.0% in December, down by 4.6 pp from December 2015. The share of NPLs decreased by 4.5 pp to 17.2% in the corporate[16] and by 1.6 pp to 9.3% in the household sector.[17] On the one hand, the NPL share declined as a result of collection, restructuring, write-off and sale of a part of NPLs and, on the other, due to an increase in new lending.

Chart IV.2.10 **NPL share in total loans, gross principle**
(in %)



Source: NBS.

Despite the relatively high share of NPLs in total loans, the capital adequacy ratio of 21.2% recorded in September indicates that the domestic banking sector is highly capitalised. In November, total allowances for loan impairment came at 70.9% of NPLs (10.2 pp more than a year earlier), while loan loss provisions,[18] at 119.2% in November, continued to fully cover the amount of gross NPLs.

[15] See Text box 2, page 27.

[16] Includes companies and public enterprises. If only companies are observed, the share of NPLs in total loans came at 17.5% in December, down by 6.0 pp from end-2015.

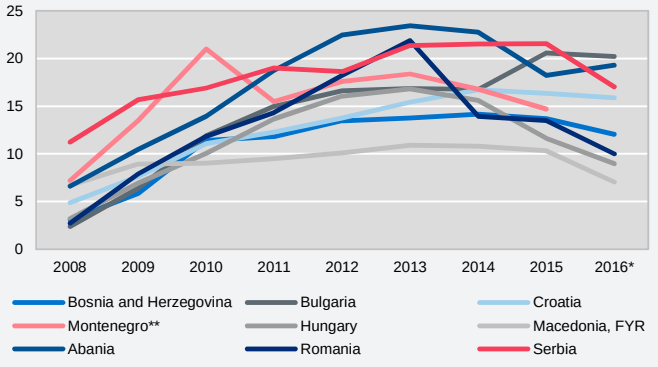
[17] With entrepreneurs and private households included, the share decreases by 1.7 pp to 10.0%.

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

Text box 2: NPL resolution results

The financial crisis and the ensuing recession pushed up the level of NPLs in countries across the region (and beyond). What characterised Serbia is that it entered the crisis with an already high level of NPLs (11.2% gross at end-2008), while this figure ranged between 2.4% and 7.2% in the rest of the region.[1] In addition to deteriorating macroeconomic conditions during the crisis (economic downturn, currency depreciation, higher inflation and elevated unemployment), the rise in NPLs in countries of the region at the time stemmed also from the fact that the vigorous credit growth in the pre-crisis period rested on less conservative assessment of credit risk and collateral by banks. As in most other countries, corporate NPLs in Serbia had the strongest sway on the rise in the share of NPLs in total loans. Owing to the initially higher level, the share of corporate NPLs exceeded 20% in 2012 and reached 23.0% in mid-2014.

Chart O.2.1 **Share of NPLs in total loans, gross principle**
(in %)



Sources: IMF and NBS.
* Latest available data.
* * Q3 2015.

NPLs adversely affect loan supply, and consequently investment and economic growth. At the same time, the inability to collect these receivables reduces the profitability of banks. In this light, since the outbreak of the crisis, efforts have been put forth to reduce the level of non-performing loans. The best results so far have been achieved through activities implemented under the comprehensive NPL Resolution Strategy adopted in August 2015 and prepared by the NBS, relevant ministries and the Deposit Insurance Agency, with the participation of representatives from international financial institutions (the IMF, World Bank and EBRD).

Implementation of this complex Strategy required cross-institutional coordination, which is why two action plans were prepared. One was carefully defined and calibrated by the NBS and the other by the Government. **Activities envisaged by the NBS Action Plan,[2] aiming at strengthening banks' capacities for NPL resolution and contributing to the development of the NPL market, have been fully implemented, some even ahead of deadline, and their implementation was one of the factors with a strong sway on reducing NPLs in 2016.** The regulatory framework for the treatment of restructured receivables has been enhanced to promote sustainable practice of restructuring and to prevent evergreening. Distressed asset management in banks has been improved by imposing additional requirements for banks in the context of strategic planning and the process of distressed asset management, and the Guidelines for Disclosure of Bank Data and Information Related to the Quality of Assets have been published. Also, the Guidelines for IAS 39 have been published, banks' NPL reporting system has been improved, an analysis on obstacles and limitations in the NPL market has been carried out, the database on real estate collateral has been set up, and additional requirements for banks have been introduced regarding monitoring the quality of collateral and appraisers' activities. The progress made was recognised also by the IMF, which after the latest regular review of the arrangement, assessed that significant progress has been made regarding NPL resolution. The drop in the share of NPLs was assessed as positive by Standard & Poor's, which raised Serbia's outlook from stable to positive in December.

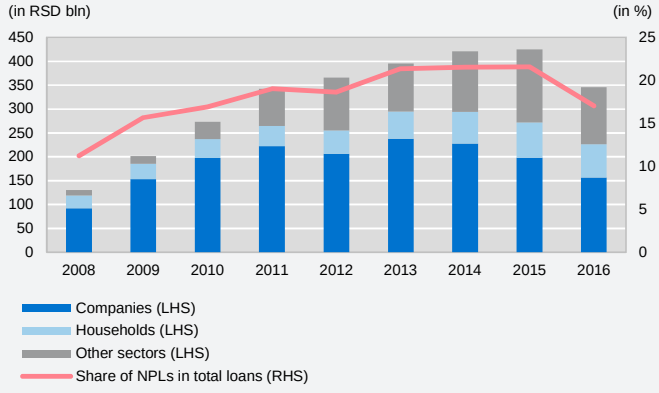
As a result of the adopted measures and implemented activities, the share of NPLs narrowed significantly in 2016, both in nominal and relative terms. According to the preliminary data, in 2016, the share of NPLs declined by 18.6% to RSD 345.6 bln, and their share in total loans dropped by 4.6 pp to 17.0%. This is the lowest level of NPLs since January 2011.

[1] An absolutely reliable comparison is not possible, as there still are methodological differences between countries in this regard.

[2] http://www.nbs.rs/internet/english/55/npl/action_plan.pdf.

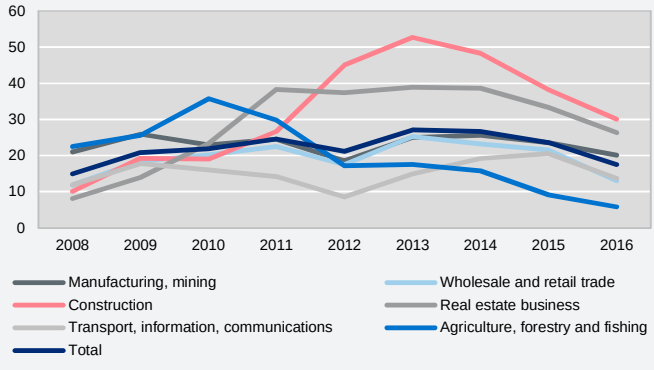
This narrowing was the most evident in case of corporates, where the share of NPLs is also the highest (45.4%). In 2016, the share of corporate NPLs in total corporate loans fell by 6.0 pp to 17.5% in December – the lowest level since February 2009. These results largely stem from enhanced activities of banks regarding collection, restructuring, write-off and sale of a part of NPLs facilitated by the NBS measures. Owing to amendments to regulations, which since early 2016 have provided for a more favourable tax treatment of write-off (write-off of loans is recognised under expenses), the amount of NPLs written off in 2016 was RSD 45.9 bln, primarily relating to corporate NPLs (RSD 41.6 bln), nearly six times the amount in 2015. The NPL market is on the rise, as confirmed by the amount of receivables sold in 2016 to entities outside the banking sector (RSD 57.1 bln), which is 3.5 times more than in 2015. The sale includes receivables from legal entities (enterprises), where a portion of these receivables was already written off. The decline in the share of corporate NPLs came as a positive contribution of economic recovery, as attested by the fact that sectors with the sharpest rise in activity (construction, agriculture, industry and trade) are the ones where the share of NPLs is dropping the fastest. This decline has been most pronounced in construction – in 2016, the share of NPLs shrank by 8.2 pp to 30.0%. Citizens have fewer problems with loan repayment, as shown by the 6.1% decline in household NPLs from late 2015 and the fact that the share of household NPLs narrowed by 1.6 pp to 9.3% in December. Across other sectors, non-financial entities in bankruptcy accounted for the largest segment of NPLs (23.5%), though, observed in absolute terms, this amount is also going down.

Chart O.2.2 **NPL structure, gross principle**



Source: NBS.

Chart O.2.3 **Share of corporate NPLs in total loans, gross principle**
(in %)



Source: NBS.

Despite the relatively high level of NPLs, the stability of the financial system in Serbia has not for a moment been threatened, as provisions for balance sheet exposures exceeded the gross amount of NPLs, and the CAR has all the time stood well above the regulatory minimum. Still, NPLs acted as a limiting factor for credit activity in previous years, and have certainly been one of the factors that worked towards the tightening of credit standards by banks. However, according to the latest results of the bank lending surveys (the NBS and EIB[3]), the trend has been reversed – in recent reporting periods, the lower level of NPLs worked towards the easing of credit standards, and this trend is expected to last into the coming period.

[3] The survey was developed in the context of the Vienna Initiative 2 and is conducted in countries of Central, Eastern and South-Eastern Europe, with the participation of subsidiaries of ten foreign banks operating in Serbia. Banks are surveyed twice a year and the last survey was conducted in September/October 2016. The results of the next survey will probably be even more favourable given the further contraction in NPLs.

3. Real estate market

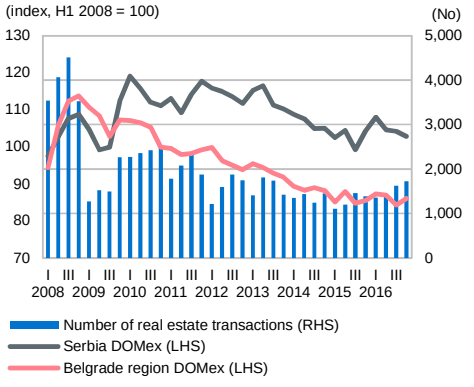
The real estate market showed gradual recovery in the course of 2016, as lower real estate prices and a drop in interest rates on housing loans pushed up demand, which reflected in the higher number of real estate transactions.

Serbia's average real estate prices, as measured by DOMex,[19] continued declining in Q4 (1.3%), reflecting lower real estate prices in Vojvodina, southern and eastern Serbia, as well as in Šumadija and western Serbia. On the other hand, having dipped in Q3, average real estate prices in Belgrade went up in Q4 (2.4%). This trend made the disparity between real estate prices in Belgrade, as the most expensive region, and the rest of Serbia expand further, from 68% in Q3 to 75% in Q4. Average real estate prices in Serbia equalled EUR 851.9 per square metre in Q4, and EUR 869.4 per square metre at the level of 2016.

The drop in real estate prices in 2016 reflected partly in the higher number of real estate transactions,[20] which started climbing in Q2 and were around 20% higher than in 2015. The stronger turnover in real estate continued to benefit from lower costs of borrowing. Besides a further cut in interest rates on EUR-indexed housing loans, as of Q4, banks started to approve dinar housing loans at a rate under 5%, which illustrates confidence of the banking sector in the monetary policy measures aimed at maintaining macroeconomic stability. According to the bank lending survey, looking ahead, banks expect housing loan demand to rise, with real estate market conditions remaining conducive to its further growth.

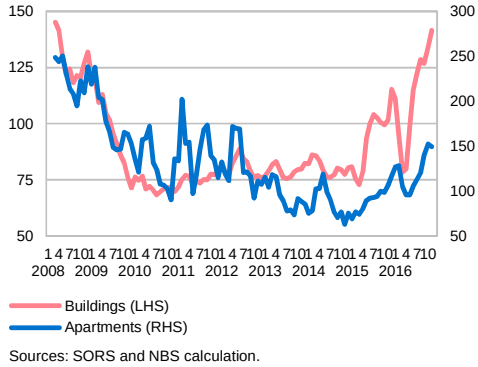
On the other hand, the supply of flats, measured by the number of newly built flats, declined in Q3 compared to the same period last year, partly due to the high base effect. Still, the number of issued housing construction permits in October and November was around 40% higher y-o-y, which means that in the coming quarters the supply of housing can be expected to rise.

Chart IV.3.1 **DOMex and real estate transactions**



Source: National Mortgage Insurance Corporation.

Chart IV.3.2 **Indices of the number of issued construction permits**
(3M averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

[19] The DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans

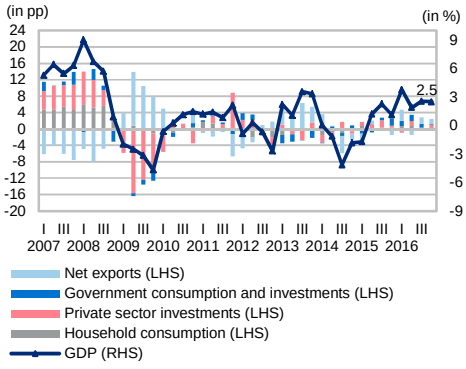
[20] The number of real estate transactions and flat prices per square meter also relate only to real estate purchased by insured loans.

4. Aggregate demand

Results achieved towards macroeconomic stabilisation, further improvement of the business ambience and brighter outlook of economic growth made investment in fixed assets and exports stay the drivers of GDP growth in Q4 as well (0.2%, s-a). A positive contribution came also from household consumption, primarily thanks to improved situation in the labour market. According to the preliminary estimate of the Statistical Office, GDP growth in Q4 equalled 2.5% y-o-y.

Investment is expected to continue up in 2017, and coupled with further recovery of household consumption, it should provide the highest contribution to the acceleration of GDP growth to around 3%. A positive contribution is also expected from net exports on account of activation of earlier investment and further growth in the euro area and our other key foreign trade partners.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q4 2016.

Domestic demand

Favourable labour market trends, sustained positive effects of low oil prices and lower costs of repayment of both the existing and new loans propped up the growth in disposable income and **household consumption** (which inched up by 0.1% s-a in Q4). These improvements are also reflected in retail turnover which went up by 1.2% s-a in Q4 and the higher number of tourist arrivals (4.2% s-a) and overnight stays (2.8% s-a). For the sixth consecutive quarter, household consumption continued up in y-o-y terms as well (0.4%), contributing 0.3 pp to GDP growth.

Movements in key indicators of household consumption also point to its increase in Q4. Real net wage bill in the private sector rose 1.4% s-a in Q4, and social insurance transfers by 0.8% s-a, which is partly attributable to the one-off pension bonus of RSD 5,000 paid out in November. Also, newly approved consumer loans continued their upward trajectory, while remittances kept their Q3 level.

Table IV.4.1 **Investment indicators**

	2015	2016			
	IV	I	II	III	IV
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	-1.8	0.7	0.4	5.3	-1.5
Industrial production of capital goods	5.9	5.0	-1.8	-3.6	3.4
Exports of equipment*	7.4	22.2	0.9	1.3	9.7
Imports of equipment*	-7.3	5.3	-0.2	-1.1	0.8
Inventories of capital goods	3.8	5.9	1.0	2.9	-3.5
Industrial production of intermediate goods	0.9	4.0	5.1	-1.7	-0.6
Exports of intermediate goods*	3.2	3.4	4.5	0.8	8.9
Imports of intermediate goods*	3.3	-2.3	0.8	0.9	4.9
Inventories of intermediate goods	3.0	2.1	2.3	6.9	-0.7
Industrial production of construction materials	3.2	2.1	-0.6	-0.3	0.6
Inventories of construction materials	0.4	2.8	2.3	1.8	2.7
Government investment**	4.2	4.2	4.1	4.0	3.8

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

According to our estimate, a positive contribution to GDP growth in Q4 (0.1 pp) should come from the increase in **private investment** (0.4% s-a), already evident from rising indicators in construction as well as in production and imports of equipment. The production of construction materials inched up by 0.6% s-a. Domestic production of equipment went up by 9.6% s-a, while imports of equipment by 0.8% s-a. In y-o-y terms, the rise in private investment in Q4 sped up to 7.1%, adding 1.1 pp to GDP growth.

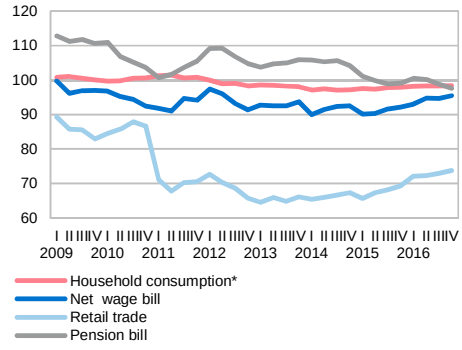
As regards sources of funding investment, positive readings continued, as reflected in further FDI inflow and a rise in newly approved investment loans. The net FDI inflow remained high in 2016 (EUR 1,857 mln), exceeding the 2015 figure (EUR 1,804 mln). Newly approved investment loans also went up in Q4 (by around RSD 59 bln), and according to the results of the bank lending survey, their growth is expected to continue in the coming period.

A negative contribution to GDP in Q4 came from falling inventories (0.4 pp) mostly as a result of a drop in inventories of industrial products (1.5% s-a), stemming from a reduction in inventories of petroleum products and chemical and tobacco products. Inventories of agricultural products also drifted down, while the exports of corn went up in Q4.

Final government consumption continued down from Q3 – it dropped by 0.9% s-a in Q4, giving a negative 0.2 pp contribution to GDP. This decline was caused by further employment rightsizing in the public sector, which reflected in lower expenditures for wages, while thanks to austerity measures, expenditures for the purchase of goods and services also dropped. In y-o-y terms, the rise in this component of aggregate demand slowed down (0.6%), giving a positive contribution of 0.1 pp to GDP growth.

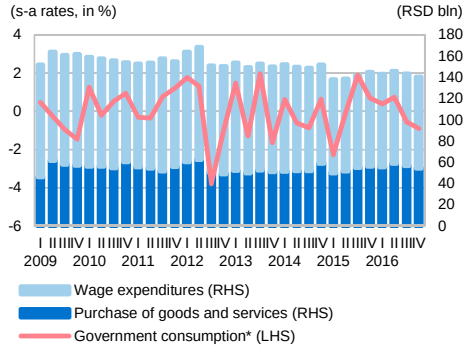
On the other hand, continued intensified implementation of infrastructure projects drove up **government investment** by 3.8% s-a in Q4, in real terms, and gave a positive contribution to GDP of 0.1 pp. In y-o-y terms, government investment slowed down in Q4 (2.0%), adding 0.1 pp to GDP growth.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q4 2016.

Chart IV.4.3 **Government consumption**
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q4 2016.

Text box 3: Contribution of household consumption to the growth of Serbia's economy

Investment and exports were the main drivers of Serbia's GDP growth in 2016 as well, but a positive contribution also came from household consumption. It picked up on the back of positive trends in the labour market, i.e. the rise in employment and wages in the private sector that stemmed from the improvement in the business and investment environment and activation of earlier FDI. This to a large extent neutralised short-term adverse effects of fiscal consolidation on wages and employment in the public sector, so that the total wage bill in 2016 increased by 3.8%. Positive effects on household consumption also came from higher real disposable income of households that went up owing to the oil price slump and lower interest rates which made the repayment of loans easier and pulled down the cost of new borrowing. According to our estimate, the rise in household consumption equalled 0.6% in 2016, giving a positive contribution of 0.5 pp to GDP growth. The pace of growth in household consumption is expected to accelerate in 2017 thereby providing further support to Serbia's economic recovery.

The increase in household consumption in 2016 was also indicated by the trajectory of real indicators – retail trade, hospitality industry, and tourist arrivals and overnight stays. These indicators are suitable for estimating household consumption because the relevant data are regularly issued and easy to access (published monthly, with a lag of 30 to 45 days from the end of the observed period), while comparable long-term time series are readily available, enabling the assessment of correlation with household consumption. The imports of consumer goods are another indicator for assessing household consumption. The use of this indictor is problematic as it does not represent de facto consumption, since the goods imported are not necessarily consumed immediately, rather the better part of them is stored as inventory and spent later. Also, a part of imported consumer goods is kept unclassified, which further reduces the explanatory power of this indictor in regard to household consumption. Another indicator is VAT revenue, which however, besides higher consumption, often also illustrates higher collection efficiency, i.e. more streamlined operation of the Tax Administration, so it is difficult to pinpoint exactly which effect helped its rise. To assess household consumption, one can also use a series of sectoral indicators on trade, transport and telecommunications, which are available quarterly and with a relatively significant lag (70 days from the end of the period observed). As such, they are most often used as a confirmation of the registered trends in household consumption.

To obtain a complete picture of the household consumption trajectory, besides indicators, it is important to analyse trends in key sources of household consumption. The two main sources of consumption are the private sector wage bill and total social contribution payments, inclusive of pensions, which together make up over 50% of all sources of consumption. Other sources of consumption include remittances (around 10%) and new consumer and cash loans (around 10%), while the remaining 30% are made up of the so-called alternative income.

Movements in indicators and sources of household consumption in 2016 (Table O.3.1) confirm its recovery in the period observed. Retail trade and the hospitality industry rose relatively sharply in 2016 compared to previous years, with tourist arrivals and overnight stays also posting significant growth rates. Favourable results in tourism and hospitality stem from the Government's programme of promoting development of domestic tourism through subsidies in the form of vouchers for tourist services in Serbia. On the other hand, according to the preliminary data of the Statistical Office, the imports of

Table O.3.1. **Key indicators and sources of household consumption in 2016***
(real annual growth rates, in %)

Household consumption	**0.6**
Indicators	
Retail trade	7.6
Hospitality turnover***	7.7
Number of domestic tourists	13.0
Number of overnight stays of domestic tourists	13.3
nominal	-2.2
VAT revenue	7.8
Volume of services in passenger transport**	5.3
Telecommunications**	0.9
Green market turnover**	-6.2
Sources	
Private sector wage bill	6.2
Total social transfers	-0.1
Pension bill	-0.3
Net remittances inflow, nominal	-6.0
New consumer loans, nominal	15.4
New cash loans, nominal	47.0

* NBS estimate.
** Q1-Q3 2016.
***January-November.
Sources: SORS and NBS calculation.

consumer goods were down in 2016, but we believe that a portion of unclassified goods were consumer goods and that after re-classification, this category will show an increase. The rise in household consumption is also confirmed by indicators in transport and telecommunications, as well as VAT revenue, which can in part be credited to the more efficient work of the Tax Administration. In terms of sources of consumption, wage bill and social transfers – making up around 50% of total sources – went up, while a part of consumption was financed from the newly approved consumer and cash loans.

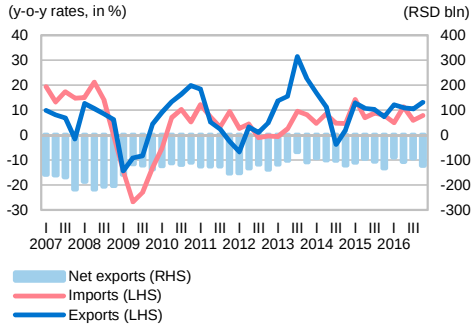
The improvement in overall economic conditions, reflected in the expected rise in economic activity and a continued increase in employment and wages in the private sector, will reflect positively on final consumption this year as well. Also, better than expected results of fiscal consolidation in 2016 created room for the Government to adopt measures that will improve the standard of living of the general population and additionally spur economic activity. These measures, adopted in late 2016, primarily relate to increasing the main sources of consumption (wage and pension bills) and should give a contribution of around 0.8 pp to GDP growth in 2017 (Table O.3.2). The strongest boost to growth is expected from the increase in pension bill (by around 0.4 pp), of which around a half relates to the one-off pension bonus of RSD 5,000 paid out in November 2016. The other part of the contribution comes from the 1.5% increase in pensions as of 1 January 2017. Besides pensions, the rise in household consumption in 2017 (around 0.25 pp) is expected to be sparked by the increase in wages of a portion of the public sector. Also, in September 2016, the Government made a decision to increase the net minimal wages by 7.4%, from RSD 121.0 to RSD 130.0 per working hour, which will be in force from January through December 2017. We estimate that this measure should contribute around 0.2 pp to a rise in household consumption and around 0.15 pp to GDP growth in 2017. Hence, observed in aggregate terms, household consumption in 2017 should give additional support to the growth of Serbia's economy.

Table O.3.2. **Effects of Government measures on final consumption and GDP growth**
(in pp)

	Effects on final consumption	Effects on GDP
Wage increase in a segment of the public sector (3-6%)	0.3	0.25
One-off aid to pensioners (RSD 5,000)	0.3	0.2
Pension growth by 1.5% from 1 January 2017	0.3	0.2
Increase in minimum wage (7.4%)	0.2	0.15

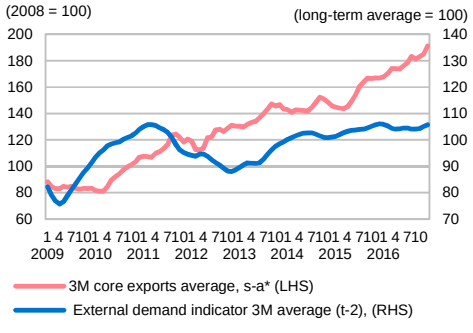
Sources: Ministry of Finance, SORS and NBS calculation.

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



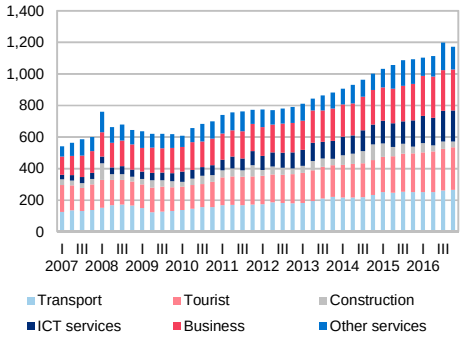
Sources: SORS and NBS calculation.
* NBS estimate for Q4 2016.

Chart IV.4.5 **Movements in external demand and core exports indicators**



Sources: European Commission, SORS and NBS.
* Excluding agriculture, energy products, motor vehicles and base metals.

Chart IV.4.6 **Exports of services**
(s-a data, in EUR mln)



Sources: SORS and NBS calculation.

Net external demand

Real exports of goods and services picked up in Q4 by 3.9% s-a, mainly owing to accelerated growth in the euro area, Serbia's key trade partner, activation of earlier investments and last year's exceptionally favourable agricultural season. With real exports outpacing the imports of goods and services (2.3% s-a), net exports contributed 0.5 pp to GDP in Q4, maintaining a positive contribution at the y-o-y level (1.3 pp).

The high growth in exports was signalled by the 1.6% s-a rise in the external demand indicator[21] in Q4, reflecting an increase in 17 of the 20 observed countries. The improvement was in large part due to better economic climate in Italy, Serbia's main foreign trade partner, as well as to continued favourable perception of the economic situation in Germany which also accounts for a sizeable portion of Serbia's foreign trade activity. By contrast, the cost competitiveness of the Serbian economy deteriorated in Q4 due to increased unit labour costs in manufacturing.

Growth in euro-denominated commodity exports scaled up in Q4 (6.2% s-a) on the back of higher exports in manufacturing (19 out of 23 industries) and agriculture. The main boost came from the exports of base metals, triggered by the rising global prices of steel and copper and accelerated production at the Smederevo steel plant following privatisation. Another considerable impetus to growth originated from the exports of food and rubber and plastic products which recovered from a dip in Q3. Exports posted growth in a string of other manufacturing industries that are mostly export-oriented (electronic, textile, paper packaging, metal).

Following a lapse in Q3, the automobile industry recorded a mild increase in exports in Q4 (0.8% s-a), which means that Fiat's lower export figures were fully compensated by higher exports of other manufacturers within the industry whose share in Serbia's overall exports is constantly on the rise. Slight growth was recorded in the exports of petroleum products which can be attributed to the gradual recovery in the prices of these products. On the other hand, the tobacco industry and, to

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

a lesser degree, the chemical and pharmaceutical industries reported dampened exports in Q4.

Exports of agricultural products rose 8.0% s-a in Q4, mainly due to the high exports of cereals (10.0% s-a) and fruit and vegetables (5.0% s-a). In terms of quantity, corn boasted the highest exports owing to this season's record yields and large export inventories, as well as competitive prices in the neighbouring countries.

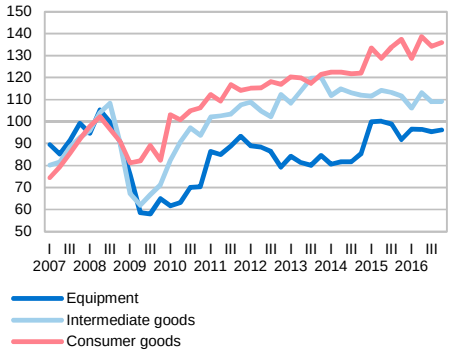
Following robust growth in Q3 (7.7% s-a), services exports dropped 2.2% s-a in Q4 driven by lower exports of construction services (23.4% s-a), while the exports of tourist, transportation, information and computer services continued on the upward path.

In addition to exports, Q4 also saw a rise in euro-denominated commodity imports (3.6% s-a). While all components of commodity imports were on a decline in Q3, in Q4 they recorded growth, mostly with respect to consumer goods, led by the recovery in household consumption. Equipment imports registered growth in response to the on-going implementation of a number of investment projects, while higher imports of intermediate goods indicate increased activity in manufacturing and construction.

Observed by the EU economic destination, Q4 saw higher imports of energy, most notably crude oil, due to larger processing volumes following the overhaul of the Pančevo refinery in Q3. Electricity imports also rose on account of lower production at home, while the imports of natural gas declined, due in part to lower consumption by the chemical industry. Imports of intermediate goods and consumer durables perked up as well, while the imports of capital goods declined slightly.

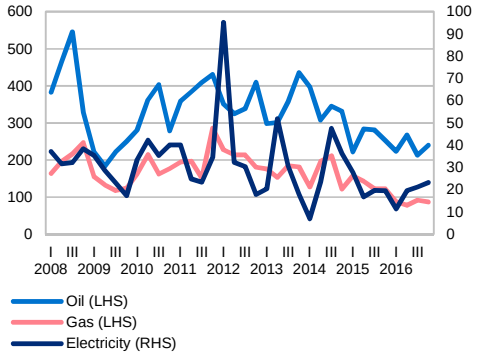
Faster growth in commodity exports relative to that in imports also led to further improvement in terms of trade indicators. In December, the exports-to-imports ratio reached a record high of 78.8%, up by 1.6 pp from September. Commodity exports in December more than doubled from the pre-crisis level[22] (105.3%), while imports stood at 9.0% above their pre-crisis level.

Chart IV.4.7 **Imports by key components**
(s-a, H1 2008 = 100)



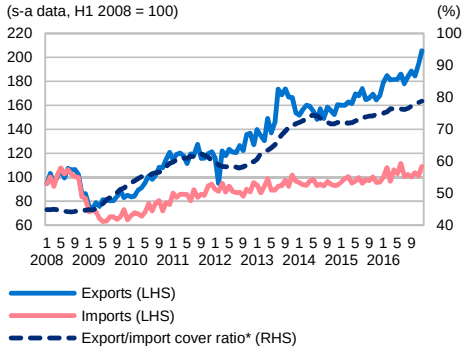
Sources: SORS and NBS calculation.

Chart IV.4.8 **Energy imports**
(s-a data, in EUR mln)



Sources: SORS and NBS calculation.

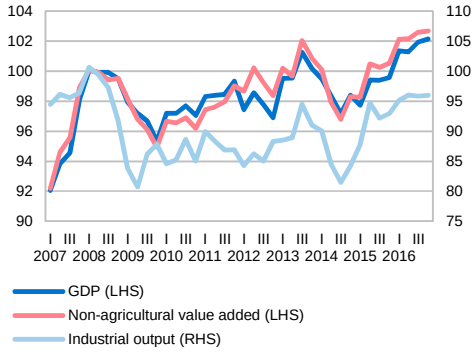
Chart IV.4.9 **Commodity trade in euros**
(s-a data, H1 2008 = 100) (%)



Sources: SORS and NBS calculation.
* 12-month moving average.

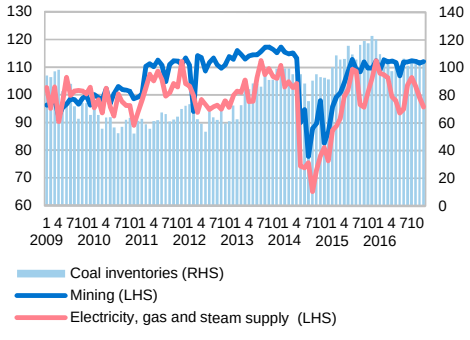
[22] H1 2008.

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



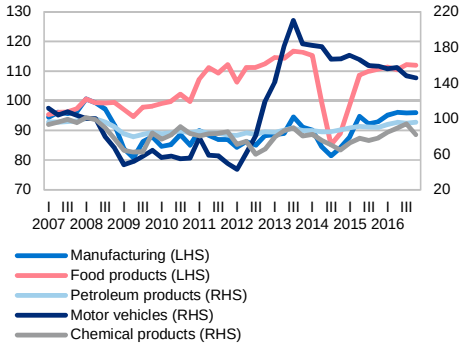
Sources: SORS and NBS calculation.

Chart IV.5.2 **Physical volume of production in energy and mining**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.3 **Physical volume of production by branches of manufacturing**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

5. Economic activity

Favourable developments in industry and construction and a successful agricultural season of 2016 reflected positively on economic activity which has been trending above its pre-crisis level since the start of 2016. According to NBS estimates, growth of the economy continued in Q4 (0.2% s-a) and, as in Q3, it was mainly driven by agriculture, manufacturing and construction. Preliminary estimate of the Serbian Statistical Office suggests that GDP rose by 2.5% y-o-y in Q4, while annual growth is anticipated at 2.7%.

According to our estimates, GDP growth in 2016 was mainly driven by industry (0.8 pp) which was, on the supply side, positively affected by the activation of earlier investments, persistently low oil prices and a cut in interest rates. On the demand side, GDP rose amid uninterrupted growth in domestic demand and GDP of the euro area. Agriculture, construction and the majority of service sectors will most likely remain positive contributors.

According to the NBS estimate, GDP continued up in Q4 (0.2% s-a). As in the previous quarter, growth was led mainly by agricultural production which boasted above-average crop yields, and by the manufacturing and construction industries which continued to grow on the back of earlier investments and implementation of infrastructure projects. To a lesser degree, a positive contribution was provided by those service sectors dominated by the private sector, most of which expanded in Q4. Owing to positive trends in place since mid-2015, the country's economy returned to its pre-crisis level early in 2016 and surpassed it in Q4 – by 2.1% in terms of GDP, or by 2.7% as measured by NAVA.

According to the preliminary estimate of the Serbian Statistical Office, GDP grew by 2.5% y-o-y in Q4. In our judgement, this was mainly attributable to agriculture, but also to trade, transport, and accommodation and food sectors which benefited from the recovery in household consumption over the past year. In addition, the industrial sector, most notably manufacturing, and the construction sector also remained positive contributors.

After a slight drop in Q3, the physical volume of industrial production rose 0.2% s-a in Q4, amid reassuring developments in manufacturing (1.1% s-a)

where 16 out of 24 industries recorded growth. By contrast, a contraction in the physical volume of production was recorded in mining (0.2% s-a) and electricity, gas and steam supply (2.3% s-a).

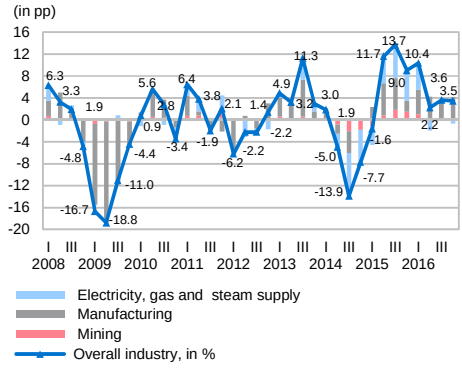
Petroleum products gave the largest boost to manufacturing output in Q4 owing to the relaunching of production at the Pančevo refinery following the overhaul in Q3. Considerable growth in the physical volume was also recorded in the production of base metals, chiefly owing to the recovery of global prices of steel and copper. In addition, a successful agricultural season continued to boost food production, while a further rise in investment led to the increased production of machinery and equipment, as well as construction materials. Conversely, automobile production continued to contract gradually owing to the lower output at Fiat Automobiles Serbia. The chemical, pharmaceutical and textile industries also recorded lower production in terms of physical volumes.

Y-o-y, the total physical volume of industrial production continued up (3.5%), mostly on account of the rise in manufacturing (4.1 pp). Growth was posted by 18 of the 24 manufacturing industries, most of which are export-oriented, which suggests that external demand continues to exert a positive influence on industrial growth. On the other hand, lower physical volume of production in the electricity, gas and steam supply sector gave a negative contribution (0.7 pp) to the physical volume of overall industry.

According to the Serbian Statistical Office's estimate, the physical volume of agricultural output rose by 8.1% in 2016, with a positive contribution of 0.6 pp to GDP. This was mostly induced by good yields of almost all of the main crops which outperformed their ten-year averages. We estimate that a mild rise was achieved in fruit production due to better plum yields, while wine growing subsided. Animal husbandry stagnated as the contracted pork production was offset by the higher production of other types of meat, as well as milk and dairy products.

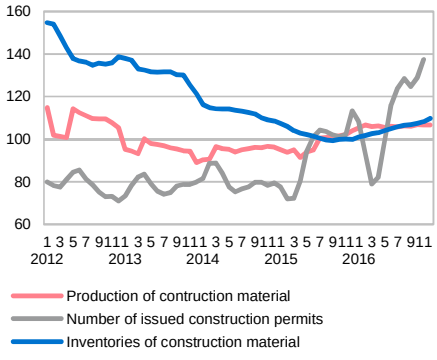
On-going implementation of infrastructure projects and legislative improvements continued to reflect positively on construction which, according to our estimates, remained on the growth side in Q4 as well. This is confirmed by the increased production of construction materials. In October and November, the number of issued construction permits increased further, by 37.3%

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



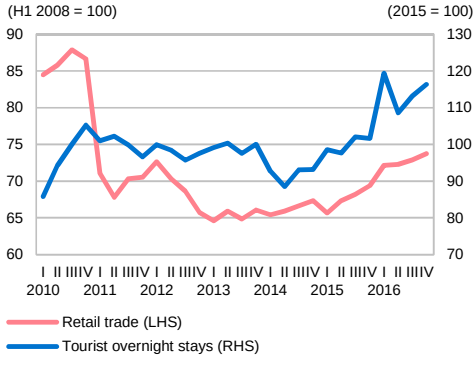
Sources: SORS and NBS calculation.

Chart IV.5.5. **Construction activity indicators**
(quaterly averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.6 **Service sector indicators**
(s-a data)



Sources: SORS and NBS calculation.

y-o-y, and is expected to provide an impetus for construction growth in the following quarters.

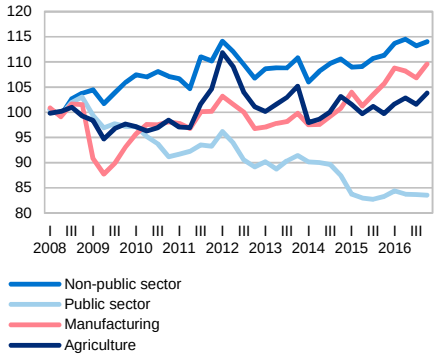
Table IV.5.1 **Contributions to quarterly GDP growth**
(in pp)

	2015	2016			
	Q4	Q1	Q2	Q3	Q4*
GDP (s-a, in %)	**0.2**	**1.8**	**-0.1**	**0.6**	**0.2**
Agriculture	0.0	0.4	-0.1	0.4	0.1
Industry	-0.1	0.5	0.0	-0.2	0.0
Construction	0.0	0.2	0.1	0.1	0.0
Services	0.0	0.5	0.1	0.3	0.1
Net taxes	0.0	0.1	0.0	-0.1	0.0

Sources: SORS and NBS calculation.
* NBS estimate.

Owing in particular to the recovery of private consumption, we estimate that the majority of the service sectors upheld the upward trend in Q4 as suggested by the movements of available indicators. Retail trade continued slightly up in Q4 (1.2% s-a), maintaining the relatively high y-o-y growth rate (6.4%). In addition, October and November saw a continued rise in the y-o-y turnover in the hospitality industry, as well as an increased number of tourist arrivals and overnight stays. In our best judgement, higher household consumption is likely to boost the volume of passenger transport, while growth in industry and trade should achieve the same for freight transport. More positive movements are expected in information and communications, while an increase in new loans to the private sector is likely to give an impetus to the financial sector.

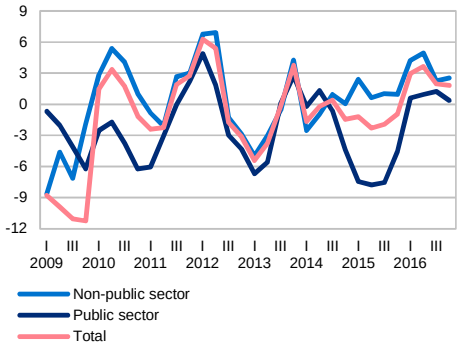
Chart IV.6.1 **Real net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

According to preliminary data of the Serbian Statistical Office, GDP growth in 2016 is estimated at 2.7%, which corresponds to our November projection. The main contributing factor was industrial growth (0.8 pp) which was, on the supply side, positively affected by the activation of earlier investments, persistently low oil prices and a cut in interest rates. On the demand side, GDP rose amid further growth in domestic demand and GDP of the euro area. Positive contributions are also expected from agriculture (0.6 pp) on account of above-average crop yields, as well as from construction (0.3 pp) and the majority of the service sectors.

Chart IV.6.2 **Real net wages**
(y-o-y growth, in %)



Sources: SORS and NBS calculation.

6. Labour market developments

As economic growth continued in Q4, developments in the labour market were favourable, such as growth in real net wages and employment.

Wages and labour productivity

Real net wages edged up 0.5% s-a in Q4 on the back of the recovery in private sector wages (0.8% s-a), while real public sector wages dipped slightly (0.2% s-a). Hence the average public vs. private sector wage gap narrowed relative to Q3 and equalled 2.0% in December. Real net wages continued to rise in y-o-y terms as well (1.8%). At the annual level, after declining for three years, real net wages rose 2.5% in 2016, thereby matching the rate of growth of the country's economy.

Compared to Q3, real net wages rose in agriculture, manufacturing, energy and construction in Q4, while at the same time maintaining the upward trend in the sectors of trade, hospitality, and information and communications.

A steady rise in employment and average wages led to an increase in the real net wage bill (0.8% s-a) – as in the prior period, this increase went hand in hand with the higher wage bill in the private sector (1.4% s-a), whereas in the public sector it dropped slightly (0.5% s-a). The average nominal net wage in the Republic of Serbia equalled RSD 48,165 in Q4, up by 4.6% from Q3 and by 3.4% y-o-y. At year level, the average wage in 2016 gained 3.7% from 2015.

Employment in industry rose faster than production and impacted on productivity contraction, which, coupled with the increase in real gross wages, pushed unit labour costs up (3.1% s-a) in Q4. Similar movements were recorded in manufacturing, with a somewhat higher increase in unit labour costs (3.6% s-a) relative to the overall industry.

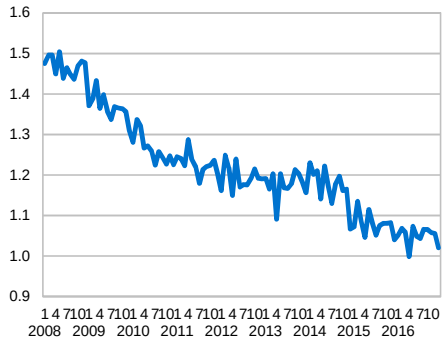
Employment

Further economic growth and stepped-up efforts to combat the grey economy reflected favourably on formal employment in Q4 as well. According to data from the Statistical Office's **Central Registry of Compulsory Social Insurance**, formal employment continued up in Q4 (0.2%) owing to a larger number of private entrepreneurs and their employees (0.8%), as well as increased employment with legal entities (0.1%).

By sector, the rise in employment was the most pronounced in mining, manufacturing, trade, and information and communications, i.e. sectors contributing a good deal to GDP growth. In addition, employment figures rose in the accommodation and food, financial and education sectors, at the same time dropping significantly in agriculture and construction under the influence of seasonal factors.

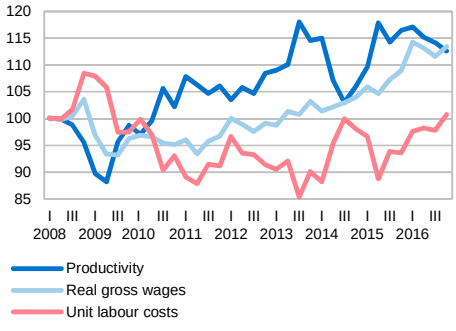
Data of the **National Employment Service** available for Q4 indicate a rise in unemployment, with the number of unemployed persons equalling 700,947 in December. To a degree, this is attributable to lower demand for seasonal workers in this quarter. Unemployment rose across occupational groups, yet the number of people receiving unemployment benefits continued to decline and equalled 38,286 in December.

Chart IV.6.3 **Ratio of average nominal net wage in public and non-public sector**



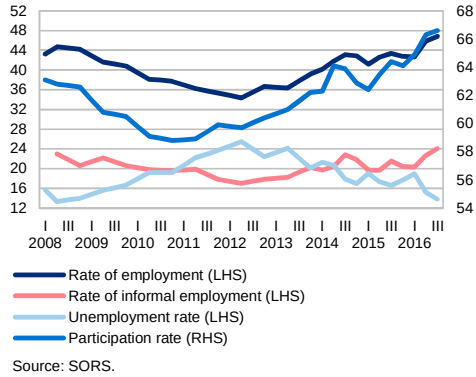
Sources: SORS and NBS calculation.

Chart IV.6.4 **Movements in productivity, real gross wages and unit labour costs in industry** (s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.6.5 **Labour market indicators under the Labour Force Survey** (in %)



Source: SORS.

Table IV.6.1 **Movements in formal employment and unemployment**
(quarterly growth rates, end-of-period)

	2016			
	Q1	Q2	Q3	Q4
Total number of formally employed	0.2	1.6	0.6	0.2
Employed with legal persons	0.1	1.4	0.7	0.1
Entrepreneurs and their employees	1.1	3.5	1.2	0.8
Individual farmers	-0.9	-1.1	-1.5	0.2
Unemployed persons	3.4	-5.7	-3.1	2.4
First-time job seekers	1.6	-4.7	-2.8	0.9
Used to be employed	4.4	-6.1	-3.2	3.1

Sources: SORS and National Employment Service.

The National Employment Service announced the results of the latest 2016/2017 **Employer Survey**, according to which the gross job creation rate[23] in 2016 was 12.1%, and the gross job destruction rate 9.8%, meaning that net job creation was 2.3%. Based on the survey, a positive net job creation rate is expected in 2017, at 4.0%.

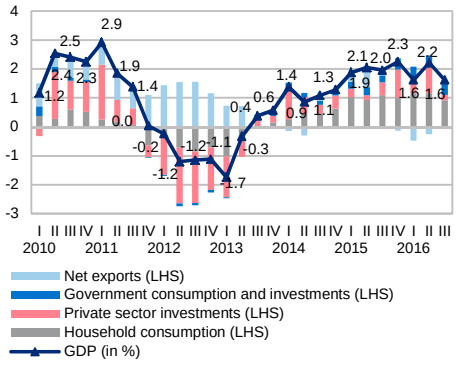
The **Labour Force Survey** data available for Q3 indicate an increase in employment to 46.8%. Employment rose across all sectors – in addition to the expected seasonal rise in agriculture, construction and some service sectors, a considerable increase was also recorded in the sector of industry. In part, employment edged up on account of an upturn in informal employment – by 1.4 pp to 24.1%. The same source puts Q3 unemployment at its lowest (13.8%) in the last three years, that is, since comparable data became available. Long-term unemployment also reached a minimum – 9.0%, while youth unemployment (15–24 years) fell below 30% for the first time in three years (to 28.5%).

7. International environment

Global economic activity gradually picked up in H2 owing to improved economic performance in advanced economies and in most emerging market economies. Euro area growth was supported by labour market recovery, low energy prices and the effects of the ECB's accommodative monetary policy stance. Growing external demand from the euro area is likely to contribute to a more favourable economic outlook for Central and Eastern Europe. The recovery in oil prices should prop up the recovery of Russia's GDP, whereas China's stimulative economic policy measures continued to ensure a gradual transition towards a new model of economic growth.

Despite the gradual growth caused primarily by the base effect from energy prices, global inflation remains low. In 2017 inflation is expected to stay below target in most countries. The Fed continued to normalise its monetary policy and raised its policy rate in December 2016, whereas the ECB extended its quantitative easing programme until the end of this year. Central banks of Central and Eastern European countries generally

Chart IV.7.1 **Contributions to y-o-y GDP growth rate of the euro area**
(in pp)



Source: Eurostat.

[23] The gross job creation/destruction rate is the ratio of the number of newly employed/dismissed persons and the total number of employed in companies observed at the beginning of a year. The net job creation rate is the difference between gross job creation and gross job destruction rates.

maintained the current degree of monetary expansion. International financial and commodity market developments were marked by the dollar's appreciation and the growth in oil prices, along with high volatility.

Economic activity

The faster pace of economic growth in H2 in some advanced economies (the USA, Japan and the UK) was neutralised by a gradual slowdown in some emerging market economies (Brazil and India), leaving the IMF's January global growth forecast for 2016 and 2017 unchanged relative to the October forecast. Risks to global growth are mildly tilted to the downside and relate mostly to the still present geopolitical tensions in some regions and uncertainty regarding monetary policy measures and the associated capital flows. On the other hand, the implemented and announced fiscal stimuli in the two largest economies (the USA and China), along with higher resilience of European countries to the effects of Brexit, could spur global economic growth.

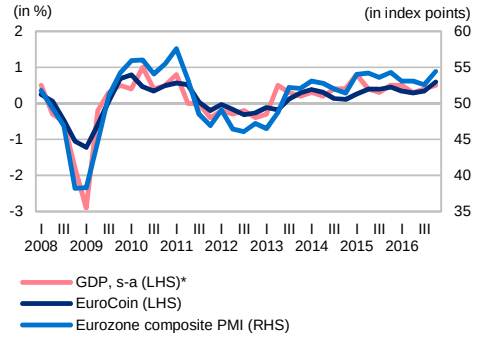
GDP growth in the euro area sped up in Q3 relative to Q2 (0.4% s-a), though it slowed down y-o-y (from 2.2% to 1.6%). Household consumption continued to encourage growth as a result of ongoing positive labour market trends (the unemployment rate dropped to 9.6% in December). Net exports also made a positive contribution in terms of both the sustained growth in exports and the decline in imports.

Observed by country, there was widespread growth in Q3, with acceleration in Italy and France and a mild deceleration in Germany and Spain. As in the euro area, growth in most countries was driven by household consumption, while in Italy and France it stepped up thanks to the recovery in investment.

The movement of leading indicators showed that GDP growth sped up in Q4, spread widely across countries and sectors, as confirmed by Eurostat's flash estimate (0.5% s-a). In Q4, both economic activity indices (Manufacturing PMI and Services PMI) averaged above their Q3 levels, moving in all the observed countries above 50 points on average – the point separating activity expansion from contraction. The Economic Sentiment Indicator also rose in most countries, while in the euro area it was 2.5% higher on average than in Q3.

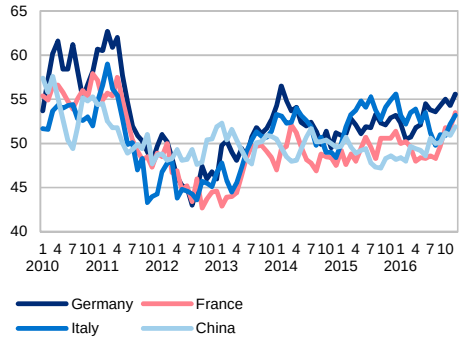
Domestic demand, i.e. household consumption and investment, should remain the main driver of this year's

Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



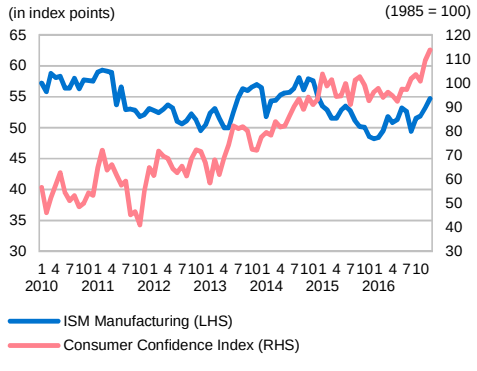
Sources: Eurostat, Markit Group and Banca d'Italia.
* Eurostat's preliminary flash estimate for Q4 2016.

Chart IV.7.3 **PMI Manufacturing for selected countries**
(in index points)



Source: Markit Group.

Chart IV.7.4 **Leading economic indicators in the USA**



Source: Institute for Supply Management, Conference Board.

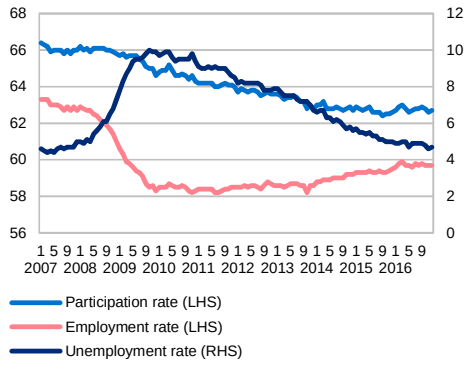
GDP growth, which was revised slightly upward in the latest IMF forecast, by 0.1 pp to 1.6%. According to the Consensus Forecast, growth will be somewhat lower (1.4%), though it was also revised up by 0.1 pp from the October 2016 forecast. The expected rise in employment and wages should reflect on the increase in disposable income, which will, despite being somewhat weighed down by higher oil prices and the gradual rise in inflation, still encourage the continued growth in private consumption. In addition to consumption, lower operating expenses on account of low interest rates will most likely be conducive to investment activity, as will the improved profitability of companies and higher demand in the real estate market. The contribution of external demand will depend on global economic growth, which, according to the latest estimates, is showing some signs of recovery, while additional impetus is expected from the euro's depreciation against the dollar.

Driven by the dominant impact of private consumption, **GDP growth in the USA** continued in Q3, accelerating relative to Q2 (from 0.4% to 0.9% s-a) on the back of robust growth in exports (above all soybean) and the recovery of inventories. Growth in private consumption continued to be positively impacted by labour market recovery, as indicated by the decline of the unemployment rate to 4.7% in December. Further, optimism sparked by the announced economic policy measures led consumer confidence, as measured by the Consumer Confidence Index, to its highest level in the last 13 years this December, thus private consumption will remain a fillip to growth in the period ahead. Besides private consumption, the ISM Manufacturing Index indicated further economic growth in Q4, as it averaged 4.1% above the Q3 level. According to the preliminary estimate of the US Bureau of Economic Analysis, GDP growth equalled 0.5% s-a in Q4.

The IMF estimates that the announced fiscal stimuli (tax reductions and investment in infrastructure) should speed up economic growth going forward, hence it revised the GDP growth forecast for 2017 upward by 0.1 pp to 2.3%, and by 0.4 pp to 2.5% for 2018. The latest Consensus Forecast estimate predicted similar growth in 2017, and somewhat lower growth in 2018 (2.3%).

Private consumption remained the main driver of **GDP growth in Central and Eastern Europe** in Q3. Romania remained the leader in terms of growth in the region in Q3 (4.4% y-o-y) owing to positive effects of fiscal stimuli, whereas in Poland and Hungary growth was dragged down by diminished investment, and in the Czech

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



Source: Bureau of Labor Statistics.

Table IV.7.1 **Economic growth estimate by country**
(in %)

	October 2016		January 2017	
	2016	2017	2016	2017
Poland	3.1	3.3	2,7	3,0
Czech Republic	2.5	2.5	2,4	2,5
Hungary	2.0	2.6	2,0	2,9
Albania	3.3	3.6	3,2	3,6
Bulgaria	2.8	2.8	3,3	3,0
Bosnia and Herzegovina	2.7	3.0	2,2	2,9
Macedonia	2.6	3.4	2,3	3,0
Romania	4.8	3.3	4,8	3,5
Slovenia	2.1	2.3	2,4	2,4
Croatia	2.4	2.2	2,7	2,7

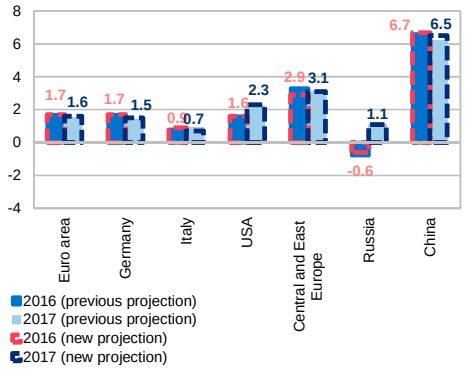
Sources: Consensus Forecast.

Republic by lower external demand. In Southeast Europe GDP growth continued to be driven by domestic demand, buttressed by labour market recovery and low energy prices, with an additional contribution coming from external demand spurred by continued expansion of the euro area. In 2017 growth is expected to step up in most Central and Eastern Europe countries, and to move in the interval between 2.5% and 3.5%, with domestic demand remaining the key contributor. Potential risks to this projection relate to growth in the euro area, its main trade partner, and changes to global capital flows.

Economic activity in Russia continued to recover gradually, with the y-o-y decline in GDP slowing down from 0.6% in Q2 to 0.4% in Q3. GDP is expected to fall in Q4 as well and then cross into positive territory starting from 2017, supported in the main by the recovery of oil prices. According to the latest IMF forecast and the Consensus Forecast, after declining by 0.6% in 2016, GDP is expected to grow by 1.1% in 2017.

Movements of the key indicators pointed to an acceleration in **China's GDP** growth in Q4 compared to the rest of the year, which was confirmed by the official data. Y-o-y growth accelerated to 6.8% in Q4, while in 2016 as a whole it stood at 6.7%, in line with the earlier estimate of the Chinese authorities. The acceleration was facilitated by more favourable movements in industry, which, according to Manufacturing PMI, recorded the best performance since early 2013, and in services, whose activity reached a two-year high. In its latest estimate, the IMF revised the GDP growth forecast up by 0.3 pp to 6.5%, due to expectations that fiscal and monetary stimulus measures will continue to be implemented, with elevated downward risks that primarily relate to high corporate debt and a relatively strong increase in lending.

Chart IV.7.6 **Revisions of real GDP growth forecasts for 2016 and 2017 by the IMF**
(in %)

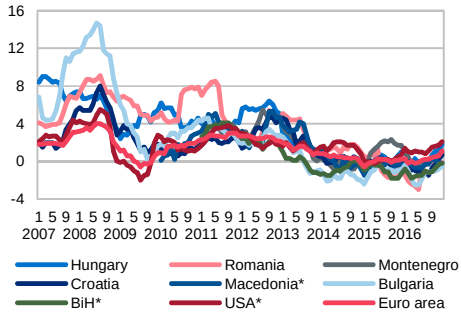


Sources: IMF WEO Update (October 2016) and IMF WEO (January 2017).

Inflation movements

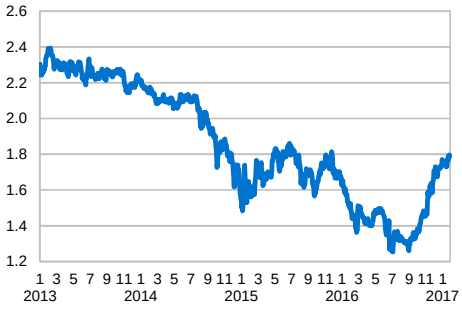
Though inflation is gradually increasing, it is still below target in most of the advanced economies, and will probably remain there in the coming period, according to projections of their central banks. In the **euro area**, Serbia's key trade partner, inflation grew steadily in the last quarter of 2016, reaching 1.1% in December and 1.8% in January, which is close to the inflation target and the highest rate since February 2013. The rise in inflation reflects for the most part the continued y-o-y growth in energy prices (8.1% in January compared to 2.6% in December), while a more lasting recovery is mainly hindered by indirect effects of falling oil prices in the

Chart IV.7.7 **HICP across selected countries**
(y-o-y rates, in %)



Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.
* CPI.

Chart IV.7.8 **Long-term inflation expectations in the euro area**
(in %)



Source: Thomson Reuters.

previous period. Core inflation, which excludes the volatile prices of energy and unprocessed food, remained stable in January at 0.9% y-o-y. Germany and Italy, Serbia's most important individual trade partners, recorded y-o-y inflation growth to 1.9% and 0.9% in January, respectively, owing to an increase in energy and food prices.

A gradual rise in inflation in the euro area should continue into 2017 and 2018 owing to an accommodative monetary policy stance and the expected economic recovery, though it will probably remain below the medium-term inflation target in both these years (1.3% and 1.5% respectively, according to the latest ECB projection published in December 2016). This is also suggested by inflation expectations, which stand at 1.4% for 2017 and 1.5% for 2018 according to the ECB Survey of Professional Forecasters published in January. Still, it is an increase compared to the previous survey from October – by 0.2 pp for 2017 and 0.1 pp for 2018, principally because of the rise in oil prices (expressed in euros). Long-term inflation expectations (for 2021) remained at 1.8%. These survey-based inflation expectations no longer exceed market expectations, which have been rising constantly since September 2016. Thus, at end-January, the market expected that five-year ahead inflation (in the year 2022 for the year 2027) would be 1.79%.[24]

In most **Central and Eastern European** countries inflation was still quite low. Though deflationary pressures subsided to a degree, some countries recorded negative y-o-y inflation rates in Q4 (Bulgaria, Bosnia and Herzegovina, Macedonia, Romania). Inflation in Croatia and Montenegro was positive but still low, while it was somewhat higher in Hungary (1.1–1.8%). In Russia it fell to 5.4% y-o-y in December, while Turkey still faces relatively high inflation compared to other countries in the region (7.0%–8.5% y-o-y in Q4).

US inflation continued up in Q4, reaching 2.1% y-o-y in December, its highest rate in the last two and a half years. Core inflation (excluding food and energy prices) also rose, coming at 2.2% y-o-y in December. Headline inflation was driven primarily by energy prices, and core inflation by the price of housing. Higher inflation increased the probability that the Fed's policy normalisation would be faster than previously expected.

[24] The five-year, five-year breakeven forward.

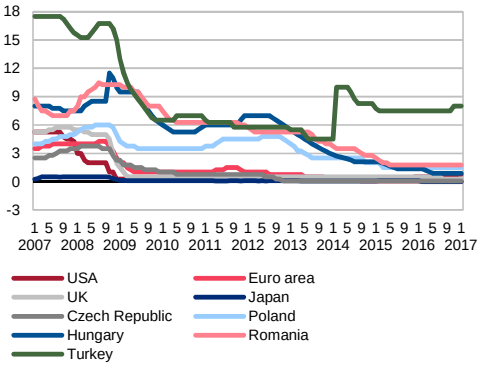
Monetary policy

The divergence of monetary policies of leading central banks, the ECB and the Fed, increased further. On the one hand, the **ECB** did not change its policy rate (0%), but in December it extended the duration of its quantitative easing programme by an additional nine months, until the end of 2017, though it will cut asset purchases from the current EUR 80.0 bln to EUR 60.0 bln per month starting from April. In addition, the ECB adjusted the technical conditions of the programme by trimming the minimum remaining maturity of eligible securities to one year, on the one hand, and by expanding the programme to include securities with lower yields than the ECB's deposit facilities interest rate (-0.4%), on the other. While the ECB's monetary policy was not changed in January, the Bank expressed readiness to make it more accommodative by extending the quantitative easing programme and/or increasing its scope.

On the other hand, the **Fed** continued to normalise its monetary policy thanks to positive developments in the real sector and a continued rise in y-o-y inflation since July 2016. In mid-December it raised its policy rate by 0.25 pp, for the first time since December 2015. The rate is now in the range of 0.50–0.75%. In December, most FOMC members expected that economic activity would continue to grow and that the policy rate would be raised three times in 2017, by 25 bp each time, instead of twice, as most of them had previously expected. Medium-term projection of the policy rate at end-2017 stood at 1.375%. In line with expectations, the Fed did not change its policy rate in January.

Central banks of most **Central and Eastern European** countries maintained their current degree of policy accommodation, in line with macroeconomic movements. The Hungarian central bank raised the degree of policy accommodation by cutting the lending facilities interest rate by 15 bp to 0.9%, while keeping its other rates unchanged. The central bank of Turkey also reacted – it raised its interest rates to stop the decline of the exchange rate of the Turkish lira. In late November, it increased the policy rate by 50 bp to 8.0% and the lending facilities rate by 25 bp to 8.5%. At the same time, the bank cut its foreign exchange required reserve rate by 50 bp for all maturities, freeing up around USD 1.5 bln to the financial system. The Czech central bank

Chart IV.7.9 **Policy rates across selected countries**
(annual level, in %)



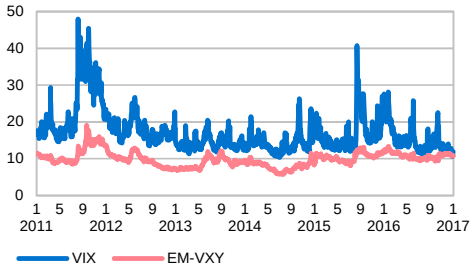
Sources: Central banks of selected countries.

announced that it would probably stop using the exchange rate as an additional monetary policy instrument, as well as foreign exchange market interventions to prevent the national currency from exceeding the set cap, while the precise date will depend on the outlook for achieving the inflation target.

Financial and commodity markets

The last quarter of 2016 was characterised by changing movements in financial and commodity markets. Partly due to the US elections and partly to the expected Fed policy rate increase, VIX (the measure of implied volatility of financial markets) went up to 22.5% in November. However, as the markets settled, it declined to 12.0% in late January.

Chart IV.7.10 **Implied volatility of the global financial market***
(in %)



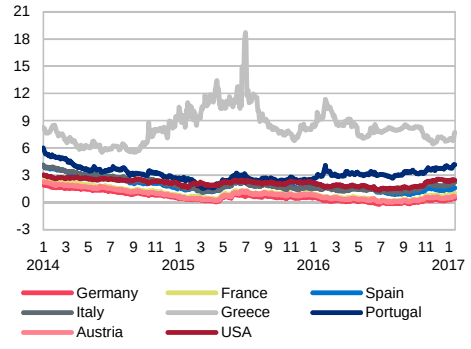
Source: Bloomberg.

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

At the same time, rising inflation expectations, first in the USA and then in other advanced economies, brought about higher yields on long-term government securities. For instance, yields on US ten-year government securities rose in Q4 from 1.6% to 2.4% and yields on equivalent German securities entered positive territory. In January yields on these German securities and on ten-year government securities of advanced European economies continued up, while yields on US securities stagnated.

Unlike Q3, when **currency movements** recorded no significant changes, with the exception of the pound sterling, Q4 was characterised by the dollar's appreciation from early November, along with the depreciation of the yen and currencies of some emerging market economies. The dollar started to strengthen in the latter half of October, due in large part to expectations that the Fed would raise its policy rate in December, and to the higher probability that the Fed's policy normalisation would be faster than previously expected as a result of the announced fiscal stimuli. In Q4, the dollar strengthened against the euro by 6%, only to weaken by 2% in January.

Chart IV.7.11 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

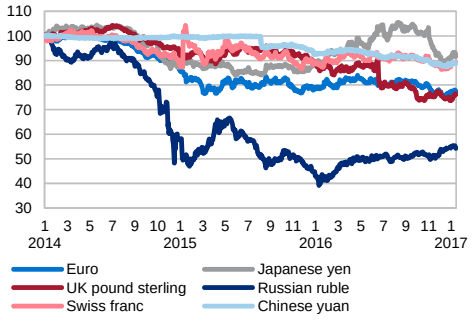
Investors' expectations regarding monetary policies of leading central banks also influenced the **price of gold**. After relative stability in Q3, the price of gold started to fall in October. It declined further in November but started to recover in mid-December, though it still stood 13.4% below its end-Q3 level. The price of gold continued to recover in January, and by the end of the month it was 5.8% higher than at end-2016.

The dollar's strengthening, announced infrastructure projects and other measures to stimulate US economic growth, and China's stimulus measures led to a surge in the prices of **iron, copper, aluminium and other metals**, which continued to grow in January.

Brent crude oil price was unstable in Q4, ranging from USD 44 to USD 56 per barrel, mostly due to the reactions of the market to negotiations between OPEC countries on cutting back production, while the main market trends remained mostly unchanged. Oil prices exceeded USD 50 per barrel in early October following hints of an agreement between OPEC countries on curtailing production, though they started to decline in the second half of the month. Prices continued down in November after the announcement of the International Energy Agency that OPEC's daily oil output had reached a record level in October, considerably above the agreement between its members. Still, at a meeting in late November, OPEC countries reached an agreement to cut production as of January 2017. Following that, the price of Brent crude oil exceeded USD 55 per barrel for the first time in 18 months. In January it averaged around that level and occasionally exceeded it. Movements of oil prices going forward will greatly depend on whether the agreement is observed; if so, the prices should rise, since global demand would exceed supply. The effect of this agreement could be mitigated by increasing adjustable production from oil shale in the USA. Oil futures indicate a moderate rise in oil prices, though uncertainty is heightened. Based on oil futures, the price of oil will stand at around USD 56 per barrel in December 2017, and hover thereabout throughout 2018.

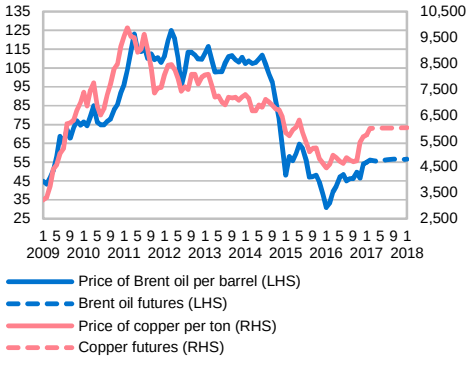
The gradual increase in **world food prices** continued. Measured by FAO index, December food prices were up by 0.5% in real terms relative to September. Vegetable oil prices rose the most (9.0%), followed by dairy products (5.4%), which was offset by the decline in the prices of sugar (-16.7%) and meat (-0.4%). The increase in the prices of vegetable oils was driven by palm and soybean oil prices due to low global inventories, reduced supply, concerns over weather conditions and growing production of biofuels. The recovery of dairy prices resulted from the limited production of milk in the EU and Oceania, and the still rising demand.

Chart IV.7.12 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



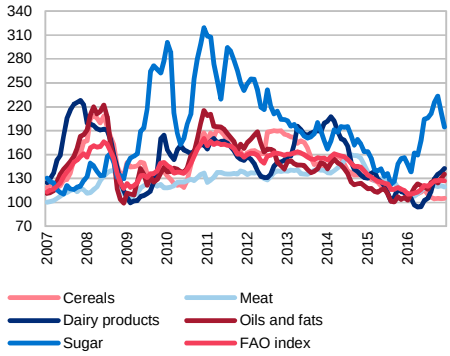
Source: IMF.
* Growth indicates appreciation.

Chart IV.7.13 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart IV.7.14 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

World cereal prices, relevant to Serbia, were higher in December than in September by 0.9% in real terms, though still lower than in 2015 – by 7.6% in real terms. Meat prices did not change significantly in Q4, while sugar prices declined as a result of the weakening of Brazil's currency against the dollar and the rise in sugar exports from Brazil, the world's leading producer and exporter of sugar. Still, in real terms, the prices were on average higher in 2016 than in 2015 because of contracted supply from Brazil, India and Thailand.

In the whole of 2016, measured by FAO index, food prices were on average lower by 2.9% y-o-y in real terms, meaning they declined for five consecutive years in both nominal and real terms. While the prices of sugar and vegetable oils were significantly higher in 2016 (by 32.3% and 9.9%, respectively, in real terms), the decline in the prices of cereals, meat and dairy products kept the FAO index below the 2015 average. Cereals were around 10% cheaper than in 2015, and by almost 40% than in 2011. Despite growing moderately during the year, meat prices were 8.2% lower in real terms.

V. Inflation projection

Under our central projection, y-o-y inflation will enter the target tolerance band (3.0±1.5%) in Q1, driven primarily by the rise in petroleum product and cigarette prices. It is expected to remain relatively stable within the target band until the end of the projection horizon. Higher inflation will reflect the low base effect from fruit and vegetable prices and a gradual increase in domestic aggregate demand and inflation abroad, while low food production costs and the high base for petroleum product prices (from March onwards) will act as a damper. The risks to the projected inflation path are symmetric and relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth.

Under our central projection, GDP growth will step up to 3.0% in 2017 and further up to 3.5% in 2018. This year, growth will continue to be led by investment and net exports, with an increasing contribution from household consumption. In 2018, GDP growth should be led mainly by domestic demand, i.e. investment and consumption.

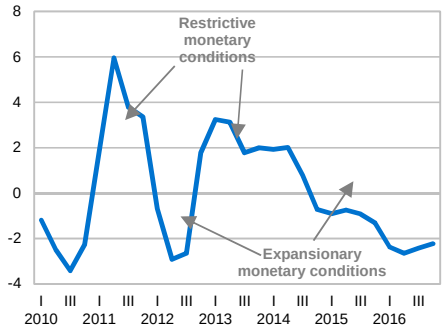
The medium-term inflation projection aims to show the expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. The projection assumes an active monetary policy which seeks to keep 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*, inflationary pressures remained subdued in Q4 and y-o-y inflation amounted to 1.6% in December. Looking at domestic factors, the key contributors to weak inflationary pressures were the effects of fiscal consolidation, relative stability of the exchange rate and low inflation expectations of the financial and corporate sectors. While global oil prices regained some ground encouraging a modest inflation rise in the euro area, the impact of prices from the international environment stayed relatively weak.

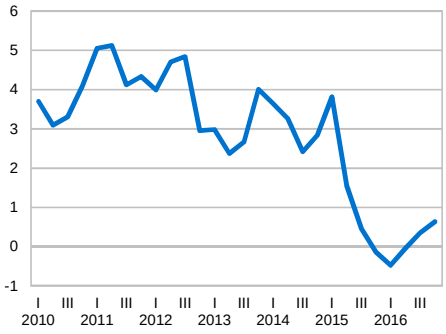
As inflationary pressures have been subdued for an extended period of time, short- and medium-term inflation expectations of the financial and corporate sectors remained broadly stable, moving between 2% and 3%, i.e. within the edges of the new target band (3.0 ± 1.5%), thus facilitating the achievement of the inflation target in the period ahead.

Chart V.0.1 **Monetary conditions index**
(in %)



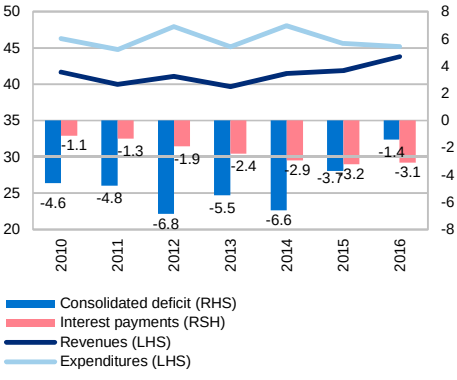
Source: NBS.

Chart V.0.2 **Real interest rate**
(in %)



Source: NBS.

Chart V.0.3 **Fiscal trends**
(in % of GDP)



Source: Ministry of Finance.

The value of the dinar against the euro stayed practically unchanged in Q4. The first half of the quarter saw appreciation pressures, sparked primarily by the lower than usual foreign currency demand of domestic enterprises, but also by the October increase in non-residents' investment in government securities. Appreciation pressures were also underpinned by the country's improved macroeconomic prospects, a positive assessment of Serbia's performance under the programme with the IMF, and a lower risk premium. At quarterly level, however, non-residents scaled down their portfolio of dinar government securities amid expectation of a faster normalisation of the Fed's monetary policy. The exit of foreign investors from dinar securities, but also foreign currency purchases for the payment of energy imports ushered in depreciation pressures in December, which persisted throughout January.

The Monetary Conditions Index points to a sustained expansionary monetary policy stance in Q4, which is consistent with the ongoing disinflationary pressures and an open negative output gap. However, the degree of monetary expansion lessened somewhat relative to a quarter earlier due to a rise in the real interest rate[25] (prompted by the further fall in inflation expectations) and the narrowing of the depreciation gap of the real exchange rate (caused by a mild real appreciation of the dinar). The real interest rate, however, stayed below the neutral level, though less so than in Q3.

Consolidated budget deficit in 2016 turned out lower than anticipated earlier, measuring 1.4% of GDP compared to the 2.1% target value set for the sixth review of the arrangement with the IMF. We can appreciate this result all the more in light of the fact that it was achieved a year earlier than planned, i.e. the original fiscal consolidation plan envisaged a structural adjustment in the amount of around 4% of GDP over a period of three years. The narrowing of the consolidated budget deficit reflects primarily a cutback in government expenses. In 2016, deficit reduction was also aided by the continuing growth in receipts from excise tax, VAT and social contribution payments, and by the increase in non-tax revenue. Excluding interest payment expenses, Serbia recorded a primary surplus of 1.8% of GDP in 2016. Consistent with favourable fiscal developments, the share of public debt

[25] Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

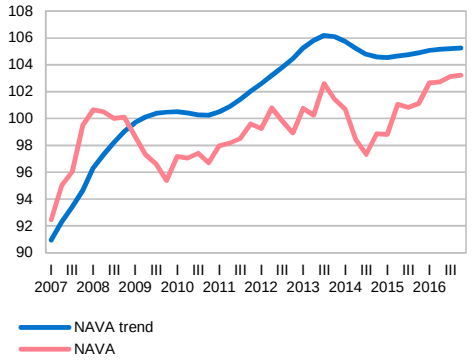
in GDP started to fall in 2016, also a year earlier than expected, amounting to 72.9% at year-end. This ratio would have been lower by further 0.9 pp had it not been for the hefty rise in the value of the dollar against the euro.

In Q4, GDP grew by 0.2% s-a q-o-q or by 2.5% y-o-y. On the production side, the largest positive contribution to growth is estimated to have come from agriculture, owing to a particularly good agricultural season, but also from manufacturing and construction. On the expenditure side, GDP growth was led by investment and net exports, while final consumption acted as a drag due to slashed government consumption. At the same time, household consumption picked up, mainly under the impact of more favourable labour market trends.

NAVA[26] contracted marginally in Q4 (by 0.1% s-a), sustaining the negative output gap[27] at the level recorded a quarter earlier. This means that the disinflationary pressures from aggregate demand were of similar intensity as in the previous quarter.

After the 0.3% s-a growth in Q3, leading economic activity indicators suggest that the euro area's GDP accelerated to 0.4% in Q4. The recovery of the euro area economy is supported by domestic demand that continues to benefit from the accommodative monetary policy stance of the ECB. The ECB has kept its main interest rate at zero, but extended the quantitative easing programme until the end of 2017, reducing the volume of monthly asset purchases from EUR 80 bln to EUR 60 bln. The Fed, on the other hand, proceeded with monetary policy normalisation after a year, raising its policy rate by 0.25 pp in December (to 0.50–0.75%) and signalling a faster pace of rate increases in 2017.

Chart V.0.4 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Inflation projection assumptions

External assumptions

The assumption for the euro area's GDP growth in 2017 has been revised slightly upward from the November projection (from 1.3% to 1.4%), while the assumption for 2018 is 1.5%.[28] Domestic demand in the euro area will continue to be supported by the accommodative monetary policy measures of the ECB and the consequent

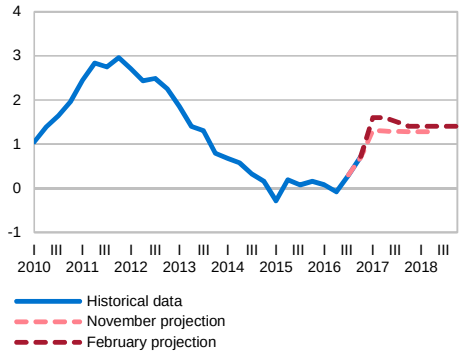
Table V.0.1 **Projection assumptions**

	2017		2018	
External assumptions	Nov.	Feb.	Nov.	Feb.
EU inflation (annual average)	1.3%	1.5%		1.4%
ECB policy rate (year-end)	0.0%	0.0%		0.0%
Euro area GDP growth	1.3%	1.4%		1.5%
International prices of primary agricult. commodities (Q4 to Q4)*	11.0%	9.0%		3.2%
Brent oil price per barrel (year-end, USD)	51	56		56
Internal assumptions				
Administered prices (Dec to Dec)	4.0%	4.0%		4.0%
Trends				
Appreciation trend of the real exchange rate (average)	0.7%	0.6%		0.7%
Real interest rate trend (average)	1.6%	1.4%		1.2%

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

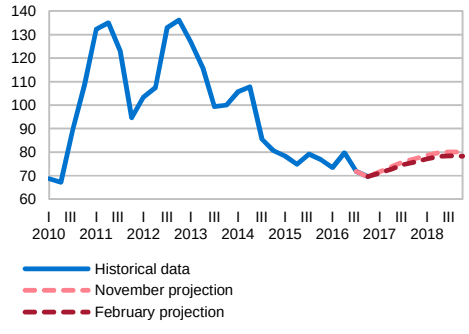
[26] NAVA (non-agricultural value added) is GDP less agricultural production and net taxes.
[27] Output gap is calculated based on NAVA. NAVA trend estimated by the Kalman filter is used as an approximation of potential output.
[28] The assumption for the euro area's GDP growth in 2017 and 2018 is consistent with the January Consensus Forecast.

Chart V.0.5 **Assumption for euro area inflation**
(y-o-y growth, in %)



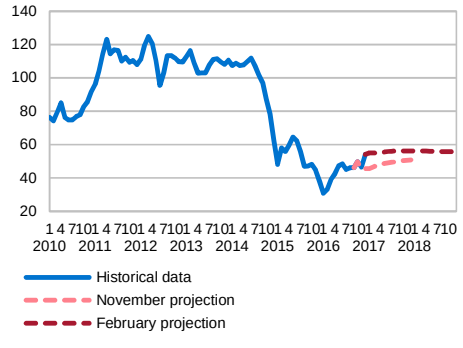
Sources: Consensus Forecast and NBS estimate.

Chart V.0.6 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.7 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

improvement in financial conditions, as well as by the labour market recovery. Both upside and downside risks to the euro area growth have intensified. Upside risks relate to the possible acceleration of growth as a result of the ECB's accommodation and the recovery of the euro area's trade partners, while downside risks are associated with the pace of Brexit and uncertainty surrounding the demand for euro area exports.

Under the impact of the y-o-y rise in energy prices, notably prices of oil, euro area inflation edged up in late 2016, touching 1.1% y-o-y in December, i.e. its highest level since September 2013. It is expected to continue rising this and the next year on the back of ECB measures and further euro area economic recovery. However, over the coming several months the main driver of its growth will be energy prices, i.e. their low last year's base. The assumption for average euro area inflation this year has been revised slightly up from the November projection (1.5% vs. 1.3%), while that for 2018 is 1.4%. Based on statements from ECB officials, the main refinancing rate is expected to stay at the present 0.0% and asset purchases to be continued at least through end-2017.

After falling sharply since mid-2016, international prices of primary agricultural commodities (corn, wheat, soya bean)[29] have regained some ground in the last two months. As the latest data from the futures markets indicate, this trend is likely to persist over the projection horizon. In 2017 their growth should be slightly lower than expected three months ago (9.0% vs. 11%) and in 2018 it should be significantly lower than this year (3.2%). Consistent with this, the assumption regarding the movement of these prices has been trimmed negligibly down from the November projection.

Global oil prices[30] rallied in Q4 as a result of the largest oil producers' agreement to cut output. In fact, they shot past USD 55 per barrel at end-December, but then receded to around USD 54 in January. Based on the latest available futures, oil prices are expected to amount to USD 56 per barrel at end-2017 and to be at a similar level at end-2018 as well. This being somewhat higher than the levels assumed in November, we have revised our assumption for global oil prices slightly upward.

[29] Measured by the composite index which comprises dollar prices of wheat, corn and soya bean on benchmark commodity markets.

[30] Brent.

Internal assumptions

In view of the outlook for international prices of primary agricultural commodities and the influence they have on their counterparts in Serbia, we have assumed that domestic primary agricultural commodity prices will record an increase both this and the next year.

The assumption for administered price growth in 2017 remains unchanged from November (4.0%, 0.75 pp contribution to inflation). For its major part, this growth will come as a result of the assumed increase in the prices of cigarettes, electricity and natural gas due to the rising global oil prices. Even though at this point we do not know whether electricity prices will actually be adjusted, to be on the safe side, we have assumed an increase similar to that of last year. In 2018, administered prices are again expected to grow by 4.0%.

The results of fiscal consolidation continue to outperform the targets under the arrangement with the IMF. Thus, the reduction of the public debt-to-GDP ratio started in 2016 – a year earlier than planned, and this should help keep the country risk premium relatively stable. Besides, a decrease in external imbalances, along with an FDI inflow, which is likely to stay more than sufficient to cover the current account deficit, will provide additional support to the stability of the foreign exchange market going forward.

The projection operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and caused by the removal of price disparities (notably in terms of administered prices) and by the Balassa-Samuelson effect[31].

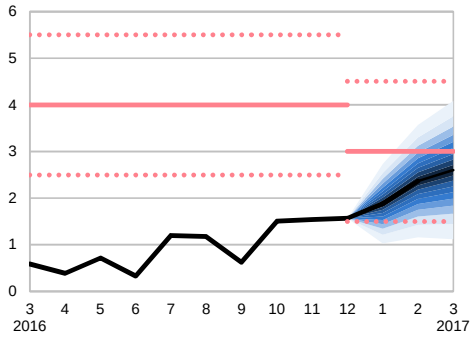
Projection

Inflation projection

Under our central projection, y-o-y inflation will enter the target tolerance band in Q1 2017 and stay therein until the end of the projection horizon. As of January 2017, the inflation target is 3.0±1.5%, i.e. 1.0 pp lower than before.

[31] In transition economies, the process of convergence towards income levels in advanced economies is accompanied by the relatively faster growth in prices (price convergence).

Chart V.0.8 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

Short-term inflation projection

Under the short-term projection, y-o-y inflation will enter the target tolerance band (3.0±1.5%) in Q1, driven by the low base effect and rising global oil prices, as well as by higher cigarette prices.

At quarterly level, consumer price growth will be powered by the seasonal increase in fruit and vegetable prices, and to a lesser extent, by the expected upward revision of the prices of petroleum products (due to surging global oil prices and excise tax adjustment for inflation in 2016) and cigarettes (due to the January excise tax increase). Working in the opposite direction will be the seasonal decline in the prices of fresh meat and travel packages.

Core inflation (CPI excluding food, energy, alcohol and cigarettes) should also enter the target tolerance band in Q1. At quarterly level, core inflation will record a mild fall, amid a seasonal decline in prices of travel packages, clothes and footwear.

Medium-term inflation projection

Y-o-y inflation is projected to enter the new target band (3.0±1.5%) in Q1 and stay therein until the end of the projection horizon (end-2018). Higher inflation will reflect primarily the low base effect from fruit and vegetable prices and a gradual increase in domestic aggregate demand and inflation abroad (notably the euro area), while low food production costs and the high base for petroleum product prices (from March onwards) will act as a damper.

As a result of a particularly good agricultural season, fruit and vegetable prices fell by around 7% in 2016, knocking about 0.5 pp off the headline inflation rate. Assuming an average agricultural season this year, these prices can be reasonably expected to increase from their current low level and their negative contribution to the y-o-y inflation rate to dwindle from Q2 onwards. In fact, their contribution should turn positive in H2, which means that fruit and vegetable prices will serve as a catalyst to the y-o-y inflation growth.

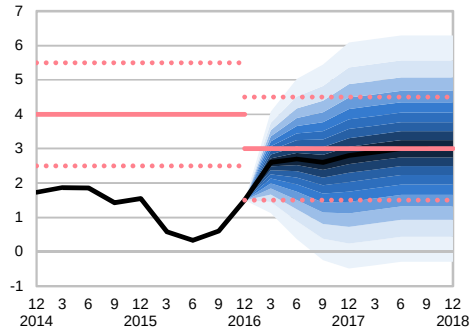
This year is likely to see a further recovery in domestic demand, and consequently, weaker disinflationary pressures on account of the negative output gap. The gap opened back in 2008 following the spill-over of the global financial crisis to Serbia, but has been narrowing down for more than two years now and is likely to continue on a downward path in the medium term, aided by the past monetary policy easing of the NBS and the ECB's monetary accommodation. The monetary policy stance of the ECB contributes to Serbia's economic growth not only through stronger demand for our exports, but also through interest rates on euro-indexed loans[32], given that low interest rates encourage credit and, by extension, economic activity.

The analysis of inflation components shows that the y-o-y growth in prices of non-food products and services has been low for quite some time already, averaging 1.6% in the last year. Still, we expect that the likely further rise in euro area inflation and the strengthening of aggregate demand in Serbia will bring about a mild increase in the prices of these products and services, bringing non-food inflation close to 2.5% y-o-y at the end of the projection horizon.

Conversely, a dampening effect on inflation in the coming period will to some extent come from the low food production costs on account of movements in primary agricultural commodity prices (corn, wheat and soya bean). And while these prices did increase in late 2016, their average level in Q4 was lower than in Q3. Looking at historical data, these prices are relatively low and are likely to continue the trend over the projection horizon. However, as they are expected to make some recovery in the period ahead, their disinflationary impact will grow weaker (narrowing of the negative RMCP gap[33]), which will, coupled with last summer's increases in fresh meat prices help keep the y- o-y food inflation[34] in the positive territory. Food inflation is projected to revolve around 2% in 2017 and to trend closer to 3% in 2018.

The ongoing recovery of global oil prices sent domestic petroleum product prices up by more than 15%[35] in the period March–December 2016 and added 0.9 pp to the headline inflation rate. From March onwards, these price

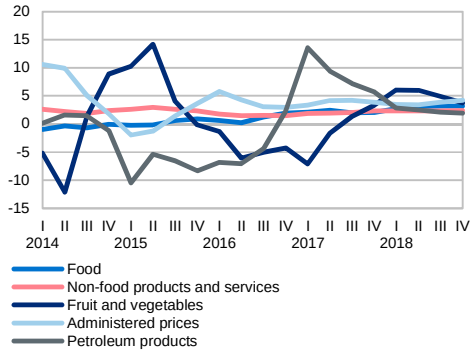
Chart V.0.9 **Inflation projection**
(y-o-y, in %)



Source: NBS.

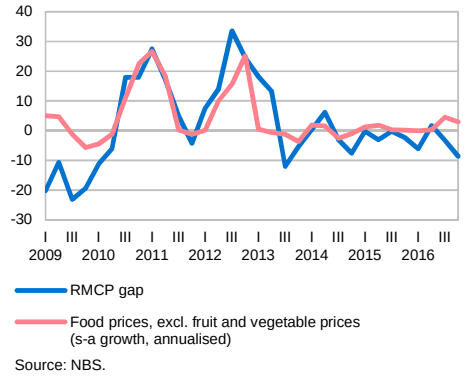
The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Each following shade includes 10% probability, which means that outturns of inflation somewhere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

Chart V.0.10 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

Chart V.0.11 **Impact of RMCP on food prices**
(in %)



Source: NBS.

[32] The markets expect 3M EURIBOR to stay negative until end-2018.

[33] Real marginal costs of processed food producers (RMCP) are calculated as the ratio of primary agricultural commodity prices and food prices. Negative RMCP gap opens when these costs fall below the trend level.

[34] Food inflation excluding fruit and vegetables.

[35] Global oil prices soared by around 50% during the same period.

increases (i.e. high base) will be dropping out of the annual comparison and thus slow down the y-o-y inflation growth. Though the contribution of petroleum product prices to the y-o-y inflation should remain positive, it will get increasingly weaker and probably turn neutral by the end of the forecast period.

The risks to the projected inflation path relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth this and the next year.

Based on the latest available data from the futures markets, we have assumed that the international prices of primary commodities will rise both this and the next year, though more moderately in 2018. However, as primary commodity prices are generally rather volatile, the likelihood that they will deviate from the assumed path is not at all negligible. At this point, our estimate is that the prices of oil and primary agricultural commodities are equally likely to deviate in either direction. And having in mind the impact of these prices on prices in Serbia, we may assume that actual inflation could also deviate from the projected path in either direction.

The risks associated with developments in the international financial markets continue to be tilted to the upside, mainly because of the expected further normalisation of the Fed's monetary policy. The majority of the FOMC members predicted in December that there would be as many as three rate hikes in 2017. The increase in the Fed's rate could dampen portfolio investment in emerging markets, Serbia included. A potentially smaller capital inflow could lead to depreciation of the dinar and ultimately, to some upward pressure on the domestic prices. The accommodative monetary policy stance of the ECB, on the other hand, will continue to work in the opposite direction.

The projection operates on the assumption that administered prices will grow by around 4.0% this and the next year. Administered price growth in 2017 reflects largely the assumed rise in cigarette, electricity and natural gas prices. At this point, however, it remains uncertain whether electricity prices will be increased in 2017 and by how much. Absent this increase, y-o-y inflation would fall short of the projected trajectory by around 0.2 pp.

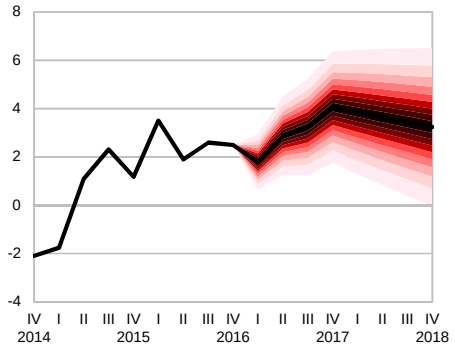
On balance, the risks to the projected inflation path are judged to be symmetric.

Looking ahead, monetary policy decisions of the NBS will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, particularly those from the international environment. This means that the NBS will keep a close eye on developments in the domestic market and international commodity and financial markets, and will as so far use all available instruments to make sure inflation remains low and stable over the medium term which, together with the preservation of financial stability, will contribute to sustainable economic growth.

GDP projection

After growing 2.7% in 2016, the Serbian economy is projected to step up to 3.0% in 2017 (unchanged from the November projection) and further up to 3.5% in 2018.

Chart V.0.12 **GDP growth projection**
(y-o-y rates, in %)



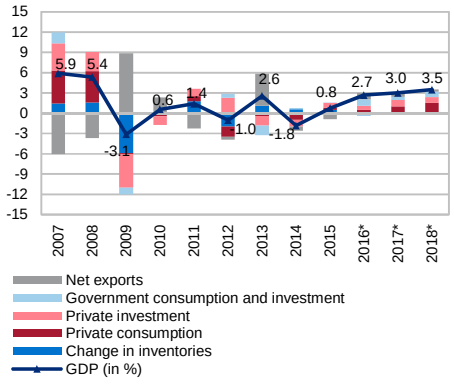
Source: NBS.

This year growth should continue to be led by investment and net exports. A further increase in investment activity is suggested by a number of factors – improved business environment, expected further recovery of economic activity worldwide, and particularly in the euro area as Serbia's key trade partner, favourable terms of lending to enterprises and continuing strong inflow of FDI. It is estimated that the investments implemented thus far and the expected strengthening of external demand will support solid export performances of the domestic economy and grease the wheels of export growth. However, as the consequently stronger needs for intermediate goods and equipment will serve as a fillip to import growth, the contribution of net exports to GDP will be smaller than in 2016, albeit positive.

The recovery of household consumption in the period ahead will be underpinned by higher wages and employment in the private sector and increased pensions, but also by the lower cost of borrowing and the still relatively low oil prices which have a positive effect on the disposable income of households.

Considering the expected and already implemented investments, as well as the likely increase in final consumption, the largest positive contribution to GDP growth on the production side will come from industry and services. Led by manufacturing, industrial production growth will be also aided by the sectors of energy and mining that have a relatively low base due to major overhauls last year. A further pick-up in activity is expected in construction industry too. On the other hand,

Chart V.0.13 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

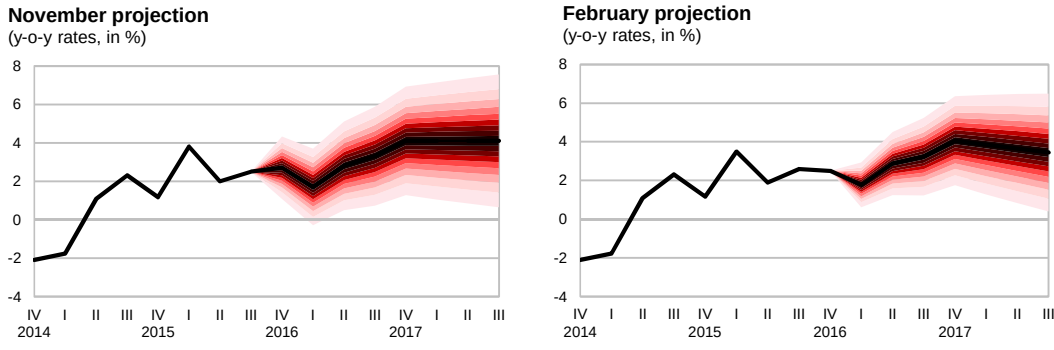
assuming an average agricultural season (yields at the level of the ten-year average), agricultural production is likely to fall by around 4% and thus act as a drag on GDP growth.

GDP growth in 2018 should be led mainly by domestic demand, i.e. investment and consumption. The contribution of net exports will stay positive owing to the still relatively high expected export growth rate.

The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area and the prices of primary commodities in the international markets, and with the further pace of structural reforms at home.

The extended duration of the ECB's quantitative easing programme, a potentially faster growth of the euro area's trade partners and the entrenchment of oil prices at a relatively low level could help accelerate the euro area recovery going forward, resulting in stronger demand for our exports and faster investment growth, and thus, higher than projected growth of our economy. Another risk to the upside is embodied in greater use of the EU pre-accession funds as Serbia progresses on its path to the EU. On the other hand, the recovery of the euro area could be slowed down by the slackening growth of emerging markets (notably China), a faster pace of Brexit and geopolitical tensions. If these downside risks materialised, Serbia would probably see a slowdown in investment and exports, and consequently, a lower than projected GDP growth.

Chart V.0.14 **Current vs. previous GDP growth projection**



Source: NBS.

The implementation of structural reforms and improvement in the investment and business environment, reflected in Serbia's significant progress on the international competitiveness rankings,[36] enhance the country's medium-term growth prospects. However, it is the pace of further implementation of structural reforms that will determine whether growth will be faster or slower than projected. The risks associated with global oil prices are also judged to be symmetric, i.e. equally likely in either direction and hence with a potential to either accelerate or decelerate GDP growth.

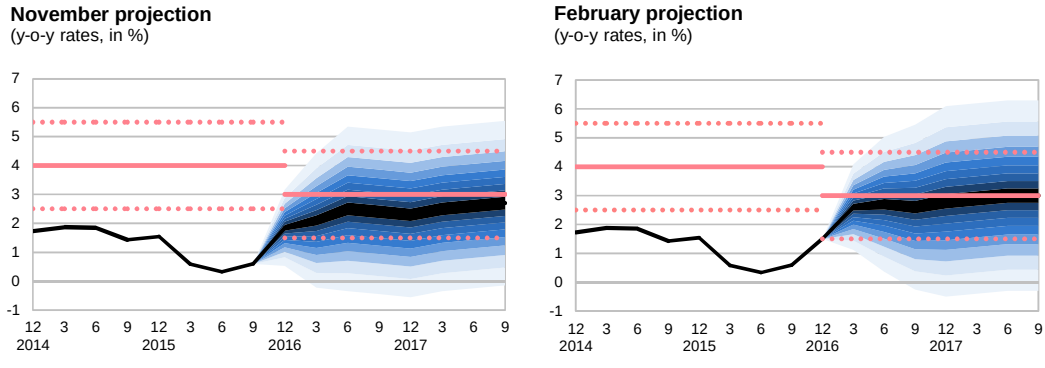
In addition to oil prices, the prices of primary agricultural commodities and base metals in the international market could also affect our GDP projection, given that Serbia is a net exporter of those products. These prices may also depart from the assumed path equally to the downside as to the upside.

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

Comparison and outcome of inflation projections

The new medium-term inflation projection is slightly higher than in November, but the projection range remains symmetric. Like in other countries, this is due to the fact that global oil price growth in late 2016 and early this year proved faster and is likely to cause a somewhat higher rise in domestic petroleum product prices than

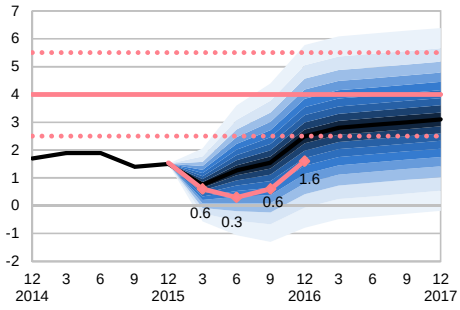
Chart V.0.15 **Current vs. previous inflation projection**



Source: NBS.

[36] See the latest World Economic Forum's *Global Competitiveness Report* and the World Bank's *Doing Business*.

Chart V.0.16 **Achievement of February 2016 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Table V.0.2 **Projections of key macroeconomic indicators for Serbia**

	2017		2018	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	3.2	2.4	3.5	3.0
European Commission	2.4	2.4	3.3	3.3
Consensus Forecast	3.0	2.6	-	3.2
Bloomberg	2.5	2.4	3.0	3.0
GDP (%)				
IMF	2.8	3.0	3.5	3.5
European Commission	3.0	3.0	3.3	3.3
Consensus Forecast	2.5	2.8	-	3.1
Bloomberg	2.7	3.0	3.0	3.2
Current account deficit (% of GDP)				
IMF	3.9	3.9	3.8	3.9
European Commission	4.3	4.2	4.7	4.2
Consensus Forecast*	3.6	3.8	-	3.9
Bloomberg	4.0	3.9	3.7	3.8
Fiscal deficit (% of GDP)				
IMF	2,2	1.7	1.7	1.3
European Commission	1.5	1.2	1.2	1.0
Consensus Forecast	-	-	-	-
Bloomberg	2.4	1.8	1.9	1.7

Sources: IMF (Republic of Serbia: Forth and Fifth Reviews under the Stand-By Arrangement, Country Report No. 16/287 and Republic of Serbia: Sixth Review under the Stand-By Arrangement, Country Report No. 16/386), European Commission (Autumn 2016 Forecast and Winter 2017 Forecast), Consensus Forecast October 2016 and January 2017) and Bloomberg Quarterly Survey (October 2016 and January 2017).

* Based on NBS projection of dollar GDP from August 2016, November 2016 and February 2017.

assumed in November. On top of this, domestic petroleum product prices are also affected by the ongoing strengthening of the dollar against the euro, and hence the dinar, against the backdrop of further normalisation of the Fed's monetary policy. Consequently, the major difference between the new and the previous projection relates to Q1 2017.

In the last twelve months, y-o-y inflation was moving below the February 2016 central projection rate, but within the projection range. Inflation deviated south of the central projection rate mainly because of the stronger than anticipated disinflationary effects from the international but also domestic environment. Namely, primary agricultural commodity prices declined in 2016 instead of going up as anticipated, while on the side of domestic factors, inflation fell short of the projected level mainly as a result of weaker than expected administered price growth[37] (by around 0.3 pp), but also as a result of exceptionally good agricultural season last year which prompted a sharp decline in fruit and vegetable prices.

Projections of other institutions

Macroeconomic projections for Serbia by other relevant institutions have improved since the November *Inflation Report*. Namely, their expectations regarding inflation and the budget deficit have been scaled down, while their expectations regarding Serbia's economic growth have been revised up.

Overall, these institutions expect inflation of around 2.5% this year and around 3.0% next year. In terms of economic performance, they forecast Serbia's GDP to grow around 3.0% in 2017 and around 3.3% in 2018. Also, they expect consolidated budget deficit to contract further, i.e. to 1.2–1.8% of GDP in 2017 and to 1.0–1.7% in 2018. Besides, the majority of these institutions estimate that Serbia's current account deficit will be under 4.0% of GDP in both 2017 and 2018.

[37] 2.2% vs. 3.9%.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	2016
EXTERNAL LIQUIDITY INDICATORS (in %)																
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.6	6.6	6.6	6.0	5.8	5.9	6.2	6.2
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.8	237.4	268.4	295.5	270.4	261.9	254.2	259.1		
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	29.7	31.0	28.1	27.5	28.2	29.9	29.9
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.0	13.4	14.2	12.0	13.8	12.4	10.6		
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.7	26.7	23.7	21.2		
EXTERNAL SOLVENCY INDICATORS (in %)																
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	74.8	77.1	78.3	76.2	76.1	76.0		
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.5	12.2	10.1	11.5	10.7	10.8	10.9		
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	167.8	160.4	156.7	153.4		
FINANCIAL RISK EXPOSURE INDICATORS (in %)																
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	250.2	238.5	220.1	211.7	207.3	207.3
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	208.7	200.7	211.5	196.6	196.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	97.7	103.1	110.9	113.1	105.8	106.8	108.9
MEMORANDUM: (in EUR million)																
GDP[1]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	7,629	8,389	8,817	9,304[2]	34,141[2]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,235	25,742	25,726	25,727		
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,593.5	4,731.4	4,021.7	1,055.5	1,036.1	932.3		
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	9,501	9,291	9,552	10,205	10,205
Short-term debt[3]	951	968	1,044	1,832	1,852	1,758	612	455	196	99	305	324	288	464		
Current account balance	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-385	-297	-299	-390	-1,371

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

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during 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 – 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 now includes liabilities under SDR allocation (EUR 484.1 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 988.1 mln, of which EUR 430.2 mln relates to domestic banks and EUR 557.9 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	2014	2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	2016
Real GDP growth (in %)[1]	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	0.8	3.8	1.9	2.6	2.5	2.7
Consumer prices (in %, relative to the same month a year earlier)[2]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	1.7	1.5	0.6	0.3	0.6	1.6	1.6
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,378	9,501	9,291	9,552	10,205	10,205
Exports (in EUR million)[3]	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	15,631	3,946	4,375	4,394	4,599	17,314
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	8.2	11.8	9.3	8.5	13.5	10.8
Imports (in EUR million)[3]	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	18,899	4,516	5,111	4,935	5,334	19,895
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	4.4	1.7	7.4	4.3	7.3	5.3
Current account balance[3]																
(in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1577	-385	-297	-299	-390	-1,371
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-4.7	-5.1	-3.5	-3.4	-4.2	-4.0
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2[7]	17.7	19.0	15.2	13.8		
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	379.3	368.0	353.7	378.5	373.6	390.7	374.1
RS budget deficit/surplus (in % of GDP)[4]	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.3	-2.8	-0.9	0.5	2.9	-3.1	-0.2
Consolidated fiscal result (in % of GDP)[4]	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.6	-3.7	-1.7	-0.2	1.3	-4.6	-1.4
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	70.4	74.6	71.5	70.9	70.8	72.9	72.9
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.85	111.37	109.02	110.44	114.28	111.29
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	99.46	111.25	108.60	111.07	109.90	117.14	117.14
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	120.73	122.87	123.02	123.29	123.26	123.12
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	120.96	121.63	122.92	123.31	123.29	123.47	123.47
MEMORANDUM:																
GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	7,629	8,389	8,817	9,304[6]	34,141[6]

[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 the break in the series for 2007, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

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

[5] According to ESA 2010.

[6] NBS estimate.

[7] Revised data for 2014 and 2015 according to the new methodology of Labour Force Survey.

Notes:

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

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Charts

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Table in text box

Executive Board meetings and changes in the key policy rate

2016

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.50	0
11 February	4.25	-25
17 March	4.25	0
7 April	4.25	0
17 May	4.25	0
9 June	4.25	0
7 July	4.00	-25
11 August	4.00	0
8 September	4.00	0
13 October	4.00	0
10 November	4.00	0
8 December	4.00	0

2017

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.00	0
14 February	4.00	0
14 March		
11 April		
12 May		
8 June		
10 July		
10 August		
7 September		
9 October		
9 November		
7 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 8 December 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0%.

The Executive Board expects inflation to remain low and stable, moving within the target tolerance band as of early 2017 (3.0%±1.5 pp). Inflation will enter the target tolerance band owing to the effects of past monetary policy easing, rising domestic demand, and the gradual recovery of global oil prices and inflation in the international environment, notably the euro area as Serbia's most important foreign trade partner. In contrast, relatively low food production costs will continue to generate disinflationary pressures for some time yet.

Persisting uncertainties in the international financial and commodity markets also mandate caution in monetary policy conduct. As for the international financial market, the uncertainties pertain to the pace of the Fed's monetary policy normalisation and the continuation of the ECB's quantitative easing programme, as well as their impact on global flows of capital. However, the Executive Board underlined that successful implementation of fiscal consolidation and structural reforms, as well as the narrowing of external imbalances, are helping to improve the Serbian economy's macroeconomic prospects and boost its resilience to negative shocks from abroad.

The next rate-setting meeting will be held on 12 January 2017.

Press release from Executive Board meeting held on 12 January 2017

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0%.

The Executive Board's decision to keep the existing degree of monetary policy accommodation was guided by inflation factors, the effects of past monetary policy easing and the fact that the inflation target has been lowered to 3.0%±1.5 percentage points as of the beginning of 2017. The Executive Board expects that inflation will remain low and stable, moving within the target band from early this year. Such inflation movements will be aided by the recovery of domestic demand and movement in global oil prices, as well as by the gradual rise in inflation in the international environment, primarily in the euro area, which is Serbia's key foreign trade partner. On the other hand, relatively low costs of food production will continue to be the source of disinflationary pressure for some time yet.

As assessed by the NBS Executive Board, the prevailing uncertainty in the international commodity and financial markets mandates caution in the conduct of monetary policy – primarily given the prices of oil and other primary commodities in the global market, as well as the pace of normalisation of the Fed's monetary policy and its impact on global capital flows. The risks emanating from the international environment will be mitigated by the ECB's monetary accommodation. Also, successful implementation of fiscal consolidation and structural reforms, as well as the narrowing in external imbalances and economic growth led largely by investments and exports, have improved the economy's macroeconomic prospects and strengthened its resilience to potential shocks from the international environment.

The next rate-setting meeting will be held on 14 February 2017.

Press release from Executive Board meeting held on 14 February 2017

In its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0%.

In making the decision, the NBS Executive Board was guided by the new medium-term inflation projection, the effects of past monetary policy easing and the fact that the inflation target has been lowered to 3.0%±1.5 pp as of early 2017. Inflation is expected to stay low and stable, moving within the new target band from early this year. Such movement in inflation should be supported primarily by the recovery of global oil prices and inflation in the international environment, as well as rising domestic demand. On the other hand, relatively low food production costs should generate disinflationary pressures for some time yet.

The NBS Executive Board assessed that the uncertainties in the international environment, mostly in terms of movements in global oil prices and developments in the international financial market, mandate caution in monetary policy conduct. The monetary policies of the leading central banks have diverged still further, thereby increasing the

uncertainty regarding their impact on global capital flows. However, the Serbian economy's resilience to potential adverse impacts from the international environment has improved owing primarily to better macroeconomic prospects, most notably accelerated economic growth coupled with further narrowing of internal and external imbalances.

In today's meeting, the Executive Board adopted the February Inflation Report which will be publicly presented on Wednesday, 22 February, when monetary policy decisions and underlying macroeconomic developments will be discussed in more detail.

The next rate-setting meeting will be held on 14 March 2017.

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