National Bank of Serbia

February 2019

# 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 7 February 2019.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

## ABBREVIATIONS

**bn** – billion
**bp** – basis point
**CPI** – Consumer Price Index
**EBRD** – European Bank for Reconstruction and Development
**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
**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
**mn** – million
**NAVA** – non-agricultural value added
**NPL** – non-performing loan
**OFO** – other financial organisation
**OPEC** – Organization of the Petroleum Exporting Countries
**pp** – percentage point
**Q** – quarter
**q-o-q** – quarter-on-quarter
**RHS** – right hand scale
**RMCP** – real marginal cost of processed food production
**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

Since the November *Report*, the global economy slowed down, and the global growth projections for this and next year were again mildly revised down. Weaker external demand and specific supply-side factors in some members of the euro area, our key trade partner, dampened the pace of growth of the bloc's GDP. According to the estimates of relevant international institutions, economic growth in Central and Southeastern European countries, though revised mildly down, will remain relatively high owing to the contribution of domestic demand. The period from the previous *Report* was also marked by the slowdown in inflation in the international environment, mainly as a result of falling global oil prices in Q4 2018. Consistent with expectations, the normalisation of the monetary policies of leading central banks continued, with indications that it will be slower than expected because of the slowdown in global economic growth and lower oil prices.

***Since the November Report, the international environment was marked by the weakening of the global growth outlook, falling global oil prices and resulting lower inflation, as well as slower than expected normalisation of the monetary policies of leading central banks.***

Economic and financial indicators in the domestic market remain favourable. Inflationary pressures remained low in the face of vigorous economic growth and positive labour market trends. In the course of Q4, **y-o-y inflation continued to move within the target tolerance band**, standing at 2.0% in December, this being its average value in 2018. The prices of food (mainly vegetables), petroleum products and cigarettes provided more than three quarters of the contribution to inflation in December. This suggests that inflationary pressures are subdued, as confirmed by low and stable core inflation of around 1% and the one- and two-year ahead inflation expectations of financial and corporate sectors anchored around the target. Anchored inflation expectations signal the credibility of monetary policy and greater resilience to potential negative effects of developments in the international environment.

***Consistent with our expectations, y-o-y inflation continued to move within the target tolerance band, reaching 2.0% in December, this being its average value in 2018. Cost-push and demand-side pressures remain low, as confirmed by core inflation of around 1% y-o-y and the inflation expectations of financial and corporate sectors somewhat below the 3% target.***

In making the decision to upgrade Serbia's outlook from stable to positive and affirming the long-term foreign and local currency sovereign crediting ratings at BB in late 2018, Standard & Poor's particularly highlighted the measures whereby the NBS increased the credibility and efficiency of monetary policy in the inflation targeting regime. As stated by the Agency, the decision reflected vigorous economic growth and the results the NBS has achieved in preserving price and financial stability.

***In late 2018, Standard & Poor's upgraded Serbia's rating outlook from stable to positive.***

*The key policy rate has been flat at 3.0% since April 2018, this being its lowest level in the inflation targeting regime.*

Based on the analysis of economic developments in the country and abroad and expectations for the coming period, in the period from the previous *Report*, the NBS Executive Board kept the key policy rate unchanged. These decisions of the Board were **guided by the assessment that inflation would move within the target tolerance band over the projection horizon, reflecting also the effects of past monetary policy easing**. Caution in monetary policy conduct was mandated by trends in the international environment. As assessed by the Executive Board, the uncertainty as to the pace of normalisation of monetary policies of the Fed and ECB could negatively affect capital flows towards emerging economies. Though significantly lower from October, oil prices are still a factor of inflation that calls for caution. Protectionism and geopolitical tensions remain the sources of instability in the international commodity and financial markets. However, the Executive Board underscored that the resilience of our economy to potential negative effects from the international environment has increased owing to more favourable macroeconomic indicators and prospects.

*Lending growth accelerated further – to 9.9% y-o-y in December, led primarily by elevated corporate borrowing.*

Owing to past monetary policy easing, a reduced country risk premium and persistently low interest rates in the international money market, the **financial conditions of the private and government sectors remained favourable**. This, along with the effects of economic growth, higher wages and employment, pushed up y-o-y lending growth to 9.9% in December, excluding the exchange rate effect. In Q4 2018, lending growth was led primarily by elevated corporate borrowing, positively affected (according to the banks' assessment stated in the January Bank Lending Survey) by favourable credit conditions and rising loan demand, primarily of SMEs. In addition to efforts invested in the resolution of NPLs, lending growth contributed to a further drop in the share of NPLs in total loans, to 5.7% in December. Down by 16.7 pp from the adoption of the NPL Resolution Strategy, this is the lowest level since this indicator of the banks' portfolio quality is monitored.

*Economic growth and positive labour market trends contribute to the continued favourable fiscal trends, while a considerable rise in capital government expenditure and higher public sector wages and pensions are the source of financing investment and consumption, but not to the extent that would generate major inflationary pressures.*

**In our estimate, public finance recorded a surplus for the second year in a row**. According to available data for eleven months, the consolidated budget saw a surplus of RSD 73.6 bn, against the background of a significant rise in government capital expenditure. Positive fiscal trends were supported by lower interest expenses in an environment of government's lesser needs to borrow and a lower cost of borrowing, owing to past monetary policy easing by the NBS and a lower country risk premium. At end-2018, central government public debt stood at EUR 23.0 bn and its share in projected GDP at 53.6% (vs.

57.9% at end-2017). A reduction in public debt and the currency risk was aided by the December payout of the maturing USD 1 bn euro bond, issued in the international market in 2013. Further movement of the public debt share within sustainable bounds and its downward trajectory are expected in the coming period as well.

*For the fourth year in a row, the net FDI inflow covered the current account deficit, whose share in GDP in 2018 remained unchanged, despite softening external demand and increased imports that reflected investment needs and rising global oil prices.*

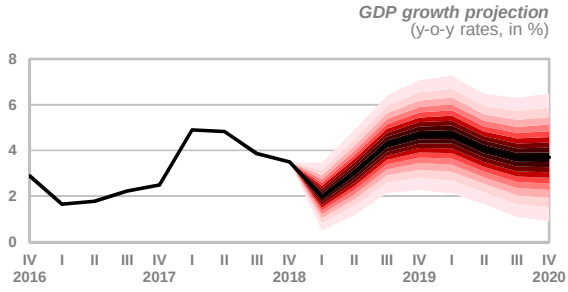
In 2018, the current account deficit stood at EUR 2.2 bn, **its share in GDP (5.2%) remaining at the 2017 level**. More favourable trends compared to 2017 were recorded in trade in services and on the secondary income account, where surpluses widened, while the deficit on the primary income account contracted. This largely compensated for the higher commodity deficit, which resulted from higher imports based on rising production and investment, and higher global oil prices, while manufacturing exports continued to record a relatively high growth rate, with almost all its sectors providing a positive contribution. Given high investment growth, such import trends are expected. The imported equipment will raise the Serbian economy's exporting capacities and bring about a reduction in the current account deficit in the medium run. At the same time, a high net FDI inflow, which reached EUR 3.2 bn in 2018, was more than sufficient to cover the current account deficit, pushing FX reserves up and ensuring stronger resilience of our economy to external shocks.

*According to the preliminary data of the Serbian Statistical Office, real GDP growth reached 4.4% in 2018, exceeding our expectations stated in the previous Report and being the highest in the past ten years.*

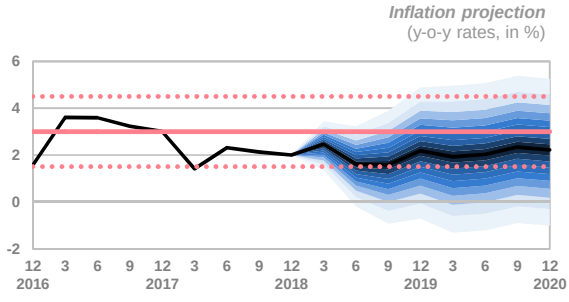
Despite the slowdown in external demand growth, notably in the euro area, **domestic factors** – past investment, implementation of infrastructure projects, improvement of the business environment, favourable financial conditions and positive labour market trends – **drove Serbia's economic growth strongly up, helping it accelerate to 4.4% in 2018**. According to the preliminary estimate of the Serbian Statistical Office, GDP grew 3.5% y-o-y in Q4. On the production side, similarly to the previous quarter, the strongest contribution to growth came from the service sectors as favourable trends in the labour market continued, and from agriculture owing to an excellent agricultural season, as well as from construction – though to a lesser extent. On the other hand, a negative impact came from the industry against the background of softening external demand.

*We have kept the GDP growth forecast for 2019 unchanged (3.5%). In the medium run, we expect GDP to accelerate to around 4%, led by investment, exports and sustainable growth in household consumption.*

GDP growth is expected to reach 3.5% in 2019 and to be fully driven by domestic demand. On the production side, we expect further growth in the service sectors, industry and construction, while agriculture will most probably give a negative contribution due to the base effect. In the medium run, GDP growth is expected to accelerate to around 4% and to be led by investment, exports and sustainable rise in household consumption. The risks to




*Y-o-y inflation will continue to move within the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band.*




*The key risks in the coming period are assessed to emanate from the international environment and, as such, can impact the monetary policy stance as well.*

the projection are judged to be symmetric. In the short run, i.e. during 2019, the risks from the international environment are assessed to be tilted to the downside and those from the domestic environment to the upside.

Under the February central projection, which is somewhat lower compared to the November projection, y-o-y inflation is expected to continue to move within the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band. As in the previous projection, rising aggregate demand is likely to stay the main inflation factor throughout the projection horizon. In addition, disinflationary pressures generated by past appreciation of the dinar should gradually wane, while administered price growth will be somewhat faster than in prior years. Conversely, the main disinflationary factor in the coming period will be the high base for the prices of fruit and vegetables and petroleum products. Uncertainties surrounding the inflation projection are associated primarily with trends in the international commodity and financial markets, including, to an extent, administered price growth that could turn out to be smaller than assumed, which is why risks to the projection tilt mildly to the downside.

Monetary policy decisions will continue to depend on the assessment of the impact of domestic factors and factors from the international environment on inflation in Serbia. Given that the key risks to the projection emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on economic developments in Serbia. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and the strengthening of resilience to external uncertainties.

# II Monetary policy since the November *Report*

***In deciding not to change the 3.0% key policy rate since the previous Inflation Report, the NBS Executive Board was guided by the outlook for inflation and its underlying factors, as well as the effects of past monetary policy easing.***

***Inflationary pressures remained low even in conditions of strong economic growth, supported also by the effects of past monetary policy easing, and positive labour market developments, characterised by a further increase in wages and employment and a drop in the unemployment rate. According to the Executive Board's estimate, inflation will continue to move within the target tolerance band in the next two years, the period for which inflation is projected, probably staying below the 3% target until end-2019.***

***Caution in monetary policy conduct was warranted by developments in the international environment. Uncertainty regarding further normalisation of monetary policies by the Fed and the ECB could reflect on capital flows to emerging markets. Oil prices remain an inflation factor that requires caution, even though they fell sharply since October last year. In addition, protectionism and geopolitical risks are still viewed as the sources of uncertainty in the international financial market. The Executive Board, however, underlined that the resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects.***

Since the November Inflation Report, the NBS Executive Board kept the key policy rate at 3%, its lowest level yet in the inflation targeting regime. The decisions on monetary policy were based on the November inflation projection, which was almost unchanged relative to the August projection. The projection predicted that inflation would continue to move within the target tolerance band in the next two years – below the target midpoint by end-2019, though temporarily approaching it in the first months of the year owing to the low base effect. According to the Executive Board's estimate, the main driver of inflation in the medium run would be the rising aggregate demand. Besides, the disinflationary pressures on account of past appreciation of the dinar would gradually wane, while administered prices were expected to pick up slightly faster this year than in the previous year. In the short term, it was expected that disinflationary effects would stem from low food production costs and, during 2019, also from the high base for fruit and vegetables and petroleum products, whose contribution to inflation would be declining. Regarding economic activity, the November projection revised GDP growth for 2018 again up, to 4.2%, as upside risks in terms of domestic demand growth, highlighted in the August projection, had materialised. The growth forecast for this year stayed unchanged (3.5%), in view of the high base a year earlier.

According to the preliminary estimates of the Serbian Statistical Office, GDP growth in 2018 outperformed our November expectations, amounting to 4.4%. The Serbian economy grew at the highest rate in the last ten years, with a positive contribution from both production and service sectors, owing to preserved macroeconomic, fiscal and financial stability, as well as improvement of the overall business and investment environment.

In deciding on monetary policy since the last Report, the NBS Executive Board assessed that inflationary pressures stayed low even in conditions of strong economic growth. For five years in a row, inflation has been low and stable – measuring 2.0% y-o-y in December, this at the same time being its annual average in 2018. Inflation continued to be driven by the increase in prices of a small number of products – over 75% of the contribution to y-o-y inflation at end-2018 came from the

prices of vegetables, as well as cigarettes and petroleum products. That inflationary pressures stayed low was also indicated by the low and stable core inflation, which stood at 1.0% in December, this being at the same time its annual average. Low inflationary pressures were further indicated by the one-year and two-year ahead inflation expectations of the financial and corporate sectors anchored around the 3.0% target.

In keeping the key policy rate on hold, the Executive Board was guided by the expectation that future inflation movements would reflect to a large extent the gradual rise in domestic demand. Namely, robust economic growth, continued positive labour market developments, characterised by the rise in wages and employment and the drop in unemployment rate will all contribute to the further rise in domestic demand. Besides, domestic demand growth is also supported by the past monetary policy easing of the NBS through lower interest rates on new dinar loans and lower costs of existing loan repayment, which reflected positively on households' disposable income. In addition, interest rates on euro-indexed loans remain low, aided by the ECB's still accommodative monetary policy stance, as well as by greater interbank competition and Serbia's lower risk premium.

Lower country risk premium and general macroeconomic stability are underpinned by the positive fiscal trends. In the first eleven months of 2018, consolidated budget recorded a surplus of RSD 73.6 bn, whereas the central government recorded a surplus of 0.6% of GDP in 2018 (with a primary surplus of 2.7% of GDP). During 2018, public debt contracted by 4.3 pp to 53.6% of GDP. The deficit of around 0.5% of GDP is planned for this year, which is a medium-term deficit target ensuring continued downward path of public debt in the period ahead. This should positively affect the country risk premium and credit rating. Together with further high FDI inflow, which more than fully covers the current account deficit and contributes to its reduction in the medium run, this will buttress relative stability in the FX market.

The Executive Board stated that the past appreciation of the dinar exerted a disinflationary effect through lower import prices expressed in dinars. In this regard, we expect disinflationary pressures to persist for some time yet, though they will gradually wane. However, given the expected moderate price growth in the euro area, our most important trade partner, the Executive Board pointed out that the rise in dinar-denominated import prices is likely to stay relatively low.

Besides domestic demand, the Executive Board assessed that external demand would recover further as well, but pointed out that global economic growth outlook was less favourable than initially expected. This was mainly due to trade and geopolitical tensions between the leading global economies. Growth in the euro area was dampened in H2 2018. In addition to subdued production in automobile industry, headwinds also came from the slower growth in services, consumption and investments. On the other hand, the growth of Central and South East European countries, which are also our important trade partners, was faster than expected, despite the decline in net exports due to slackening external demand. Investment grew in many countries, owing to the stepped-up use of EU funds.

In deciding on monetary policy, the Executive Board took into account uncertainty in terms of the pace of normalisation of monetary policies of leading central banks, dollar-euro relation and capital flows to emerging economies. The Fed raised its target range for the federal funds rate in December as well, to 2.25–2.50%, signalling a slower pace of the federal funds rate increase compared to its September projections. On the other hand, the ECB implemented its QE programme at the reduced monthly volume of EUR 15 bn from October until end-2018, ending the programme thereafter. In order to maintain optimal liquidity, the ECB will continue to reinvest the principal payments from maturing securities for an extended period of time, even after raising its interest rates. Besides, the ECB confirmed that it would keep its policy rate unchanged at least through the summer of 2019, whereas market participants expect the rates most likely not to go up until the end of 2019. Caution was mandated by the significant volatility of the global oil prices which plummeted since October, after a hike in the great part of the year, so that 2018 ended with the prices over 20% lower relative to end-2017.

In addition, the Executive Board pointed out that rising protectionism in the international trade and geopolitical tensions could have an adverse effect not only on the global economic growth, but also on commodity and financial markets, thus warranting caution in monetary policy decision-making.

Based on the February inflation projection, which is somewhat lower compared to November, the Executive Board decided in its February meeting to keep the key policy rate unchanged. The Executive Board pointed out that caution in monetary policy conduct is still mandated, primarily because of developments in the international environment. Leading central banks, the Fed and the ECB

hinted in January that their monetary policy normalisation might turn out to be slower than previously announced. It is uncertain to which extent the normalisation would be slower and different to what the markets expect, which could affect the stability of global capital flows. Also, potential escalation of trade tensions could heighten instability in the international financial market, and, consequently, fuel uncertainty regarding capital flows. Besides, even though global oil prices declined at the end of the previous year, both supply- and demand-side factors make their future movements uncertain.

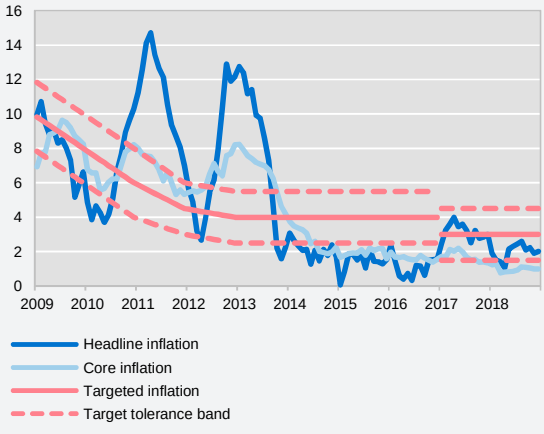
Having estimated that the key risks in the implementation of monetary policy come from the international environment, the Executive Board stressed that trends in the international financial and primary commodity markets, especially markets of crude oil and primary agricultural commodities, will continue to be closely monitored and analysed. The Executive Board noted that the resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term. Together with maintaining financial stability, this will contribute to sustainable economic growth and strengthen the country's resilience to external uncertainties.

## *Text box 1: Ten years into the inflation targeting*

The NBS has been pursuing inflation targeting as its monetary policy regime for full ten years. This text box will shed light on its development and assess the success achieved, taking into account the specificities of our economy and circumstances in the international environment.

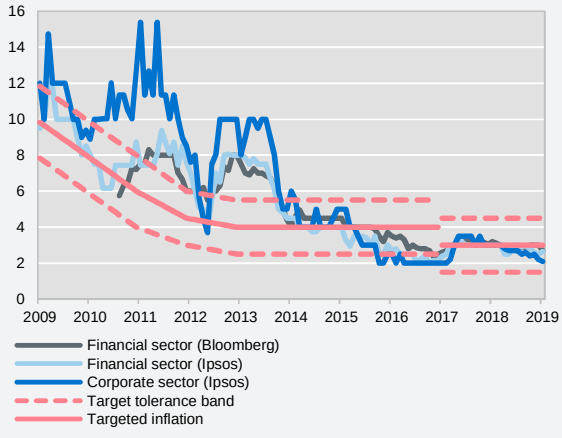
In mid-2006, the NBS launched preparations to introduce inflation targeting as a monetary strategy. Inflation targeting was embraced as previous strategies proved to be ineffective (targeting of monetary aggregates and the exchange rate, with some periods without a clear monetary strategy) since inflation was high and volatile, and internal and external imbalances pronounced. Positive experiences of other central banks also served as an incentive, as well as the fact that many of them introduced inflation targeting as a monetary strategy even before they fulfilled the theoretical criteria that were considered desirable for its efficient implementation. The years between 2006 and 2009 were a transition period of the so-called implicit inflation targeting, during which the main principles of the regime were gradually introduced into practice.

Chart O.1.1 **Headline and core inflation**
(y-o-y rates, in %)




Sources: SORS and NBS calculation.

Chart O.1.2 **One-year ahead inflation expectations**
(y-o-y rates, in %)




Sources: Gallup, Ninamedia, Ipsos and Bloomberg.

Formal (explicit) inflation targeting began in 2009, after the NBS and the Serbian Government concluded the *Agreement on Inflation Targeting* in December 2008, agreeing that inflation targeting was the most adequate monetary regime to achieve price stability in Serbia. The *Memorandum on Inflation Targeting* as Monetary Strategy was also adopted.

The hitherto practice and success in the implementation of the inflation targeting regime can be observed in two subperiods:

1. initial years of inflation targeting (2009–2012), marked by high and volatile inflation, which in April 2011 reached its peak of 14.7% in the inflation targeting regime;

2. period of low and stable inflation, when first in 2013 inflation declined sharply to around 2%, where it stayed over the following five years, and where it still stands (2.0% y-o-y in December 2018).

### Beginnings and challenges of inflation targeting (2009–2012)

In the first phase of inflation targeting, the main challenge to ensuring low and stable inflation were insufficient coordination between fiscal and monetary policy measures, poor transmission through the interest rate channel against the background of a relatively high degree of euroisation, and low monetary policy credibility. Along with shocks from the international environment (effects of the global economic crisis, volatile prices of primary commodities in the global market, public debt crisis in some euro area countries etc.), these factors caused frequent changes in the stance of monetary policy, which resulted in its diminished predictability. In addition, this period featured high short-term exchange rate volatility, which not only impacted on inflation volatility, but also undermined business uncertainty, consumer confidence and financial stability.

The first year of fully-fledged inflation targeting was marked by the culmination of the global economic crisis. The year started with the inflation rate of 10% and the key policy rate of 17.75%. Due to crisis-induced dampened aggregate demand,

inflationary pressures declined significantly, which opened room for the lowering of the key policy rate to 9.5% until the end of the year, and to 8.0% in H1 2010. However, a bad agricultural season and a sharp rise in global primary commodity prices spilled over to rising food prices and inflation expectations in 2010, which, together with dinar's depreciation against the euro of 9.1% in an environment of accommodative fiscal policy, drove up inflation above the upper bound of the target tolerance band as of October. To curb inflationary pressures, in August 2010, the NBS launched the cycle of monetary policy tightening, which ended in April the following year, with a hike in the key policy rate to 12.5%. Despite this, in April 2011, inflation reached 14.7% y-o-y, only to fall to a single-digit level until September, reflecting the slowdown in food price growth and past monetary policy measures.

With the weakening of inflationary pressures in mid-2011, the NBS began to accommodate monetary policy. However, the monetary policy stance was changed again in H2 2012, due to significant weakening of the dinar against the euro in H1, caused by, among other things, expansionary fiscal policy and deepening external imbalances. Inflation moved above the upper bound of the target tolerance band, although the key policy rate was raised to 11.25% until end-2012.

**Achievement and maintenance of low and stable inflation and the anchoring of inflation expectations (2013–2018)**

The key policy rate hikes in late 2012 and early 2013, a drop in inflation expectations – to which the NBS contributed by intensive communication with the public and the message it would undertake all necessary measures and activities to achieve and maintain price stability – including relative stability of the exchange rate, yielded their full effects in 2013. Y-o-y inflation declined vigorously, from 12.2% at end-2012 to 2.2% in December 2013. Since then, inflation has been low and stable, and comparable with inflation in advanced European economies, averaging around 2%. In the 2014–2016 period, inflation was low and stable also under the influence of the unexpectedly sharp fall in the prices of primary agricultural commodities and oil in the global market. That low inflationary pressures in Serbia in this period were not only the result of factors from the international environment was confirmed by low and anchored inflation expectations, and a significantly higher level of inflation in some European countries, whose currencies weakened amid pronounced internal and external imbalances.

Almost all the time since the start of 2017, inflation in Serbia has been moving within the bounds of the new, lower target tolerance band of 3±1.5%, reflecting adequate measures of monetary policy and its full coordination with fiscal policy. After moving around the midpoint of 3% in 2017 on average, in 2018 it was lower, averaging 2%. Our expectations are similar for 2019 as well. Low inflationary pressures are also confirmed by core inflation moving around 1% y-o-y and the inflation expectations of financial and corporate sectors anchored around the target midpoint.

Sustainable curbing of inflationary pressures since 2013 reflects several factors:

1. adequate and timely monetary policy measures;
2. ensured relative stability of the exchange rate;
3. anchored inflation expectations; and
4. consistent fiscal consolidation and full coordination of monetary and fiscal policy measures.

The path towards price stability was paved primarily with **adequate and timely monetary policy measures**. In early 2013, monetary policy was tightened to the level of the key policy rate of 11.75% in order to ensure that inflation declined in the period ahead and that inflation expectations were curbed on a durable basis – until end-2013, y-o-y inflation fell to 2.2%, and the inflation expectations of financial and corporate sectors were within the NBS target tolerance band. The NBS Executive Board adequately assessed the movement in key factors from the domestic and international environment, and their impact on inflation going forward – with two-digit current y-o-y inflation (11.4% in April), the Board decided to initiate the monetary policy easing cycle in May 2013, during which the key policy rate was trimmed from 11.75% to 3.00%.

In addition, the adoption and consistent implementation of the fiscal consolidation programme until end-2014 enabled the continuation of monetary policy easing in 2015 at a much faster pace – in that year alone, the key policy rate was cut by 3.5 pp. The NBS proceeded with monetary policy easing in the following years, but more cautiously, bearing in mind the effects of its past significant easing and risks from the international environment. Monetary policy easing gave the key impetus to the sharp drop in interest rates on private sector dinar loans (corporates and households), which as of mid-2013 fell by over 10 pp, contributing to lending growth and higher domestic demand. An additional incentive to domestic demand and economic growth came from lower costs of the repayment of outstanding loans, through the impact on lower costs of operation of the corporate sector and access to funds for new investment, as well as through rising disposable income of households.

**Ensuring relative stability of the exchange rate**, in an environment of turmoil in the international financial market and volatile capital flows, played an important role in achieving and maintaining price stability in the 2013–2018 period, as well as in preserving and strengthening stability of the financial system as a whole. Relative exchange rate stability increased certainty in the operation of corporates, contributing to the launch of a vigorous investment cycle, whose results are palpable today in vibrant economic growth. Equally important, the stability of the exchange rate and inflation, along with significantly lower interest rates, contributed to higher efficiency of fiscal consolidation measures and the minimization of negative effects on the standard of living of citizens. Relative stability of the exchange rate was supported by more efficient monitoring of trends in the FX market and communication with market participants. An important contribution to the relative stability of the dinar exchange rate in the period observed also came from reduced external and internal imbalances and undertaken structural reforms, owing to which the domestic economy's resilience to potential shocks from the international environment increased.

Aware of the importance of anchored inflation expectations and their dependence on central bank credibility, the NBS paid particular attention to **higher transparency and improved communication with the public,** so as to explain to the public the manner of pursuing monetary policy and its transmission mechanism, and to explain the decisions made. In addition, the operational monetary policy framework was changed and adapted to deliver and maintain price stability and ensure further development of the dinar money market, which is an important precondition for successful implementation of the inflation targeting strategy, while at the same time taking into account the specificities of the domestic financial market.

With the decision to lower the inflation target to 3±1.5% starting from 2017, the NBS additionally confirmed its commitment to keeping inflation low and stable in the medium run. The NBS thus contributes to the further improvement of the business and investment climate, a decline in long-term dinar interest rates, a greater use of the dinar in financial transactions, and a reduction in the currency risk and costs of the corporate, household and government sectors.

The hitherto experience in the implementation of the inflation targeting regime has shown that it played an important role in ensuring sustainable price stability, anchoring inflation expectations and strengthening monetary policy credibility, owing to its sufficient flexibility and the fact that it enabled monetary policy's adjustment to the specificities of the domestic economy – a high pass-through effect of the exchange rate on inflation, a relatively high degree of euroisation and underdeveloped domestic financial market. Moreover, as a result of achieved price and overall macroeconomic stability and relative stability of the exchange rate, the degree of euroisation declined in time, the interest rate channel strengthened and the domestic financial market developed, bringing about higher efficiency of monetary policy in the inflation targeting regime and its stronger impact on overall macroeconomic trends. Such holistic approach ensured higher certainty of doing business and investment, contributing to the sustainability of economic growth and favourable outlook for its further acceleration, including an increase in employment and the standard of living.

**Ten years into the inflation targeting regime have shown that success largely depends on commitment to policy implementation. More than five years of low and stable inflation are a visible result of the work of the NBS, which will remain committed to maintaining price and financial stability in the years to come**. We will continue to carefully analyse monetary policy efficiency, best world practice in this field, and to follow and develop new ideas. In this way, taking into account the specificities of the domestic economy, we will provide the best framework for monetary policy functioning in the coming period and give maximum contribution to sustainable growth of the economy and the standard of living of our citizens.

# III Inflation movements

*The year behind us was marked by low and stable inflation, which stood at 2.0% in December, this being also its annual average. At end-2018, over 75% of y-o-y inflation came from the prices of vegetables, as well as from the prices of cigarettes and petroleum products. Weak inflationary pressures are further indicated by core inflation, which moved around 1.0% during 2018, and inflation expectations of the financial and corporate sectors, which were somewhat below the target midpoint of 3.0%.*

*Consumer prices rose by 0.1% in Q4, led by the increase in the prices of fresh vegetables and the rise in prices of clothes and footwear, as well as of transport services. Working in the opposite direction were lower prices of fresh fruit and a decrease in petroleum product prices, due to a significant decline in global oil prices.*

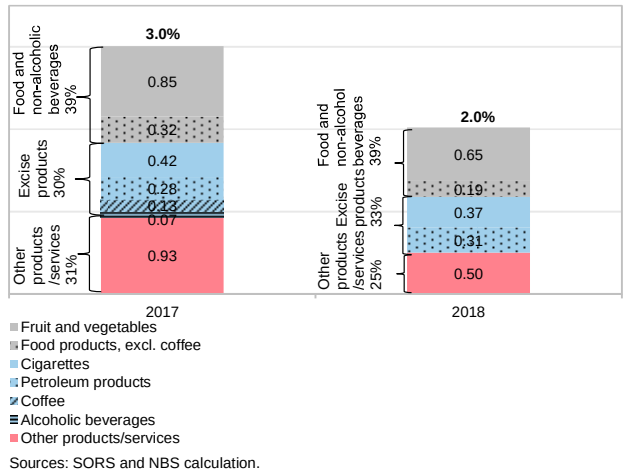
## Inflation movements in Q4

**Inflation remained low and stable in 2018, standing at 2.0% in December, this being also its annual average**. Relative to 2017, all basic CPI components, except services, grew at a slower pace. In 2018, the greatest contribution to y-o-y inflation came from the prices of food (0.8 pp), primarily vegetables (0.9 pp), followed by cigarettes (0.4 pp) and petroleum products (0.3 pp). The contribution of all other products and services combined came at 0.5 pp, which indicates that demand side inflationary pressures remained low during 2018. This is also evidenced by low and stable core inflation, which stood at 1.0% in December, this being also its annual average.

**At quarterly level, consumer price growth of 0.1%** was lower than expected in the November *Inflation Report*, primarily due to a significant decline in global oil prices in Q4 and the subsequent fall in domestic petroleum product prices.

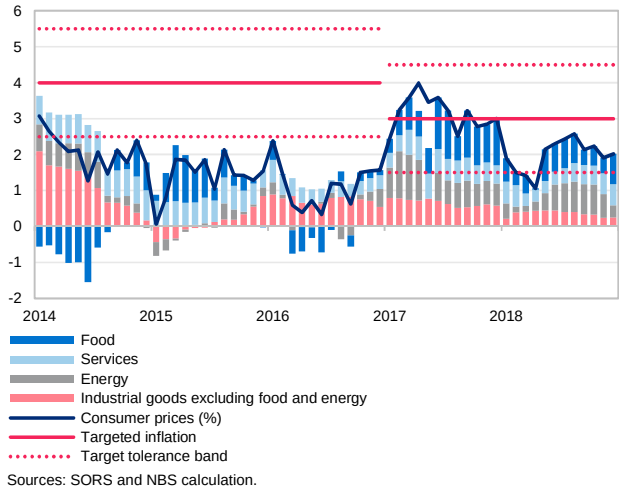
Consumer price growth in Q4 was aided by higher prices of **food and non-alcoholic beverages** (0.3%, 0.1 pp contribution). **Average unprocessed food prices stagnated in Q4**, as the hike in fresh vegetable prices (14.4%, 0.6 pp contribution) was fully neutralised by the decline in prices of fresh fruit (-23.3%, -0.5 pp contribution) and fresh meat (-1.9%, -0.1 pp contribution). On the other hand, **processed food** prices went up by 0.5% (0.1 pp contribution) amid a rise in the prices of milk and dairy products, confectionery and non-alcoholic beverages, while somewhat lower prices of oils and fats worked in the opposite direction.

Chart III.0.1 **Contribution to y-o-y inflation in December 2017 and 2018**
(in pp)



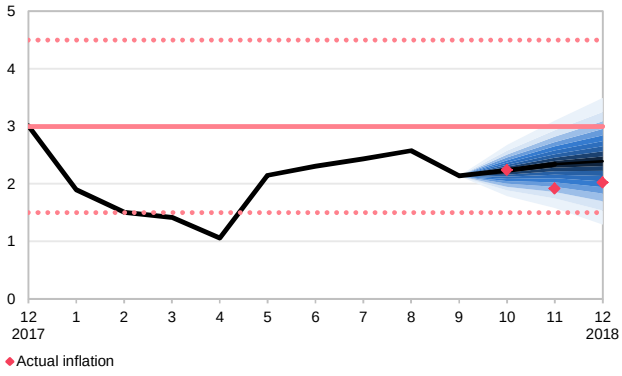

Sources: SORS and NBS calculation.

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



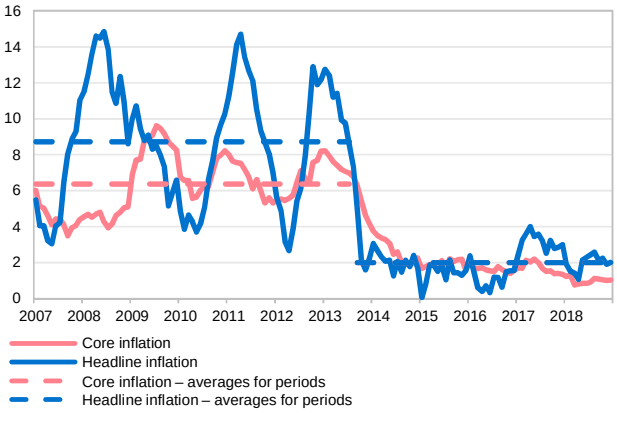

Sources: SORS and NBS calculation.

Chart III.0.3 **Short-term inflation projection from November 2018 and actual inflation**
(y-o-y rates, in %)



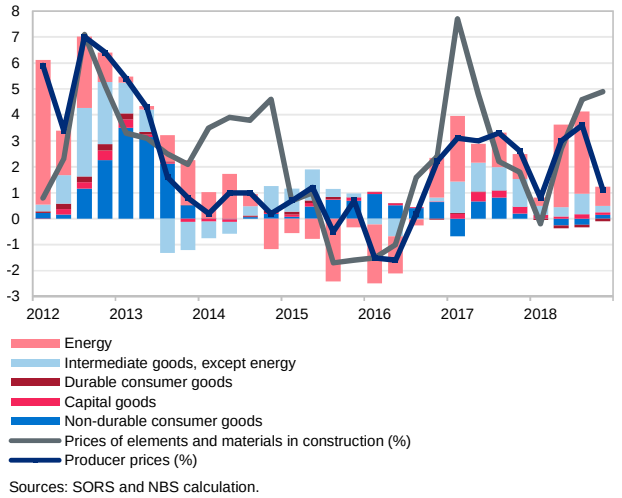

Sources: SORS and NBS calculation.

Chart III.0.4 **Headline and core inflation**
(y-o-y rates, in %)




Sources: SORS and NBS calculation.

Chart III.0.5 **Contribution to y-o-y producer price growth***
(in pp)




Sources: SORS and NBS calculation.
* Industrial producer prices for the domestic market.

**Energy prices** declined by 1.2% in Q4 (-0.2 pp contribution), owing to a decrease in the prices of **petroleum products** (-3.5 %). In addition, the prices of solid fuels (coal and firewood) grew less than usual for this part of the year.

A positive contribution to quarterly inflation came from the rise in **prices of services** (0.5%, 0.1 pp contribution), above all prices of transport services (2.3%), namely technical inspection of vehicles (3.8%) and intercity transportation (2.2%).

At 0.4% in Q4 (0.1 pp contribution), growth in the prices of **industrial products excluding food and energy** was driven by the seasonal increase in the prices of clothes and footwear (2.2%).

The **prices within core inflation** (excluding energy, food, alcohol and cigarettes) edged up by 0.5% (0.2 pp contribution), led mainly by the rise in prices of clothes and footwear, followed by transport services and pharmaceutical products. Working in the opposite direction, prices of audio and TV devices and equipment declined.

**Administered prices almost stagnated during Q4**. As there was no increase in electricity prices in 2018, administered price growth slowed down y-o-y, measuring 2.4% at end-Q4 (0.4 pp contribution).

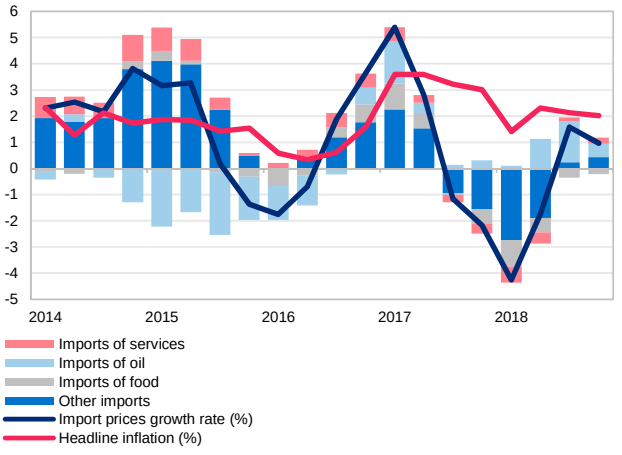
In the last five years, headline and core inflation averaged around 2%, which is one of the indicators that inflationary pressures have been suppressed on a more durable basis.

## Producer and import prices

**Industrial producer prices in the domestic market** dropped in Q4 and thus, slowed their y-o-y growth to 1.1% in December. This is primarily the result of a slower y-o-y growth in the **prices of energy production** (primarily domestic crude oil and petroleum products), given that their contribution to the increase in producer prices fell to around 0.7 pp in December (from around 3.2 pp in September). The y-o-y growth in prices in the production of **intermediate and capital goods** also slowed down. After falling for two consecutive quarters, the prices of **non-durable consumer goods** rose y-o-y, while the prices of **durable consumer goods** continued down. Unlike industrial producer prices, the **prices of elements and materials incorporated in construction**, which are used to approximate cost-push pressures in construction, rose in Q4, pushing up the y-o-y growth of these prices to 4.9% in December.

**Dinar import prices**[1] declined by 1.5% in Q4 relative to the previous quarter, when they stagnated. The strongest influence came from global oil prices expressed in the US dollar, which decreased by 10.1% on average in Q4 relative to Q3, on the back of increased supply and weaker global economic growth outlook. Besides, global prices of food expressed in the US dollar fell by 2.6% on average, a slight decrease (-0.1%) also being recorded in the prices of German exports, which are used to approximate prices of imported equipment and intermediate goods. In contrast, consumer prices in the euro area, which are used to approximate prices of service imports, went up by 0.5%. The quarterly decline in import prices expressed in dinars slowed down their y-o-y growth, which averaged 1.0% in Q4.

Chart III.0.6 **Contribution of individual components to y-o-y growth rate of import prices in dinars**
(in pp)

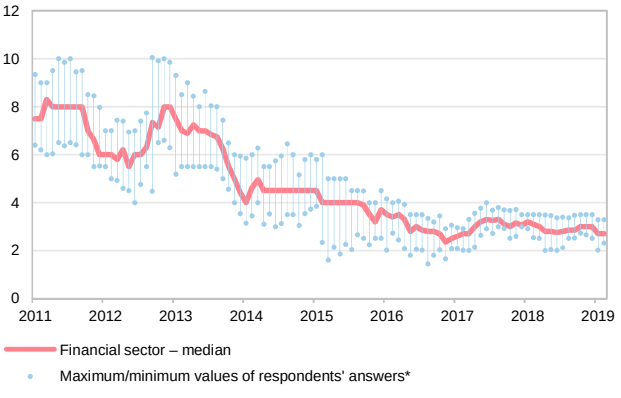



Sources: Destatis, FAO, Bloomberg, Eurostat, SORS and NBS calculation.

## Inflation expectations

Owing to the achieved and maintained price stability, and inflationary pressures that stayed low in the face of strong economic growth, the financial and corporate sectors expect inflation to continue moving within the NBS target tolerance band in the next two years. Anchored inflation expectations indicate the confidence of market participants in the measures taken by the NBS, and give a positive contribution to the efficiency of monetary policy.

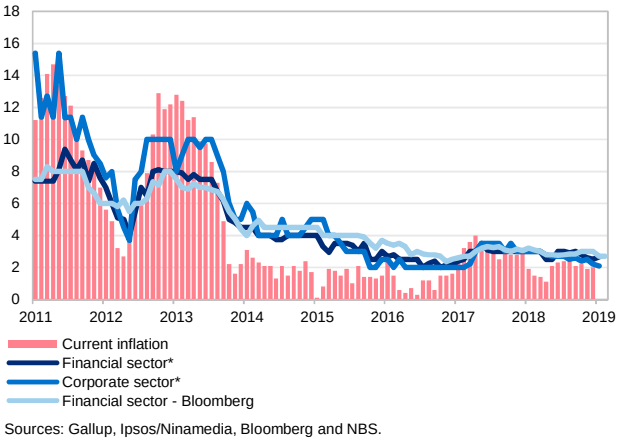
Chart III.0.7 **One-year ahead inflation expectations of the financial sector**
(y-o-y rates, in %)




Source: Bloomberg.
* 10-90 percentile range.

According to the results of the Ipsos survey, one-year ahead inflation expectations of the **financial sector** declined during Q4 2018 from 2.8% in October to 2.5% in December, only to reach 2.7% in January. Lower short-term inflation expectations than the target midpoint are probably a result of low current inflation, which averaged around 2.0% in 2018. According to the Bloomberg survey results, the financial sector expects inflation in Q4 2019 to move around 3.0%, whereas according to the January and February results, it lowered its one-year ahead expectations to 2.7%. Looking at the longer horizon, the financial sector has expected price stability and inflation within the NBS target tolerance band for more than five years now (since October 2013). Anchored inflation expectations are also reflected in the significantly lower dispersion of individual expectations of financial sector representatives.

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

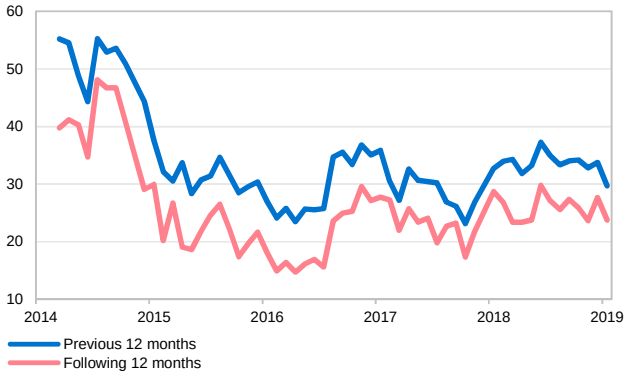



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.
* Ipsos and Gallup until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

One-year ahead **inflation expectations of the corporate sector** declined from 2.4% in October to 2.1% in

[1] The weighted average of the global oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's main foreign trade partners, is used as an indicator of import prices.

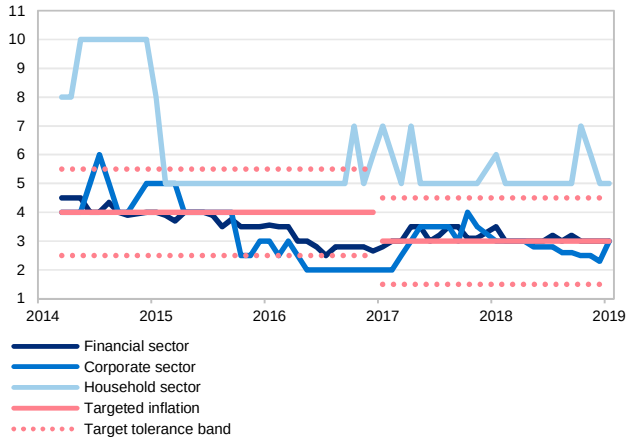
Chart III.0.9 **Household perceived and expected inflation***
(in index points)




Sources: Ipsos/Ninamedia and NBS.

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

Chart III.0.10 **Two-year ahead inflation expectations***
(y-o-y rates, in %)




Sources: Ipsos/Ninamedia and NBS.

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

January. **One-year ahead inflation expectations of the household sector**, which are typically higher and more volatile than other sectors' expectations, declined during Q4 2018 from 8.0% in October[2] to 6.0% in December, the same as in January. At the same time, the results of the qualitative survey of household inflation expectations[3] show that the index of perceived inflation continued to record higher values than the index of expected inflation, indicating that households expect inflation to be lower in the next 12 months than in the past year.

**Two-year ahead** inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), and stand at the 3.0% target midpoint. The corporate sector has somewhat lower inflation expectations, which ranged from 2.3% to 2.5% during Q4, reaching the target midpoint of 3.0% in January. Two-year ahead inflation expectations of households declined from October, equalling 5.0% in January.

Preserved macroeconomic, fiscal and financial stability contribute positively to expectations regarding economic growth, as well as corporate expectations regarding investment growth in fixed assets and loan availability. At the same time, households expect a rise in standards of living over the next year.

[2] Expectations rose to 8% in October, probably on the back of media reporting on meat, vegetable and petroleum product price hikes.

[3] For more details on the qualitative expectations of households see the February 2016 Inflation Report – Text box 2.

# IV Inflation determinants

## 1. Financial market trends

*The price of new dinar borrowing of the private sector was revised slightly upward towards the end of 2018. Due to lower borrowing needs, the government did not issue securities in the primary market in Q4, while interest rates at January auctions were similar to the ones from previous auctions of the same maturity.*

### Interest rates

**The average repo rate**[4] displayed minimum volatility in Q4, reaching 2.4% at its end, almost unchanged from the quarter before.

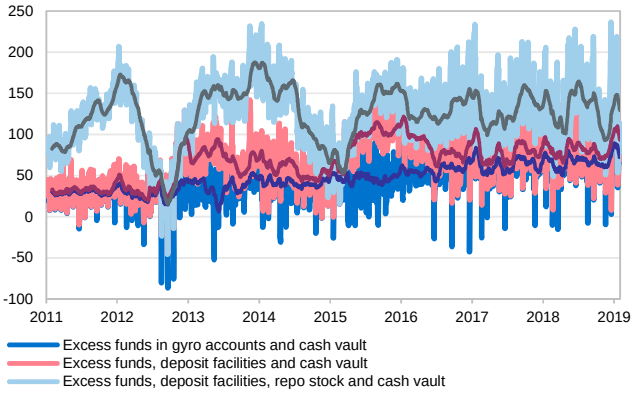
Average daily trading volumes in the **interbank overnight money market** rose from RSD 2.4 bn in Q3 to RSD 3.7 bn in Q4. Higher bank activity in this market also led to a mild increase in BEONIA rate, which averaged 2.2% in December – up by 0.2 pp from its average value in September. BELIBOR rates of all maturities also went slightly up in Q4 (up to 0.1 pp), moving on average from 2.4% (for one-day maturity) to 3.2% (for six-month maturity) in December.

In January, the average repo rate dropped by 0.1 pp, moving at 2.3% at the month's end, while interest rates in the interbank money market almost flatlined from December.

Owing to good fiscal performance in 2018, the government did not auction any dinar or FX securities in Q4.

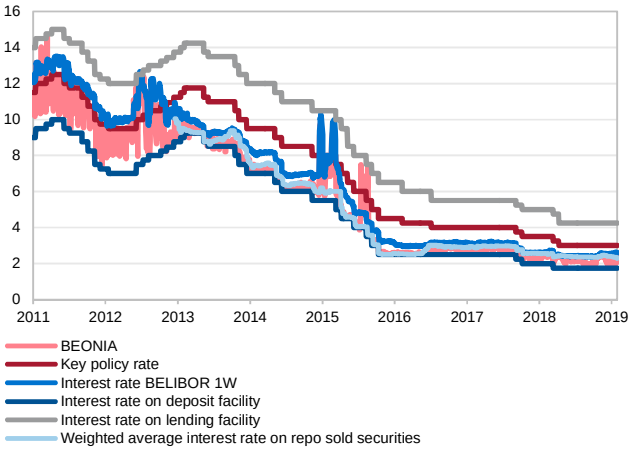
On the other hand, it organised two early buyback auctions of dinar three-year securities maturing on 22 February 2019. On both auctions it realised the planned buyback volume of RSD 10 bn, redeeming securities at 2.9% in November and at 3.0% in December. Also, Q4 saw the maturing of dinar securities in the nominal

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




Source: NBS.

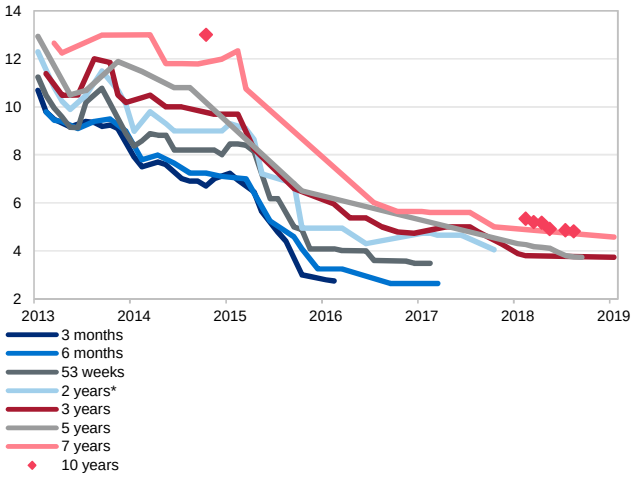
Chart IV.1.2 **Interest rate movements**
(daily data, p.a., in %)




Sources: Thomson Reuters and NBS.

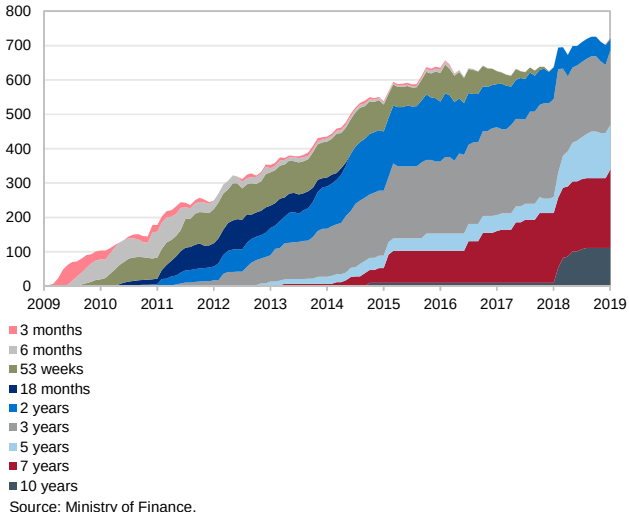
[4] The rate achieved at repo auctions weighted by the amount of securities sold.

Chart IV.1.3 **Interest rates in the primary market of government securities**
(p.a., in %)



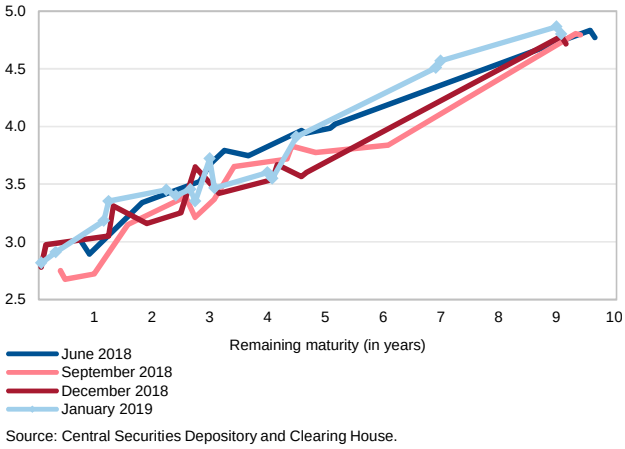

Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.4 **Stock of sold dinar government securities**
(in RSD bn)




Source: Ministry of Finance.

Chart IV.1.5 **Yield curve in the secondary government securities market**
(average values, p.a., in %)




Source: Central Securities Depository and Clearing House.

amount of RSD 5 bn, so the stock of dinar securities sold contracted by RSD 25 bn, to RSD 701.3 bn.

**The turnover in the secondary market** increased, from RSD 49.5 bn in Q3 to RSD 70.9 bn in Q4. Average rates of yield to maturity for up-to-one-year securities edged up from 2.8% in September to 3.0% in December. For longer maturities, they declined slightly, moving between 3.05% (for the remaining maturity of 15 months) and 4.8% (for the remaining maturity of 109 months) in December.

Q4 also saw the maturing of euro securities in the nominal amount of EUR 189.8 mn, so that at year-end the stock of euro securities sold decreased to EUR 2,869.0 mn.

At three **auctions of dinar securities** held in January, three-year maturity was sold at 3.7% and seven-year maturity at 4.6%. The sale volume, in nominal amount, was RSD 42.8 bn. Three **auctions of euro securities** were also held, resulting in the sale of EUR 175.2 mn worth of securities in the nominal amount. The rates achieved at these auctions were 1.25% for three-year maturity, 1.75% for five-year maturity and 3.25% for ten-year maturity.

In Q4, the weighted average **interest rate on dinar loans** edged down by 0.6 pp to 7.7%, reflecting the changed structure of new loans, i.e. the higher amount of new dinar loans to corporates which are generally approved at lower rates than household loans. Interest rates on new dinar household loans went up by 0.2 pp to 10.3% in December, while those on corporate loans rose by 0.6 pp to 5.6%.

Q4 saw a mild rise in the weighted average interest rate on total dinar household loans due to an increase in rates on cash loans (by 0.2 pp to 10.8%) and other non-categorised loans[5] (by 0.8 pp to 9.3%), while interest rates on dinar housing and consumer loans were cut by over 1 pp, to 4.6% and 7.0%.

Dinar corporate loans for current assets and investment financing were approved at higher rates than in September, rising to 5.9% and 6.2% respectively in December. On the other hand, interest rates on other dinar corporate loans declined to 4.8%.

The weighted average interest rate on **new euro-indexed** household loans declined negligibly in Q4, to 3.9% in December, reflecting lower rates on consumer and other loans, while rates on housing and cash loans remained unchanged at 2.8% and 3.4%, respectively. In euro-indexed corporate loans, the average interest rate was

[5] Including loans to entrepreneurs and farmers.

revised slightly upward (to 2.75% in December), due to the rise in rates on investment loans to 3.2%, and other loans – to 2.9%. Conversely, interest rates on euro-indexed current assets loans dropped to 2.4%.

**Interest rates on household savings** went up in Q4 – by 0.5 pp to 3.1% on dinar savings and by 0.2 pp to 1.0% on euro savings. Interest rates edged up in November during the Savings Week, while going marginally down in December. Interest rates on corporate time deposits stayed almost unchanged, measuring 2.75% for dinar deposits and 0.7% for euro deposits in December.

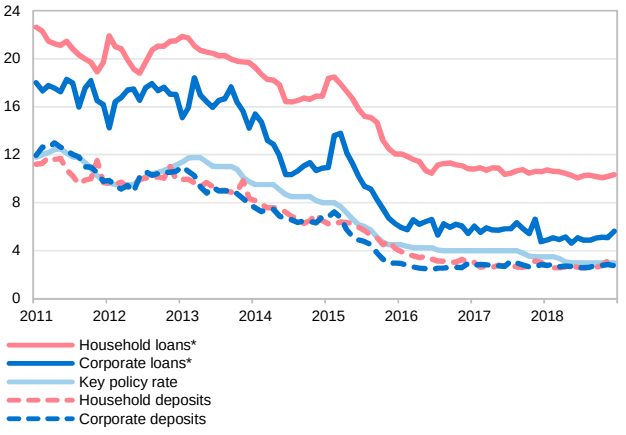
## Risk premium

One of the main sources of uncertainty in Q4 was protectionism in international trade, which also fuelled volatility in the international financial market and, hand in hand with geopolitical tensions, led to higher risk aversion of investors. This also put upward pressure on the risk premia of emerging markets in Q4, with composite indicator EMBI Global rising by 73 bp and EMBI Europe by 51 bp. In addition to global factors, macroeconomic instability in some Latin American countries also triggered a rise in their risk premia and the composite indicator EMBI Global.

Global factors reflected also on Serbia's risk premium, pushing it up by 53 bp in Q4, to 159 bp. However, at the year-end it was still significantly below the composite measures EMBI Global (435 bp) and EMBI Europe (339 bp), and among the lowest in the region. Serbia's risk premium benefited from domestic factors that worked in the opposite direction, primarily significant narrowing of internal and external imbalances, which reduced the borrowing needs, and favourable growth prospects. This simultaneously boosted the country's resilience to potential shocks coming from the international environment. This was confirmed by Standard & Poor's which in December improved Serbia's credit rating outlook for long-term borrowing in the local and foreign currency to positive from stable, and affirmed the country's credit rating at BB.

The rise in the risk premia of emerging economies from Q4 2018 was largely offset in January 2019, with EMBI Global dropping by 57 bp from end-2018. Compared to regional peers, Serbia's risk premium recorded the sharpest fall, by 44 bp to 115 bp, owing to the declining yield on Serbia's eurobond. After Poland, Serbia's risk premium was the lowest in the region.

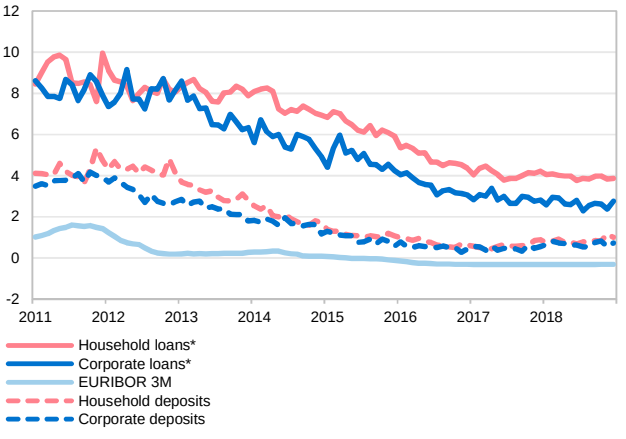
Chart IV.1.6 **Interest rates on new dinar loans and deposits**
(weighted average values, p.a., in %)




Source: NBS.

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

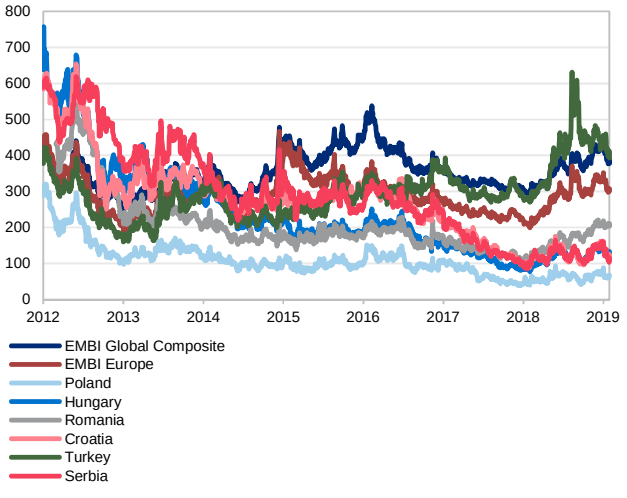
Chart IV.1.7 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)




Sources: European Banking Federation and NBS.

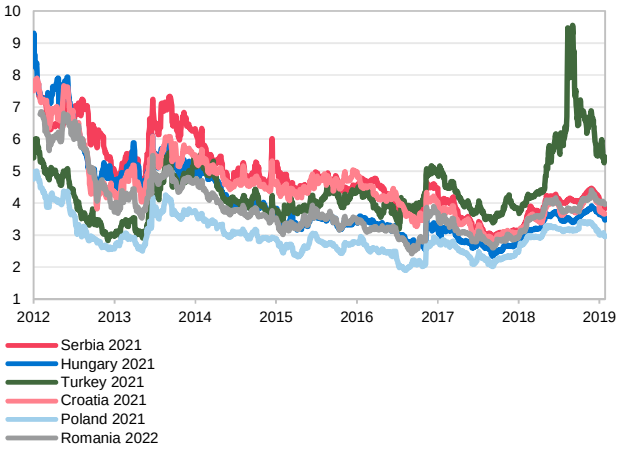
* Excluding revolving loans, current account overdrafts and credit card debt.

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



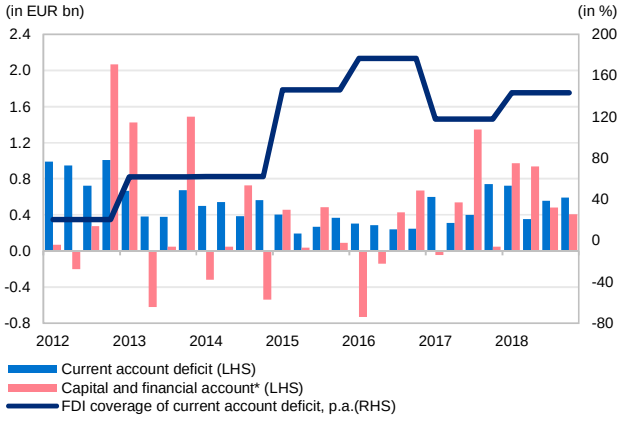

Source: JP Morgan.

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




Source: Bloomberg.

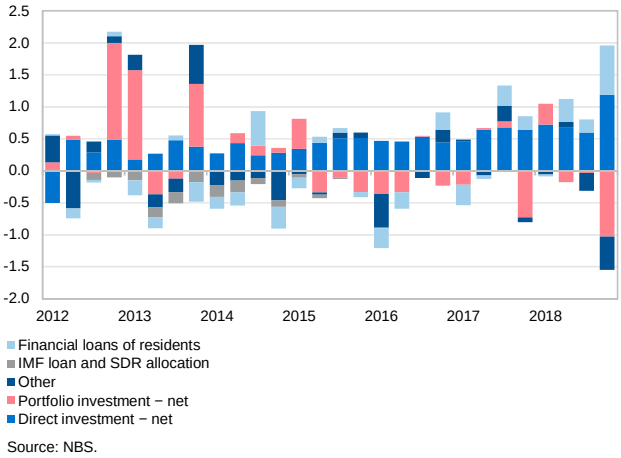
Chart IV.1.10 **Current account deficit and net capital inflow**




Source: NBS.

Note: Preliminary data for Q4 2018.
* Excl. changes in NBS FX reserves.

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




Source: NBS.

Note: Preliminary data for Q4 2018.

## Foreign capital inflow

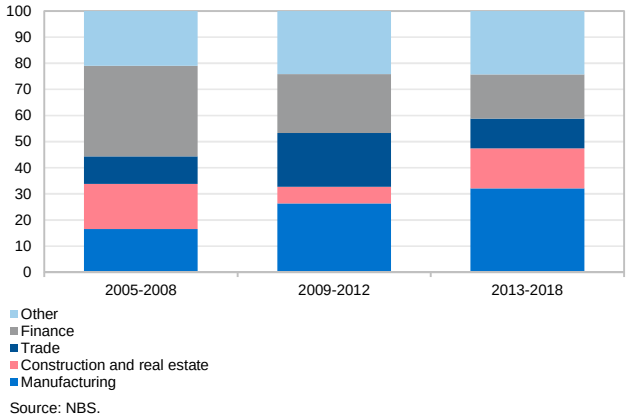
The balance of payment financial account recorded a net capital inflow in Q4 as well. The inflow was generated mostly by FDI and, to a lesser extent, by the higher credit borrowing of residents. On the other hand, portfolio investment recorded an outflow, which mainly referred to redemption of the maturing eurobond issued at end-2013 in the amount of USD 1.0 bn. This additionally pushed down the public debt-to-GDP ratio.

According to preliminary data for Q4, net FDI inflow amounted to EUR 1,184.2 mn, fully covering the current account deficit. Hence, the net FDI inflow in 2018 surpassed our expectations, reaching EUR 3.2 bn. In 2018 as well investment was highly diversified by project and geography, the bulk of it channelled to export-oriented sectors. According to our estimate, investment in manufacturing accounted for 28%, followed by investment in transport, financial sector, construction, mining and trade. The major portion of FDI originated from EU countries (around 61%), while investment from Asian countries made up around 26%.

**Portfolio investment** recorded a net outflow of EUR 1,027.8 mn in Q4. At the year-level, the outflow was smaller – EUR 913.0 mn. The major portion of the Q4 outflow referred to the redemption of the maturing eurobond issued in the international market. In addition, the government did not organise security auctions in Q4, but instead bought back RSD 20.0 bn worth of three-year government securities maturing in February this year, a part of it from non-residents.

Resident liabilities under **financial loans** increased in Q4, generating a net inflow of EUR 771.9 mn. The most of it concerned higher net borrowing of banks (EUR 328.2 mn), while corporate liabilities went up by EUR 303.0 mn and government liabilities by EUR 140.7 mn.

Chart IV.1.12 **FDI structure by sector**
(in %)




Source: NBS.

Note: Preliminary data for 2018.

## Text box 2: Balance of payments trends in 2018

Consistent with the NBS projection, the current account deficit reached EUR 2.2 bn in 2018, with its share in GDP (5.2%) kept at the 2017 level. The projection was achieved despite the rise in global oil prices and elevated imports of equipment and raw materials for investment and industry purposes, which drove up the deficit on trade in goods. On the other hand, manufacturing exports continued strongly up in 2018. In addition, for the fourth year in a row, the current account deficit was more than fully covered by the net FDI inflow worth EUR 3.2 bn, owing to which the net capital inflow on the financial account reached EUR 2.8 bn in 2018 (vs. EUR 1.9 bn in 2017). Such trends brought about a rise in FX reserves, signalling greater resilience of our economy to external shocks.

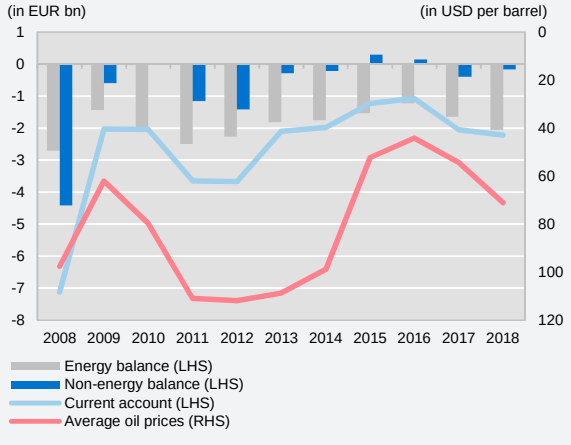
More favourable trends in 2018 compared to 2017, i.e. higher surpluses were recorded in the trade in services and on the secondary income account, while the deficit on the primary income account narrowed. This significantly compensated for the higher deficit on trade in goods, which was the result of higher imports driven by rising investment and higher global oil prices.

According to the balance of payments methodology, **goods exports** expanded by 8.3% in 2018 to EUR 15.2 bn, reflecting, as before, rising manufacturing exports (9.1%). Due to weaker external demand, notably in the euro area, which is our major foreign trade partner, the growth in manufacturing exports in 2018 was somewhat slower than in earlier years, but remained dynamic and broad-based, given that it was recorded in 21 of 23 sectors. Becoming increasingly important are exports to other markets as well, which diminishes the effects of the euro area slowdown on our exports. Following weaker performance in H1 2018, under the impact of low export inventories due to the 2017 drought, with the new season, as of July 2018 the exports of agricultural products have recorded more favourable movements. The growth in H2 2018 was supported primarily by higher exports of cereals, which would have probably been higher but for the low water levels on the Danube. At the year-level, the exports of agricultural products were similar to 2017 (down by 0.6%). As a solid export base was created owing to the excellent agricultural season in 2018, the positive trends from H2 2018 are likely to continue into H1 2019.

According to the balance of payments methodology, **goods imports** rose by 13.4% to EUR 20.5 bn in 2018. The rise in imports was dominantly led by increased production and investment, as also confirmed by the fact that around 70% of the growth concerned the imports of equipment and intermediate goods, which were up by EUR 1.7 bn or 12.2% y-o-y.[1] Such import trends were to be expected, given the investment upswing in 2018. In the medium run, they will contribute to the reduction in the current account deficit, as the imported equipment will increase the exporting capacities of the Serbian economy. A rise in imports was also supported, though to a significantly lesser extent, by the recovery of private consumption, as suggested by rising imports of consumer goods by EUR 0.42 bn or 11.5% y-o-y. In terms of groups of products (SITC), the greatest rise was recorded for energy products, raw materials[2], industrial and power machines, electrical and telecommunications devices, chemical products and various finished products.

The widening trade deficit in 2018 is due primarily to the deficit on the **trade balance of energy products**, which increased by EUR 413 mn from the year before. Such trends reflect an increase in the net imports of oil and petroleum products by EUR 309 mn and an increase in net imports of gas and coal (by EUR 86 mn and EUR 25 mn, respectively), while net electricity exports rose by EUR 7 mn. Around 89% of growth in the imports of oil, petroleum products and gas (EUR 449 mn) is due to the rise in their prices in the global market, while the rest reflects a higher imported quantity due to greater needs of the economy.

Chart O.2.1 **Impact of energy balance and oil prices on the current account**



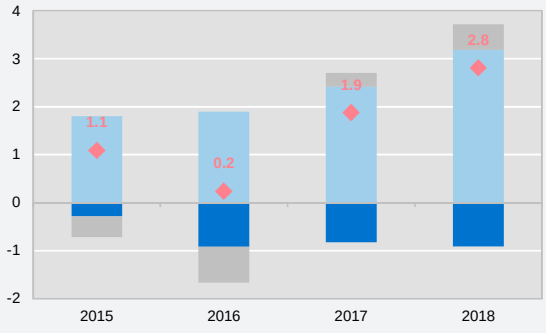

Sources: SORS, NBS calculation, Bloomberg.

[1] BEC classification.

[2] SITC 6 – products of various materials: iron, steel, non-ferrous metals, construction material, paper, wood, leather, natural rubber etc.

**The surplus on trade in services** increased further in 2018, by 13% to EUR 1.1 bn, continuing to work towards a reduction in the current account deficit. The surplus increased most notably on account of information-communications and business services, whose net exports have been increasing each year.

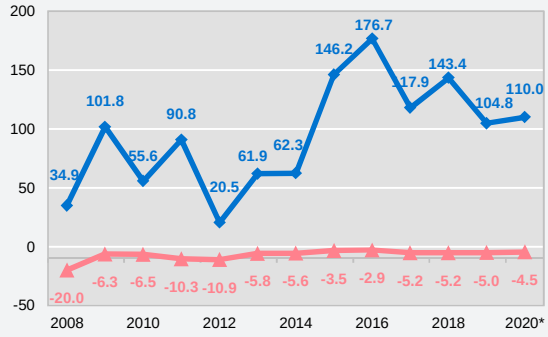
Chart O.2.2 **Financial account**
(in EUR bn)




Other investment
Portfolio investment
FDI
Financial account (excluding change in FX reserves)

Sources: SORS and NBS calculation.

Chart O.2.3 **Coverage of current account deficit by FDI**
(in %)




Gross FDI
Net FDI

Sources: SORS and NBS calculation.
* NBS projection.

The deficit on the **primary income account** declined in 2018, primarily as the result of smaller FDI expenditure as dividend payments were smaller, while the amount of reinvested earnings was similar to last year's level, signalling the commitment of foreign investors already present in the market to step up their investment in our economy. Expenditure was smaller in respect of portfolio investment as well owing to, among other things, a more favourable fiscal position and the government's lesser need to borrow, including the maturing of securities issued at higher effective rates and more favourable terms of new borrowing. The deficit declined also on the back of lower loan interest expenses.

The surplus on the **secondary income account** widened further, most notably as a result of higher remittances inflows (by 18.7%).

The inflow on the balance of payments **financial account** was by EUR 0.9 bn higher in 2018 (EUR 2.8 bn) than in 2017, owing primarily to a high FDI inflow. Further improvement in macroeconomic indicators and the business environment resulted in the **net FDI inflow of EUR 3.2 bn in 2018**. For the fourth year in a row, this ensured full coverage of the current account deficit by FDI (143.4%). Non-resident investment was broadly diversified by project and geography. As before, the bulk was channelled to export-oriented sectors, which is likely to support the growth in exports at high rates in the coming period as well. According to our estimates, most investment (around 28%) went to manufacturing, followed by the transportation sector, financial sector, construction, mining and trade. As usual, the bulk of the inflow came from EU countries (around 61%), while the share of investment from Asian countries continued up, reaching around 26% in 2018.

The **portfolio investment** outflow reached EUR 913 mn, mainly due to the maturing euro bond in December, based on which EUR 788 mn were paid to non-residents. An outflow was also recorded in respect of the repayment (mainly early) of debt to the London Club creditors worth EUR 141 mn in April, whereby Serbia settled all its obligations to the Club. In the first seven months of 2018, non-residents stepped up their investment in government securities in the primary market, most notably dinar securities of the longest maturities, while acting as net sellers in the remainder of the year. Such trends can be associated with the government's lesser need for funding – in Q4, the government did not organise sales auctions, but carried out an early buyback of securities. Other factors include further monetary policy normalisation by the FED and the expected wind-down of the ECB's quantitative easing programme.

In 2018, resident debt towards foreign creditors increased significantly. The net inflow from **financial loans** came at EUR 1.3 bn. For the second year in a row, bank borrowing increased (by EUR 603 mn), confirming that the deleveraging of parent banks towards their subsidiaries in Serbia has ended. Company borrowing accounted for EUR 510 mn and

government liabilities to foreign creditors rose by EUR 198 mn. As exporters approved more trade loans than were used by our importers, the net outflow from **trade loans** came at EUR 347 mn. The net outflow in respect of cash and deposits equalled EUR 404 mn, as banks increased their deposits abroad by EUR 547 mn and non-residents increased their deposits with banks by EUR 143 mn.

The above trends in the current and financial accounts brought about an increase in Serbia's FX reserves by EUR 1.1 bn, according to the balance of payments methodology[3]. At year-end, they stood at EUR 11.3 bn, ensuring the coverage of over five months of imports and the coverage of short-term external debt of 260.9%[4], which confirms external sustainability that we expect to be maintained in the coming period as well.

[3] Excluding currency changes and changes in market values of securities and gold.

[4] According to the stock of external debt by remaining maturity in September 2018.

## Trends in the FX market and exchange rate

End-of-period, the dinar gained 0.2% against the euro in 2018. Appreciation pressures, prevailing in the major part of the year, reflected further improvement of macroeconomic indicators and favourable prospects going forward, as confirmed by the continued growth in long-term foreign resident investment and an improved credit rating outlook.

Since September, FX supply and demand were almost matched, leading to the weakening of appreciation pressures and occasional occurrence of moderate depreciation pressures. End-of-period, the dinar strengthened by 0.2% against the euro in Q4. At the same time, it lost 1.6% vis-à-vis the dollar as the dollar gained ground against the euro.

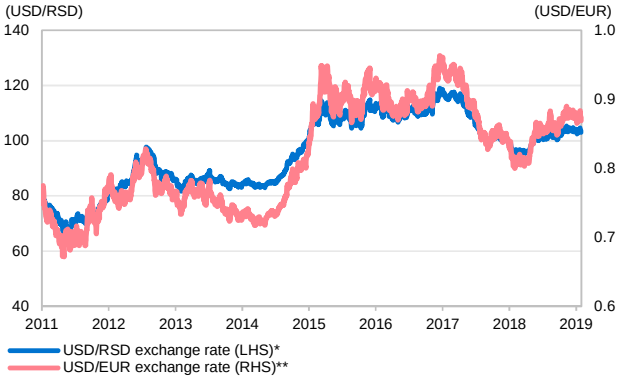
In terms of factors of the domestic FX market, Q4 saw a seasonally higher FX sale to companies, notably energy importers. A somewhat higher FX sale to non-residents was also observed in Q4. Although higher than in Q3, demand was fully covered by FX supply – on account of the relatively high purchase of foreign cash, rising FX-indexed corporate borrowing[6] and card payments by foreign citizens in Serbia.

To mitigate excessive daily volatility of the dinar exchange rate against the euro, in Q4 the NBS intervened in the IFEM by selling EUR 15.0 mn net. In October, it intervened on the sale side and in November on the purchase side. In December, it intervened both on the sale and purchase side. At the year-level, the NBS bought EUR 1,580.0 mn net, pushing up the level of FX reserves.

Moderate depreciation pressures prevailed in January, notably in an environment of elevated FX demand of energy importers, which is why the NBS intervened by selling EUR 130.0 mn.

Trading volumes in the IFEM[7] increased in Q4 to EUR 27.8 mn on average per day, up by EUR 5.8 mn from Q3. The highest trading volumes were recorded in December (EUR 32.1 mn on average per day). Measured by EWMA[8] and EGARCH[9], after a mild increase in October, the volatility of the dinar exchange rate against the euro declined in the following two months.

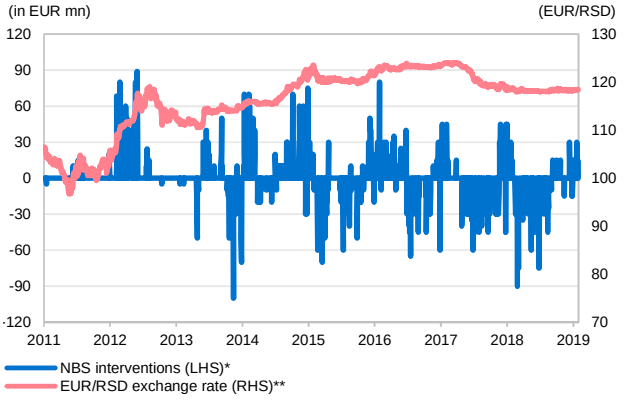
Chart IV.1.13 **Movements in RSD/USD and EUR/USD exchange rates**




Source: NBS.

* USD 1 in RSD.
** USD 1 in EUR.

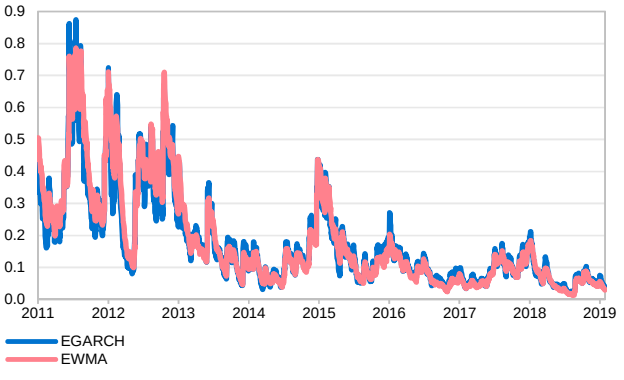
Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**




Source: NBS.

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

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




Source: NBS.

[6] Aiming to balance their open long FX position and diminish their exposure to the FX risk, banks sell foreign currency, which results in dinar's appreciation.

[7] Excluding the NBS.

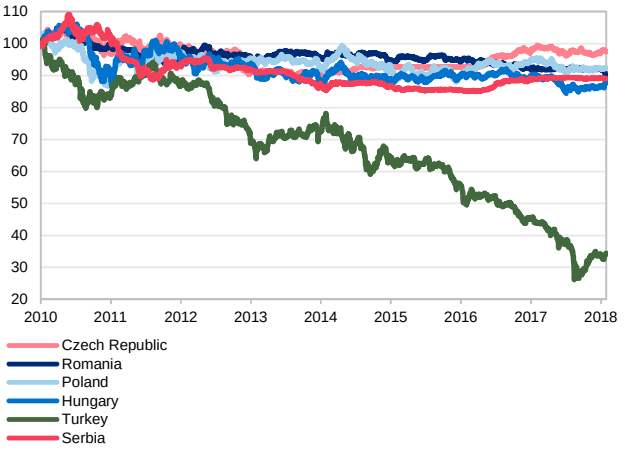
[8] EWMA – Exponentially Weighted Moving Average.

[9] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

Q4 experienced higher activity in the FX swap market as well. At two-week auctions held by the NBS, EUR 82.0 mn were both swap bought and sold from/to banks, including EUR 55.0 mn at three-month auctions, which is an increase from Q3 when EUR 27.0 mn were sold and bought at two-week and three-month auctions each. The last quarter of 2018 saw FX swap trade between banks, worth total EUR 33.0 mn. In late January, besides regular, an additional FX purchase swap auction was held for the purpose of regulating dinar liquidity of the banking sector. Against the backdrop of reduced dinar liquidity excesses, banks obtained dinar liquidity worth RSD 22.5 bn on a two-week term. This is at the same time pre-empted unjustified growth in short-term interest rates in the interbank money market.

Other currencies of regional peers running similar exchange rate regimes displayed divergent trends in Q4. End-of-period, the Turkish lira strengthened the most against the euro (18.0%), while the Hungarian forint gained 0.7%. The Czech koruna and Romanian leu remained unchanged, while the Polish zloty lost 0.7%.

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




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

## 2. Money and loans

***Y-o-y growth in monetary aggregates stepped up in Q4, led by rising economic and lending activity. In December, domestic loans also picked up y-o-y, to 9.9% from 7.7% in September. The growth was achieved against the background of banks' continued efforts to resolve the NPL issue.***

### Monetary aggregates

In December 2018, monetary aggregates M1, M2 and M3 rose by 18.3%, 16.7% and 14.5% y-o-y, respectively, reflecting mainly growth in economic and lending activity. Working in the opposite direction was a rise in government deposits in the banking sector, owing to the fiscal surplus and successful auctions of five- and ten-year securities in the prior period, primarily during H1.

At the year-level, a positive contribution to M3 growth in 2018 came from both the dinar and FX component. Achieved macroeconomic stability, reflected in low and stable inflation, anchored inflation expectations and relative stability of the exchange rate, prompted a rise in the share of dinar corporate and household deposits in total deposits by 1.4 pp in the course of the year, to 32.2% in December.

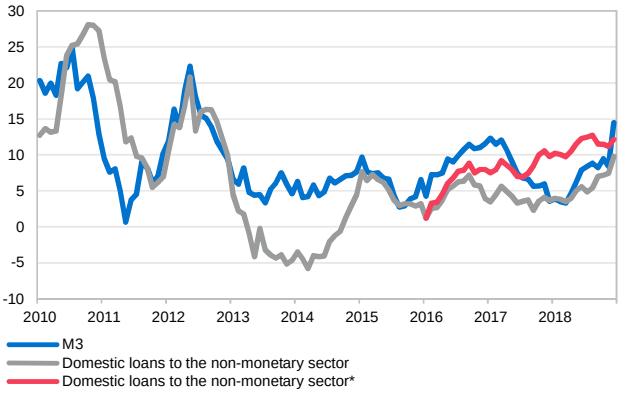
Demand deposits rose by RSD 104.0 bn in 2018, driven mainly by mounting corporate transaction deposits. The

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

| | 2018 | | | | Share in M3 Dec 2018 (%) |
|---|---|---|---|---|---|
| | March | June | Sept. | Dec. | |
| M3 | 3.3 | 7.9 | 8.2 | 14.5 | 100.0 |
| FX deposits | 0.5 | 4.6 | 5.2 | 13.2 | 61.0 |
| M2 | 8.5 | 13.7 | 13.5 | 16.7 | 39.0 |
| Time and savings dinar deposits | 6.0 | 14.4 | 8.7 | 11.2 | 8.6 |
| M1 | 9.4 | 13.5 | 15.1 | 18.3 | 30.4 |
| Demand deposits | 11.3 | 14.9 | 14.6 | 20.6 | 23.4 |
| Currency in circulation | 3.8 | 9.5 | 16.5 | 11.4 | 7.0 |

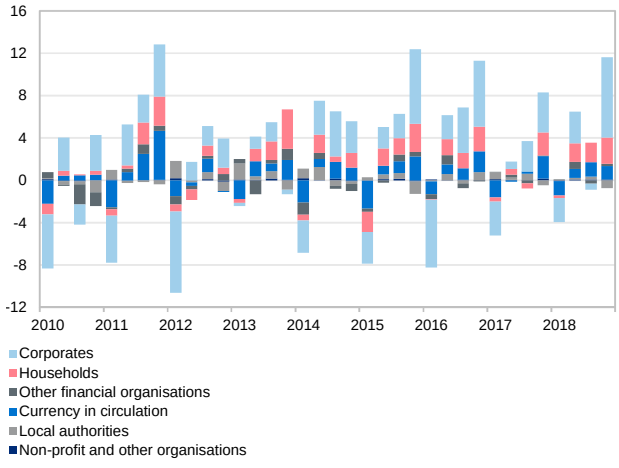
Source: NBS.

Chart IV.2.1 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



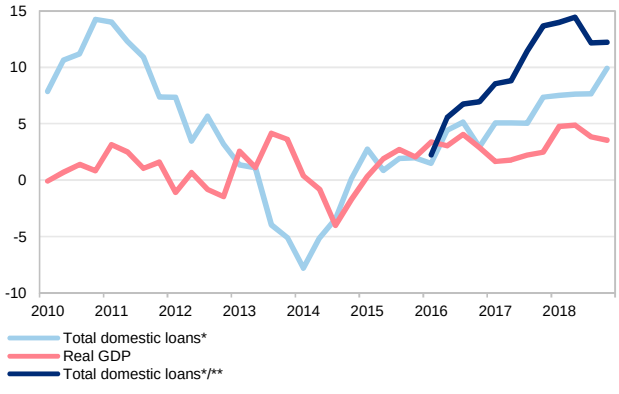

Source: NBS.
* Excluding the effect of NPL write-off and sale since early 2016.

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




Source: NBS.

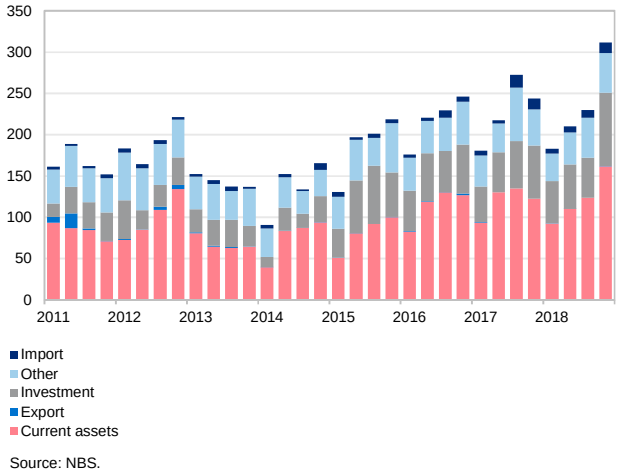
Chart IV.2.3 **Lending activity and GDP**
(y-o-y rates, in %)




Sources: NBS and SORS.

* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

Chart IV.2.4 **Structure of new corporate loans, by purpose**
(in RSD bn)




Source: NBS.

acceleration of economic growth brought about a RSD 62.0 bn rise in corporate deposits in 2018, most notably transaction deposits of companies in manufacturing, trade and construction sectors. In addition, households raised their deposits by RSD 41.3 bn. Growth was recorded in other sectors as well.

Term dinar deposits increased by RSD 22.6 bn in 2018, led chiefly by higher dinar household savings,[10] which rose by RSD 11.0 bn, this being their highest rise since 2013. In December 2018, savings reached a new peak of RSD 60.5 bn, up by 22.2% from end-2017. The latest Analysis of the Profitability of Dinar and FX Savings for August 2012 – December 2018, as well as all analyses carried out so far, suggest greater profitability of saving in the local currency, both in the long and short run.[11] In addition, term corporate deposits increased by RSD 8.9 bn, mainly on account of elevated deposits of companies in the fields of trade and construction.

Owing to the FX inflow from exports, FDI and corporate external borrowing, corporate FX deposits rose by EUR 904.8 mn in 2018. At the same time, FX household savings climbed by EUR 574.0 mn, to maximum EUR 9.6 bn in December 2018.

## Loans

Excluding the effect of exchange rate changes[12], in December 2018 total domestic loans stepped up their y-o-y growth to 9.9%, with corporate loans rising by 8.1% and household loans by 12.5% y-o-y. The accelerated lending growth was prompted by the high approval of corporate loans in December, and persisted despite the continuation of banks' NPL resolution efforts. In 2018, banks wrote off RSD 36.0 bn and sold to non-bank entities RSD 34.8 bn worth of NPLs directly from their balance sheets. Excluding the effect of NPL write-off and sale[13], y-o-y growth of domestic loans in December 2018 reached 12.2%, with household loans going up 13.6% and corporate loans 11.6% y-o-y.

[10] Money supply M3 includes only resident funds. Including non-resident funds, at end-December dinar savings stood at RSD 61.1 bn and FX savings at EUR 10.0 bn.

[11] For more detail see the Analysis published on the NBS website on 1 February 2019: http://nbs.rs/internet/english/15/mediji/vesti/20190201_analiza_e.pdf.

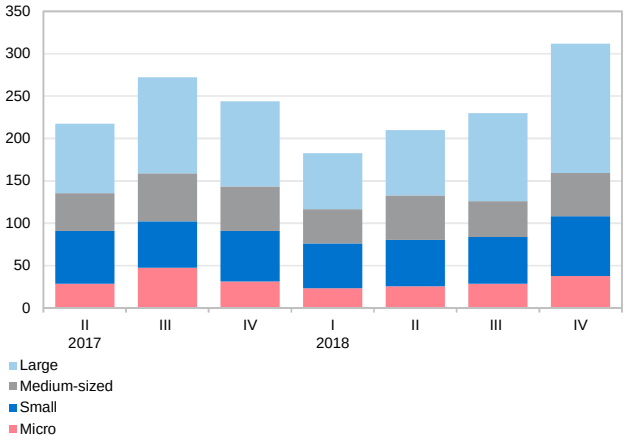
[12] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate), taking into account the currency structure of loan receivables.

[13] Excluding the NPL write-off and sale effect since the beginning of 2016. Concluding with December in 2018, banks wrote off RSD 182.3 bn worth of NPLs (of which RSD 135.6 bn of corporate loans, and RSD 41.8 bn of household loans), and sold RSD 88.8 bn worth of NPLs, which were in their balance sheets at the moment.

Excluding the exchange rate effect, in Q4 2018, **corporate loans** rose by RSD 58.7 bn and over 60% of this growth referred to company lending. **Sector-wise**, corporate loan growth was recorded across almost all sectors in Q4 2018, driven mainly by lending to companies in transport and communications, manufacturing and real estate. **In terms of purpose**, liquidity and current assets loans still accounted for the bulk of corporate loans (48.8%), followed by investment loans with 32.7%.

The volume of **new corporate loans** in Q4 (RSD 311.6 bn) expanded by 35.5% q-o-q and by 27.7% y-o-y, mostly due to the high loan approval in December. Current assets loans were the dominant corporate loan category in Q4 (51.9% of new corporate loans), with over 50% of these loans being placed in the micro, small and medium-sized enterprise market segment. The volume of investment loans in Q4 2018 (RSD 89.1 bn) rose by 38.4% from the same period last year, and almost doubled from Q3. Their share in total new corporate loans in Q4 amounted to 28.6% and they were mostly used by micro and small enterprises. On the annual basis, RSD 242.7 bn worth of investment loans were approved, up by 14.0% from 2017, confirming that loans, same as in the last three years, served as a significant source of investment financing.

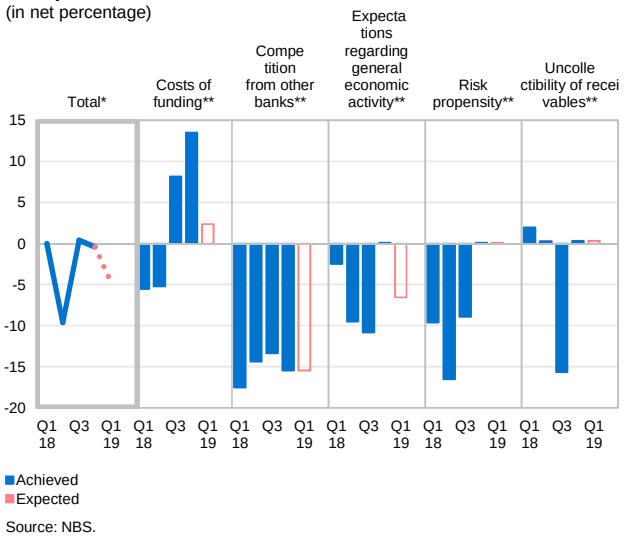
Chart IV.2.5 **Structure of new corporate loans, by enterprise size**
(in RSD bn)




Source: NBS.

The results of the **NBS bank lending survey from January**[14] show that banks, for the second quarter in a row, saw no changes in corporate credit standards – judging that the majority of factors did not impact them in Q4 2018. Banks expect a mild loosening of credit standards in Q1 2019 in almost all corporate loan categories, due to the influence of competition and positive expectations regarding the general economic situation. The survey findings show that, in banks' view, in Q4 2018 they continued to reduce the price of corporate loans, increase their maximum maturity and amount, while lowering collateral requirements for FX loans. Banks deem that corporate loan demand expanded in Q4, mostly in the segment of small and medium-sized enterprises, with current assets and capital investment loans being in highest demand. Banks expect similar tendencies in Q1 2019.

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)



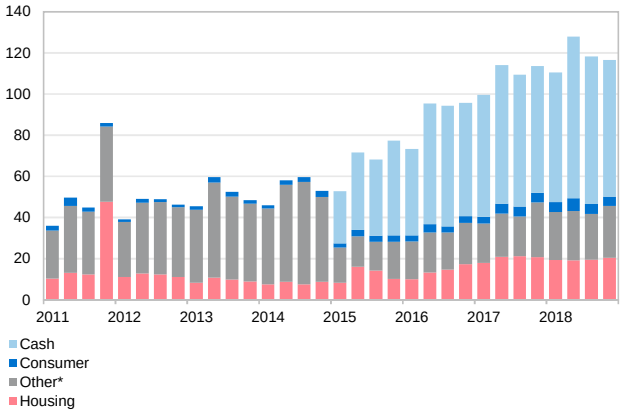

Source: NBS.

* 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.

Excluding the exchange rate effect, **household loans** increased by RSD 21.3 bn in Q4 2018. The bulk of loans were cash loans and housing loans, which picked up by

[14] The NBS implements the survey since the start of 2014.

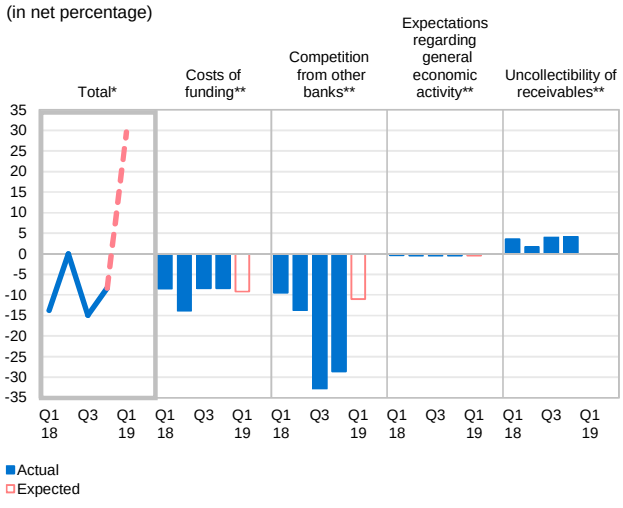
Chart IV.2.7 **Structure of new household loans**
(in RSD bn)




Source: NBS.

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

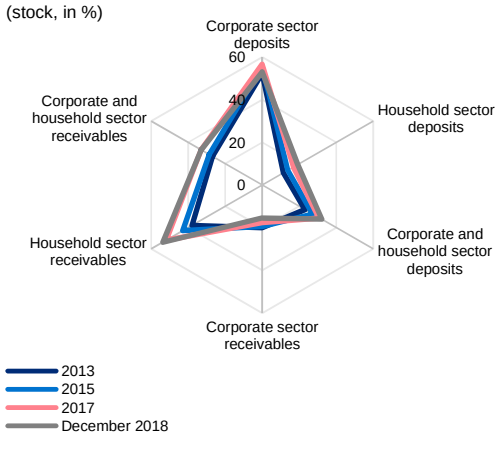
Chart IV.2.8 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)




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 **Dinarisation of corporate and household deposits and receivables**
(stock, in %)




Source: NBS.

¬RSD 12.0 bn and RSD 6.3 bn, respectively in Q4. At the level of 2018, housing loans went up by RSD 27.0 bn, an increase higher than in the last two years taken together. The acceleration in GDP growth was also supported by investment activity of entrepreneurs, financed by bank loans, which rose by RSD 8.9 bn in 2018.

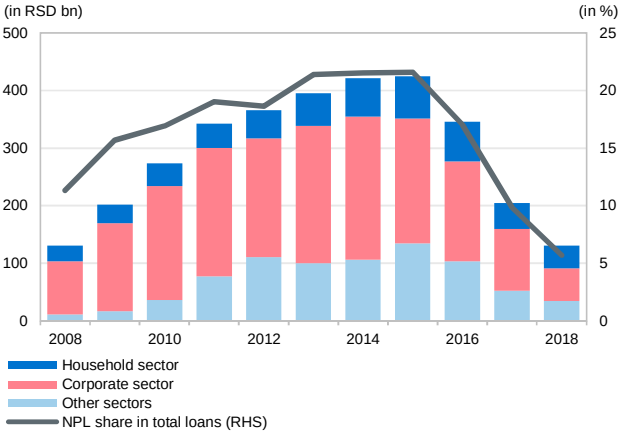
The volume of **new household loans** in Q4 (RSD 116.7 bn) was 1.4% lower than in Q3, but 2.7% higher than in the same period last year. In Q4 citizens continued to use predominantly cash loans and refinancing loans, which made up almost 60% of new household loans and were almost entirely approved in dinars (over 99%). The volume of new housing loans (RSD 20.4 bn) rose by 4.7% from Q3. Overall in 2018, RSD 78.3 bn worth of housing loans were approved, indicating that the recovery in housing lending has extended into the second year.

The results of the **January bank lending survey** show that, in banks' assessment, interbank competition, lower cost of funding sources and higher risk appetite were the main factors behind the easing of household credit standards for dinar cash loans and refinancing loans, as well as FX housing loans in Q4 2018. Q4 2018 saw the easing of price terms, as well as collateral requirements for dinar household loans. Banks expect that household credit standards will be tightened in Q1 2019, under the impact of "other factors", while competition and cost of funding sources will continue to work toward standards easing in Q1 as well. In banks' assessment, interest margin, fees and commissions and collateral requirements will be reduced, but requirements regarding loan maturity will be tightened, both for dinar and FX loans. This may be associated with the new regulations the NBS adopted in December 2018 with a view to preventing new NPLs in the banking system and warding off negative consequences on financial stability and citizens. These measures are targeting cash, consumer and other household loans (with the exception of housing loans and current account overdrafts) with the repayment term of eight years or longer. Banks assess that household demand for dinar consumer and FX housing loans expanded in Q4 2018, which was additionally supported by the favourable situation in the real estate market, and which should also boost loan demand in Q1 2019.

**The share of dinar receivables in total corporate and household receivables at end-December** reached 33.0%, up by 0.2 pp relative to end-Q3. Dinarisation of household receivables reached the maximum 53.6% in December, while the dinarisation of corporate receivables went up by 0.8 pp to 15.4%.

NPL resolution strategy continued to yield excellent results, receiving positive impetus from accelerated economic growth. In close to three and a half years since the Strategy was adopted, the **NPL stock** contracted by almost 70%, and NPL share in total loans dropped by 16.7 pp. From the start of 2018, NPL share in total loans decreased by 4.1 pp to 5.7% in December, with corporate NPL ratio going down by 5.3 pp to 5.1%[15], and the household NPL ratio by 1.3 pp to 4.4%.[16] NPL coverage remained high nonetheless – in December 2018, allowances for impairment of total loans stood at 78.7% of NPLs, while regulatory provisions for balance sheet exposure continued to fully cover gross NPLs, by 162.2%. Also, following the introduction of Basel III standards[17], capital adequacy ratio went up further, reaching 22.8% at end-Q3 2018 and testifying to the high capitalisation of the domestic banking sector.

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




Source: NBS.

## 3. Real estate market

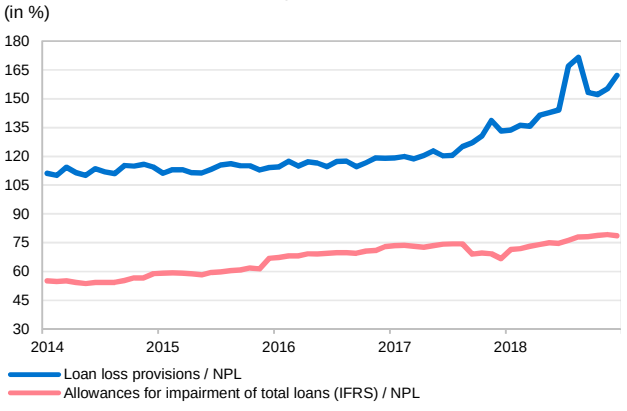
***Real estate prices continued up in Q4, reaching the annual growth rate of 1.2%. The extension of growth into the third year signals a rebound in the real estate market.***

As measured by DOMex[18], the average price of real estate in Serbia increased by 1.6% in Q4. Real estate prices went up in all regions, save for Southern and Eastern Serbia, where they edged down by 0.8%. The sharpest increase was recorded in the Belgrade region (2.2%). At the annual level, prices of real estate in Serbia rose by 1.2% in 2018. This was the third year of uninterrupted growth. Real estate turnover[19] expanded by 1.8% at the annual level.

The average real estate price in Serbia in Q4 equalled EUR 910.2 per square metre. Prices were highest in the Belgrade region, averaging EUR 1,219.4 in Q4, the highest value in the last five years.

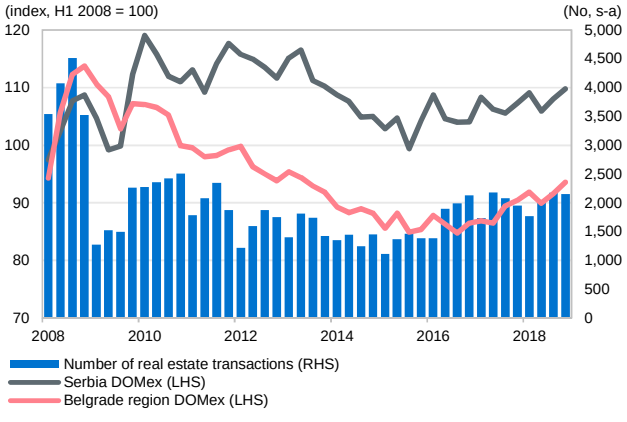
Similar developments may be expected in the real estate market going forward. On the supply side, the number of construction permits in residential construction

Chart IV.2.11 **Selected banking sector indicators**




Source: NBS.

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




Source: National Mortgage Insurance Corporation.

[15] Includes companies and public enterprises. Looking at companies only, in December 2018 the share of NPLs in total loans stood at 5.2%, down by 5.6 pp y-o-y.

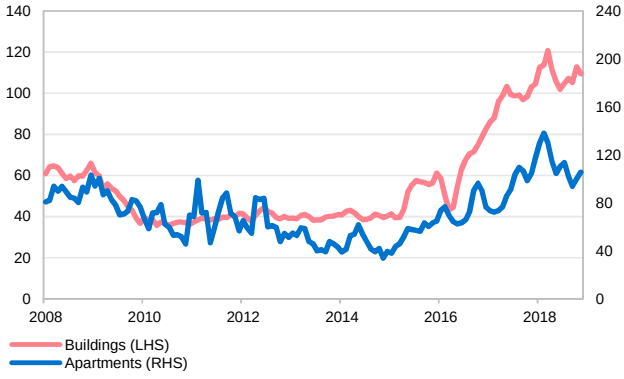
[16] With entrepreneurs and private households included, the share decreased by 1.5 pp to 4.4%.

[17] The regulatory Basel III framework is applied as of 30 June 2017.

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

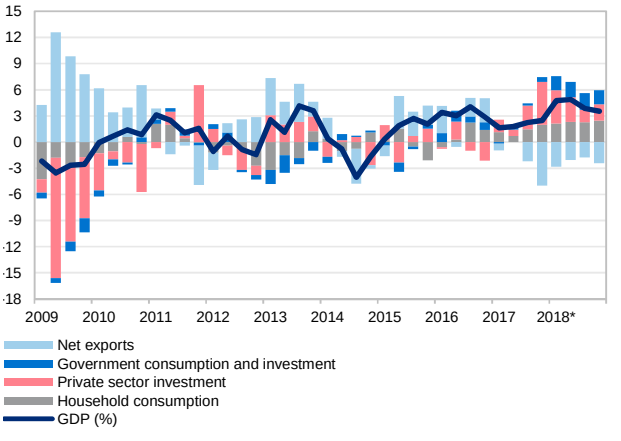
[19] The number of real estate transactions and flat prices per square metre also relate only to real estate purchased by insured loans.

Chart IV.3.2 **Indices of the number of issued construction permits for new construction**
(quarterly averages s-a, 2017 = 100)




Sources: SORS and NBS calculation.

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




Sources: SORS and NBS calculation.
* NBS estimate for Q4 2018.

Table IV.4.1 **Movement in main indicators and sources of household consumption**
(real y-o-y growth rates, in %)

| | 2018 | | | |
|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 |
| **Household consumption** | **3.1** | **3.3** | **3.3** | **3.6*** |
| **Indicators** | | | | |
| Retail trade | 3.3 | 3.3 | 4.8 | 4.8 |
| Catering turnover | 9.6 | 10.7 | 11.0 | 9.0** |
| Number of domestic tourists | 10.1 | 8.7 | 8.6 | 5.8 |
| Number of overnight stays of domestic tourists | 9.2 | 13.6 | 10.2 | 6.7 |
| Consumer goods imports (BEC classification), nominal | 13.0 | 5.7 | 10.4 | 16.5 |
| **Sources** | | | | |
| Total wage bill, nominal | 7.5 | 8.9 | 9.9 | 11.4*** |
| Net remittances inflow, nominal | 12.0 | 15.6 | 35.5 | 6.4 |
| New consumer and cash loans, nominal | 8.3 | 17.5 | 10.8 | 7.0 |

Sources: SORS and NBS calculation.
* NBS estimate.
** October (SORS estimate).
*** October– November.

continued up, rising by 17.7% y-o-y in the eleven months of 2018. A further rise in demand is supported by the continuation of favourable terms of housing loans and rising employment and wages, as confirmed by the results of the Bank Lending Survey.

# 4. Aggregate demand

*A favourable macroeconomic environment and accelerated implementation of infrastructure projects led to the growth in fixed investment. In addition, positive movements in the labour market and favourable borrowing terms boosted household consumption, so that domestic demand was the key driver of GDP growth in Q4 (3.5% y-o-y). The contribution of net exports remained negative, due to faster growth in imports, mainly of equipment and intermediate goods, driven by the needs of the ongoing investment cycle.*

## Domestic demand

Household consumption growth stepped up in Q4 (from 3.3% in Q3 to 3.6% y-o-y), adding 2.5 pp to GDP growth. This is also confirmed by the positive movements of activity indicators in service sectors (trade and accommodation and food services). In y-o-y terms, retail trade turnover edged up by 4.8% and the number of domestic tourist arrivals and overnight stays by 5.8% and 6.7%, respectively. The rising imports of consumer goods also signal an increase in household consumption (16.5% y-o-y). In our estimate, on a quarterly basis **household consumption** rose 1.0% s-a, adding 0.7 pp to GDP growth, as a result of the continued rise in disposable income on account of higher wages and employment in the private sector and favourable financial conditions.

Indicators of the sources of household consumption also point to its increase in Q4. In the period October–November, the wage bill went up 11.4% y-o-y, reflecting the rise in private sector employment and higher average wage. Q4 saw a further growth in new cash loans, while the remittances inflow increased by 6.4% y-o-y.

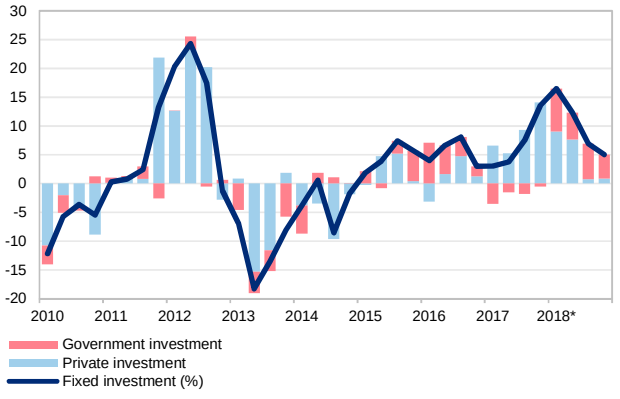
GDP movements in Q4 also received a positive boost from the **final government consumption** (0.7 pp), which, same as in Q3, rose 4.0% y-o-y. Despite the downsizing of public sector employment, the increase in the average wage and in expenditures for the purchase of goods and services in Q4 resulted in higher government consumption. According to the NBS's estimate, government consumption edged up by 0.7% s-a in Q4, contributing 0.1 pp to GDP growth.

Similarly as in previous quarters, improved business environment, accelerated implementation of infrastructure projects and favourable terms of financing encouraged investment activity. Hence, Q4 saw a rise in fixed investment by 5.0% y-o-y. In that quarter, **government investment** expanded by 27.1% y-o-y (0.9 pp contribution to GDP), owing to accelerated execution of capital budget expenditures which in October and November rose by 43.2% relative to the same period last year. Private investment growth of 1.0% y-o-y (0.2 pp contribution to GDP) is also signalled by the expansion in the physical volume of production of machinery and equipment of 8.7% y-o-y, and the rise in equipment imports by the same percent. Positive movements were also registered in the production of construction material, which grew by 5.5% y-o-y. On a quarterly basis, fixed investment also gave a positive contribution to GDP growth (0.5 pp), mainly thanks to higher **private investment** (2.8% s-a), while government investment rose at a somewhat slower pace (0.6% s-a).

Speaking of the sources of investment financing, the improved macroeconomic climate continued to reflect positively on net FDI inflow which in Q4 reached EUR 1.2 bn, rising by 85.9% from the same period last year. In addition, in Q4 investments were also largely financed by bank loans, which is confirmed by the growth of investment loans of 38.4% y-o-y in that quarter.

Another strong contributor to y-o-y GDP growth in Q4 was the increase in **inventories** (1.7 pp). This is signalled by the rise in finished product inventories in industry, driven mainly by higher inventories in food industry, production of motor vehicles, paper, and rubber and plastic products.

Chart IV.4.2 **Fixed investment***
(y-o-y growth, in pp)




Sources: SORS and NBS calculation.
* NBS estimate for Q4 2018.

Table IV.4.2 **Investment indicators**

| | 2017 | 2018 | | | |
|---|---|---|---|---|---|
| | Q4 | Q1 | Q2 | Q3 | Q4 |
| **Real y-o-y growth rates** (in %) | | | | | |
| Fixed investment (national accounts)* | 13.6 | 16.5 | 12.3 | 7.0 | 5.0* |
| Construction (national accounts)* | 16.0 | 27.1 | 22.5 | 7.0 | 3.0* |
| Government investment* | -2.8 | 47.0 | 38.6 | 44.1 | 27.1* |
| Number of construction permits issued** | 31.3 | 14.4 | 6.9 | 6.3 | -0.7** |
| Production of construction material** | 10.1 | 7.9 | 7.0 | 11.0 | 5.5 |
| Value of works performed | 23.4 | 30.0 | 24.9 | 7.0 | - |
| Imports of equipment, nominal** | 20.9 | 29.3 | 13.2 | 15.8 | 8.7 |
| Production of domestic machinery and equipment** | 18.8 | 7.8 | 14.1 | 3.4 | 8.7 |
| Finished product inventories in industry** | 10.1 | 10.4 | 9.4 | 13.6 | 9.9 |

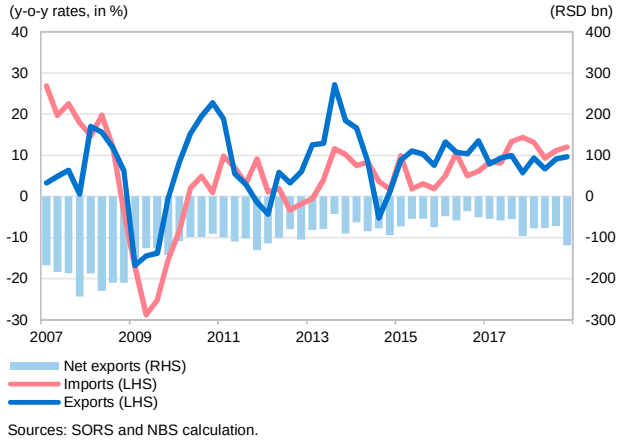
Sources: SORS and NBS calculation.
* NBS estimate for Q4.
** October– November.

## Net external demand

In Q4, goods and services exports accelerated in real terms (9.6% y-o-y), led by the further growth in manufacturing and services exports, with the increasing positive contribution of agricultural exports. However, real imports of goods and services rose at a faster pace (12.0% y-o-y) mainly owing to higher imports of equipment and intermediate goods and, to a lesser extent, because of the recovery of private consumption. Thus, the contribution of net exports to GDP remained negative in Q4 (2.4 pp).

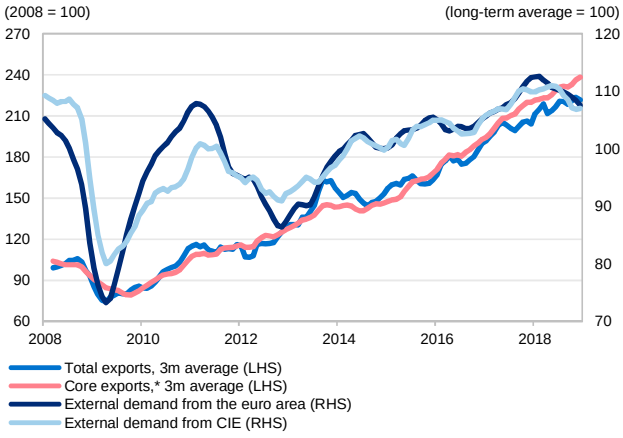
Despite softening external demand from the euro area, external trade data show that euro-denominated commodity exports sped up to 9.4% y-o-y in Q4, driven

Chart IV.4.3 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)




Sources: SORS and NBS calculation.
* NBS estimate for Q4 2018.

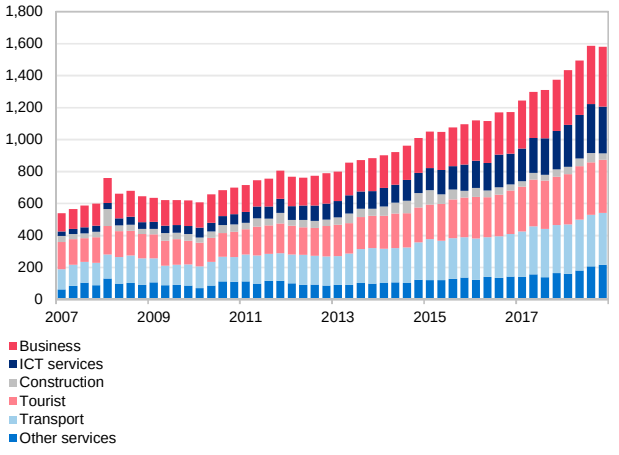
Chart IV.4.4 **Movement of indicators of external demand for Serbian exports**
(3m moving average, s-a)




Sources: European Commission, SORS and NBS.

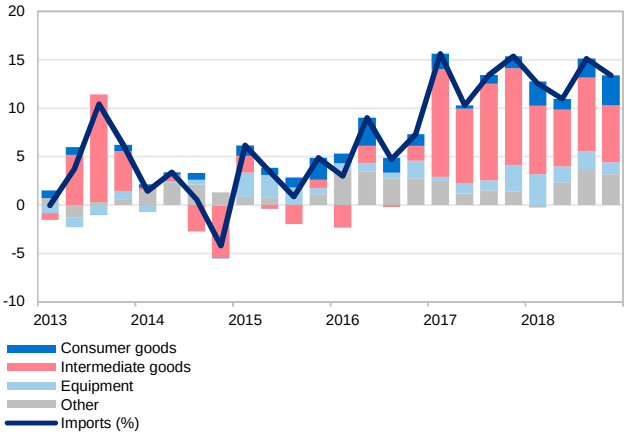
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

Chart IV.4.5 **Exports of services**
(s-a data, in EUR mn)




Sources: SORS and NBS calculation.

Chart IV.4.6 **Movement of key import components**
(contributions to y-o-y growth, in pp)




Sources: SORS and NBS calculation.

by manufacturing (7.2% y-o-y). Manufacturing export growth remained widely dispersed (in 18 out of 23 areas), receiving the greatest contribution from the exports of base metals, which in Q4 increased by 12.4% y-o-y. Smederevo Steel Plant, which posted strong export growth in 2018 (by 39.6%, to EUR 749.5 mn),[20] became the biggest individual exporter in Serbia. As before, high contributions came from the exports of chemical products, machinery and equipment, rubber and plastic products, and electrical equipment. On the other hand, motor vehicle exports were lower in Q4 (by EUR 45.5 mn or 9.2% y-o-y), since Fiat Automobiles Serbia temporarily discontinued its production in December, while a negative influence also came from lower external demand. Exports of pharmaceutical products and textile and clothing also contracted.

Agricultural exports continued to rebound amid the above-average agricultural season. Having risen by 19.6% y-o-y in Q3, they stepped up to 86.0% y-o-y in Q4. The main contributor was the export of cereals which rose to EUR 166.2 mn in Q4 and would have probably been even higher, had it not been stalled by the Danube's law water level. Given that the extraordinary agricultural season in 2018 created a good export base, positive tendencies are expected to extend into H1 2019.

Favourable trends also continued in services exports which went up by 12.9% y-o-y in Q4. As before, this growth was mostly driven by the exports of information and communication services, which in 2018 exceeded EUR 1.1 bn. In addition, high contribution also came from the exports of business services, and, to a somewhat lesser extent, tourist and transport services.

The continuation of the investment cycle and increased industry and construction needs for imported raw materials and intermediate goods triggered further growth of commodity imports. According to foreign trade data, euro-denominated commodity imports rose by 14.1% y-o-y in Q4, with imports of equipment rising by 8.7% y-o-y, and of intermediate goods by 10.4% y-o-y. Euro-denominated import growth was also affected by the higher oil price. Another contributor to import growth was the recovery of domestic consumption, which led to a 16.5% y-o-y increase in the imports of consumer goods. Similar trends are confirmed by the import structure according to the EU classification of end-use categories, which shows that the greatest contributions to imports

[20] As of April 2017 it operates under the name HBIS GROUP Serbia Iron & Steel.

came from energy and intermediate goods and, to a lesser extent, from non-durable consumer and capital goods.

In 2018, the exports-to-imports ratio measured 74.6%, or 83.8% if services are included. In December, exports of goods were 111.7% and imports of goods 30.6% above their pre-crisis levels[21].

## 5. Economic activity

***The pick-up in activity in the service sector and successful agricultural season contributed to continued GDP growth in Q4, which in our estimate measured 0.3% s-a, or 3.5% y-o-y.***

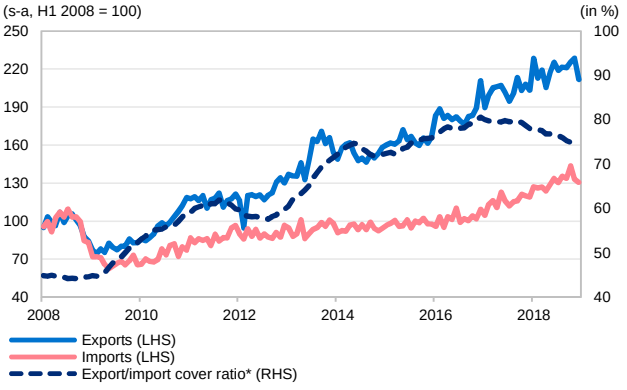
***According to preliminary data of the Statistical Office, in 2018 GDP grew by 4.4% in real terms[22], which is the highest growth in the last ten years. The greatest contribution to GDP growth in 2018, exceeding our projection from the last Report, stemmed from the above-average results in agriculture and construction, and the rising activity in the majority of service sectors.***

GDP growth continued into Q4, to 3.5% y-o-y, according to the preliminary estimate of the Statistical Office. Similar as in the quarter before, the greatest contributors were service sectors (2.1 pp, in aggregate terms), owing to persistently favourable trends in the labour market and agriculture (1.0 pp) that benefited from the excellent agricultural season. Construction also slightly expanded in Q4, giving a 0.1 pp contribution to GDP. On the other hand, industry contributed negatively (-0.3 pp), as a result of the slowdown in external demand and lower production in mining and energy.

**In quarterly terms, GDP growth was estimated at 0.3% s-a in Q4, this being the 17th consecutive quarter of economic upturn**. Compared to the pre-crisis period[23], in Q3 economic activity went up by 13.0%, measured by GDP, or by 15.9%, measured by NAVA.

The physical volume of industrial production edged down by 1.3% y-o-y in Q4, primarily due to the contraction of mining and energy output (-5.5% and -5.3%, respectively), while the physical volume of production in manufacturing remained unchanged relative to the same quarter the year before.

Chart IV.4.7 **Trade in goods in euros**



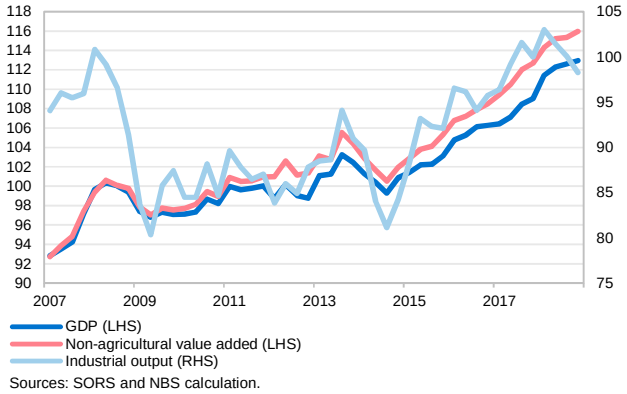

Sources: SORS and NBS calculation.
* 12-month moving average.

Table IV.5.1 **Contributions to y-o-y GDP growth**
(in pp)

| | 2017 | 2018 | | | |
|---|---|---|---|---|---|
| | Q4 | Q1 | Q2 | Q3 | Q4* |
| **GDP (in %, y-o-y)** | **2.5** | **4.8** | **4.9** | **3.8** | **3.5** |
| Agriculture | -0.9 | 0.5 | 0.8 | 1.1 | 1.0 |
| Industry | 0.6 | 1.3 | 0.6 | -0.3 | -0.3 |
| Construction | 0.7 | 0.7 | 0.8 | 0.3 | 0.1 |
| Services | 1.5 | 1.7 | 2.1 | 2.0 | 2.1 |
| Net taxes | 0.4 | 0.5 | 0.6 | 0.5 | 0.5 |

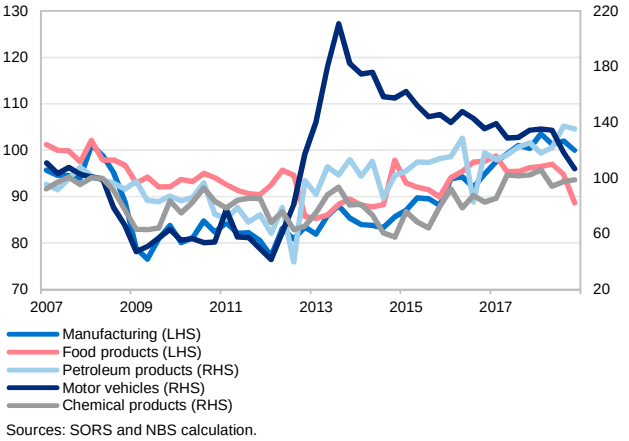
Sources: SORS and NBS calculation.
* NBS estimate.

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 by branch of manufacturing**
(s-a, H1 2008 = 100)



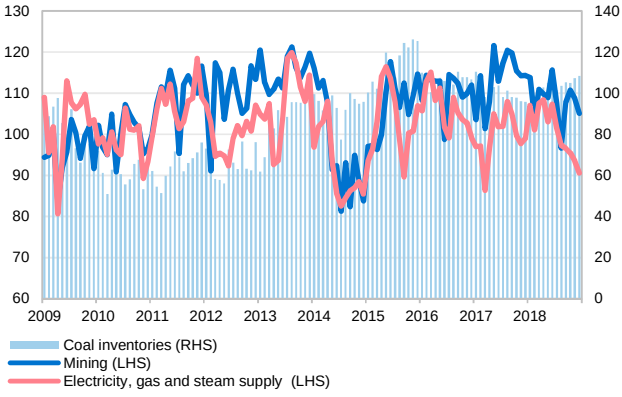

Sources: SORS and NBS calculation.

[21] Level from H1 2008.

[22] We expect the data for the period Q1–Q3 2018 to be revised upward on 28 February.

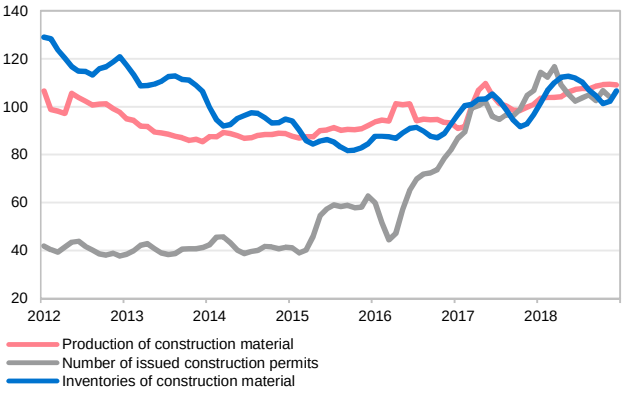
[23] Level from H1 2008.

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



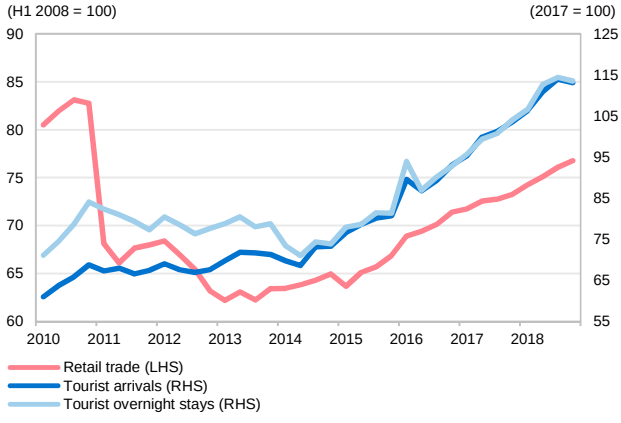

Sources: SORS and NBS calculation.

Chart IV.5.4 **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)




Sources: SORS and NBS calculation.

Chart IV.5.5 **Service sector indicators**
(s-a)




Sources: SORS and NBS calculation.

Within manufacturing, production ramped up in 13 out of 24 branches, most notably in base metals, whose physical volume of production expanded by 12.9% y-o-y. In addition, continued investment growth reflected positively on higher production of machinery and equipment (8.7% y-o-y) and construction material (5.5% y-o-y). The production of pharmaceutical products also went up (12.1% y-o-y), as well as the production of petroleum products (7.7% y-o-y). The greatest negative contribution to manufacturing (-1.3 pp) came from the contracted physical volume of production of food industry, by 7.8% y-o-y. Apart from that, automobile production continued to shrink (-21.8% y-o-y, contribution of -0.5 pp) due to temporary discontinuation of production in Fiat Automobiles Serbia.

**In quarterly terms, the physical volume of industrial production** decreased in Q4 (-1.8% s-a), due to lower production in manufacturing (-2.0% s-a), which may be associated with the slowdown in external demand. A further contraction in output was also recorded in the sector of electricity, gas and steam supply, though at a slower pace (-5.4% s-a). Mining production recovered (4.0 s-a), as evidenced by the higher coal exploitation, owing to gradual restoring of operation of thermal power plants after the capital overhauls in Q3.

The contraction in the manufacturing sector resulted from the lower output of food industry, by 6.5% s-a, which is mainly the consequence of introduction of tariffs, initially of 10% and later of 100% on products delivered to Kosovo and Metohija.

Driven mainly by the recovery of private consumption, the majority of service sectors recorded continued growth in Q4, measuring 4.1% y-o-y on an aggregate basis. This is also confirmed by the continued positive movements of indicators in trade and food and accommodation services. Namely, higher household consumption reflected on real growth in retail trade of 4.8% y-o-y. Also, the number of tourist overnight stays rose by 6.7% y-o-y, while real turnover in catering increased by 9.0% y-o-y. On a quarterly basis, in Q4 service sectors recorded similar growth as in the previous two quarters (1.0% s-a), adding 0.5 pp to GDP growth.

Following the two-digit growth in H1 due to faster implementation of infrastructure projects and the rebound in the real estate market, construction activity slowed down to 3.0% y-o-y in Q4, partly reflecting the high base from Q4 2017. Although the number of construction

permits issued in the period October–November slid by 0.7% y-o-y, construction growth in Q4 is signalled by a further rise in the production of construction material and registered employment in this sector, which reached the highest level since 2012.

At the annual level, according to preliminary data, agricultural production growth in 2018 is estimated at 16.3%, with a 1.0 pp contribution to GDP growth. The strong growth was mostly supported by favourable meteorological conditions, so **agricultural output** in 2018 exceeded the multi-year average. This is indicated by the published preliminary data on crop yields, primarily of cereals, while the majority of agricultural crops posted two-digit growth rate relative to the ten-year average.

Table IV.5.2 **Agricultural production**

| Agricultural crops/plants | Production in 2018 (thousand tonnes) | Production - multiyear average (thousand tonnes) | Deviation from multiyear average (in %) |
|---|---|---|---|
| Wheat | 2,941.6 | 2,499.0 | 17.7 |
| Corn | 6,964.8 | 6,044.0 | 15.2 |
| Soybean | 645.6 | 438.6 | 47.2 |
| Sunflower | 733.7 | 462.9 | 58.5 |
| Sugar beet | 2,583.3 | 2,853.9 | -9.5 |
| Raspberries | 122.3 | 89.2 | 37.1 |
| Sour cherries | 126.0 | 113.3 | 11.3 |
| Apples | 460.4 | 377.9 | 21.8 |
| Plums | 430.2 | 422.7 | 1.8 |
| Vineyards | 151.0 | 177.7 | -15.0 |

Source: SORS.

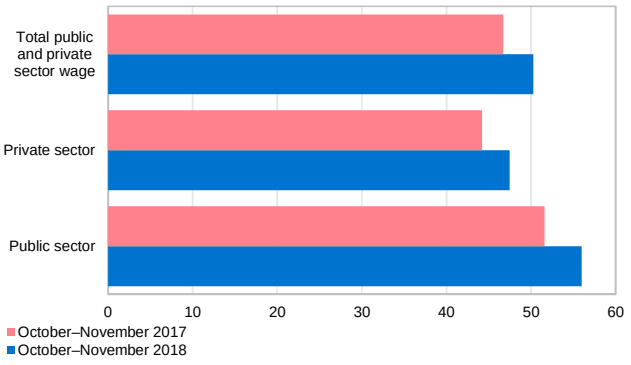
## 6. Labour market developments

***Economic upturn in 2018 helped sustain favourable labour market trends reflected primarily in a further rise in formal employment, a reduction in unemployment to the lowest levels, and higher average wages across industries. In addition, overall economic productivity was rising throughout the year as GDP grew faster than employment.***

### Wages and labour productivity

Robust economic growth and higher minimum labour cost in 2018 pushed up the nominal net wage by 7.5% y-o-y in October and November. A pick-up in the average wage in the observed period came from higher wages in the private and public sectors (7.4% y-o-y and 8.4% y-o-y respectively) owing to excellent fiscal policy results in the past four years.

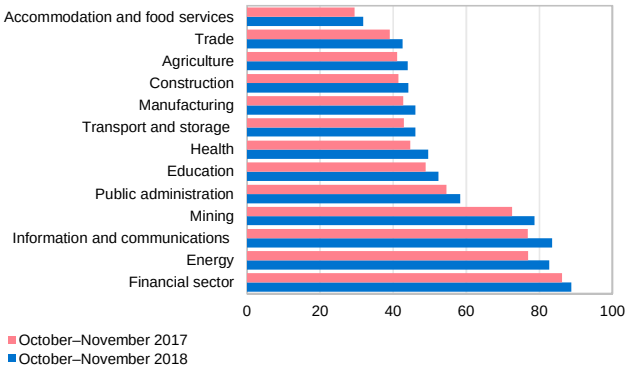
Chart IV.6.1 **Average nominal net wage**
(in RSD thousand)




Source: SORS.

The y-o-y nominal net wage increase in October and November was recorded in all economic sectors, indicating that the recovery of the labour market, as well as economic growth, is broad-based. The most pronounced wage rise was registered in the sectors of information and communication, mining and energy, followed by health and social protection, public administration and education. Trade, manufacturing, construction and transportation also recorded wage increases, as did other services which at same time registered employment gains.

Chart IV.6.2 **Nominal net wage by economic sector**
(in RSD thousand)




Source: SORS.

The 11.4% y-o-y growth in the nominal net wage bill in October and November reflected the rise in formal

employment and the increase in the private and public sector average wage.

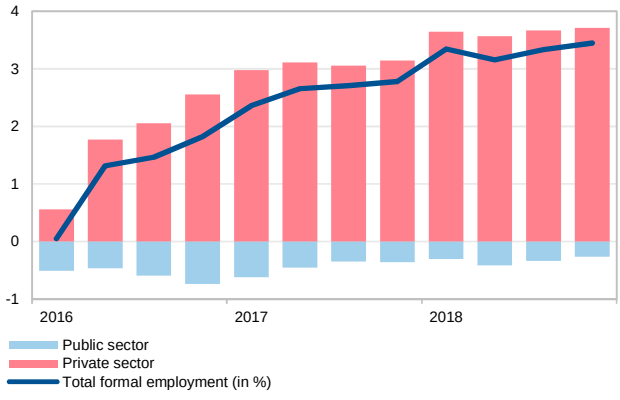
Under the preliminary estimate, in y-o-y terms overall economic productivity continued up through Q4 (0.1%) in conditions where GDP grew faster than employment, while at the level of 2018 it increased by around 1.0%.

Table IV.6.1 **Formal employment and unemployment in 2018**
(y-o-y growth rates, period average)

| | Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|
| Total number of formally employed | 3.3 | 3.2 | 3.3 | 3.4 |
| Employed with legal persons | 3.3 | 3.1 | 3.2 | 3.4 |
| Entrepreneurs and their employees | 6.2 | 6.2 | 6.7 | 6.4 |
| Individual farmers | -7.3 | -7.7 | -8.2 | -8.3 |
| The unemployed | -10.1 | -10.1 | -10.5 | -10.8 |
| First-time job seekers | -10.7 | -10.8 | -10.9 | -11.5 |
| Used to be employed | -9.8 | -9.7 | -10.3 | -10.5 |

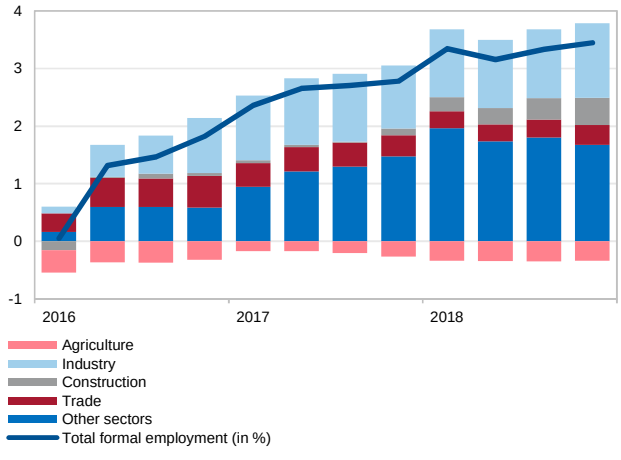
Sources: SORS and National Employment Service.

Chart IV.6.3 **Composition of y-o-y rise in total formal employment**
(in pp, period average)




Sources: SORS and NBS calculation.

Chart IV.6.4 **Contribution to y-o-y growth in total formal employment by economic sector**
(in pp, period average)




Source: SORS and NBS calculation.

## Employment

Against the background of robust economic growth in 2018, **total formal employment remained on an upward path**, recording a 3.4% y-o-y increase on average in Q4. According to the data of the Statistical Office obtained from the Central Registry of Mandatory Social Insurance, formal employment growth, which amounted to 3.3% y-o-y (annual average), was driven by an increase in employment with legal persons and a rise in the number of entrepreneurs and their employees. On the other hand, the number of individual farmers continued shrinking in Q4.

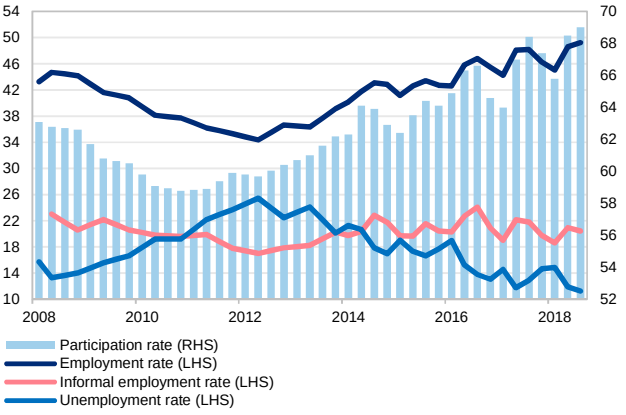
As throughout the year, formal employment growth in Q4 was driven by the private sector. Leading sectors in terms of employment increase were manufacturing, construction, trade and services and at the same time these economic activities provided the most significant boost to economic growth. On the other hand, Q4, compared to the same period the year before, saw a decline in employment in the sectors of electricity supply, agriculture and mining, as well as public administration owing to the continued public sector right-sizing.

Continuation of favourable labour market trends is also reflected in further reduction of unemployment, underpinned by the enhanced overall business and investment climate and the implementation of active labour market policies.[24] According to the National Employment Service (NES), **Q4 saw unemployment falling to the new minimum in the past quarter of a century**. At end-2018, there were 552,513 unemployed people registered with NES, down by 66,314 relative to end-2017. In y-o-y terms, unemployment was curbed in all occupational groups, primarily those associated with manufacturing, trade, catering and tourism. Construction and transportation also showed a decline in unemployment which corresponds to the rise in formal employment in the said areas, and so did agriculture and food production.

[24] Active labour market policies entail: job matching services, career guidance and councelling, employment subsidies, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

Positive labour market trends are further confirmed by the **Labour Force Survey**, which captures both formal and informal labour market trends. According to this Survey, the participation rate of working age population (15–64) stood at 69.0% in Q3, up by 0.6 pp relative to the same period the year before. The rate of overall employment also rose in Q3 by 1.0 pp to 49.2%, entirely as a result of formal employment growth, which is also indicated by the reduction in the informal employment rate (by 1.4 pp to 20.4%). Further labour market recovery is also indicated by the rate of overall unemployment which touched the historical low (11.3%) in Q3, as well as the long-term unemployment rate of 6.8% which is the new minimum in the period for which we have comparable data. In addition, youth (15–24) unemployment continued dropping, by 3.5 pp to 25.3%.

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




Source: SORS.

## 7. International environment

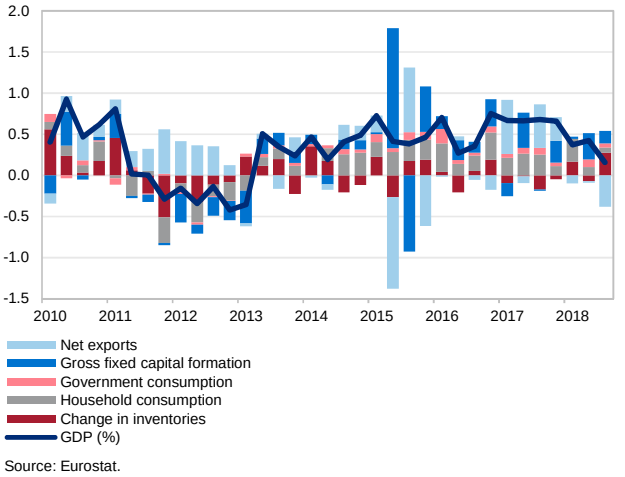
***Global economy slowed down in H2 2018, hence growth projections for the next two years were slightly revised down relative to the previous Report. Owing to softening external demand and specific factors on the supply side in some member countries, GDP of the euro area, Serbia's key foreign trade partner, also decelerated. On the other hand, the regions of Central and Southeast Europe maintained a positive growth dynamics throughout 2018. The US economy also continued to post relatively strong growth, underpinned by rising personal consumption and investment.***

***Inflation in the international environment slowed down in Q4, largely as a result of lower oil prices in the global market. As expected, leading central banks proceeded with monetary policy normalisation, signalling that it may be slower in the coming period than previously expected. Faster economic growth, coupled with the higher interest rate differential between the USA and other advanced countries and stepped-up investment in US Treasuries, helped the dollar continue gaining on other leading global currencies in Q4.***

### Economic activity

Since the previous *Report*, **global economy** continued on the upward path, though at a slower pace. Despite subdued economic performance by some countries in Q3, the IMF announced in January that it would not revise its global growth projection for 2018 relative to the October forecast (3.7%). However, the IMF made another slight downward revision of growth projections for 2019 and 2020, mainly owing to slackened global growth in H2 2018. In doing so, it noted that risks to the

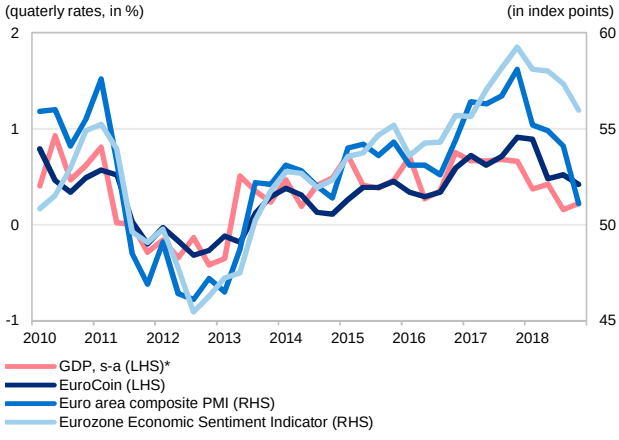
Chart IV.7.1 **Contributions to s-a GDP growth rate of the euro area**
(in pp)




Source: Eurostat.

projection were tilted down in view of the possible global exacerbation of trade tensions, tighter financial conditions, deceleration of China's growth and uncertainties surrounding Brexit talks. Moreover, the World Bank warned of a possible turn in capital flows to emerging markets.

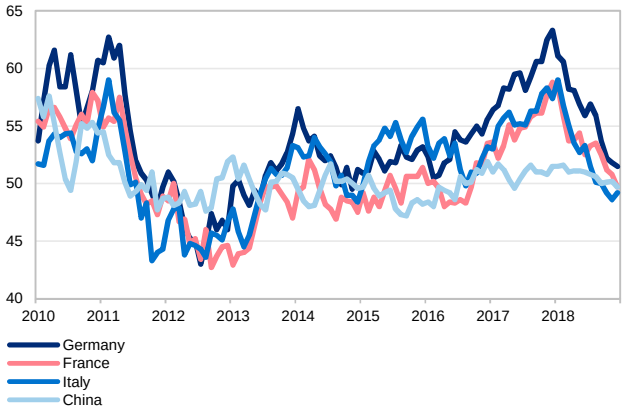
Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**




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

* Eurostat's preliminary flash estimate for Q4 2018.
** ESI is standardised relative to PMI.

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




Source: Markit Group.

Having risen at the rate of 0.4% s-a for two straight quarters, **euro area** GDP slowed down to 0.2% s-a in Q3. As in the previous quarter, its growth was mostly driven by investment in fixed assets, while household and government consumption also provided a boost. The main reason behind slackened economic growth in the euro area is weaker external demand, which can be attributed to the global slowdown and the introduction of protectionist measures, as well as to supply-side factors, i.e. lower output in the automobile industry in the wake of new regulations on automobile fuel emission. Serbia's key foreign trade partners recorded a decline in economic activity in Q3 – Germany by -0.2% s-a and Italy by -0.1% s-a.

According to the Eurostat flash estimate, euro area growth measured 0.2% s-a in Q4. Leading economic activity indicators also suggested that the euro area economy would not pick up the pace in Q4. The PMI Composite for the euro area on average equalled 52.3 points[25] in Q4, while the Economic Sentiment Indicator measured 108.9 points,[26] which is somewhat below the Q3 level, though still in the economic expansion zone. In addition, the unemployment rate in November dropped to its ten-year low (7.9%) and remained there throughout December.

In January, the ECB stated that the effects of the factors that acted as a drag on growth in 2018 will be gradually exhausted in the coming period, though economic growth will most likely be slower in the short term than previously anticipated. In the medium term, growth in the euro area will be sustained by the prolonged favourable financial conditions, rising employment and wages, lower energy prices, and global economic growth, albeit slower.

According to preliminary estimates by Destatis, German economy posted growth of 1.5% in 2018, meaning that unlike in the quarter earlier, Q4 saw an upturn in economic activity. Growth is largely due to positive developments in the labour market which stimulated domestic demand and thus offset the effects of poorer

[25] Index value above 50 points indicates expansion, and below 50 a decline in economic activity.

[26] The index has been designed to indicate long-term average with 100 points.

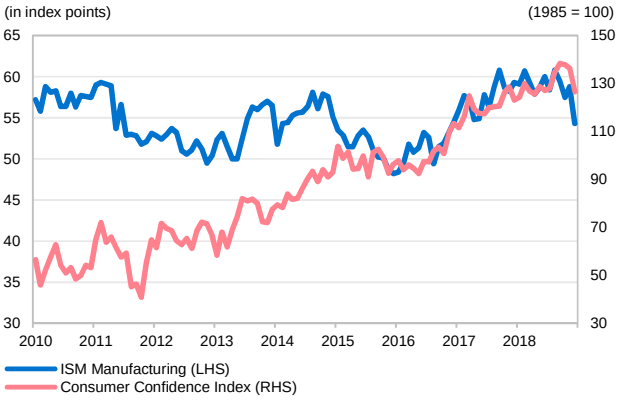
export. The preliminary estimates issued by Istat indicate that Italy's GDP declined for the second quarter – the fall equalled 0.2% s-a in Q4 and "technically" pushed the Italian economy into recession. The decline is a consequence of poorer results in agriculture and industry, while activity in the service sectors stagnated.

Though somewhat slower than in Q2, **US** economy continued strongly up in Q3 (0.8% s-a, or 3.4% annualised). Personal consumption remained the main driver of growth (with 2.4 pp), while investment in fixed assets also exerted a positive contribution. A decline in the export of goods worked in the opposite direction, whereby the contribution of net exports in Q3 was negative (-2.0 pp). According to the latest preliminary estimate of the Federal Reserve Bank of Atlanta, economic activity stagnated in Q4 to 2.7% annualised. Even so, favourable labour market dynamics was sustained, primarily on account of the further rise in the participation (63.1%) and employment rates (60.6%), as well as due to the increase in the number of new nonfarm payrolls, which reached a two-year maximum (around 250,000 on average). The unemployment rate in Q4 equalled 3.9% in Q4 and, though slightly up, it still hovered around its lowest level in almost half a century.

Growth in the **Central European region** continued up in Q3, prompting Consensus Forecast to revise up its 2018 growth projection in January to 4.5% from the October figure of 4.2%. The growth was driven by domestic demand, most notably private consumption and public investment which outweighed the effects of slower external demand, primarily from the euro area. In Q4 2018, as in the coming period, the region is expected to undergo a period of slower growth, though for most countries it should remain above the level of potential growth owing to favourable labour market developments and low borrowing costs.

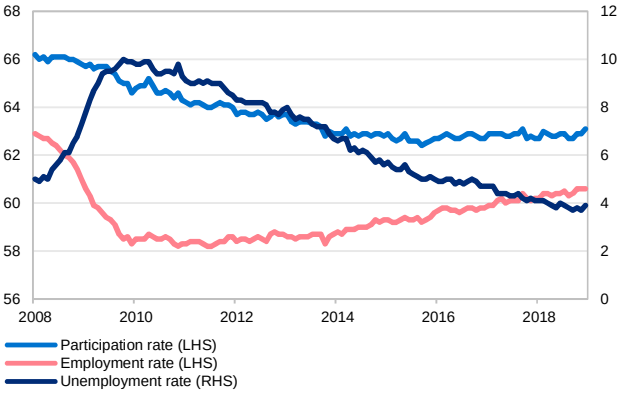
The majority of countries in the **Southeast European region** had a positive growth dynamics in Q3. Owing primarily to the favourable developments in the labour market, this is expected to continue in Q4 as well, although at a slightly slower pace. In addition to Serbia, Romania also recorded higher than potential growth in 2018. The January Consensus Forecast revised its 2018 growth estimate for this region, increasing it by 0.3 pp to 3.8% relative to October.

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



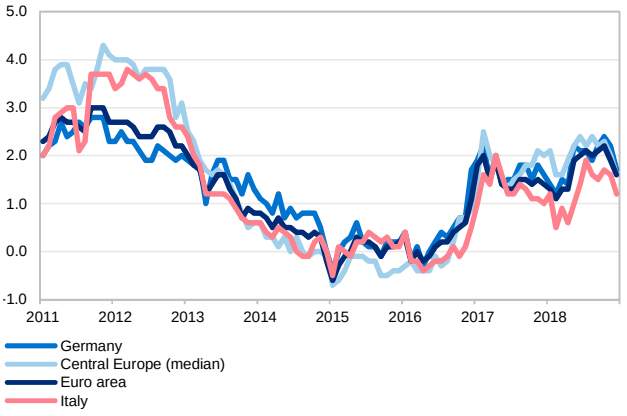

Source: Institute for Supply Management, Conference Board.

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




Source: Bureau of Labor Statistics.

Chart IV.7.6 **HICP across selected countries**
(y-o-y rates, in %)




Source: Eurostat.

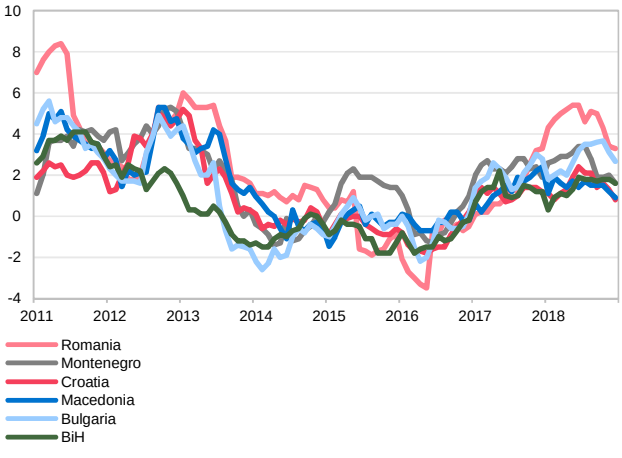
**Russia's** GDP growth slowed down to 1.5% y-o-y in Q3 (from 1.9% y-o-y in Q2), in wake of poorer agricultural performance and erratic trends in the manufacturing industry under the impact of protectionism and geopolitical tensions. Stepped-up activity in mining and a rise in the export of goods and services (contributing around 1.2 pp to GDP growth) worked in the opposite direction. Growth is expected to continue in Q4 on the back of a moderate rise in household and government consumption, as well as higher oil production. In January, the IMF kept its 2018 growth estimate for the Russian economy unchanged (1.7%), though it revised down the growth forecasts for 2019 and 2020, anticipating lower oil prices relative to the October projection.

Preliminary estimates indicate that **China's** economic growth in Q4 lost an additional 0.1 pp and dipped to 6.4% y-o-y, mostly in response to stricter financial sector regulations and the prolonged trade dispute with the USA. The government responded to growth deceleration in 2018 by increasing public investment, while monetary authorities loosened regulatory requirements to ensure additional liquidity in the banking sector. In order to encourage economic activity, the Chinese authorities are expected to continue with fiscal and monetary accommodation measures going forward. Taking into account the factors that have so far acted as a drag on growth, on the one side, and the incentives of Chinese authorities on the other, the IMF did not change its growth forecast for 2018 (6.6%), or for 2019 and 2020.

## Inflation movements

In response to lower energy prices, average y-o-y inflation in the **euro area** slowed down from 2.1% in Q3 to 1.9% in Q4 2018. Core inflation remained relatively low and averaged 1% y-o-y in Q4, the same as in Q3. However, domestic price pressures continued to build up amid high capacity utilisation and favourable labour market developments. Euro area employment rate soared to a record 67.5% in Q3. Wages also continued up, facilitated by the agreement on wages which some countries signed in the prior period. At the same time, an increasing number of sectors and countries witnessed wage growth, which boosted confidence in its sustainability. Such movements are expected to continue going forward. Coupled with continued economic growth and the effects of the ECB's monetary policy which remains highly expansionary, this ought to be conducive to the achievement of the inflation target of below, but close to 2% over the medium term. As for Serbia's main foreign trade partners, average y-o-y inflation, measured by the Harmonised Index of Consumer Prices, equalled

Chart IV.7.7 **Movement in the Consumer Price Index for selected countries**
(y-o-y rates, in %)




Sources: Statistical offices of selected countries.

2.1% in both Q3 and Q4 in Germany, while Italy's inflation dipped from 1.7% in Q3 to 1.5% in Q4.

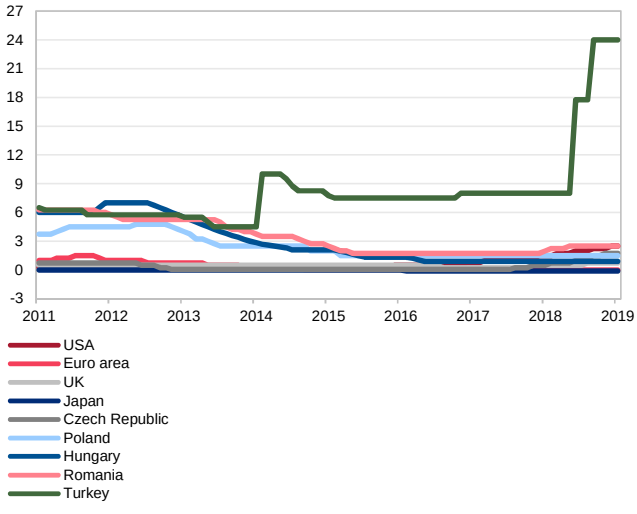
Inflation in **Central and Southeast European countries** also slowed down in Q4. It was the lowest in Macedonia and Croatia (1.2% y-o-y) and the highest in Romania (3.7% y-o-y on average in Q4). Depreciation of the rouble and the announced VAT increase drove inflation in **Russia** up from 3.0% y-o-y in Q3 to 3.9% y-o-y on average in Q4. Having reached its new 15-year peak in October (25.2% y-o-y), inflation in **Turkey** rolled back in the following two months, reaching 20.3% in December 2018. This was facilitated by the recovery of the Turkish lira, declining global oil prices, subdued economic activity and restrictive monetary policy measures implemented so far.

Measured by the personal consumption expenditure price index, both headline and core inflation in the **USA** trended close to the Fed's target rate of 2% in Q4. Headline inflation slackened from 2.2% in Q3 to an average of 1.9% in October and November, largely in response to falling energy prices. In contrast to that, domestic cost pressures continued to build up amid favourable labour market developments – low unemployment and rising wages, as well as robust growth in economic activity. Excluding food and energy prices, inflation in October and November also averaged 1.9%, down from 2% in Q3. Measured by the CPI, after recording 2.6% y-o-y in Q3, inflation slowed down to 2.2% y-o-y on average in Q4, owing to a fall in global oil prices. FOMC members estimated that inflation movements are in line with expectations and consistent with maintaining inflation within the inflation target over the projection horizon.

## Monetary policy

In its meetings during Q4, as well as in January 2019, **the ECB** reaffirmed its decision to keep interest rates on record low levels at least through the summer of 2019, and in any case as long as necessary to ensure the sustainable convergence of inflation to levels that are below, but close to, 2% over the medium term. As previously announced, the ECB wrapped up its asset purchase programme in December, after almost four years. It stated that it would continue reinvesting the principal payments from maturing securities for an extended period of time past the date when it starts raising its policy rate, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. ECB officials underlined they have at their disposal all the

Chart IV.7.8 **Policy rates across selected countries**
(p.a., in %)

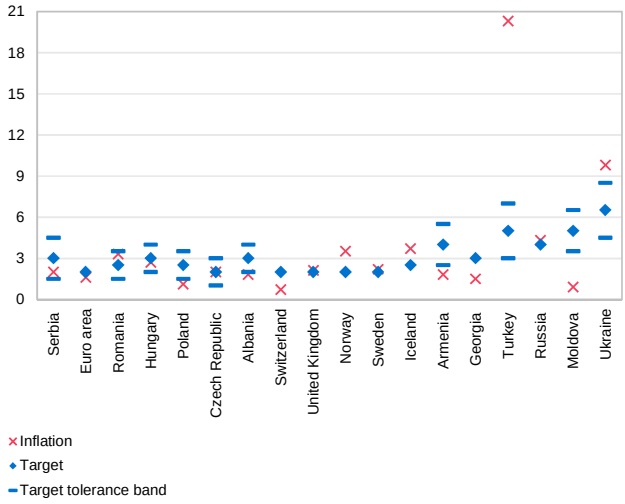



Sources: Central banks of selected countries.
* As of June 2018, after a year and a half, the one-week repo rate is again the key policy rate.

instruments that can be adjusted if needed, to ensure that inflation continues to move towards the target in a sustainable manner.

In its meeting in December, **the Fed** stated that solid performance in the labour market continued and that economic activity maintained its strong growth rate. Noting that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labour market conditions and inflation target, **the FED** decided, in a unanimous decision by FOMC members, to raise the target range for the federal funds rate by 25 bp to 2.25–2.50%, its fourth hike in 2018. The press release from December stated that the Fed would continue normalising its balance sheet by reducing reinvestments of principal payments by USD 50 bn a month. Following the meeting in January, the Fed decided to keep its rate on hold. Unlike before, the January press release did not state whether any further rate hikes should be anticipated, but noted that the Fed would be flexible in terms of further normalisation of its balance sheet. This is an additional signal that the Fed's monetary policy normalisation might be slower than previously expected.

Chart IV.7.9 **Inflation and target by country in December 2018**
(p.a., in %)




Sources: Eurostat and websites of central banks.

The fall in global oil prices paved the way for inflation slowdown in the majority of **Central and Southeast European countries**, easing off the pressure on their central banks to pursue a tighter monetary policy. On the other hand, domestic cost pressures grew stronger as a rule, driven by low unemployment and wage growth.

The **Czech** central bank raised its policy rate by 25 bp to 1.75% in November. During 2018, the policy rate was lifted five times by a total of 125 bp. The decision to raise the policy rate was made amid stronger inflationary pressures triggered by the koruna depreciating against the euro more than had been anticipated, as well as in view of a solid labour market – the lowest unemployment rate in the EU, which reflected on wage growth and household consumption. The key policy rate was kept unchanged at the December meeting.

As previously announced, the reserve requirement ratio became the new policy rate in **Hungary** and during Q4 and in January it was maintained at 0.9%. Under the impact of shifting oil prices in the global market, headline inflation showed volatile movements too (down from 3.8% y-o-y in October to 2.7% in December), while growth in domestic demand reflected on the rise in core inflation. The Monetary Council stressed that in the period ahead it would track core inflation relative to inflation target more than it had done so far, and reiterated readiness to engage in gradual and cautious

monetary policy normalisation, though not specifying the timeframe for the beginning of this process.

After lifting its policy rate three times in H1, the **Romanian** central bank kept its rate on hold in H2 2018, taking into account slower growth and the anticipated inflation stabilisation. In November, inflation returned within the target tolerance band (3.4% y-o-y) and in the long term it is expected to continue trending in the upper bound of the inflation corridor (between 2.5% and 3.5%).

The central bank of **Turkey** did not change its policy rate in Q4, having lifted it by 625 bp to 24.0% in Q3. Though inflation slightly slowed down at end-2018 (to 20.3% y-o-y in December), it is still far above the inflation target of 5±2.0%.

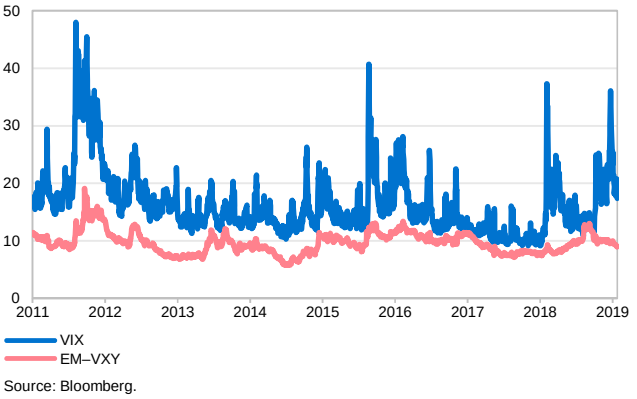
Of central banks in the observed countries, the **Polish** central bank has kept its rate on hold the longest – at 1.5% since March 2015.

In view of the inflation outlook, in Q4 the central bank of **Russia** raised its policy rate for the second time in 2018, by 25 bp to 7.75%, following a cycle of rate trimmings that began in 2015. In December, y-o-y inflation (4.3%) overshot the central bank's 4% target and is expected to continue up during H1, only to slow down to around 5.0–5.5% by end-2019 and return to the target in H1 2020, as the effects of the depreciating rouble and VAT increase gradually wane. Following the September decision to halt all FX purchases, the Russian central bank stated in December that owing to stabilised financial conditions, FX purchases would continue in January 2019.

## Financial and commodity markets

During Q4 2018, the value of shares on US stock markets plummeted on concerns over rising protectionism, global growth prospects and sustainability of US corporate earnings, primarily of tech and trade sectors. Heightened uncertainty in terms of the dynamics of the Fed's monetary policy normalisation further contributed to the rise in financial market volatility. The implicit measure of **financial market volatility** (VIX) rose by 13 pp to 25% in Q4, and in December it touched its highest level since February 2018 (36%). Volatility abated during January 2019, following the publication of the Fed's December meeting minutes and statements of its officials, which said that monetary policy normalisation in 2019 would be slower than previously announced – at the end of the month it equalled 16.6%. Measured by EM-VXY, which tracks volatility of currencies in emerging markets, volatility declined in Q4 – by 0.6 pp to 9.8%, owing to

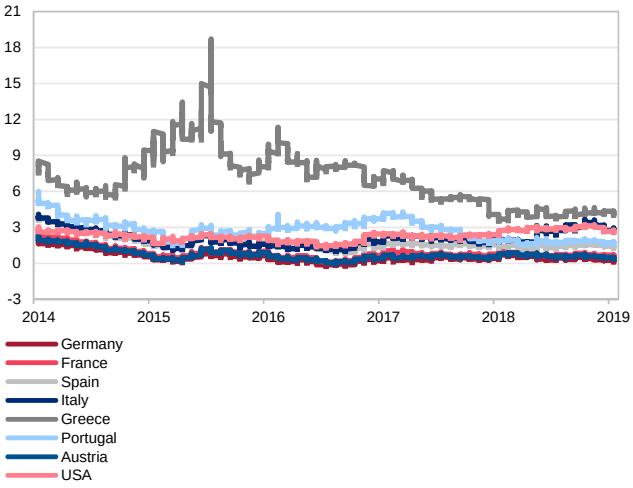
Chart IV.7.10 **Implied volatility of the global financial market***
(in %)




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.

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



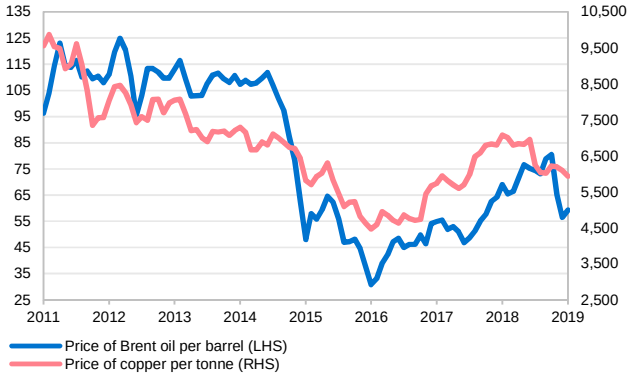

Source: Bloomberg.

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.

somewhat improved economic movements in Mexico and Brazil. In January 2019, EM-VXY edged down further, reaching 8.9% by the end of the month, its lowest level since May 2018.

The fall in US stock indices and increased investors' risk aversion were mirrored in contracted yields on US government bonds. Yields on ten-year US Treasuries decreased by 0.4 pp in Q4, dropping below 3% in December, for the first time since September, and dipping further by the end of the month, to their lowest level since January 2018 (2.7%). Yields on benchmark German bonds also declined, by 0.3 pp to 0.2%, amid investors' concern over the euro area's future economic growth, higher volatility in stock markets and tensions between Italy and the EU. Although yields on ten-year Italian government bonds rose during the quarter, they too dipped at end-December – by 0.1 pp relative to end-Q3, coming at 2.7% – in the wake of the Italian Government reaching an agreement on budget with the European Commission. Yields on ten-year bonds of all observed countries edged down further during January.

Though the contracted yields on US Treasuries exerted pressure on the dollar to depreciate, exacerbation of global growth prospects induced higher investors' risk aversion and led to the dollar gaining further strength in Q4 against most of the leading world currencies. The weakening of the euro against the dollar (by 1.1% in Q4) is a result of the euro area's subdued economic growth, as well as tensions surrounding Brexit, the Italian budget and political uncertainty in France. The Japanese yen, which is also considered a safe currency, was the only to gain on the dollar in Q4 (by 2.4%). In January, the dollar lost to most leading world currencies. **The price of gold** rose by 7.7% in Q4 in response to heightened ambiguity in stock markets and concerns over the global economic downturn. It rose by another 3.5% in January, coming at its highest level since May 2018.

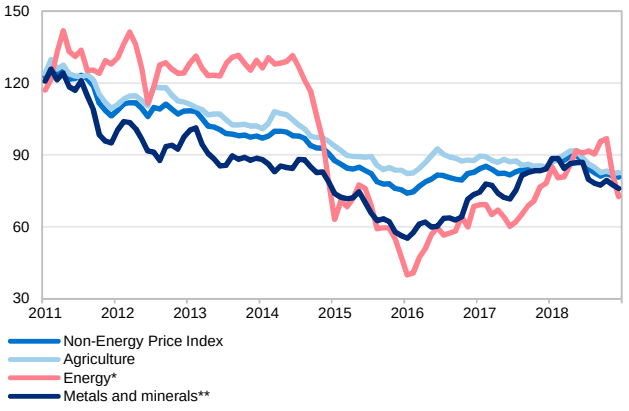
**The global oil price** decreased significantly, from USD 83 per barrel at end-Q3 to USD 53 per barrel at end-2018. At the start of Q4, oil price reached its four-year maximum (USD 86.1 per barrel), sparked by market wariness over the introduction of sanctions to Iran. However, the significant increase in oil supply in the USA, Russia and Saudi Arabia, together with poorer prospects of global growth, drove the price down for the remainder of the quarter. In January 2019, the price of oil resumed its upward trajectory, coming at USD 61 per barrel at the end of the month. This was facilitated by hints of alleviated trade tensions between the USA and China, contracted supply from OPEC members, as well as

sanctions imposed by the USA on Venezuela's state-owned oil company.

Based on the World Bank's primary commodities' price index, the **prices of metals and minerals** continued to contract, though at a slower pace – by 1.8% in Q4. The fall was driven by lower prices of aluminium and nickel, while the prices of most of the other components did not change significantly owing to budding optimism following trade talks between the USA and China. On the other hand, the iron ore price oscillated during Q4 – after reaching its six-month peak in October, it plummeted in November, only to end December 4.2% higher than at end-Q3.

Measured by the FAO index, **world food prices** continued down, falling 1.7% in Q4, primarily owing to a decrease in the prices of dairy products and vegetable oil. The prices of vegetable oil dropped 6.8% in Q4, and at end-2018 touched their ten-year low owing to subdued global demand and high inventories held by chief producing countries, while dairy product prices declined by 11%, due to increased supply from New Zealand. The price of cereals edged up 1.9% supported by the prospects of lower wheat yields in Argentina and diminishing wheat inventories in Russia, as well as due to high demand for corn. August saw sugar prices drop to their lowest level since December 2008, however, they rebounded in Q4 (by 11.3%) due to the anticipated lower supply from Brazil, the world's biggest sugar producer. The prices of meat did not change significantly (-0.2%).

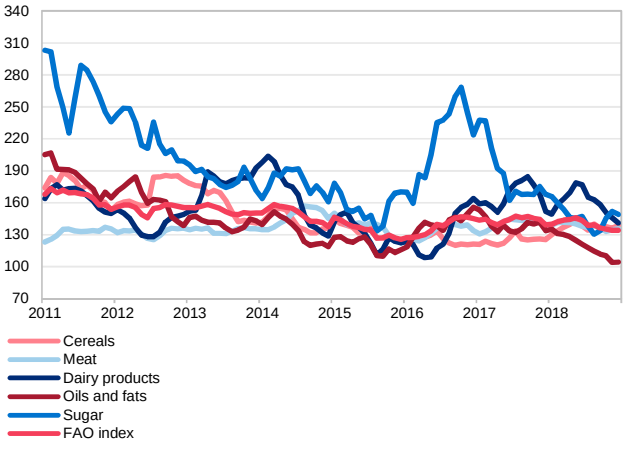
Chart IV.7.14 **Primary Commodity Prices Index**
(2010 = 100)




Source: World Bank.

* Crude oil, natural gas and coal.
** Copper, aluminium, iron ore, lead, nickel, zinc, copper and tin.

Chart IV.7.15 **World Food Price Index**
(in real terms, 2002−2004 = 100)



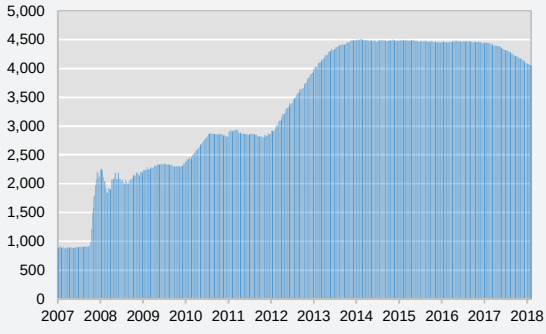

Source: UN FAO.

## *Text box 3: Monetary policy normalisation by leading central banks and the potential impact on Serbia*

Having reached the zero lower bound during the global financial crisis, major central banks started applying unconventional monetary policy tools, such as direct loans to banks, quantitative easing, forward guidance and negative policy rates. The unconventional measures in major economies of the world were designed against the backdrop of subdued economic growth, reduced liquidity and high unemployment. However, they were only resorted to after the effects of traditional measures had been exhausted, i.e. when these measures failed to provide for sustainable growth acceleration. Only when sustainable economic growth was restored was it possible for major central banks to embark on the process of monetary policy normalisation, i.e. to return into the conventional landscape.[1] As the quantitative easing programmes continuously expand the size of central banks' balance sheets, monetary policy normalisation is assessed as necessary to fend off financial imbalances and secure leeway for a future relaxation when the need arises.

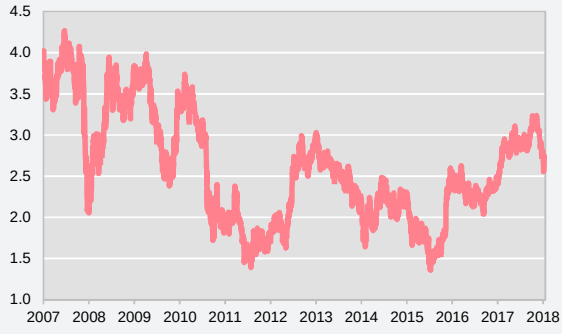
After the period of highly accommodative monetary policy stance, major central banks embarked on the process of policy normalisation, though at a very slow and cautious pace. The **Fed** is well ahead of its peers on the path to policy normalisation. It ended its asset purchases in 2014, started increasing its policy rates in December 2015, and embarked on the plan to shrink its balance sheet in 2017. By all indicators, the quantitative easing programme produced the desired effects and economic growth and inflation in the USA are at sustainable levels, hence such monetary policy normalisation could be pursued by the Fed. Though there were concerns that initiation of the reduction in the size of the Fed's balance sheet would give rise to significantly higher yields on long-term securities, they did not change substantially in 2017 when this measure was announced and introduced (Chart O.3.2). The Fed's policy rate target range was lifted from 0–0.25% in December 2008 by 25 bp in December 2015, and once more by the same amount in December 2016 to 0.50–0.75%. The policy rate was raised three more times in 2017 to 1.25–1.50%, and normalisation continued into 2018, when the rate was raised on four more occasions to 2.25–2.50% at end-2018. However, due to weaker global growth prospects, FOMC members reduced their forecast of rate hikes in 2019 from three to two, while expecting another hike in 2020. At the same time, the Fed management point out that greater monetary policy caution is needed as the policy rate is nearing a neutral level and that its further evolution will depend on the future developments in the real sector and labour market. In its January meeting the Fed emphasised that its monetary policy would be more flexible in the coming period and did not, as so far, indicate which direction it expected the policy rate to take. This reflected on the expectations of market participants, who believe that there will be no further policy rate hikes in 2019, while they even expect a rate cut in 2020.

Chart O.3.1 **Total assets of the Fed**
(daily data, in USD bn)




Source: Federal Reserve Bank of St. Louis.

Chart O.3.2 **Yield on ten-year US Treasuries**
(daily data, in %)



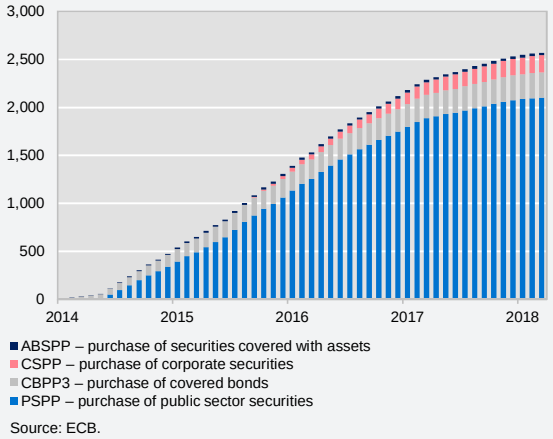

Source: Bloomberg.

[1] Some economists believe that the way in which economies operate and the concept of "normal" changed in the aftermath of the financial crisis. Normal now implies lower neutral interest rates due to potential output deceleration amid ageing population in developed countries, weaker productivity growth, etc. and lower inflation on account of globalisation, technological innovations and labour market deregulation, all of this dampening inflationary pressures on the supply side. In this point of view, unconventional monetary policy instruments will become a standard part of the monetary policy toolkit.

In April 2017 the **ECB** began to gradually reduce the pace of its asset purchases from EUR 80 bn in the period April 2016–March 2017 to EUR 60 bn per month until December 2017 and then to EUR 30 bn per month since January 2018. The first indication of monetary policy normalisation appeared in June 2018 with the announcement that, after an additional decrease to EUR 15 bn per month beginning from October, the asset purchase programme would be closed by the end of 2018 after running for almost four years. From the onset, this programme was conditional on progress towards a sustained adjustment in the path of inflation to levels below, but close to, 2% and the decision to end it depended on the ECB's assessment that economic growth and inflation were on sustainable grounds. However, the ECB judged that a substantial monetary stimulus was still required through reinvestment of matured securities and low interest rates to sustain the medium-term inflationary pressures in view of uncertainty stemming from protectionism, weak economic performance of some emerging markets and instability in the global financial markets. In order to further steer the expectations, in its June press release, the ECB stated that it would keep the interest rates record low at least through the summer of 2019, while market participants expect that the ECB's policy rates will most likely not go up until the end of 2019 either. After the publication of early economic indicators for Q4, which were lower than in Q3, it was expected that the ECB might raise the policy rate around mid-2020 at the earliest. The term structure of interest rates in the money market indicates that even when the interest rates go up, this will happen only gradually and in line with the continuous and gradual inflation rise towards the target. The ECB's December release provided a more precise guidance for the reinvestment of the principal payments from securities purchased under its QE programme linking the reinvestment period with the policy rate hikes: it stated that the reinvestment would continue for an extended period of time past the date when the ECB starts raising the interest rates.

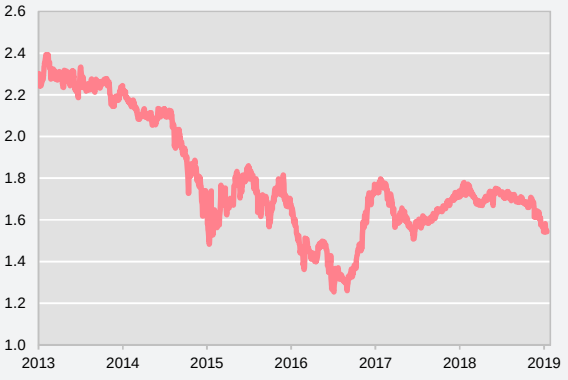
Even though the ECB made the first step towards monetary policy normalisation, we should bear in mind that against the backdrop of excess liquidity as a consequence of the asset purchase programme, the interest rates and yields on the bonds of euro area member states will remain at relatively low levels for quite some time. It seems that neither the announcement nor the very ending of the asset purchase programme significantly affected long-term interest rates since risk-free interest rates and expected inflation rates in the euro area in January 2019 are at closely the same level they used to be when the programme was launched.

Chart O.3.3 **Cumulative purchase of assets by the ECB under assets purchase programme**
(in EUR bn)




Source: ECB.

Chart O.3.4 **Long-term market inflation expectations in the euro area***
(y-o-y rates, in %)




Source: Thomson Reuters.
* Five-year, five-year breakeven forward.

**The Bank of England** started raising its interest rates in November 2017, from record low 0.25% to 0.5%, and the policy rate was brought up by additional 0.25 pp in 2018. In June 2018 the guidance on the start of the reduction in the size of central bank's balance sheet changed stipulating that it should occur when the policy rate reaches the level of around 1.5% relative to the past 2.0%. It was emphasised that this would be a gradual and predictable process lasting for a couple of years. The **Riksbank** raised the policy rate by 0.25 pp to -0.25% in December 2018 and continued reinvesting

the principal payments from securities purchased under the asset purchase programme. **The Norges Bank** lifted the policy rate for the first time in seven years, by 0.25 pp to 0.75% in September 2018 and the next hike is expected in March 2019. Unlike other leading central banks, the **Bank of Japan** has not yet embarked on the monetary policy normalisation process and will continue its quantitative easing with yield curve control programme in the coming period. Furthermore, it committed to expand the monetary base until inflation, which is currently at the level of 1%, overshoots 2% and is stable at that level. It also pledged to continue with the policy of very low interest rates over a longer time span to support economic activity and reaching of the inflation target.

One of the most significant questions for monetary policy makers in emerging markets, including the National Bank of Serbia, is certainly the question of the nature and magnitude of potential effects of leading banks' policy normalisation on their economies. These effects can work their way primarily through the following channels:

1. **expectations channel** – monetary policy normalisation of leading central banks may induce investors to expect that yields in developed countries will increase, leading to higher expected yields in emerging markets and/or capital outflow from emerging markets;

2. **balance sheet channel** – asset purchases by central banks pushed liquidity levels up, resulting in higher portfolio investment in emerging markets. On the other hand, the shrinking of central banks' balance sheets might reverse capital flows;

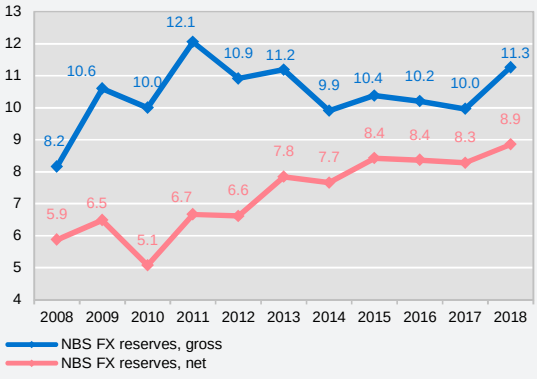
3. **interest rate channel** – policy rate increases in the euro area money market would push up the cost of new corporate and household borrowing in euros, lifting also the costs of the repayment of existing euro and euro-indexed loans;

4. **trade channel** – economic growth of developed countries, which is a precondition for monetary policy normalisation, has a positive impact on emerging markets' exports.

The magnitude of potential effects through the said channels will depend primarily on the pace of monetary policy normalisation of leading central banks and on the extent of its consistency with market expectations. However, by all indicators, it will be slower than previously expected in the case of both the Fed and the ECB considering the global economic growth deceleration. In addition, the effects of monetary policy normalisation of leading banks on emerging markets largely depend on the specific characteristics of individual economies. In the case of Serbia, the negative impact of global factors has been broadly offset by considerable improvement of macroeconomic indicators and increased resilience of the domestic economy to potential shocks from the international environment. **Stronger resilience of the domestic economy primarily stems from reduced internal and external imbalances, inflation expectations anchored within the target tolerance band, stable and robust financial sector and an adequate level of FX reserves**. The government's needs for external financing have been significantly reduced owing to successful fiscal consolidation and sound public finance. **Diversifying exports** by product and market, Serbia has also decreased its exposure to disruptions in certain segments of external demand in the last couple of years. Inflation expectations of the financial and corporate sectors anchored within the target tolerance band suggest monetary policy credibility. This is particularly important in view of the IMF's analysis[2] which suggests that anchored inflation expectations limit the pass-through effect of the potential depreciation of the national currency on the domestic prices and provide more leeway to the monetary policy of emerging markets for mitigation of potential negative effects of monetary policy normalisation of developed countries. The reduction of NPLs to record low level (5.7% in December), high capital adequacy ratios (despite the decreased regulatory minimum by the introduction of Basel III standards), and greater availability of domestic sources of funding at lower cost in conditions of sustainable economic growth have considerably strengthened the **resilience of the domestic banking sector** to potential shocks from the international environment. That the domestic banking sector is resilient to shocks from the domestic and international environment despite the numerous challenges it faced during and after the crisis is confirmed by the macroprudential stress-tests conducted by the NBS on a regular basis.

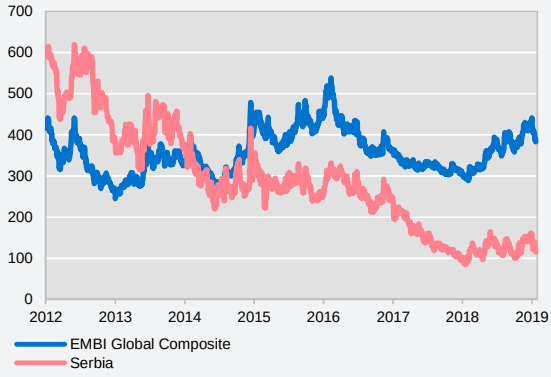
[2] World Economic Outlook, October 2018; Chapter 3

Chart O.3.5 **Elevated level of FX reserves**
(in EUR bn)




Source: NBS.

Chart O.3.6 **EMBI**
(daily data, in bp)




Source: JP Morgan.

In the period ahead the NBS will also carefully watch and analyse the decisions of central banks of developed countries and assess their potential effects on Serbia, while simultaneously continuing to boost the resilience of the financial sector and the economy to external uncertainties through its monetary, macroprudential and microprudential policy.

# V Inflation projection

***Under the February central projection, which is somewhat lower than the November projection, y-o-y inflation will continue to move within the target tolerance band – most probably in its lower part, until the end of the projection horizon.***

***As in the previous projection, rising aggregate demand will be the main factor shaping the inflation outcome over the entire projection horizon. In addition, disinflationary pressures generated by the past appreciation of the dinar will gradually wane and administered prices will grow at a somewhat faster pace than in the previous years. On the other hand, the strongest disinflationary effect in the period ahead will be coming from the high base for fruit, vegetable and petroleum product prices. Uncertainties surrounding the inflation projection are associated primarily with developments in the international commodity and financial markets and, to an extent, administered price growth at home, which could turn out lower than assumed, which is why the risks to the projection are judged to be slightly tilted to the downside.***

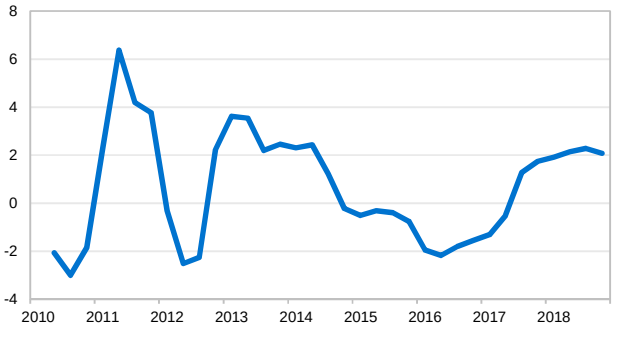
***The GDP growth forecast for 2019 has been kept unchanged (3.5%). GDP growth is expected to be fully driven by domestic demand. In contrast to the previous projection, when we envisaged a neutral contribution of net exports, we now expect a slightly negative contribution, given less favourable developments in the international environment compared to the time of the previous projection, more specifically slower than expected growth in the euro area. On the production side, growth will be sustained in services, industry and construction, while agriculture is most likely to provide a negative contribution due to the base effect. We expect GDP growth to accelerate to around 4% in 2020, led by investment, exports and viable growth in household consumption. In the medium term, risks to the GDP projection are judged to be symmetric, while in the short term, i.e. during 2019, those stemming from the international environment are judged to be tilted to the downside and those from the domestic environment to the upside.***

The medium-term inflation projection aims to show expected inflation movements (CPI) in the coming period, the main factors behind such movements and the underlying risks. The projection is set out in the form a range and the central projection. 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 our expectations, inflation continued to move within the target band in Q4, measuring in December 2.0% y-o-y, this at the same time being its average value for the year as a whole. Like in most regional peers, the strongest contribution to inflation in 2018 came from food and petroleum products, suggesting that the underlying inflationary pressures remain low. In addition, inflation in Q4 was lower than expected at the time of the November *Report* due to a sharp fall in the global oil price by the end of the year. Core inflation (excluding food, energy, alcohol and cigarettes) was stable throughout 2018, revolving around 1% y-o-y, where it also stood in December. Subdued inflationary pressures are further indicated by both one- and two-year ahead inflation expectations of the financial and corporate

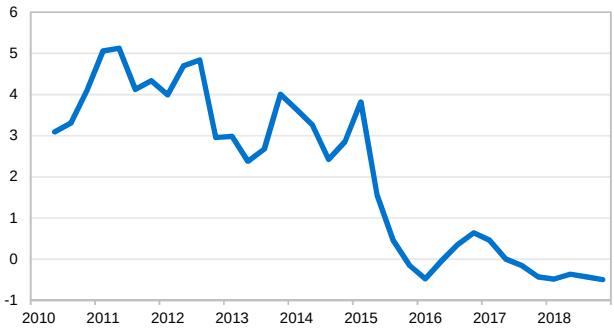
Chart V.0.1 **Monetary Conditions Index***
(in %)




Source: NBS.

* The monetary conditions index is a combined indicator of the gap of the real interest rate and the gap of the real exchange rate. Value >0 indicates restrictive monetary conditions, and value <0 indicates expansionary monetary conditions.

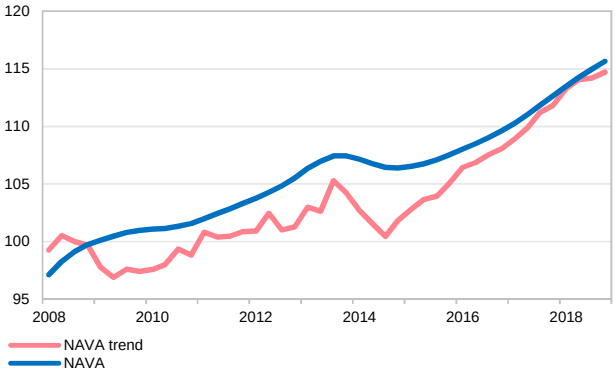
Chart V.0.2 **Real interest rate**
(in %)




Source: NBS.

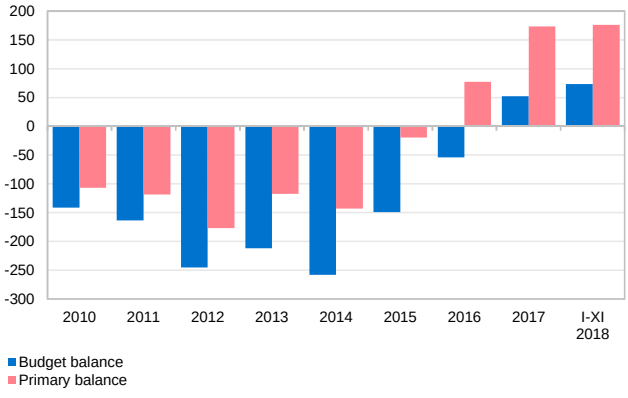
Note: Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

Chart V.0.3 **Output gap**
(Q3 2008 = 100)




Sources: SORS and NBS calculation.

Chart V.0.4 **General government fiscal and primary budget balance**
(in RSD bn)




Source: Ministry of Finance.

sectors, which have been anchored within the target band for quite some time already and which slid below the 3.0% target midpoint at the close of the year.

As of September, FX demand and supply in the IFEM were almost balanced, which led to the weakening of appreciation pressures and occasional occurrence of milder depreciation pressures. End-of-period, in Q4 the dinar gained 0.2% against the euro, while losing 1.6% against the dollar due to the strengthening of the dollar vis-à-vis the euro.

Since April 2018 the key policy rate has been kept unchanged at 3.0%, its lowest level in the inflation targeting regime. As in the previous period, caution in the conduct of monetary policy was warranted by global developments, notably further monetary policy normalisation by the Fed and the ECB, and the volatility of the global oil price. Besides, uncertainties in the international financial market remain heightened because of protectionism and geopolitical tensions. On the positive side, the resilience of our economy to potential negative external effects is now much stronger owing to improved macroeconomic fundamentals.

The Monetary Conditions Index, showing a combined impact of the real interest rate gap and the real exchange rate gap, continued to move above the neutral level in Q4. At the same time, its deviation from the neutral level moderated slightly from Q3 amid slower growth in domestic relative to euro area prices and minimal depreciation of the dinar at quarterly level. The real interest rate, on the other hand, stayed below the neutral level, indicating the same degree of monetary policy accommodation on that account as in Q3.

In contrast to softening external demand in H2 2018, mainly demand of the euro area, which affected primarily the manufacturing output, domestic factors provided a strong boost to economic growth. Based on the preliminary estimate of the Serbian Statistical Office, GDP grew 3.5% y-o-y in Q4 (0.3% s-a), led by services, agriculture and construction, and receiving headwinds from the industry (largely because of slackening external demand). On the expenditure side, Q4 GDP growth is estimated to have been led by household consumption and fixed investment, and, to a lesser degree, by final government consumption. Net exports, on the other hand, again acted as drag on GDP.

Economic growth and positive trends in the labour market contribute to continuing favourable fiscal trends, while a

significant rise in government capital expenditure and the increase in pensions and public sector wages in their turn spur investment and consumption growth, though not to a degree that would generate major inflationary pressures. In the first eleven months of the year, consolidated budget operated at a surplus (RSD 73.6 bn), real revenue rising by 4.1% and expenditure by 5.8% y-o-y. With interest expenses of RSD 102.6 bn, the primary surplus amounted to RSD 176.2 bn. In 2018 as a whole, the central government surplus came at 0.6% of GDP (with a primary surplus of 2.7% of GDP), while the Law on the 2018 Budget envisaged a deficit. At end-2018, central government public debt equalled EUR 23.0 bn and its share in projected GDP – 53.6% (vs. 57.9% at end-2017). The reduction in public debt and currency risk in 2018 is largely attributable to the December payment of the matured eurobond, issued in the international market in 2013 in the amount of USD 1.0 bn.

## Inflation projection assumptions

### External assumptions

Prospects for global economic growth have been dampened once again, hence the majority of relevant institutions no longer expect global economy to grow at a rate similar to last year's, but slower. According to the IMF's January forecast,[27] instead of last year's 3.8%, global growth will measure 3.5% this year and 3.6% the following year, which is 0.2 pp and 0.1 pp below the October forecasts. The main reasons for this year's revision is the carry-over from lower growth in H2 2018, as well as the anticipated weakening of investor sentiment and a contraction in Turkish economic activity, which is now projected to be deeper than expected. Also, the IMF anticipates growth in advanced economies to slow down to 2.0% this year (from 2.3% in 2018), and in emerging countries to 4.5% (from 4.6% in 2018).

Despite alleviated trade tensions between the USA and China in Q4, the risk of another exacerbation has not been reduced, therefore the IMF's global growth forecast is tilted to the downside. In addition, the IMF listed the possibility of a "no-deal" Brexit for the UK and a deeper than envisaged slowdown in China as potential triggers that could diminish investor sentiment even further.

Relative to its earlier projection, the Consensus Forecast trimmed down its latest projection of **economic growth**

Table V.0.1 **Major projection assumptions**

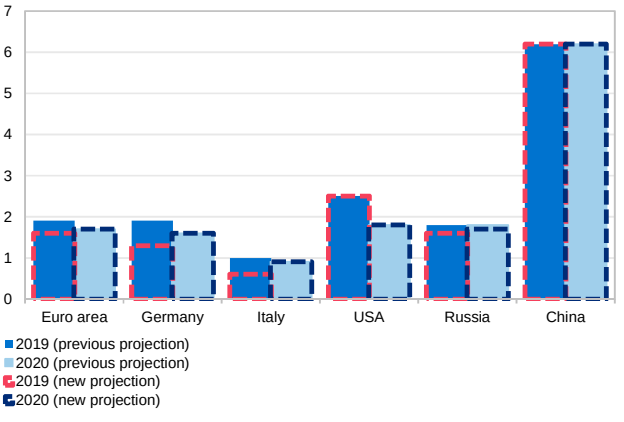
| | 2019 | | 2020 | |
|---|---|---|---|---|
| **External assumptions** | Nov. | Feb. | Nov. | Feb. |
| Euro area GDP growth | 1.8% | 1.5% | 1.7% | 1.4% |
| Euro area inflation (annual average) | 1.7% | 1.5% | 1.7% | 1.5% |
| ECB key policy rate (average)* | 0.1% | 0.0% | 0.5% | 0.4% |
| International prices of primary agricult. commodities (Q4 to Q4)** | 9.0% | 1.6% | 5.0% | -0.9% |
| Brent oil price per barrel (December, USD) | 75 | 61 | 72 | 61 |
| **Internal assumptions** | | | | |
| Administered prices (Dec to Dec) | 4.0% | 4.4% | 4.0% | 4.0% |
| **Trends** | | | | |
| Appreciation trend of the real exchange rate (average) | 0.4% | 0.3% | 0.5% | 0.4% |
| Real interest rate trend (average) | 0.4% | 0.5% | 0.3% | 0.3% |

* ECB Survey of Professional Forecasters.

** Composite index of soybean, wheat and corn prices.

Sources: NBS, ECB, Consensus Forecast, Euronext, CBOT and Bloomberg.

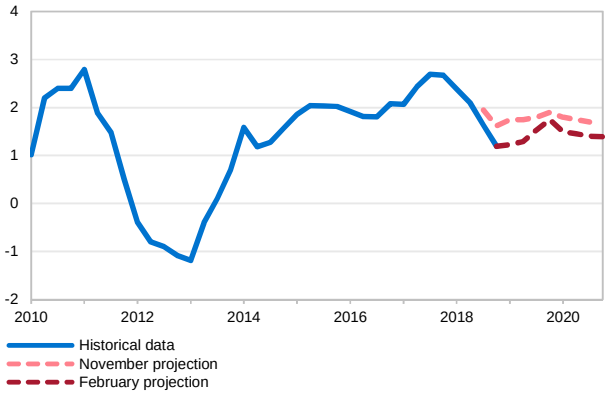
Chart V.0.5 **IMF's revised forecast for real GDP growth for 2019 and 2020**
(in %)




Sources: IMF WEO Update (January 2019) and IMF WEO (October 2018).

[27] World Economic Outlook Update, January 2019.

Chart V.0.6 **Assumption for euro area GDP growth**
(y-o-y growth, in %)




Sources: ECB, Consensus Forecast and NBS calculation.

**in the euro area, Serbia's main trade partner**, by 0.3 pp for both this and the following year to 1.5% and 1.4%. The euro area growth estimate was revised down by the IMF as well – by 0.3 pp in 2019 to 1.6% – while the projected growth for 2020 is slightly higher than the Consensus Forecast figure (1.7%). The World Bank also revised down its euro area growth forecast, by 0.1 pp to 1.6% in 2019, keeping its projection for 2020 unchanged (1.5%). The ECB will announce its new projections in March, however, it stated in January that euro area growth will be slower than anticipated, largely on account of slackened growth of external demand and factors specific for some sectors in several countries. The ECB stated that the impact of these factors will gradually wear off and that euro area growth will continue to be underpinned by favourable financial conditions, a further rise in employment and wages, lower energy prices and stepped-up, albeit somewhat slower, global growth. It also noted that risks to the euro area's economic growth are now more skewed to the downside on account of uncertainty in terms of geopolitical factors and protectionism, vulnerabilities in emerging markets and financial market volatility.

Table V.0.2 **Economic growth estimate by country**
(in %)

| | October 2018 | | January 2019 | |
|---|---|---|---|---|
| | 2019 | 2020 | 2019 | 2020 |
| Poland | 3.6 | 3.2 | 3.7 | 3.2 |
| Czech Republic | 3.0 | 2.6 | 2.8 | 2.6 |
| Hungary | 3.2 | 2.6 | 3.4 | 2.7 |
| Albania | 3.8 | - | 3.8 | 3.5 |
| Bulgaria | 3.4 | 3.0 | 3.3 | 3.0 |
| Bosnia and Herzegovina | 3.2 | - | 3.1 | 3.0 |
| Macedonia | 3.2 | - | 2.9 | 2.9 |
| Romania | 3.3 | 3.2 | 3.2 | 2.9 |
| Slovenia | 3.5 | 2.8 | 3.4 | 2.8 |
| Croatia | 2.7 | 2.4 | 2.7 | 2.5 |

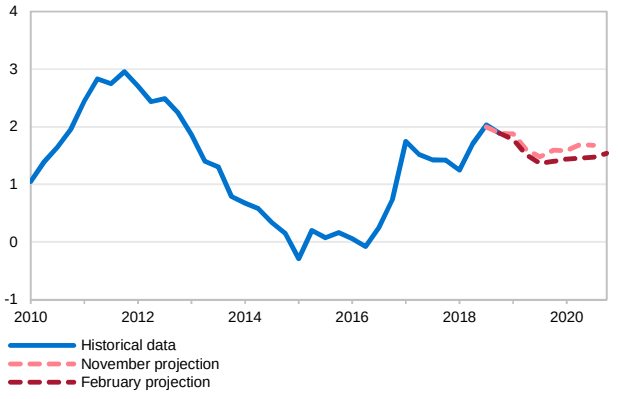
Source: Consensus Forecast.

As regards **our key trade partners within the euro area**, the Consensus Forecast trimmed Germany's growth projection for this year by 0.3 pp to 1.4%, relative to its forecast three months earlier, while the projection for 2020 has not been changed (1.6%). Germany's growth rates have been trimmed due to weaker than expected private consumption, poorer industrial production in the wake of the introduction of new automobile fuel emission standards, and slower external demand. The Consensus Forecast also revised down Italy's growth projection for 2019 to 0.5%, from 1.0% since three months ago, and for 2020 to 0.7% from 0.9%. The estimate that Italy's growth is to be slower is attributable to subdued domestic demand and relatively higher borrowing costs, considering high yields on government debt.

As for growth prospects of **countries in the region**, which are also our important trade partners, most countries are likely to see prolonged robust growth, with the risk of a possible decline in activity of export-oriented sectors, as well as changes in capital flows amid expectations of the ECB lowering its monetary policy expansiveness. Growth forecasts for most countries in our region have been trimmed only slightly owing to the contribution of domestic demand (notably household consumption and fixed investments), which will most likely offset the negative contribution of net exports on account of subdued demand, primarily from the euro

area. According to the January Consensus Forecast, growth in the **Southeast European region** in 2019 was slightly revised down relative to October, by 0.1 pp to 3.2% (mostly due to decelerating external demand), while estimated growth for 2020 is 3.0%. In view of expectations of a significant contraction in economic activity in Turkey in 2019 and slow recovery in 2020, the IMF revised its growth projections for **emerging European countries** to only 0.7% in 2019 (after 3.8% in 2018), despite Central and Eastern Europe posting generally satisfactory growth, and in 2020 to 2.4%, which is 1.3 pp and 0.4 pp lower than in the previous forecast.

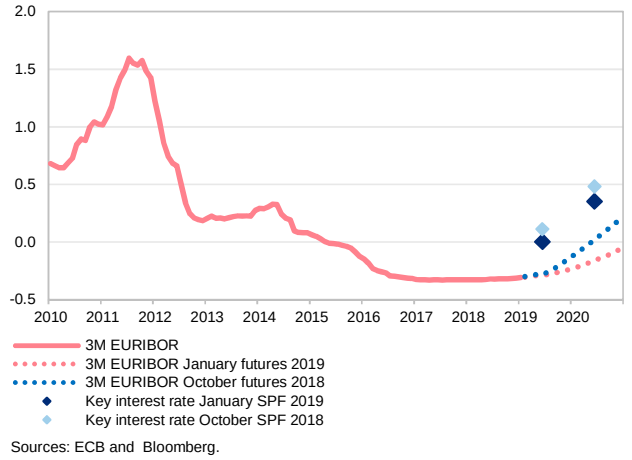
Chart V.0.7 **Assumption for euro area inflation**
(y-o-y growth, in %)




Sources: ECB, Consensus Forecast and NBS calculation.

Though **inflation in the euro area** trended somewhat higher over the past months, mostly on the back of prior energy price hikes, low core inflation signalled low inflationary pressures. With the anticipated global economic downturn and falling oil price in the global market, expectations as to its movements going forward were also lowered. According to the ECB Survey,[28] professional forecasters lowered their expectations relative to October by 0.2 pp to 1.5% in 2019, and by 0.1 pp to 1.6% in 2020. The downward revision of inflation reflects the decrease in the expected price of oil in the coming period (17% lower in H1 2019 relative to the previous, October survey), as well as the decrease in expected core inflation. Similarly to the ECB survey, the Consensus Forecast also trimmed its expected inflation for 2019 and 2020 to 1.5%, which is an assumption of our projection as well. The same is indicated by long-term market expectations, which were also lowered over the previous three months.[29]

Chart V.0.8. **Expected ECB interest rate* and 3M EURIBOR futures**
(p.a., in %)




Sources: ECB and Bloomberg.

* ECB Survey of Professional Forecasters (SPF).

**Major inflationary pressures are not expected in the countries of the region either**. After raising it to 3.0% in October, the Consensus Forecast lowered its 2019 inflation forecast for Southeast European countries to 2.7% in January, largely in view of the fall in energy prices. The same inflation rate is forecast for these countries in 2020 as well.

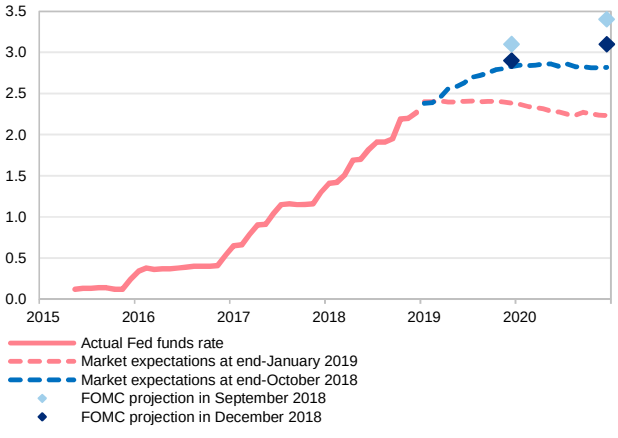
**Conditions in the international financial market remained relatively favourable**. Since the start of this year, the **ECB** no longer implements the quantitative easing programme, though it still fully reinvests the principal payments from maturing securities thereby maintaining its balance sheet at a relatively high level. In

[28] ECB Survey of Professional Forecasters (SPF).

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

December, the ECB announced it will continue with this practice for an extended period after it begins raising its policy rate, i.e. for as long as necessary to maintain favourable financial conditions and a high degree of monetary accommodation. Also, the ECB reiterated that it still expects the policy rate to remain unchanged at least through the summer of 2019. Professional forecasters are of the view that the policy rate will stay unchanged even longer than that – until the end of the year – and, according to the January survey, they expect monetary policy normalisation to unfold at a slower pace than three months ago. They now anticipate the average policy rate for 2020 and 2021 of 0.35% and 0.74% respectively. The slower pace of normalisation of the ECB's monetary policy is also suggested by the end-January futures, according to which three-month EURIBOR should remain negative all the way until end-2020 and not mid-2020, as expected at end-October.

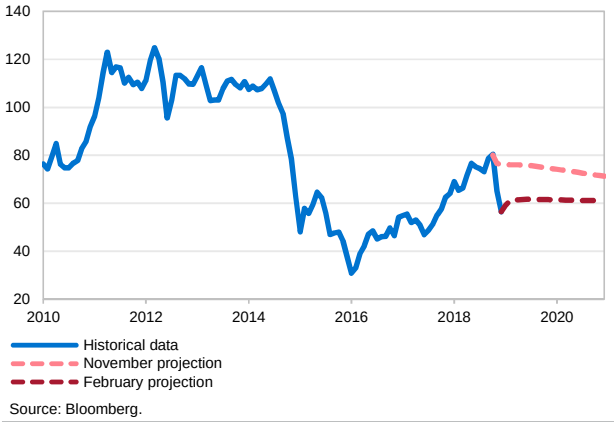
Chart V.0.9 **Expected Fed funds rate***
(p.a., in %)




Sources: Fed and Bloomberg.
* Futures-based market expectations.

The Fed's monetary policy normalisation is also expected to decelerate, considering that this year's global growth and inflation will be slower than anticipated. In December, for the fourth time in 2018, the Fed raised its target range for the federal funds rate to 2.25–2.50%, however, its projections signalled a slower pace of increases in 2019. The median projection for the federal funds rate is 2.9% in 2019 (instead of 3.1%, as stated in September) and 3.1% in 2020 (instead of 3.4%). This means that the Fed foresees two rate hikes this year, and not three, as expected in September, while the expectation of one increase in 2020 has not been changed. In view of expectations that economic growth could be slower than previously thought, the Fed stated in January that it will be more flexible in terms of monetary policy measures going forward. Looking at futures, market participants do not expect to see an increase in the federal funds rate this year.

Chart V.0.10 **Assumption for Brent oil prices**
(USD/barrel)

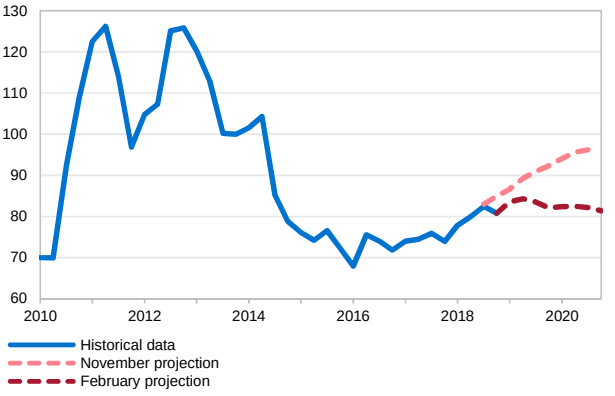



Source: Bloomberg.

Uncertainty in terms of future trends in the international environment relates to movements in **global primary commodity prices**. This mostly concerns the global **oil price**, which hovered at around USD 60 per barrel since the start of the year, though the market expects it to remain close to that level for the following two years, over the projection horizon. Such expectations reflect the estimate that reduced production by OPEC countries will not be sufficient to trigger a significant rise in the global oil price, bearing in mind the anticipated contraction in oil demand in response to slower global growth (notably China's), as well as the likely increase in US oil production. In accordance with oil futures from early

February (average for the last two weeks), the new projection operates on the assumption of a lower global oil price – USD 61 per barrel until the end of the projection horizon. Looking at other primary commodities in the global market, expectations in terms of their price movements have been mostly revised down, primarily in view of the anticipated global downturn and trade tensions. This year, global markets are likely to see the **prices of metals** post a decline which, according to the IMF's January projection, will be higher than expected in October (7.4% compared to 5.3%). Afterwards, in 2020, the prices of metals should be stable. The IMF also revised down the prices of the majority of **primary agricultural commodities**. In view of the stock exchange data of Euronext Paris and the Chicago Board of Trade, our projection assumed a 1.6% rise in these prices in 2019, followed by a mild decline of 0.9% in 2020.

Chart V.0.11 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)

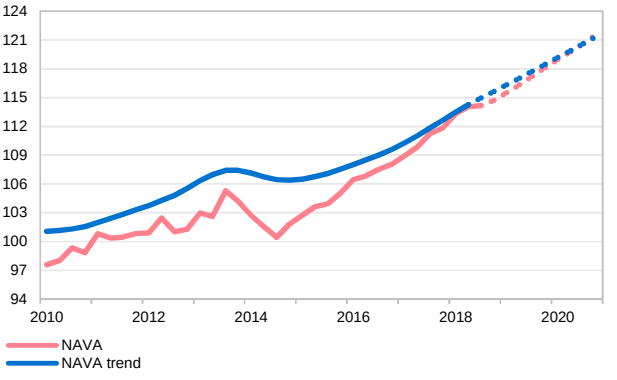



Sources: CBOT, Euronext and NBS calculation.

### Internal assumptions

**Primary agricultural commodity prices in the domestic market**[30] increased over the previous months, once again pushing food production costs above the neutral level. However, bearing in mind the movements of futures on the Paris and Chicago stock markets, we expect domestic prices of agricultural products in H2 2019 to post a moderate fall relative to the current level. That would help production costs return to the neutral territory. In the coming period, as so far, domestic agricultural commodity prices are likely to mirror the dynamics of their global counterparts, given their mutual dependence, therefore they are expected to decline slightly in the following year.

Chart V.0.12 **Output gap projection**
(Q3 2008 = 100)




Sources: SORS and NBS calculation.

Further growth in **aggregate demand** is a projection assumption. Although the downward trend of the negative output gap – unfolding since 2014 – has slowed down over the past three quarters, we expect it to continue in the coming period. The output gap is likely to enter positive territory in the following year, primarily on account of domestic demand trending up. Domestic demand will be sustained by a further increase in wages and employment in the private sector, increased public sector wages and pensions, past monetary policy easing by the NBS and the still relatively low interest rates in the euro area. The global slowdown, primarily in the euro area, our main foreign trade partner, will result in the external demand contribution dropping to lower levels than previously projected.

[30] Measured by the composite index of the prices of wheat, corn and soy bean.

As for **administered prices**, the anticipated adjustment to the prices of electricity and natural gas did not take place last year, therefore increase in these prices was halted at 2.4% in 2018. According to the assumption for 2019, growth in administered prices will be 4.4%, mainly on account of tobacco price adjustments reflecting the increase in the excise tax, as well as the rise in the prices of natural gas and electricity. Growth assumptions for administered prices in 2020 have not been changed relative to the previous projection and they still stand at around 4.0% annualised.

As in previous projections, we expect **inflation expectations** to remain anchored around the central midpoint until the end of the projection horizon.

Table V.0.3 **Fiscal Strategy 2019–2021**
(in % of GDP)

| | 2019 | 2020 | 2021 |
|---|---|---|---|
| Public revenues | 39.9 | 39.2 | 38.7 |
| Tax revenues | 35.3 | 35.1 | 34.9 |
| Non-tax revenues | 4.3 | 3.8 | 3.6 |
| Public expenditures | 40.4 | 39.7 | 39.2 |
| Expenditures for employees | 9.2 | 9.2 | 9.2 |
| Pensions | 10.4 | 10.4 | 10.4 |
| Interests | 2.0 | 1.8 | 1.6 |
| Capital expenditures | 4.0 | 4.0 | 4.1 |
| Total balance | -0.5 | -0.5 | -0.5 |
| Primary balance | 1.4 | 1.3 | 1.1 |

Source: Ministry of Finance.

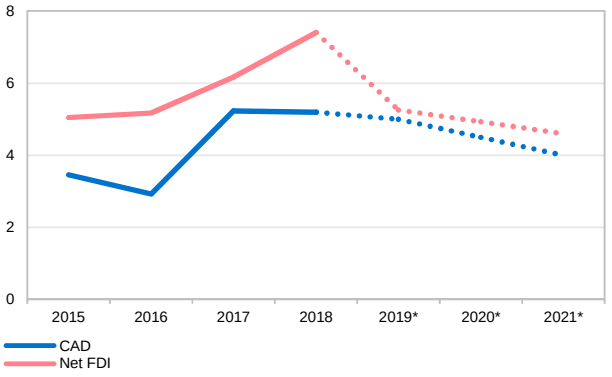
**Positive fiscal trends** are expected **to continue** in the period ahead. The planned deficit for this year is 0.5% of GDP, considering the sustained increase in capital expenditures and the rise in wage and pension outlays. The Fiscal Strategy for 2019, with projections for 2020 and 2021, envisaged a gradual reduction of the share of revenues and current expenditures in GDP, with an increase in capital expenditures. The planned deficit of 0.5% of GDP in the medium term will pave the way for the downward trajectory of public debt to be sustained in the coming years – to 50.7% at end-2019 and 48.1% at end-2020, which will further contribute to Serbia's resilience to shocks from the international environment. Risks to the public debt projection pertain to movements in the international environment, primarily the EUR/USD exchange rate, and the pace of the Fed and ECB's monetary policy normalisation.

The achieved economic growth rates, balanced public finance and the downward trajectory of public debt, along with low and stable inflation, all form a basis for further enhancement of macroeconomic indicators. The continued decline of public debt in the coming period should reflect positively on **country risk premium and credit rating**. With the sustained inflow of FDI, which more than fully covers the current account deficit and contributes to its reduction in the medium term, this will remain conducive to further **relative stability in the FX market.**

Exports are expected to maintain a high growth rate in 2019 as well, driven by past investment and growth, albeit slower, of external demand. Imports of equipment and intermediate goods are also expected to rise owing to the continuation of the investment cycle. We estimate that the current account deficit will edge down this year to 5.0% of GDP, from 5.2% of GDP in 2018. The decrease in the current account deficit is anticipated mostly on account of

the improved balance of services and more favourable movements in the primary income account, which should offset the effects of the somewhat slower growth in the euro area on the balance of goods exchange. The current account deficit is expected to decrease further over the medium term, given the expectations of a higher impact of the current investment cycle on export growth in the coming years. At the same time, we estimate that the FDI inflow going forward will be stable at around 5% of GDP. As so far, this will be more than sufficient to cover the current account deficit and ensure stable movements in the FX market in the period ahead.

Chart V.0.13 **Current account deficit and net FDI inflow**
(in % of GDP)




Source: NBS.
* NBS projection.

## Projection

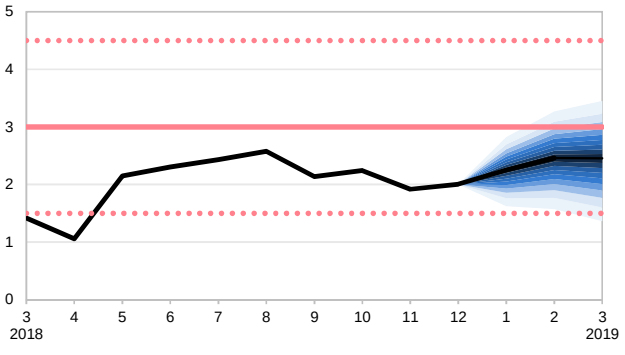
### Inflation projection

Under the current inflation projection, which is somewhat lower than the one from November, y-o-y inflation will remain low and stable over the next two years. It will continue to move within the target band, most probably in its lower part, until the end of the projection horizon.

### Short-term inflation projection

Consistent with our previous announcements, we expect y-o-y inflation in Q1 2019 to temporarily approach the target midpoint on the back of the low base effect. Dissipation of the effects of the past appreciation of the dinar should push also y-o-y core inflation in this period above its end-2018 level, even though its quarterly growth will be marginal, according to our estimates.

Chart V.0.14 **Short-term inflation projection**
(y-o-y rates, in %)




Source: NBS.

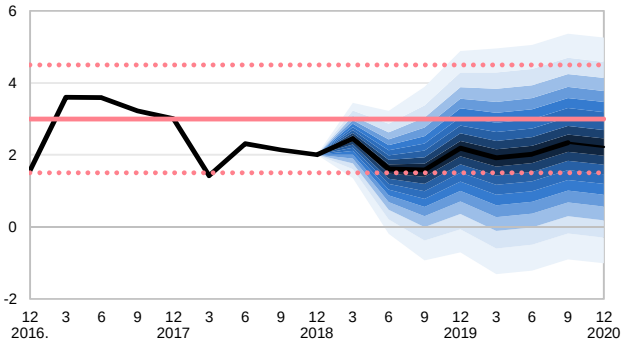
At **quarterly level**, consumer prices are expected to record seasonally higher growth than in other quarters of the year, reflecting mainly the rise in fruit and vegetable prices, regular annual adjustment of excise tax on cigarettes and the increase in prices of utility services. Disinflationary pressures, on the other hand, should come from the seasonal fall in the prices of travel packages and fresh meat, as well as from petroleum product prices due to the sharp drop in global oil prices in late 2018.

The risks to the short-term inflation projection are associated primarily with the movements in unprocessed food prices, above all fruit and vegetable prices, as well as with the movements in international commodity and financial markets and their short-term effects on prices in Serbia.

### Medium-term inflation projection

Based on projection assumptions, in the next two years y-o-y inflation is expected to continue to move within the target tolerance band – most probably in the lower part of

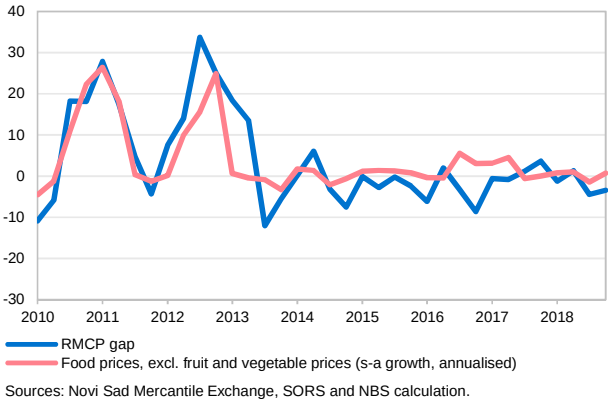
Chart V.0.15 **Inflation projection**
(y-o-y, in %)




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.0.16 **RMCP and food prices**
(in %)




Sources: Novi Sad Mercantile Exchange, SORS and NBS calculation.

the band. Its movement in the coming year will be largely determined by the base effect, primarily for fruit and vegetable prices. Y-o-y inflation is expected to rise until April and fall towards the lower bound of the band thereafter, returning to the current level (around 2%) at the turn of the year.

Such inflation profile until the end of the projection horizon, i.e. next two years, reflects the impact of different factors. As in the previous projection, the main driver of inflation throughout the projection horizon will be rising aggregate demand. In addition, the disinflationary pressures generated by past appreciation of the dinar should gradually wane, with administered price growth being somewhat faster than in the years before. On the other hand, the main generator of disinflationary pressures will be the high base for the prices of fruit, vegetables and petroleum products.

Growth in **aggregate demand**, ongoing since late-2014, is expected to continue, i.e. disinflationary pressures from the negative output gap will weaken. According to our estimate, these pressures are likely to dissipate next year, once the output gap enters the positive zone. Such movement in the output gap will be supported by positive labour market trends and rising public sector wages and pensions, through the positive impact on the disposable income of households. Lower interest rates also have a positive effect on the disposable income, including lower loan repayment costs, achieved owing to NBS past monetary policy easing. Serbia's economic growth will be buoyed by rising euro area economies (though their pace of growth is slower than in earlier projections), the still exceptionally accommodative monetary policy of the ECB, and the persistently low rates on euro-indexed loans.

Past **appreciation of the dinar** produced disinflationary effects through lower dinar-denominated import prices. We expect disinflationary pressures to continue for some time yet on these grounds, but they will wane in time. However, given the expected relative stability of the **dinar exchange rate**, including a rise in prices in the euro area, our key trade partner – by around 1.5%, the growth in dinar-denominated import prices is likely to remain relatively low until the end of the projection horizon.

**The costs of raw materials in food production** are assessed to be again above the neutral level. From the previous medium-term projection, domestic prices of primary agricultural commodities went up, pushing up food production costs. In H2 this year, these prices are expected to decline moderately, thus bringing food production costs back to the neutral level. Thereafter, we expect these costs to move around the neutral level,

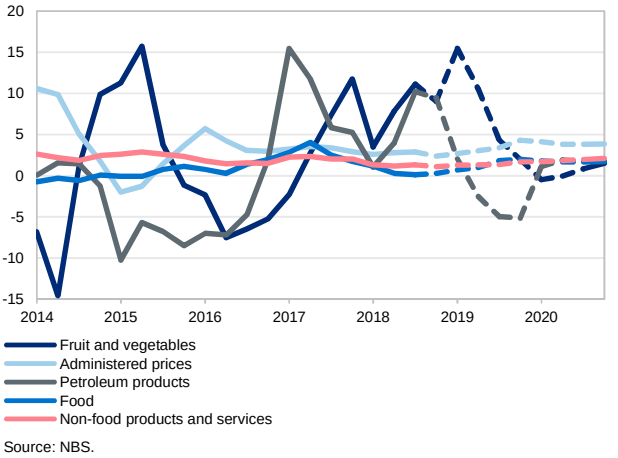
consistent with the assumed movement in global primary agricultural commodity prices (a mild fall in 2020) given that these prices have the strongest impact on their domestic counterparts.

**Administered price** growth is expected to reach 4.4% this year, mainly based on the adjustment of cigarette prices and the expected rise in the prices of natural gas and electricity, which did not take place last year. Thus, the contribution of administered price growth to inflation will be by 0.3 pp higher than last year. Similarly to the previous projection, administered price growth in 2020 is expected at around 4.0%.

Consistent with the previous projection, the main disinflationary impact in the coming period will come from the high base for the prices of fruit, vegetables and petroleum products. In the last eight months of 2018, **fruit and vegetable prices** increased more than expected (contributing 0.65 pp to y-o-y inflation in 2018), which brought them to the zone above the neutral level. This is why we expect their contribution to decline sharply as of May this year, with the possibility of entering the negative zone.

The upward trend of **global oil prices** was reversed in October last year, with these prices plummeting from USD 86 to around USD 60 per barrel early this year. Such developments have already brought about lower prices of petroleum products and their falling contribution to y-o-y inflation from 0.7 pp in October to 0.3 pp in December 2018. Moreover, assuming oil prices stabilise around the current level, the contribution of petroleum products should continue down, entering the negative zone in Q2 this year, both on account of the fall in global oil prices which has already taken place and the drop-out of last year's price hikes from the y-o-y inflation rates.

Chart V.0.17 **Projection of inflation components**
(average y-o-y rate, in %)




Source: NBS.

In terms of other inflation components, **non-food inflation** is at a relatively low level (0.9% in 2018), largely due to the influence of past appreciation of the dinar. As in the previous projection, we expect non-food inflation to rise moderately owing to the gradual waning of the effect of past appreciation of the dinar and elevated aggregate demand, it is likely to move below 3% until the end of the projection horizon. Along with rising food production costs in the short run, these factors will lead to a moderate rise in **food inflation**, whose profile will be similar to that of non-food inflation.

**The uncertainties associated with the inflation outturn** are associated primarily with trends in the international commodity and financial markets, and, to an extent, administered price growth.

The prices of primary commodities in the **international market** may be either lower or higher than assumed, both due to demand- and supply-side factors. In terms of demand-side factors, there are risks that the global growth could slacken more than estimated, including a fall in demand for primary commodities. Uncertain trade policies of the leading world economies and concerns over the escalation of trade tensions could jeopardise business optimism and negatively impact investment, productivity and economic growth, which would then dampen demand for primary commodities, notably oil. Falling demand for primary commodities would be under a particular impact of greater than expected slowdown in China's growth, given that the Chinese economy has become the main driver of demand for primary commodities in the global market. Although China responded to the growth slowdown by limiting further tightening of financial regulation, injecting liquidity by reducing banks' statutory reserves and providing fiscal stimuli, i.e. raising public investment, economic activity could still be lower than expected, especially if trade tensions do not calm down. On the other hand, trade tensions may diminish and the negative effects on global growth and demand for primary commodities be absent.

Supply-side factors are specific for each primary commodity. Uncertainties still prevail in the global **oil** market over geopolitical tensions, notably in regard to US sanctions on oil exports from Iran, and potential additional negative supply-side shocks over developments in Venezuela, Libya and Nigeria. It is also uncertain how long the current oil production cap in OPEC countries will last, and to what extent the member countries will adhere to it. In addition, though it is expected that the introduction of new standards of the International Maritime Organization in 2020 will be limited, it remains uncertain how the oil refinery and transport industry will respond to it and what the effect on global oil prices will be. On the other hand, US oil production is dynamic and its rise, including a potentially higher rise in the production of OPEC countries, could lead to a further drop in global oil prices. The movement in global oil prices will also reflect on the prices of **primary agricultural commodities**, notably cereals, not only through fuel costs in agricultural production and prices of fertilisers, but also through the impact on biofuel production. On the other hand, the heightening of trade tensions could trigger a fall in the prices of primary agricultural commodities. Besides, in the past several years the prices of primary agricultural commodities in the global market have been rising slightly, or were even declining, although the futures anticipated growth. Given the uncertainty as to the movement in global prices of oil and primary agricultural commodities, the risks to our projection in terms of global prices of primary commodities are judged to be symmetric.

The risks to the projection are also associated with trends in the **international financial market**, primarily in terms of the monetary policy stance of the ECB and Fed, and the conditions in the international financial market and euro-dollar relationship. Responding to the slowdown in global growth and inflation, the ECB and Fed have already signalled that the normalisation of their monetary policies will be slower than expected. This means global financial conditions will be favourable over a longer period than expected. Still, it is uncertain to what extent normalisation will be slower, which may trigger the instability of global capital flows. Further heightening of protectionism in international trade could additionally deepen the instability in the international financial market, including in relation to capital flows. Working in the opposite direction will be the calming of trade tensions. Given the said, the risks to the projection are symmetric.

The projection operates on the assumption that **administered price** growth will speed up to 4.4% this year, following the relatively modest last year's growth of 2.4%. In 2020, administered price growth is expected at around 4%. However, as administered price growth underperformed the projection in the past three years, the risks to the projection are judged to be mildly titled to the downside.

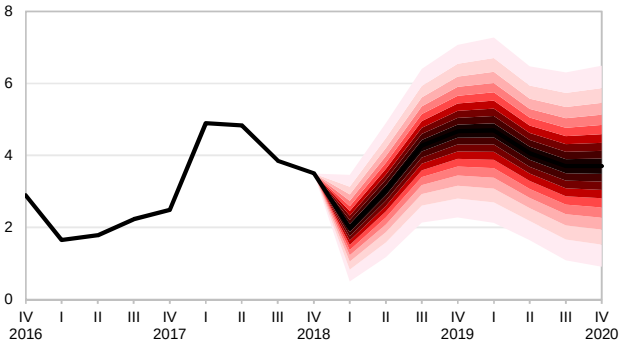
Bearing in mind all the above, the **risks to the inflation projection are assessed to be mildly tilted to the downside**.

Monetary policy decisions in the coming period will depend on the assessment of the impact of domestic and external factors on inflation at home. As the key risks emanate from the international environment, the NBS will continue to closely monitor and analyse trends in the international commodity and financial markets, and assess their impact on economic trends in Serbia. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and the strengthening of resilience to external uncertainties.

## GDP projection

The GDP growth projection for 2019 has been kept at 3.5%. However, given somewhat more pronounced risks from the international environment, notably slower than expected euro area growth, the growth structure for 2019 has been changed. Unlike the previous projection that envisaged an almost neutral contribution of net exports to GDP, we now expect a negative contribution, albeit significantly smaller than in 2018. Therefore, exports are likely to maintain a relatively robust growth pace of around 8%, with similar growth also expected for imports, whose positive structure will be preserved. On the other hand, domestic demand is assessed to largely positively contribute to GDP growth, most notably on account of faster growth in fixed investment owing to the continued high FDI inflow and intensive implementation of infrastructure projects. A higher than expected contribution is also likely to come from elevated household consumption, thanks to rising pensions and public sector wages, and the continued growth in employment and wages in the private sector.

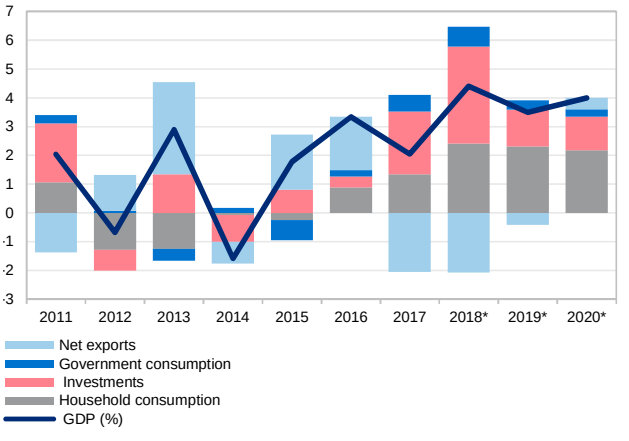
Chart V.0.18 **GDP growth projection**
(y-o-y rates, in %)




Source: NBS.

Growth in household consumption should positively impact growth acceleration in service sectors, which will in 2019 as well provide the strongest positive contribution to GDP growth, on the production side. In addition, we expect construction to continue to rise at an average pace over the past five years (around 8%), as indicated by the envisaged rise in government capital expenditure and favourable trends in the real estate market. An impetus is likely to be lent by the industry as well, reflecting, in addition to further manufacturing growth, the recovery in mining. Conversely, a negative contribution to GDP is likely to come from falling agricultural production due to the base effect.

Chart V.0.19 **Contributions to real GDP growth**
(in pp)




Sources: SORS and NBS.
* NBS estimate.

In the medium run, real GDP growth is expected at around 4%. A favourable business environment, continued EU integration process and intensive investment in infrastructure should bolster further growth in fixed investment. Investment, mainly channelled to export-oriented sectors, will also maintain the relatively vigorous pace of export growth which will, along with gradual slowdown in import growth, result in a positive contribution of net exports to GDP. A boost will come from household consumption, which is expected to rise slower than GDP in the coming period.

On the production side, gradual acceleration in GDP growth in the medium run will reflect elevated manufacturing, triggered by investment in new export capacities on the one hand, and the expected recovery of external demand on the other. Activity will step up in service sectors as well, on the back of further labour market recovery and rising domestic demand. Construction is likely to continue up, though at a slower pace than in 2018. Agricultural yields are assumed to be at the level of a multi-annual average.

The risks to the current GDP growth projection are associated primarily with the pace of euro area growth, trends in the international financial and commodity markets, and domestic agricultural production and construction. According to our estimate, the risks to the projection are symmetric. In the short run, i.e. during 2019, the risks from the international environment are judged to be tilted to the downside and those from the domestic environment to the upside. Thereafter, i.e. in the medium run, all risks to the GDP projection are assessed as symmetric.

Owing to broad-based exports, over the past several years Serbia has reduced its exposure to shocks in individual components of external demand. However, the euro area remains our key trade partner, which is why growth deceleration in the euro area could affect the growth in Serbia's exports and thus slow the rise in manufacturing. As European officials have assessed such slowdown as temporary, potential negative effects on Serbia's economic growth could be present primarily in the short run, i.e. during 2019. In addition, potential further heightening of protectionism in international trade, despite the agreement reached between the USA and China in late 2018, through the influence on slower global growth, could result in lower GDP growth in Serbia. To an extent, uncertainties also relate to the negative effect of 100% taxes on products delivered to Kosovo and Metohija, which may, if they remain, diminish manufacturing production, notably of food products.

In addition to the trade channel, Serbia, as a small and open economy, is also affected by capital flows and relationships between the main currencies in the international financial market. In an environment of continued normalisation of monetary policies of the leading central banks and reduced investor appetite, the costs of external funding may increase, which will depend primarily on the pace of normalisation and the extent to which this goes in line with market expectations. However, owing to preserved macroeconomic stability, narrowed internal and external imbalances, higher

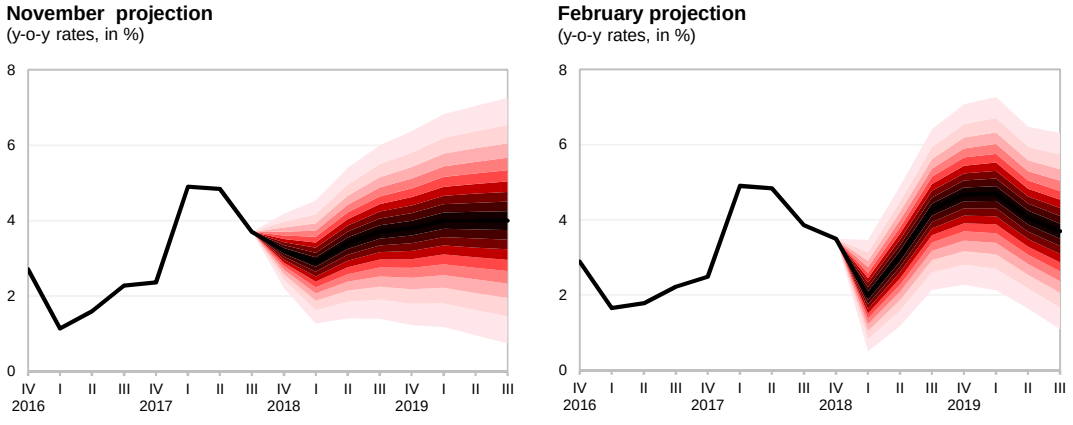
domestic demand and consequently lesser needs for external borrowing, Serbia has reduced its exposure to potential external shocks on these grounds. Besides, a weaker global growth outlook may affect a slower than expected pace of normalisation of the Fed's monetary policy, including the postponement of the start of normalisation by the ECB.

The risks to the projection are also associated with the movement in the prices of primary commodities, primarily oil, base metals and cereals. A potential oil price hike in the global market could spill over to Serbia as a net importer through a lower disposable income and higher costs of operation, while its potential drop would work in the opposite direction. On the other hand, a potential rise in the prices of cereals and base metals in the global market would positively affect Serbia as a net exporter of these products. Given that movements in these prices in the global market are possible in both directions, the risks are judged to be symmetric.

The effect of domestic factors of GDP growth could be asymmetric to the upside in the short run. This concerns primarily positive effects based on a more vigorous than assumed rise in investment, given the relatively high and project-diversified FDI inflow in 2018. Faster than expected growth in investment could reflect on more favourable than initially assumed trends in construction, which is, in addition to the continued investment in infrastructure, buoyed by positive trends in the real estate market.

The projection assumes that agricultural production in 2019 will be at the level of multi-annual averages, i.e. that it will most probably record a fall due to the high base from 2018. Continued investment in this field, which includes access to EU funds, could prop up productivity

Chart V.0.20 **Current vs. previous GDP growth projection**




Source: NBS.

and diminish potential negative trends. However, it should be borne in mind that agriculture is highly susceptible to weather conditions, whose movement is uncertain, which is why deviations from the assumption of an average season may go in either direction.

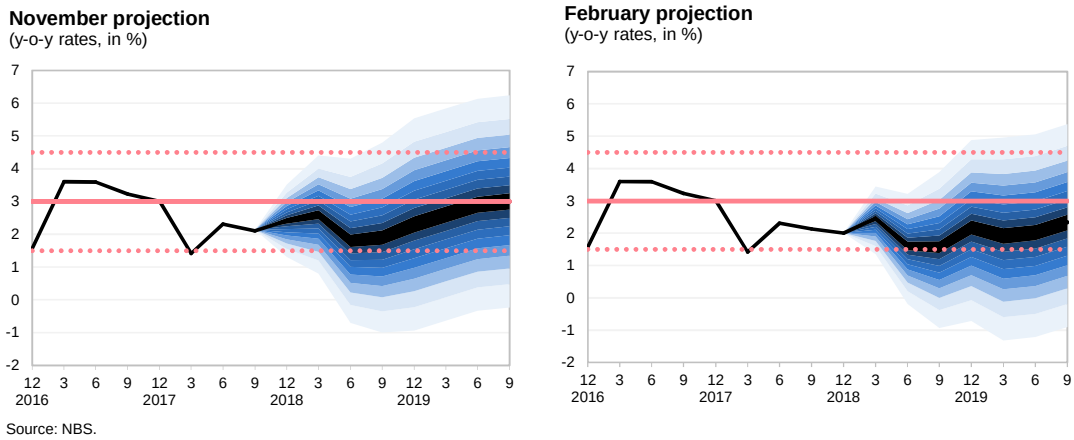
## Comparison and outcome of inflation projections

**The new medium-term inflation projection is slightly lower than the one published in the November *Report*.** The main reasons for the projected lower inflation outcome in 2019 are the sharp fall in global oil prices in late 2018 and, judging by all, slower waning of the effects of the past appreciation of the dinar than assumed in November.

Given the collapse of global oil prices in late 2018, we have assumed these prices to be lower in 2019 than envisaged by the November projection. This will lead to lower petroleum product prices, and thus, to lower inflation until the end of 2019.

Slower waning of the effects of the past appreciation of the dinar also played a role in shaping a lower inflation outcome in this projection. It is most visible in the weaker growth in the prices of non-food products and services in Q4 2018, which is why we have projected a lower y-o-y growth rate of these prices until end-2019 than foreseen by the November projection. Besides, lower growth in non-food inflation will be also underpinned by the lower expected inflation in the euro area, our key trade partner. Working in the same direction will be the slower closing of the negative output gap than assumed in the previous projection, primarily because of softening external demand.

Chart V.0.21 **Current vs. previous inflation projection**



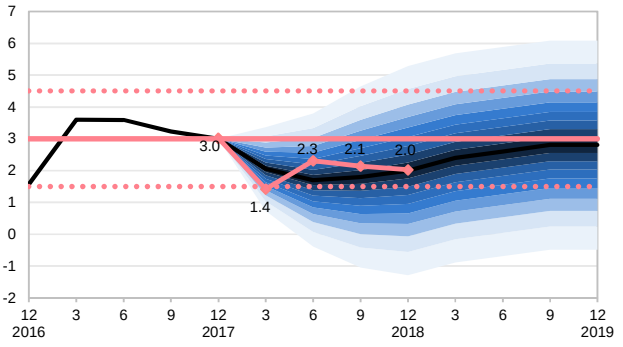

Source: NBS.

**In the past year, inflation moved within the band projected in February 2018**. More specifically, inflation revolved around the central projection value – first below, and then above it, only to settle at end-2018 exactly at the central value projected in February 2018.

Observed by component, lower end-2018 growth than projected in February was recorded for prices of food and non-food products, as well as administered prices. This reflected primarily lower costs in food production (due to lower prices of primary agricultural commodities in Serbia), slower waning of the effects of the past appreciation and the absence of the anticipated hike in natural gas and electricity prices.

On the other hand, higher than projected growth was recorded for prices of fruit, vegetables and petroleum products. First, early in the year volatile fruit and vegetable prices rose less than expected owing to favourable weather conditions and thus made inflation lower than the projected central value. In the remainder of the year, these prices, most of all vegetable prices, rose more than anticipated, thus pushing inflation above the central projection value. Petroleum product prices increased more than forecast in February 2018, chiefly because of the rise in global oil prices that was seen for the greater part of the year.

Chart V.0.22 **Achievement of February 2018 inflation projection**
(y-o-y rates, in %)




Source: NBS.

## Projections of other institutions

The majority of relevant international institutions did not release any new projections of key macroeconomic indicators for Serbia since the last Report, but those who did – the IMF, Consensus Forecast and Bloomberg – maintained their positive expectations for 2019 and 2020.

All three institutions raised their forecasts for Serbia's GDP growth in 2018: the IMF and Bloomberg from 4.0% to 4.2% and Consensus Forecast from 4.1% to 4.4%. Their growth projections for 2019 revolve around 3.5%, and for 2020 they range from 3.3% (Bloomberg) to 4.0% (IMF).

As regards inflation, all three institutions expect inflation to remain within the NBS target band and generally to be somewhat lower than projected before. Consensus Forecast and Bloomberg cut their inflation forecasts for this year from 2.9% to 2.3% and 2.6%, respectively. Bloomberg also reduced its inflation projection for 2020 (from 3.0% to 2.9%), while Consensus Forecast released its 2020 inflation forecast (2.7%) for the first time this January. The IMF raised its inflation projection for 2019

Table V.0.4 **Projections of key macroeconomic indicators for Serbia**

| | 2018 | | 2019 | | 2020 | |
|---|---|---|---|---|---|---|
| | Previous | New | Previous | New | Previous | New |
| **Inflation (annual average, in %)** | | | | | | |
| IMF | 2.1 | 2.1 | 2.3 | 2.4 | 3.0 | 3.0 |
| European Commission | 2.1 | - | 2.9 | - | 3.0 | - |
| Consensus Forecast | 2.2 | 2.0 | 2.9 | 2.3 | - | 2.7 |
| Bloomberg survey | 2.2 | - | 2.9 | 2.6 | 3.0 | 2.9 |
| **GDP (%)** | | | | | | |
| IMF | 4.0 | 4.2 | 3.5 | 3.5 | 4.0 | 4.0 |
| European Commission | 4.1 | - | 3.8 | - | 3.8 | - |
| Consensus Forecast | 4.1 | 4.4 | 3.4 | 3.6 | - | 3.5 |
| Bloomberg survey | 4.0 | 4.2 | 3.5 | 3.4 | 3.5 | 3.3 |
| *EBRD* | 4.2 | | 3.5 | | - | |
| **Fiscal result (% of GDP)** | | | | | | |
| IMF | 0.6 | 0.6 | -0.5 | -0.5 | -0.5 | -0.5 |
| European Commission | 0.4 | - | -0.3 | - | -0.5 | - |
| Bloomberg survey | 0.5 | - | -0.3 | -0.3 | -0.5 | -0.5 |

Sources: IMF (WEO, October 2018; End-of-Mission press release, October 2018 and February 2019; Country Report, July and December 2018), European Commission (Autumn 2018 Economic Forecast), Consensus Forecast (October 2018 and January 2019), Bloomberg Quarterly Survey (October 2018 and January 2019) and EBRD (Regional Economic Prospects in the EBRD Regions, November 2018).

slightly (2.4%), while keeping the one for 2020 at the NBS target midpoint (3.0%).

There are no changes when it comes to fiscal result. International institutions generally agree that Serbia will record the targeted deficit of 0.5%, though Bloomberg believes that this year's deficit will be even smaller (-0.3% of GDP). This will ensure a further decrease in the share of public debt in GDP, and thus, greater resilience to external challenges.

## Text box 4: Inflation and GDP projections for 2018

Projections of inflation and GDP are among the key elements of the inflation targeting strategy. They do not only serve as analytical support to the process of monetary policy decision-making, but also increase the efficiency of communication with the public and steer the expectations of market participants. As an inflation targeter, the NBS projects inflation and economic activity for two years ahead and publishes these forecasts in its quarterly *Inflation Reports*.

An important element of projections, which conditions the degree of their achievement, are the assumptions about the evolution of the key inflation and/or GDP factors. The external assumptions are taken over from central banks and relevant international institutions (such as the ECB, IMF, World Bank, European Commission, etc.) or are determined based on the movement of futures, while internal assumptions are grounded in the NBS expert assessment.

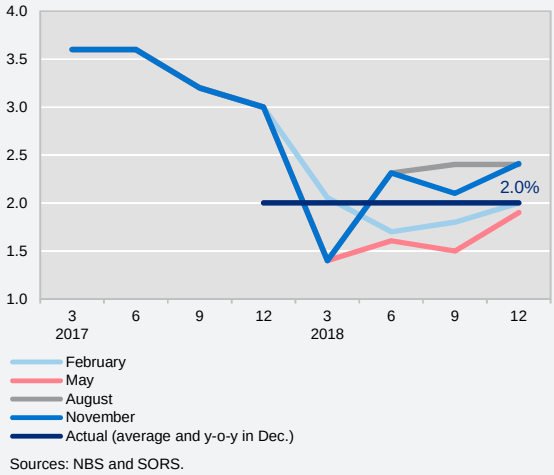
Here we will examine the main assumptions and results of the inflation and GDP projections published in the 2018 *Inflation Reports* and how they unfolded.

Last year was particularly challenging for defining assumptions and making projections primarily due to volatile global developments. Global growth outlook first improved and then subdued, oil price varied between 50 to 86 dollars per barrel (the highest level since 2014), and the monetary policies of leading central banks continued to diverge, with uncertainty surrounding the dollar-euro exchange rate and capital flows to emerging markets. On the other hand, domestic markets were stable and largely in line with our expectations. Deviations from the projected inflation profile reflected administered prices and fruit and vegetable prices, while economic growth was affected by favourable meteorological conditions for an increase in agricultural output and greater than expected investment. Bearing in mind the uncertainties coming from the international environment, the NBS continued to exercise caution in monetary policy decision-making throughout 2018.

Every inflation projection made in 2018 assumed that inflation would remain low and stable and move within the NBS target tolerance band, with the central projection ranging between 1.5% and 2.5% (Chart O.4.1), while GDP projections were revised upward twice in the course of the year, from 3.5% at the beginning of the year to 4% in August and then to 4.2% in November.

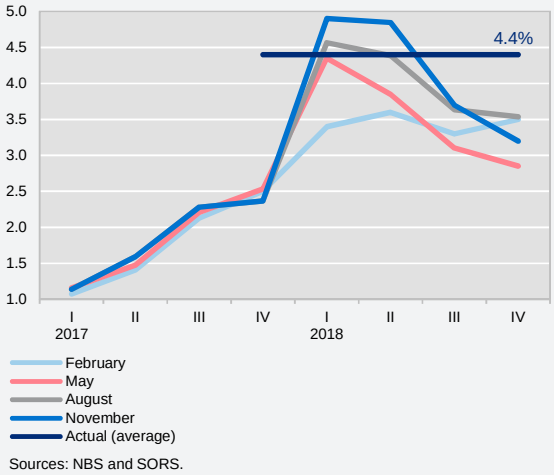
At the beginning of the year, the **February projection** implied that in 2018 inflation would move closer to the lower bound of the target tolerance band as a result of low inflationary pressures on account of the majority of factors from the domestic and international environment and the high base effect of energy, fruit and vegetable prices. Conversely, gradual recovery of domestic demand in the medium run was expected to moderately push inflation up and to ensure that it continued to move within the target tolerance band. The February projection was lower than the November 2017

Chart O.4.1 **Inflation projections in 2018**
(central projection values, y-o-y rates, in %)




Sources: NBS and SORS.

Chart O.4.2 **GDP projections in 2018**
(central projection values, y-o-y rates, in %)




Sources: NBS and SORS.

projection. The main reasons for this were a smaller than expected rise in consumer prices in Q4 2017 and the assumption of lower import prices of primary agricultural commodities expressed in dinars.

Since the February inflation projection, the key policy rate was trimmed in March and April by a total of 50 bp, to 3.0%, which is its lowest level in the inflation targeting regime. The Executive Board decided to further ease its monetary policy in consideration of additional weakening of inflationary pressures after the February projection. This was confirmed by core inflation, which dropped to 0.8% y-o-y in March, its lowest level since inflation is measured by the CPI. Both short- and medium-term inflation expectations were also anchored around the target midpoint (3.0%).

The February expectation of the NBS Executive Board for **GDP growth** was 3.5% **in 2018**. It was envisaged that further improvement of the business environment, high and project-diversified FDI inflow and implementation of infrastructure projects would continue to boost investment as one of the drivers of economic growth in 2018. A growing positive contribution was anticipated from household consumption as a result of further labour market recovery, as well as from exports as a result of past investment and a rise in external demand propped up by the assessment of the ECB and leading international institutions that the euro area and global growth outlook were strengthening. In addition, a boost to credit and hence, economic activity was also expected to stem from NBS monetary policy easing, greater interbank competition, lower country risk premium, NPL resolution and low interest rates in the euro area money market.

The **May inflation projection** was lower as inflationary pressures proved to be more subdued than expected in February. The main reasons behind a lower projection were the impact of the past appreciation of the dinar, low inflation abroad and persistently low costs in the food production. Conversely, compared to the February projection, a somewhat faster closing of the output gap was expected on account of both external and domestic demand. The May inflation projection also assumed higher global oil prices (71 dollars per barrel at the end of the year compared to 66 dollars per barrel anticipated in February) on account of both demand-side factors (the expected global growth acceleration first and foremost) and supply-side factors (primarily the oil production cap by leading exporters and geopolitical tensions). Furthermore, a somewhat higher price level of primary agricultural commodities was assumed because of their rise in the period since the previous projection.

Concerning **GDP projection**, since macroeconomic indicators exhibited more favourable than expected tendencies since the beginning of the year, primarily in construction, on the production side, and in investment, on the expenditure side, the Executive Board estimated that the risks to the 3.5% GDP growth projection for 2018 were skewed to the upside, i.e. it was more likely that this growth would be higher than forecast.

The **August inflation projection** was higher than the previous two projections owing to stronger growth in consumer prices, primarily energy and vegetable prices, in the period since the May projection, which was to be reflected in the y-o-y inflation rate over the next twelve months. A somewhat faster increase in global oil prices was indicated by futures, whereas vegetable prices, instead of a seasonal fall, recorded a rise in Q2, making the anticipated annual growth in these prices higher than presumed in the previous projections. The hike in administered prices in that part of the year stabilised at the relatively low level registered in 2017 (2.9%). However, assuming that the prices of natural gas and electricity would rise by the end of the year, the expectation, as in the past two projections, was that administered prices in 2018 would grow by around 4%, increasing their contribution to y-o-y inflation until the end of the year by 0.2 pp. On the other hand, it was expected that the fall in the prices of agricultural commodities in the period since the last projection would also push down the food production costs and hence, food prices. Past appreciation of the dinar also worked towards lower inflation projection, primarily through a lower non-food inflation since the previous projection. Global economic growth outlook was still favourable, though compared to the previous projections there were more downside risks, primarily due to trade and geopolitical tensions between leading global economies. Even though the past protectionist measures did not have a more significant negative impact, the possibility of tightened trade tensions became one of the main risks around macroeconomic projections of almost all central banks. Since it is difficult to estimate the direction and scope of future measures, as well as the effects of expanded trade tariffs, inflation risks on this account were judged to be symmetric.

When it comes to economic activity, in August the NBS revised the **GDP growth projection** for 2018 to 4.0%, up by 0.5 pp relative to May. The upward revision was a result of faster than expected construction and agriculture growth on the production side, and faster investment expansion on the expenditure side, which the NBS emphasised as upside risks in the May projection as well.

Even in the environment of robust economic growth, **the November inflation projection** for 2018 was almost unchanged from the August projection (2.4%). The only differences related to the contributions of individual inflation components, which were mutually offsetting, wherefore no change in headline inflation was expected. The November inflation projection assumed lower contribution from the prices of food (excluding fruit and vegetable prices) than before, as in the period since the last medium-term projection the prices of primary agricultural commodities declined, pushing the costs in food production down and, hence, the prices of food more than envisaged in the previous projection. In addition, the Executive Board believed that most probably there would be no adjustment to the prices of electricity and natural gas until the end of 2018 and assumed a smaller increase in administered prices than in the previous projection (2.6%). On the other hand, due to a continued rise in global oil prices (which reached their four-year ceiling of over 80 dollars per barrel in October) in Q3 the prices of petroleum products exceeded the level expected in the previous projection. Futures also indicated a higher level at the end of the year than presumed in the August projection. The risks surrounding the short-term inflation projection were associated primarily with the prices of unprocessed food, most notably fruit and vegetables, as well as developments in the global commodity and financial markets and their short-term effects on the prices in Serbia.

As upside risks with regard to domestic demand growth, highlighted in the August projection, materialised before the November projection was produced, the NBS revised up the **GDP growth projection** for 2018 again, to 4.2%. In the course of the year Serbia's growth projection for 2018 was also raised by all relevant international financial institutions – the IMF, European Commission, some rating agencies, etc.

**The year ended with 2% y-o-y inflation and the same average annual inflation rate, while GDP growth outperformed our November expectations, amounting to 4.4%, according to the preliminary estimate of the Serbian Statistical Office**. End-of-year inflation was closer to the February and May projections and somewhat lower than the August and November projections. The main reason for lower inflation lies in the global oil price, which after rising over a greater part of the year plummeted since October (dropping on some days of December to as low as below 50 dollars per barrel, i.e. the lowest level since July 2017) and ended the year 20.4% lower than in January.

Table O.4.1 **Projection assumptions**

| | Projected for 2018 | | | | Actual in 2018 |
|---|---|---|---|---|---|
| **External assumptions** | Feb. | May | Aug. | Nov. | |
| Euro area GDP growth | 2.2% | 2.4% | 2.1% | 2.0% | 1.8% |
| Euro area inflation (average) | 1.4% | 1.5% | 1.7% | 1.7% | 1.6% |
| ECB policy rate (average)* | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| Prices of primary agricultural commodities in the global market (Q4 on Q4)* | 14.3% | 15.9% | 11.3% | 6.0% | 7.8% |
| Price of brent oil per barrel (year end, in USD) | 66 | 71 | 74 | 77 | 53 |
| Price of brent oil per barrel (average, in USD) | 69 | 72 | 72 | 74 | 71 |
| **Internal assumtions** | | | | | |
| Administered prices (Dec. on Dec.) | 4.1% | 4.0% | 4.0% | 2.6% | 2.4% |

* ECB Survey of Professional Forecasters (SPF).

** Composite index of prices of soya beans, wheat and corn.

Sources: NBS, ECB, Eurostat, Bloomberg, Consensus Forecast, BSE, CBOT.

Since the key risks around macroeconomic projections remain external, the NBS will continue to carefully watch and analyse global developments and assess their impact on economic developments in Serbia. This primarily relates to global economic growth outlook, particularly the outlook for our main trade partners, and to the developments in the international financial market and the market of primary commodities, notably crude oil and primary agricultural commodities. The Executive Board will continue to implement a carefully calibrated mix of monetary policy measures aimed at maintaining low and stable inflation, while preserving financial system stability and supporting economic growth.

## Index of charts and tables

### Charts

## Tables



## Charts in text boxes



## Tables in text boxes

# Executive Board meetings and changes in the key policy rate

## 2018

| Date | Key policy rate (p.a, in %) | Change (in basis points) |
|---|---|---|
| 11 January | 3.50 | 0 |
| 8 February | 3.50 | 0 |
| 8 March | 3.25 | -25 |
| 12 April | 3.00 | -25 |
| 10 May | 3.00 | 0 |
| 7 June | 3.00 | 0 |
| 12 July | 3.00 | 0 |
| 9 August | 3.00 | 0 |
| 6 September | 3.00 | 0 |
| 8 October | 3.00 | 0 |
| 8 November | 3.00 | 0 |
| 6 December | 3.00 | 0 |

## 2019

| Date | Key policy rate (p.a, in %) | Change (in basis points) |
|---|---|---|
| 10 January | 3.00 | 0 |
| 7 February | 3.00 | 0 |
| 7 March | | |
| 9 April | | |
| 9 May | | |
| 6 June | | |
| 11 July | | |
| 8 August | | |
| 12 September | | |
| 10 October | | |
| 7 November | | |
| 12 December | | |

# Press releases from NBS Executive Board meetings

### Press release from Executive Board meeting held on 6 December 2018

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making this decision, the Executive Board took into account primarily the outlook for inflation and its factors, as well as the effects of past monetary policy easing.

Inflationary pressures stayed low even against the background of strong economic growth. Inflation continued to move within the target tolerance band, measuring in October 2.2% y-o-y. In the coming period too, inflation is expected to remain stable within the target tolerance band (3.0±1.5%), its movements reflecting mainly the steady rise in aggregate demand. Both the financial and corporate sectors expect that the achieved price stability will be maintained, as signalled by their inflation expectations anchored around the 3% target for both one and two years ahead.

The Executive Board judges that caution in monetary policy conduct is still mandated, primarily because of developments in the international environment. The expected further rate hike by the Fed and the wind-down of the QE programme by the ECB by the end of the year could affect capital flows to emerging markets. In addition, protectionism in international trade remains one of the sources of uncertainty in the international financial market, which could dampen investor sentiment. Despite a recent decline, the global oil price remains an inflation factor that urges caution, given its uncertain movement going forward. Nevertheless, the Executive Board stresses that the resilience of our economy to potential negative effects from the international environment has increased, owing to improved macroeconomic indicators and prospects.

The Executive Board assesses that the effects of past monetary policy easing contribute to economic activity which has been growing at the highest rate in the last ten years – 4.5% y-o-y in the first three quarters of 2018. A strong impetus to such economic performance comes from the two-digit investment growth, which will continue to spur manufacturing exports in the coming period. Investment expansion is also supported by favourable financing conditions, credit growth, and increased government capital investment, notably into infrastructure. Also, the net inflow of foreign direct investment, which continues to comfortably cover the current account deficit, reflects positively on export growth and a reduction in external imbalances in the medium-term.

At today's meeting, the Executive Board adopted the Memorandum on Inflation Targets until 2021, whereby the inflation target until 2021 is set at 3.0±1.5%.

The next rate-setting meeting will be held on 10 January.

### Press release from Executive Board meeting held on 10 January 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making this decision, the Executive Board primarily took into account the outlook for inflation and its factors going forward, as well as the effects of past monetary policy easing.

Inflationary pressures remained low even in conditions of strong economic growth. Inflation has been low and stable for five years straight – it measured 1.9% y-o-y in November and, according to the Serbian Statistical Office, it averaged 2.0% for the whole of 2018. In the coming period, inflation is expected to remain stable within the target tolerance band (3.0±1.5%), its movements mainly reflecting the steady rise in aggregate demand. Both the financial and corporate sectors expect that the achieved price stability will be maintained in the medium term, as signalled by their inflation expectations anchored around the 3% midpoint for both one and two years ahead.

The Executive Board judges that caution in monetary policy conduct is still mandated, primarily because of developments in the international environment. This year we are likely to see further monetary policy normalisation by the world's leading central banks, the Fed and the ECB, which could affect capital flows to emerging markets. Despite the decline recorded in the closing months of 2018, the global oil price remains an inflation factor that urges caution. Uncertainty in the international financial market also stems from protectionism in international trade and geopolitical risks, which could dampen investor sentiment.

Nevertheless, the Executive Board stresses that the resilience of our economy to potential negative effects from the international environment has increased, owing to improved macroeconomic indicators and prospects.

Serbia's vigorous economic growth continues, owing to preserved macroeconomic, fiscal and financial stability, and the improvement of the overall business and investment climate. Last year's growth was the highest in the past ten years. According to the preliminary estimate of the Serbian Statistical Office, GDP grew by 4.4% y-o-y, with a positive contribution coming from all production and service sectors. Favourable trends in the real sector continued to positively reflect on the labour market as well, which saw a further rise in employment and wages. The net inflow of foreign direct investment reached EUR 3 bn and continues to comfortably cover the current account deficit, reflecting positively on export growth and a reduction in external imbalances in the medium run.

The next rate-setting meeting will be held on 7 February.

### Press release from Executive Board meeting held on 7 February 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making this decision, the Executive Board primarily took into account the outlook for inflation and its underlying factors, as well as the effects of past monetary policy easing.

Inflation has been low and stable for five years in a row. It measured 2.0% y-o-y at end-2018, this being also its average annual value. Core inflation, which revolved around 1.0% in the course of 2018, and inflation expectations of the financial and corporate sectors, which are slightly below the 3.0% target midpoint, confirm that inflationary pressures continue to be low. In the coming period too, inflation is expected to remain stable within the target tolerance band (3.0±1.5%).

The Executive Board judges that caution in monetary policy conduct is still warranted, primarily because of developments in the international environment. Global growth outlook has weakened, while leading central banks, the Fed and the ECB, recently signalled a possibly slower pace of monetary policy normalisation than expected. However, it remains uncertain to what extent the process of normalisation will be slower and different from what markets expect, which could bring volatility to global capital flows. Furthermore, potential escalation of tensions in international trade could additionally heighten instability in the international financial market, including in relation to capital flows. Despite the fall in global oil prices in late 2018, both demand- and supply-side factors make their future movements uncertain.

As emphasised by the Executive Board, our economy's resilience to potential adverse effects from the international environment has increased owing to improved macroeconomic indicators and prospects. Public finance recorded a surplus for the second year in a row, and the share of the current account deficit in GDP in 2018 stayed at the 2017 level despite elevated imports for investment purposes, higher oil prices and softening external demand. Domestic demand is assessed to be the main driver of GDP growth this year. At the same time, investment is on the rise owing to the improvement of the business environment, implementation of infrastructure projects and favourable terms of funding, supported by past monetary policy easing. In addition, household consumption growth is underpinned by positive labour market trends.

At its meeting today, the Executive Board adopted the February Inflation Report, which will be presented to the public on 13 February. On that occasion, monetary policy decisions and their underlying macroeconomic trends will be explained in more detail.

The next rate-setting meeting will be held on 7 March.

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