NATIONAL BANK OF SERBIA

I N F L A T I O N
REPORT
First Quarter 2007

Belgrade, May 2007

Introductory Note

Memorandum of the NBS on the Principles of the New Monetary Policy Framework adopted by the Monetary Policy Committee on its session of 30 August 2006 was put together to accomplish the main objective – efficient achievement and maintenance of price stability.

Based on the above monetary policy framework, the NBS has been maintaining price stability within the framework of the defined inflationary corridor using policy rate as its main instrument and other monetary policy measures as supporting instruments. Since the NBS aims to formally adopt inflation targeting in the near future to increase transparency of its monetary policy and efficient communication with the public, it has decided to prepare and publish quarterly inflation reports as its main channel for communicating with the public. This report shall provide the public with information on the main developments in the economy that affect the decisions of the Monetary Policy Committee and the activities of the National Bank of Serbia.

Inflation report contains information on the current and expected inflation, analysis of underlying macroeconomic developments, explanation of the reasoning behind the decisions of the Monetary Policy Committee and an assessment of the monetary policy efficiency as implemented during the previous quarter. Integral parts of this report are inflation projection for at least four quarters in advance, assumptions on which such projection is based and an analysis of the basic risks involved in achievement of target inflation.

Access to such information shall enable the public to have better understanding of monetary policy implemented by the central bank and its perseverance in achieving target inflation and shall certainly play a role in curtailing inflationary expectations and maintaining price stability, which is the basic task of the NBS.

Inflation Report for the first quarter 2007 was adopted by the Monetary Policy Committee on its session of 29 May 2007.

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

Monetary Policy Committee of the National Bank of Serbia:
Radovan Jelašić, *Governor*
Ana Gligorijević, *Vice-Governor*
Diana Dragutinović, *Vice-Governor*
Mira Erić-Jović, *Vice-Governor*

C o n t e n t s

I. Overview

Inflation continued on the downward path. In the first quarter of 2007, core inflation slid to a negative rate of -0.1%, under the stronger than expected impact of disinflationary pressures of accumulated real appreciation of the dinar exchange rate from the second half of 2006, which more than offset inflationary effects of other factors. As a result, year-on-year core inflation was brought down to the lower bound (4%) of the target corridor set by the National Bank of Serbia.

Hoping to bring core inflation back to target corridor levels before the end of 2007, in Q1 the National Bank of Serbia lowered the key policy rate on several occasions, thereby relaxing the monetary policy stance.

First-quarter retail price growth amounted to 1.2% and resulted mainly from movements in regulated prices. Year-on-year retail price growth declined from 6.6% in December 2006 down to 5.6% in March this year. Such performance confirms the efficiency of monetary policy measures and creates preconditions for adoption of an explicit inflation targeting regime.

Strong growth in aggregate demand in the period under review was counterbalanced by a rise in supply, both domestic and imported. Year-on-year real GDP growth stepped up to around 7%, while the ratio of deficit on goods and services to GDP rose to roughly 23%. As a consequence, relatively high growth in aggregate demand did not have an inflationary impact. In part, this was also due to a change in the composition of GDP consumption, which was marked by a shift from personal to investment consumption. From the viewpoint of the level of economic activity, it is noteworthy that rising domestic demand did not trigger a slowdown in export growth.

Table I.0.1.

Key macroeconomic indicators

	2006	2007		
	Dec	Jan	Feb	Mar
Retail prices (y-o-y growth, in %)	6,6	6,54	5,16	5,596
Core inflation (y-o-y growth, in %)	5,9	5,3	4,7	4,0
Belibor (90 days, monthly average, annual level)	16,5	15,0	13,7	12,3
M3 (y-o-y growth, in %)	39,8	37,2	38,8	43,2
GDP (y-o-y growth)	5,0	...	...	7,0
Consolidated fiscal result (% of GDP)[1]				
Ministry of Finance methodology	-7,5	...	...	2,3
IMF methodology	-7,4	...	...	-0,5
Balance of goods and services (% GDP)	-19,8	...	...	-22,9

[1] Quarterly data.

Core inflation projection
(y-o-y rates, in %)
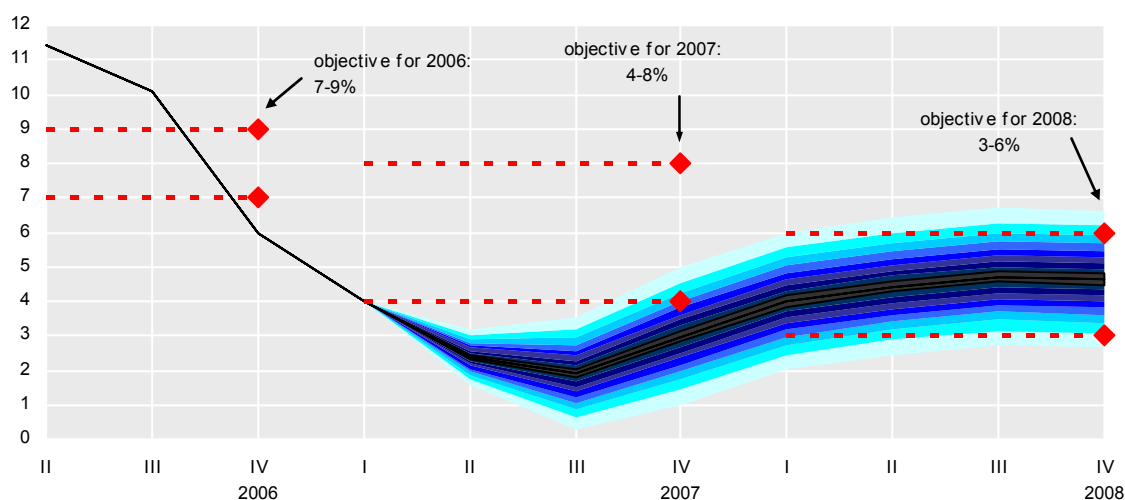
Money market interest rates continued declining and their fluctuations eased. At the same time, foreign exchange market witnessed weakening of the dinar, induced by robust demand for foreign exchange which was particularly pronounced in January. In the period under review, the dinar depreciated against the euro by 3.2%, in contrast to Q4 2006 when a 3.8% nominal appreciation of the dinar was recorded.

The most significant factors expected to exert their effect over core inflation in the second quarter are: accumulated appreciation of the real exchange rate from the second half of 2006 that will continue to produce disinflationary pressures, inflationary pressures that will come from the rise in energy prices (electricity and oil derivatives), and nominal depreciation of the dinar in Q1 2007 that will feed through a rise in import prices. Overall, quarterly core inflation rate is expected to rise to 0.7-1.1%, while year-on-year core inflation is expected to continue decreasing to below 3% by the end of Q2.

As notable upward revisions of some regulated prices are quite probable, retail price growth is estimated at around 3% in Q2, and around 5% year-on-year.

Central projection places core inflation for 2007 at around 3% (1-5% range) and headline inflation at around 6%. There is a notable risk that the target corridor (4-8%) will be undershot and practically none that it will be overshot. As projections of the National Bank of Serbia indicate, core inflation will lie within the target corridor set for next year (3-6%) as early as in the first half of 2008. Significant risks to the achievement of the projection include uncertainties regarding fiscal flows (pending adoption of a budget for 2007), adjustments in regulated prices and movements in world prices of oil. This inflation projection is consistent with moderate relaxation of the monetary policy over the next two quarters. A faster easing of monetary policy would probably bring core inflation to its target level in 2007, but could prejudice long-term macroeconomic stability and the achievement of targets set for 2008. The new (April) projection of core inflation for 2007 is 1.7 percentage points lower than projected in the last "Inflation Report," as the accumulated appreciation of the dinar generated stronger disinflationary pressures than assumed earlier.

II. Inflation Developments

Downward trends in inflation continued. At end-Q1, year-on-year retail price growth came to 5.6%, and is expected to amount to around 5% in Q2. Quarterly retail price growth of 1.2% was almost entirely due to movements in regulated prices. Year-on-year core inflation fell back to the lower bound of the target (4%) at end-Q1. It is expected that core inflation will continue declining and settle at below 3%, year-on-year, by end-Q2. In Q1, core inflation entered the negative zone (–0.1%), as a result of accumulated appreciation of the real exchange rate of the dinar from the second half of 2006.

Year-on-year retail price growth continued declining in early 2007. At end-Q1, it measured 5.6% as opposed to 6.6% at end-2006. Continued disinflation was driven by all three retail price components: regulated prices (7.9% y-o-y growth in March), prices of agricultural products (-1.6%) and market-determined prices – core inflation (4.0%). At end-Q1, inflation reached the lower bound of our spectrum of expectations specified in the previous issue of Inflation Report envisaging headline inflation to range from 5.5 to 6.3% and core inflation from 4.0 to 4.5%.

Table II.0.1

Indicators of price growth
(growth rates in %)

	XII 2005 XII 2004	XII 2006 XII 2005	III 2007 III 2006
Retail prices	17,7	6,6	5,6
Core inflation	14,5	5,9	4,0
Consumer prices	...	...	4,1
Cost of living	17,1	6,0	4,2
Prices of goods	16,3	6,1	3,7
Prices of services	22,3	5,2	7,0
Industrial producer prices	15,4	7,3	5,1
Agricultural producer prices	11,8	7,3	4.6[1]

[1] February to February.

Chart II.0.1.

Movements in prices
(quarterly growth, in %)

Retail prices
Core inflation
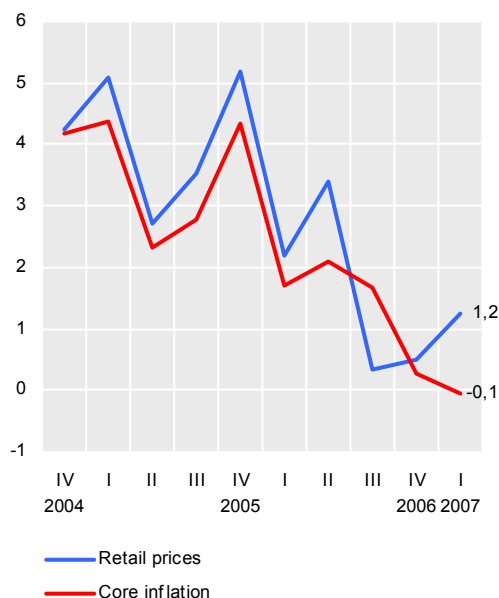
Chart II.0.2.

Movements in prices
(y-o-y growth, in %)

Retail prices
Core inflation
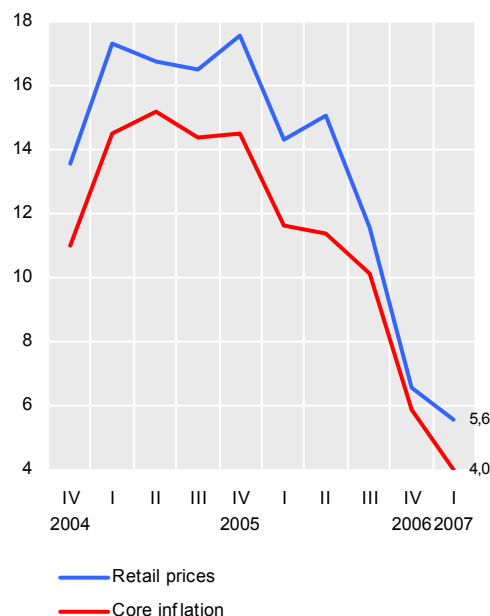
Quarterly retail price growth (1.2%[1]) was mainly determined by movements in regulated prices (1.2 percentage points). Within this group of prices, the largest single contributor to retail price growth were utilities with 0.6 percentage points, which were revised upwards in February 2007, instead in late 2006 as expected. The increase in prices of utilities was particularly pronounced in Belgrade, where costs of

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[1] Monthly breakdown: January 0.4, February 0.1, March 0.8.

central heating went up by 25%, and those of other utilities by 9%. A substantial contribution to retail price growth in Q1 (0.4 percentage points) came from prices of cigarettes, in respect of which proportionate excise duties were raised from 30 to 40% and flat excise duty on domestic cigarettes from 1 to 2 dinars. A significant drop in prices of oil derivatives (5.8%) in the first two months of the year was largely off-set by the 4.7% rise in March. Hence, their input to retail price growth (-0.1 percentage points) was insignificant. No major adjustments were made in other regulated prices.

In the first quarter, prices of agricultural products experienced a weaker growth (2.9%) than expected, which may be put down to favourable weather conditions.

Year-on-year core inflation continued down and at end-Q1 reached the lower bound of the 2007 target (4%). Quarterly core inflation entered the negative zone, -0.1%[2]. The main driving force behind continued decline in core inflation was the accumulated real appreciation of the dinar[3] from the second half of 2006. Although the National Bank of Serbia proceeded with the key policy rate cuts in 2007 leading to nominal depreciation of the dinar, such cuts proved insufficient to counterbalance the effects of accumulated real appreciation of the dinar. Strong growth in wages, recorded above all in the public sector, had an inflationary impact which, however, did not come fully to the fore in Q1 2007.

Monthly breakdown shows that after several months of decline – ending in the negative zone in February - core inflation rose to 0.1% in March.

Chart II.0.3.

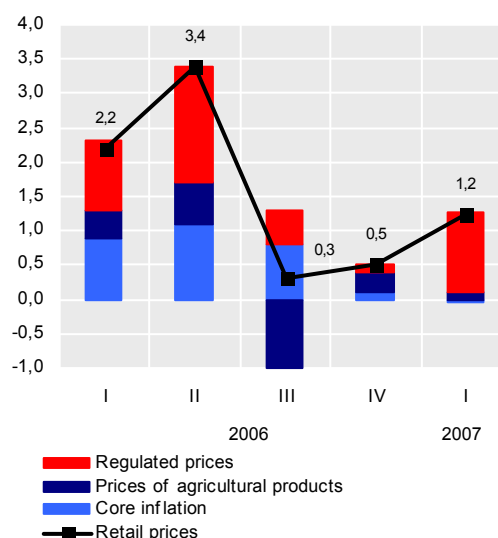**Contribution to retail price growth**
(in percentage points)

Red: Regulated prices
Dark blue: Prices of agricultural products
Blue: Core inflation
Line: Retail prices

Table II.0.2.

Retail price growth by component
(in %)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Retail prices	2,2	3,4	0,3	0,5	1,2
Core inflation	1,7	2,1	1,7	0,3	-0,1
Prices of agricultural products	11,1	16,9	-26,0	10,5	2,9
Administered prices	2,1	3,8	1,2	0,1	2,6
Electricity	0,0	11,7	0,0	0,0	0,0
Petroleum products	6,6	3,5	-1,6	-8,2	-1,3
Utilities	0,5	0,4	0,6	1,4	7,7
Social welfare services	1,6	0,0	0,1	9,1	0,6
Transport services (administered)	1,2	-0,6	6,1	1,0	0,0
Postal and telecommunications services	-0,3	5,8	0,0	4,2	1,2
Cigarettes	0,0	5,5	4,7	7,7	11,8
Medications	7,0	1,5	5,6	2,4	0,3
Other	1,8	2,3	3,0	0,8	2,3

Table II.0.3

Contribution to retail price growth rate
(in percentage points)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Retail prices	2,2	3,4	0,3	0,5	1,2
Core inflation	0,9	1,1	0,8	0,1	0,0
Prices of agricultural products	0,4	0,6	-1,0	0,3	0,1
Regulated prices	1,0	1,7	0,5	0,1	1,2
Electricity	0,0	0,8	0,0	0,0	0,0
Petroleum products	0,6	0,3	-0,2	-0,8	-0,1
Utilities	0,0	0,0	0,1	0,1	0,6
Social welfare services	0,0	0,0	0,0	0,1	0,0
Transport services (regulated)	0,0	0,0	0,2	0,0	0,0
Postal and telecommunications services	0,0	0,2	0,0	0,2	0,1
Cigarettes	0,0	0,2	0,2	0,3	0,4
Medications	0,2	0,0	0,1	0,1	0,0
Other	0,1	0,1	0,2	0,0	0,1

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[2] Monthly breakdown: January 0.0, February -0.2, March 0.1.
[3] For further information on accumulated real appreciation, i.e. appreciation gap, see *Appendix 2:* Medium-Term Core Inflation Projection Model, page 47.

Inflation Outlook for Q2 2007

Inflation rate (retail price growth) is determined by movements in its three components: regulated prices, prices of agricultural products and market–based prices – core inflation. According to our estimates, all of the three components will record smaller growth rates in Q2 than in Q1.

Several instances of upward revision are expected in respect of regulated prices. The 15% rise in electricity prices has already been announced. Price of electricity for households will be directly included in the calculation of the retail price index with 1.1 percentage point, while the increase in wholesale price of electricity is relevant in terms of its cost effects on core inflation. Surging oil prices will induce a leap in domestic prices of oil derivatives, whose growth is expected to range from 6 to 8% in Q2 (0.5-0.7 percentage points). As for other regulated prices, a 7% rise has been announced for prices of medicaments, nearly half of which will be increased in the course of Q2 (0.1 percentage point).

Several factors are expected to exert their influence over core inflation in the second quarter: 1) rise in energy prices (electricity and oil derivatives) fed through increased production costs; 2) appreciation gap of the real exchange rate that will continue to produce disinflationary pressures in the oncoming period, and 3) nominal depreciation of the dinar through a rise in import prices. Altogether, quarterly core inflation rate is expected to rise to 0.7-1.1%, while year-on-year core inflation is projected to continue declining to below 3% by the end of Q2.

In the second quarter, prices of agricultural products will experience a seasonally-induced growth of 8-14%, thereby contributing 0.3-0.5 percentage points to retail price growth. It should be noted though, that strong growth in prices of agricultural products is typical of the second quarter as seasonal fruits and vegetables first appear on the market (tomatoes, cucumbers, cherries, raspberries…). However, as the quantity of such fruits and vegetables is limited, their offer prices are significantly higher than those recorded at times of abundant supply in full season. The increase in supply of these products in the third quarter is usually followed by a sharp drop in prices. Both supply and prices are very much dependent on weather conditions[4].

Based on the above expected movements in regulated prices, prices of agricultural products and core inflation, the retail price growth has been estimated to around 3% in Q2, whereas year-on-year, it is expected to amount to around 5% at end-Q2.

Table II.0.4

Major revisions of regulated prices expected in Q2

	Growth rate (in %)	Contributions to retail price growth (p.p.)
Electricity	15	1,1
Petroleum products	6-8	0.5-0.7
Medications	3.7	0.1

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[4] This is the main reason why prices of agricultural products are not included in the calculation of core inflation in spite of the fact that they are freely formed.

Price Growth Components

Retail price index is the most frequently used measure of inflation in Serbia. It measures changes in prices of two main groups of products: products sold at regulated prices and those sold at non-regulated prices. Non-regulated prices are entirely market-determined. However, within the group of products sold at non-regulated prices, agricultural products represent a group of products whose prices are strongly influenced by supply. Regulated prices are set by the government.

Hence, from the aspect of monetary policy management, retail price index is not a fully adequate measure of inflation. Retail price index is liable to the impact of temporary changes (seasonal fluctuations), as well as external shocks (such as hike in world prices of oil and other primary products).

For this very reason, the National Bank of Serbia decided to target core inflation - an indicator of inflation which falls under the sway of monetary policy and excludes current and seasonal effects.

Core inflation is calculated by applying the exclusion-based method, whereby regulated prices and prices showing seasonal fluctuations (agricultural products) are excluded from the retail prices index calculation. In the past few years, regulated prices accounted for around 45% of the retail price index.

Price growth components	Weights
Total	**10000**
Core inflation	5181
Non-core inflation	4819
Agricultural products	325
Regulated prices	4494
Electricity	716
Oil derivatives	902
Utilities	811
Social welfare services	156
Transport services	318
Postal and telecommunications services	465
Cigarettes	319
Medicaments	229
Other	587

As the percentage increase in some of the regulated prices (electricity, for instance) is established in advance, forecasting headline inflation based on core inflation is made slightly easier. Although changes in regulated prices do not affect core inflation directly, they do exert an indirect impact through the cost effect transmission.

Consumer Price Index

Consumer price index represents an official measure of inflation in Serbia. Early this year, Serbian Bureau of Statistics disclosed for the first time ever the level of the consumer price index. It is used in a number of countries as the key indicator of inflation and is calculated according to the methodology of Harmonized Index of Consumer Prices in the EU (HICP).

Methodological differences between the retail price index and the consumer price index are reflected in the scope of coverage of products whose prices are analyzed, as well as in the calculation of their respective weights. Namely, the consumer price index includes prices of services which are not included in the retail price index, such as catering, healthcare services, educational services, financial services and rentals, while the retail price index includes prices of construction material and intermediate materials which are excluded from the calculation of the consumer price index. The weights used in calculation of the retail price index are derived from the structure of retail trade, while the weighting system of the consumer price index derives from the structure of household consumption harmonized with the structure of final household consumption taken from GDP.

Different weighting structures lead to varied contributions of selected categories of products to the overall price growth, which explains the differences in indices calculated for the same period. Namely, year-on-year price growth measured by retail price index stood at 5.6% in March, whereas measured by consumer price index, it equaled 4.1%.

In the first quarter of 2007, prices went up by 0.7% in terms of CPI, while in terms of RPI they rose by 1.2%. However, the lower rise of CPI was not due to the effect of services covered by the consumer price index (and excluded from the retail price index) but to smaller weights of regulated prices. Namely, prices of utilities, which were the largest contributors to retail price growth in Q1, have a substantially lower weight in the CPI, wherefore price growth measured by this index was smaller in the period observed.

As consumer price index is a generally recognized measure of inflation in a number of countries which all apply standard HICP methodology, its use will enable a more efficient comparative analysis.

III. Determinants of Inflation

1. Monetary Conditions

As the risk of inflation undershooting the target remained pronounced, the Monetary Policy Committee continued easing the monetary policy stance during Q1 by cutting the key policy rate. In Q1 2007, the key policy rate declined by a total of 350 basis points.

With real interest rates running above and real exchange rate below their respective medium-term trends[5], monetary policy remained tight in Q1 2007, although there are signs of its relaxation. In difference to Q2 2006 when the real exchange rate gap opened and real interest rates rose well over their historical trend, in Q1 2007 both the real exchange rate and the real interest rate followed the trend. Such development was to be expected, given the low rate of core inflation recorded in Q1 2007 and the growing risk that inflation will undershoot the lower bound of the target corridor this year again.
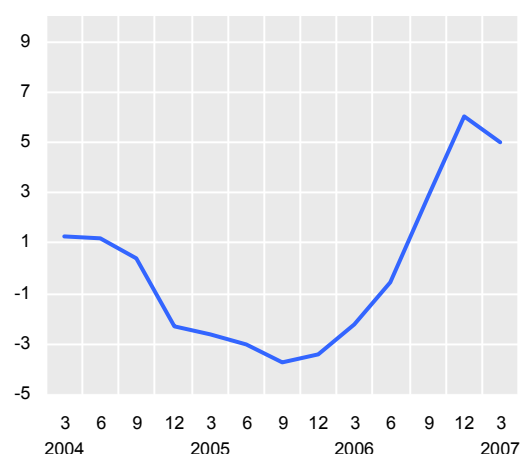
Movements in the monetary conditions index, as an indicator of the combined effect of real interest rates and real exchange rate on price stability and/or aggregate demand[6], also reveal the easing of monetary conditions and relaxation of monetary policy in Q1.

The Monetary Policy Committee responded to continuing disinflation and negative core inflation in the first two months by slashing the key policy rate by a total of 350 basis points during Q1. In the same period, the dinar depreciated against the euro by around 3% in nominal terms.

Chart III.0.1.

Monetary Conditions Index (MCI)

Monetary policy is likely to be more expansionary in the period ahead. Expected price growth could lead to a decline in real interest rates, while the effect on the real appreciation gap is less certain as the dinar is expected to continue depreciating in nominal terms.

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[5] Such movements in the real exchange rate are indicative of higher appreciation of the real exchange rate than suggested by the assessment of its trend over the past four years.

[6] Monetary conditions index has been constructed to represent a weighted indicator value of the combined effect of the real exchange rate gap and the real interest rate gap. Constructing a synthetic indicator lowers the risk of error that would arise from a simplified partial consideration of effects of individual channels of the monetary policy transmission mechanism. Rise in the value of this index indicates a more restrictive monetary policy, while a drop in its value points to easing of monetary conditions.

Interest Rates

Money market interest rates declined in line with the key policy rate cuts. Downward tendency in lending and deposit rates also continued.

In the course of Q1, the MPC revised the key policy rate downward on three occasions: from 14% to 13% in January, and further down to 11.50% and 10.50% in March.

Gradual lowering of the key policy rate was accompanied by a decline in the weighted average interest rate on securities sold by the NBS in repo operations. On the last day of March, per annum repo rate stood at 11.40%, down by 390 basis points from end-2006.

Lowering of the key policy rate did not lead to a reduction in the volume of repo sales. Namely, in Q1, repo sale accounted for sterilization of RSD 887.6 billion, up by 46.52% from Q4 2006. Net stock of securities sold increased by RSD 16.3 billion, with two-week securities accounting for 79% and six-month securities for 21% of total stock.

Although **interest rates on Lombard loans** were lowered along with key policy rate cuts, there were no major changes in the use of this type of loan in Q1. **Interest rate on the deposit facility** declined by 300 basis points relative to end-2006.

Chart III.1.1.

Weighted average repo rate
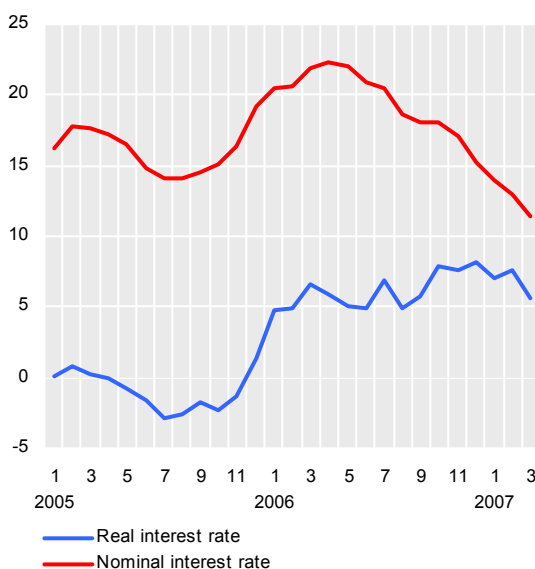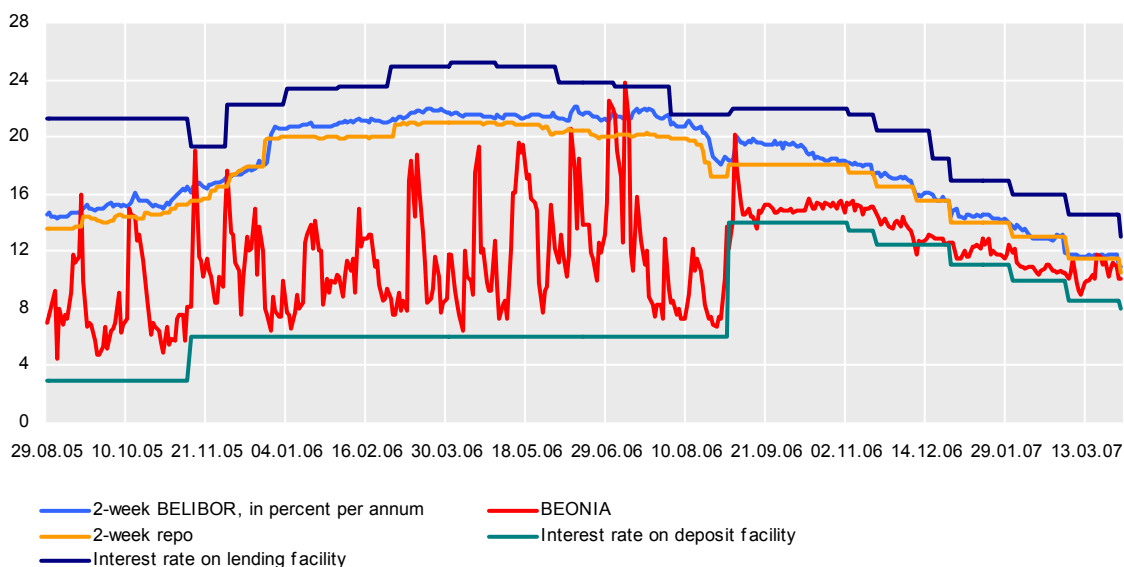nominal and real, deflated by annual price growth
(in percent per annum)

— Real interest rate
— Nominal interest rate

Chart III.1.2.

Interest rate movements
(daily data, annual level, in %)

— 2-week BELIBOR, in percent per annum
— 2-week repo
— Interest rate on lending facility
— BEONIA
— Interest rate on deposit facility

Source: National Bank of Serbia and Reuters.

Interest rates in the money market went down, reflecting the NBS key policy rate cuts. **Beonia** averaged 10.45% in March (down by 243 basis points from December 2006). Average daily amount of deposits came to RSD 1,548 million, down by RSD 709 million from December 2006.

Tomorrow Next and Spot Next (**Belibor** money market interest rates) averaged 10.41% in March. Average Belibor rates ranged from 11.08% for one-week maturity to 12.40% for six-month maturity.

As Beonia followed in the movements of interest rate on the deposit facility, instead of the key policy rate, the National Bank of Serbia took a decision in March to narrow its interest rate **corridor** by 1 percentage point, from six to five percentage points.

In line with the downward inflation trends, **money market yield curve** was at a lower level than in the preceding quarter. The yield curve slope declined with the increase of maturity, which is reflective of expectations of further decrease in interest rates.

Chart III.1.3.

Interbank money market yield curve
 (annual data)

Source: National Bank of Serbia and Reuters.
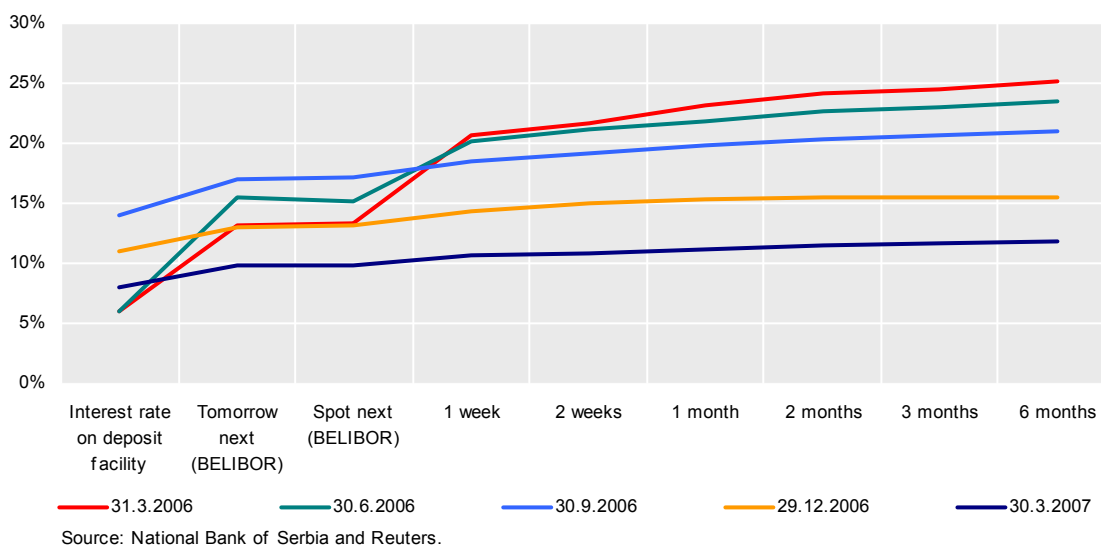
Weighted average interest rate on **total dinar deposits** trended down in the course of Q1 and in March came to 0.39% at monthly level or 4.69% at annual level[7]. Relative to end-2006, interest rates on total dinar deposits slid by 37 basis points at annual level.

Chart III.1.4.

Price of the third issue savings bills and time savings deposits
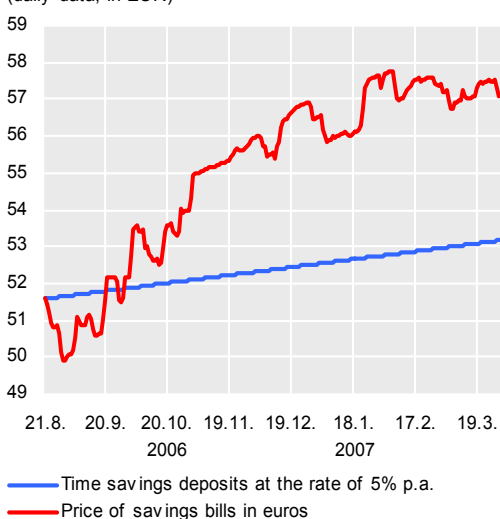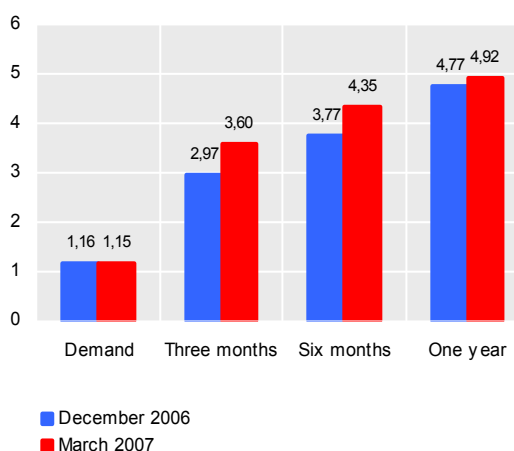(daily data, in EUR)

Chart III.1.5.

Weighted average interest rate on foreign currency savings deposits*
(in percent per annum)

*Analysis captured eight commercial banks with the highest volume of foreign currency savings deposits.

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[7] The monetary statistics methodology applied envisages monitoring of interest rates on dinar deposits only.

In order to influence the level of interest rates on dinar deposits, encourage commercial banks to collect dinar savings, as well as to mop up excess dinar liquidity, the National Bank of Serbia continued issuing and selling its **savings bills**. The first quarter of 2007 saw one issue of NBS savings bills with the interest rate of 14% p.a.

Lower interest rate by no means diminished households' interest in buying savings bills as a competitive investment option in the environment of stable exchange rate and prices.
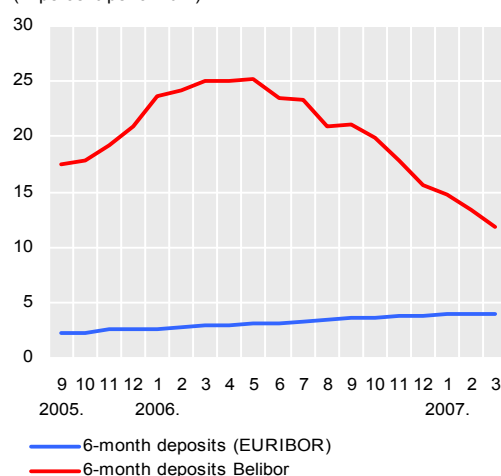
Analysis of data for eight leading banks in terms of volume of foreign currency savings deposits indicates that there was a decline in March in the weighted average interest rates on demand savings deposits, while interest rates on time deposits with three, six and twelve month maturity, rose.

Commercial bank lending rates[8] trended down in Q1 and in March came to 1.04% per month or 12.95% per annum. Compared to end-2006, total lending rates fell by 293 basis points at annual level.

Chart III.1.6.

Interest rate movements in the EU and Serbian money markets
(in percent per annum)

6-month deposits (EURIBOR)
6-month deposits Belibor

Source: Reuters and ECB, *Monthly Bulletin*.

Chart III.1.7.

ECB and FED interest rates
(in percent per annum)

FED ECB

Source: ECB, *Monthly Bulletin* and *Federal Reserve Bulletin*.

Chart III.1.8.

Weighted average interest rates on securities
(in percent per annum)

Republic of Serbia bills

Securities used by NBS in repo operations
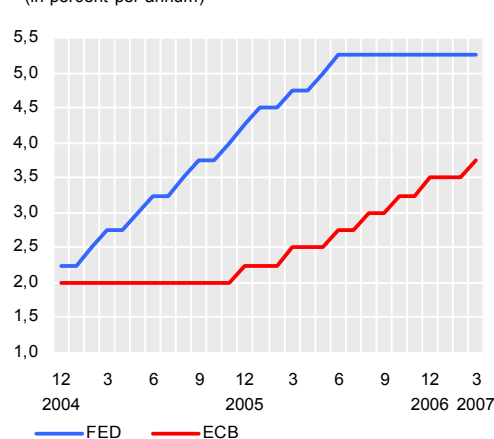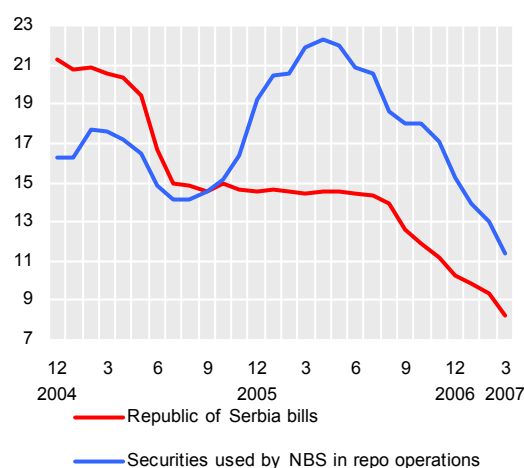
Source: NBS and RS Ministry of Finance.

Interest rate margin shrank on account of a stronger decrease of lending relative to deposit rates. It is expected that interest rate margin will continue decreasing due to increased competition among banks. However, one of the factors that could induce an increase in lending rates is a relatively slow restructuring of the economy and the resulting limitations on direct access of economic entities to foreign sources of finance.

The difference between interest rates in Serbia and those prevailing in the financial markets of the European Union and the USA continued to narrow down in Q1 2007 primarily on account of both falling interest rates in Serbia and interest rate hikes in the EU[9]. Albeit narrowed, interest rate differential continues high, which is the main reason behind the inflow of capital.

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[8] Monetary statistics methodology does not show loans with foreign currency clause separately but includes them under dinar loans. This has a direct impact on interest rate statistics, hence interest rates on dinar loans are calculated as weighted average of agreed interest rates irrespective of the foreign currency clause.

[9] The European Central Bank raised its policy rate in March to 3.75%, i.e. by 25 basis points, for the first time in 2007. Inflation and economic growth enabled the FED to take a decision in August 2006 to discontinue further growth in its policy rate and keep it at the level of 5.25%, where it also stood in March 2007.

Chart III.1.9.

Yield on government bills and frozen foreign currency savings bonds

(per annum)

Source: Belgrade Stock Exchange.
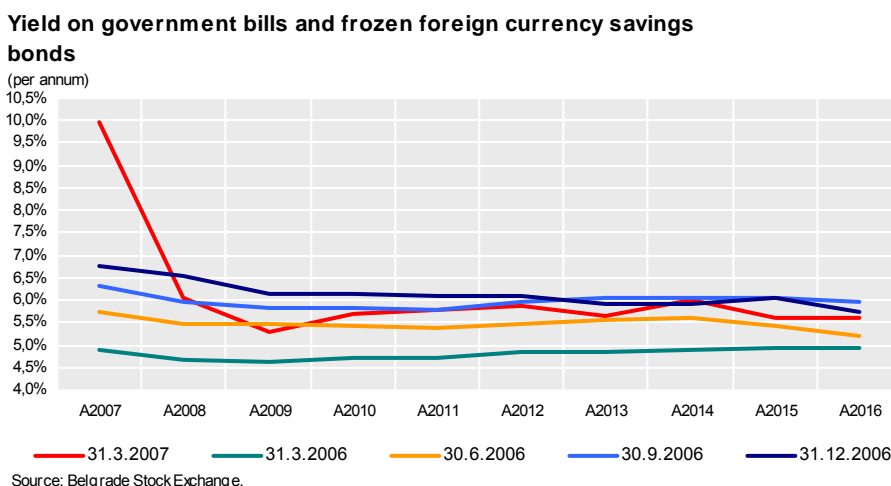
In the course of Q1, the Ministry of Finance held five auctions to sell 91-day maturity **government bills of the Republic of Serbia.** The overall volume of trade in government bills was modest and amounted to a mere RSD 3.9 billion as a result of relatively uncompetitive interest rate paid on government bills (8.21% in March) compared to the NBS rates on repo transactions.

Having declined by EUR 1.5 million from end-2006, the volume of trade in government bonds in the Belgrade Stock Exchange reached EUR 15.9 million in March. Bonds of all series, except A2014 series bonds, recorded a decrease in their annual yield rates. The yield rate on government bonds ranged from 5.30% to 6.05%, except for A2007 series bonds which recorded a 9.96% yield rate.

In March 2007, the overall volume of **trade in shares on the Belgrade Stock Exchange** hit its record monthly value of RSD 18.3 billion. In terms of volumes, trade in commercial bank shares remains on top.

Upward trend of the *Belexline index*[10] continued. On the last day of March, it reached 4,220.42 index points, up by 1,562.26 index points on end-2006.

Chart III.1.10.

BELEXline index
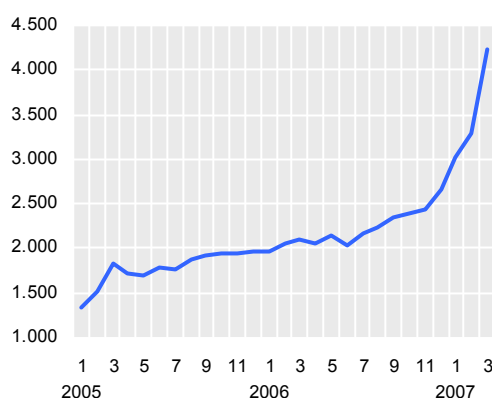
Source: Belgrade Stock Exchange.

Dinar Exchange Rate Movements

The dinar depreciated against the euro in Q1. The decline reflected high demand for foreign exchange by banks. To prevent further substantial weakening, the National Bank of Serbia responded by selling foreign exchange in the Interbank Foreign Exchange Market session.

Late-2006 depreciation of the dinar against the euro continued into Q1 2007. In the year to date, the dinar lost 3.2% (end of period) vis-à-vis the euro, in response to the NBS decision to cut the key policy rate.

At end-March, 1 EUR equalled RSD 81.5742, while the average nominal exchange rate of the euro in Q1 equalled RSD 80.0185.

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[10] Belgrade Stock Exchange decided to create and publish a new *Belexline* index. As opposed to Belexfm which includes the prices of all shares traded in at least one transaction within a day, *Belexline* indicates the movements in prices of a representative sample of securities traded in the stock exchange.

In Q1 2007, the dinar depreciated against the dollar by 1.9% in nominal terms. This was the first quarterly depreciation of the dinar against the dollar registered since 2005.

As the dinar weakened in nominal terms against both currencies constituting the "currency basket" used in calculating the nominal effective exchange rate index (with a 70% weight for the euro and 30% weight for the dollar), this index depreciated by 2.8%.

Weakening of the dinar in the period under review was due to the effect of demand-side pressures prevailing since the start of the year and occasioned primarily by increased bank demand for foreign exchange. Reduced foreign borrowing by banks in January and intensified demand for foreign exchange by bank clients in order that they settle foreign obligations as they come due were the main drivers behind high bank demand for foreign exchange.

Such high demand for foreign exchange and the resultant depreciation pressures in the first three months of the current year can be ascribed to lower net inflow of capital. Namely, net inflow of capital was, for the first time in a long while, insufficient to finance the current account deficit, which in turn resulted in a negative overall balance of payments position.

With a view to containing excessive depreciation, the NBS responded to high foreign exchange demand of banks and the resulting high depreciation pressures by intervention net sales of foreign exchange in the IFEM session. In January, interventions were substantial in value terms (EUR 412.4 million), while in February and March, the NBS intervened by selling foreign exchange on four occasions in the total amount of EUR 68.9 million.

Chart III.1.11.

Nominal exchange rate of the dinar
(in dinars, end of period)

USD —— EUR ——
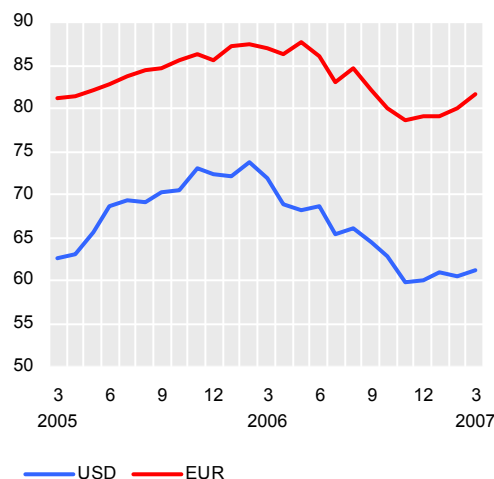
Chart III.1.12.

Year-on-year changes in the average nominal exchange rate of the dinar[1]
(in %)

EUR —— USD —— Currency basket ——

[1] Negative rates indicate depreciation and positive rates indicate appreciation of the dinar exchange rate.

On the other hand, in Q1 2007 the National Bank of Serbia purchased a net amount of EUR 242.9 million in exchange transactions, of which EUR 111.2 million in March alone.

Chart III.1.13.

NBS interventions in the fixing session[1]
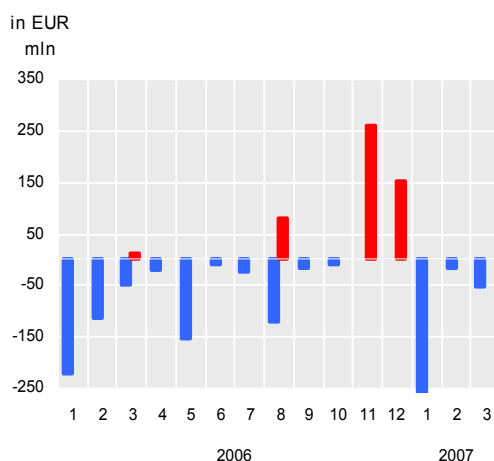
in EUR mln

[1] Positive values indicate purchase and negative values indicate sale of foreign exchange.

Chart III.1.14.

NBS interventions in the fixing session and average euro exchange rate

in EUR mln

NBS interventions in the fixing session
Average euro exchange rate

Chart III.1.15.

NBS interventions in the forex market and average euro exchange rate[1]

in EUR mln

- Forex market
- Exchange dealers and temporary payment transactions
- Average euro exchange rate

[1] Positive values indicate purchase and negative values indicate sale of foreign exchange.

Chart III.1.16.

Net NBS interventions in the foreign exchange market and average euro exchange rate

in EUR mln

- NBS interventions in the foreign exchange market
- Average euro exchange rate
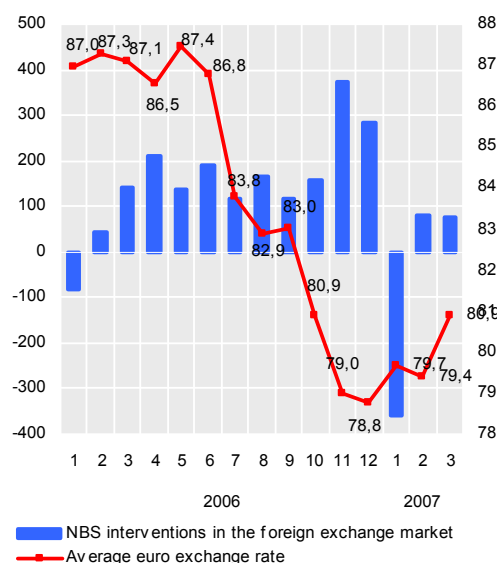
In Q1, the dinar exchange rate set in the Interbank Foreign Exchange Market session ranged between RSD 78.5050 and RSD 81.5742 for EUR 1. Although this is a relatively broad span, daily oscillations were more moderate than in the preceding quarter.

On 5 March, a new methodology was adopted for setting the middle exchange rate of the dinar against the euro. During that month, the NBS intervened in the IFEM session on three occasions only, by selling foreign exchange in the total amount of EUR 54.1 million, while direct interbank trading in the IFEM was worth a total of EUR 1.1 billion (which makes up over 95% of total trading in the IFEM). Therefore, it would be right to say that the March exchange rate of the dinar against the euro was fully market determined except on three days on which the NBS intervened in trading.
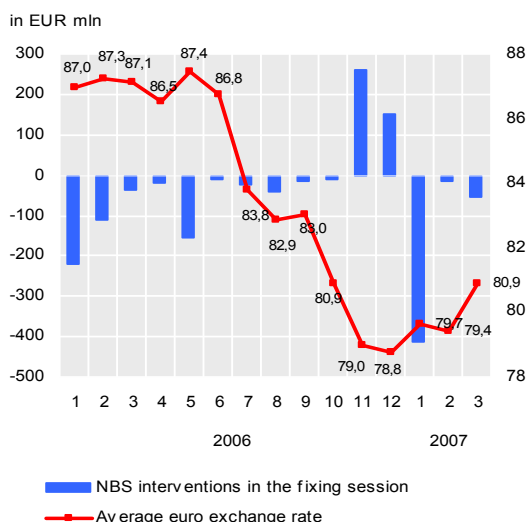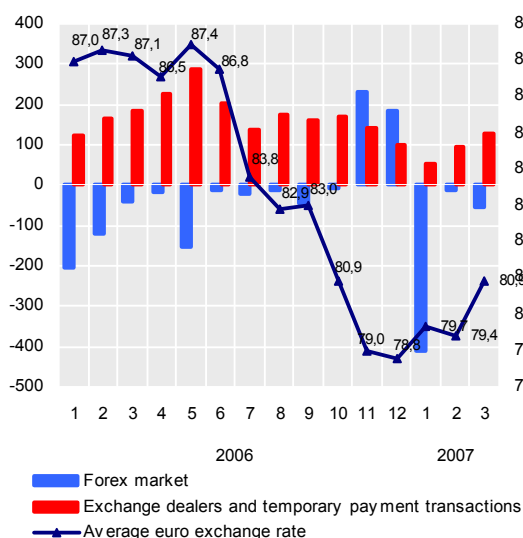
Chart III.1.17.

Daily changes in RSD/EUR exchange rate[1]

(in %)
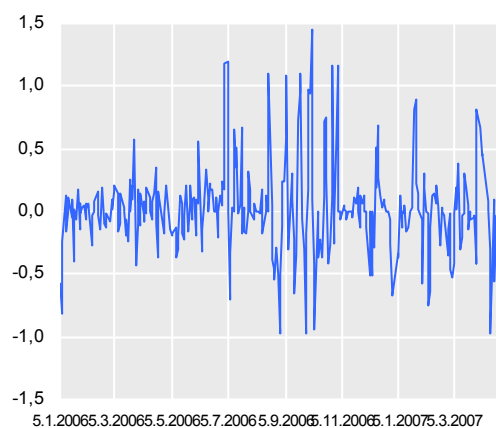
[1] Negative rates indicate depreciation and positive rates appreciation of the dinar.

Chart III.1.18.

Interbank trade in the IFEM

in EUR mln

- Outside the IFEM session
- IFEM session

As the March volume of direct interbank trading outside the IFEM session was almost 20 times larger than the volume of total trading in the IFEM session, it is clear that bank demand for foreign exchange

was met primarily from interbank trading outside the IFEM session, which is of particular importance given the new methodology for setting the exchange rate.
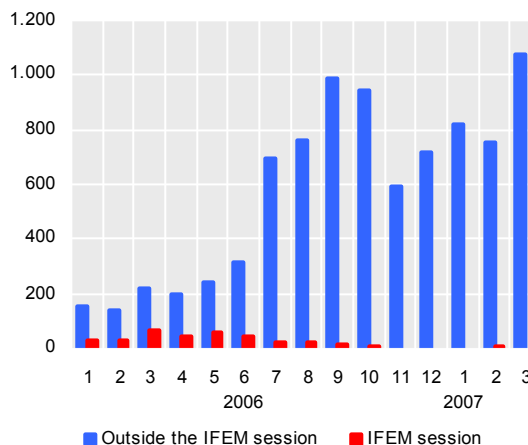
As a result of depreciation of the nominal effective exchange rate and faster growth in domestic compared to foreign prices, the real effective exchange rate of the dinar depreciated by 2.3% in Q1. In terms of individual currencies, the dinar depreciated both against the euro (2.4%) and against the dollar (2.2%) in real terms.

Year-on-year, the real effective exchange rate appreciated by 15.7%, while the real exchange rate of the euro and the dollar appreciated by 12.8% and 22.4%, respectively.

The pace and the size of change in the NBS key policy rate will reflect on the degree of depreciation of the national currency. In view of developments in the foreign exchange market and the effect of monetary policy measures, depreciation of the nominal exchange rate will have inflationary effects in the period ahead.

Chart III.1.19.

Year-on-year changes in the average real exchange rate of the dinar[1]
(in %)

EUR   USD   Currency basket

[1] Negative rates indicate depreciation and positive rates indicate appreciation of the dinar exchange rate.

Table III.1.1
Composition of trade in the IFEM in 2007
(in % of total trade)

	Jan	Feb	Mar	Q1
IFEM	100,00	100,00	100,00	100,00
fixing session	*33,72*	*3,08*	*4,91*	*15,77*
outside fixing	*66,28*	*96,92*	*95,09*	*84,23*
NBS - banks	33,42	1,91	4,77	15,32
in IFEM session	*33,42*	*1,91*	*4,77*	*15,32*
outside IFEM session	*0,00*	*0,00*	*0,00*	*0,00*
Bank - bank	66,58	98,09	95,23	84,68
in IFEM session	*0,29*	*1,17*	*0,13*	*0,45*
outside IFEM session	*66,28*	*96,92*	*95,09*	*84,23*

Table III.1.2

Composition of interbank trade in the IFEM in 2007
(in % of total interbank trade)

	Jan	Feb	Mar	Q1
Bank - bank	100,00	100,00	100,00	100,00
in IFEM session	*0,44*	*1,20*	*0,14*	*0,53*
outside IFEM session	*99,56*	*98,80*	*99,86*	*99,47*

Chart III.1.20.

NBS trade in the IFEM session and exchange rate of the euro

(in EUR mln)

NBS interventions in the IFEM session (left scale)
Exchange rate (right scale)
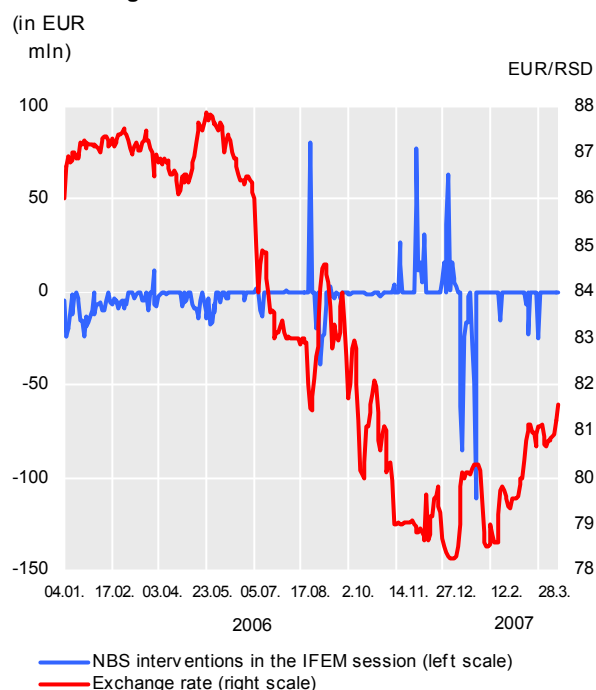
2. Import Prices

Imported inflation was positive and significantly higher than core inflation for the first time in a long while. Downward trends in world oil prices in place from September last year, rebounded in February, while March saw even stronger growth.

Following a period of high imported inflation in the second half of 2006, import prices picked up by 4.3% (per annum average) in the first quarter of 2007, as a result of 2.3% nominal depreciation of the dinar against the euro (per annum average) and 0.8% Euro zone inflation (per annum average). However, such flows did not halt the decline in core inflation, set in motion in early 2006, so that core inflation was lower than imported inflation for the first time in a long while.

After falling sharply in Q3 and settling in Q4 2006, oil prices continued down at a moderate pace in January 2007. At end January, the price of Ural oil stood at around USD 53 and it seemed reasonable to expect that it would settle between USD 50 to 55 per barrel. Such expectations regarding price growth and a further moderate decline in the year to December 2007 were justified by forecasts of slower economic growth in the largest oil-importing countries and stabilization of the geopolitical situation. However, a change in trend occurred as early as in February. The increase in oil prices at end-February relative to end-January measured 8%. The price hike continued at a still faster pace in March. Rising by 14% relative to end-February or by as much as 23% relative to end-January, the price of Ural oil shot past USD 65 by the end of Q1. As a consequence, prices of oil derivatives were revised up on five occasions in the course of the first quarter, by around 12% in total.

The main reason behind the February onset of growth in oil prices were reports of depleted oil inventories in the United States, as well as the aggravated geopolitical situation (escalation of conflict in Nigeria, the largest oil producer in Africa, and the unresolved dispute over the Iranian nuclear program).

The US oil inventories were significantly lower in Q1 than in the same period a year earlier due to forced operational outages and regular overhauls in oil refineries, sluggish imports and increased demand for oil. Lower level of oil supplies has given rise to concerns that production will not meet demand on the eve of the summer driving season.

Trends in prices of primary products were similar to those of oil prices, the main difference, however, being a considerable drop in prices of primary products in January 2007 relative to December 2006 (8%). As with oil prices, February witnessed a turnaround in primary product price fortunes – they gained 5.5% relative to January, and yet another 4% in March relative to February. Thus, and due primarily to increased demand, after their February and

Chart III.2.1.

Core and im ported inflation
(annualized quarterly growth rates)
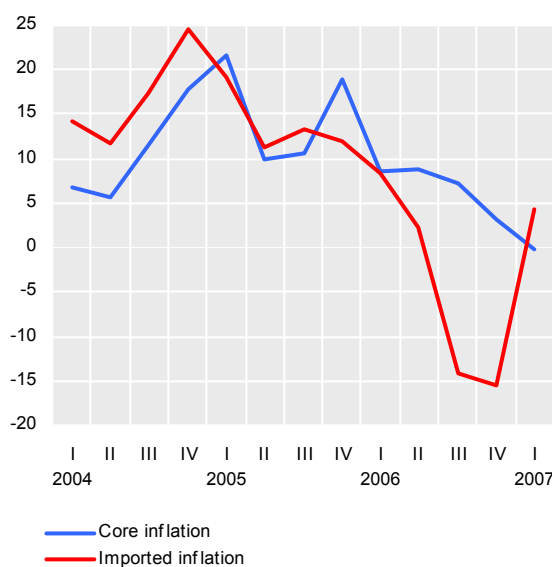
Source: NBS and Eurostat.

Chart III.2.2.

Oil prices
(in US dollars)

Source: Reuters.

March upswing, prices of primary products fell back, by end-Q1 to their end Q4 level, i.e. they were higher by 1% than at end-Q4 2006.
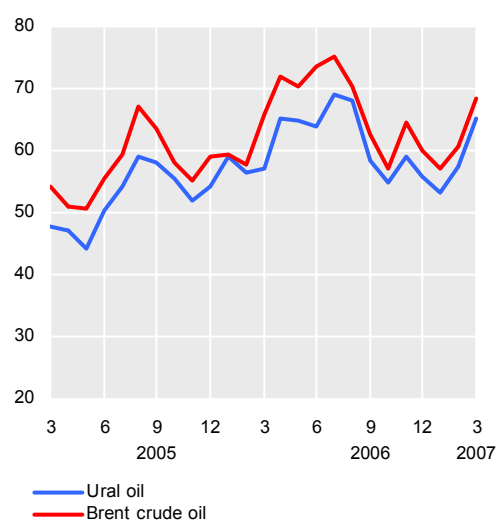
Import unit value was 5.1% higher in the first two months of 2007 than in the same period a year earlier. Import price flows in the preceding period reflected a combination of inflationary and anti-inflationary pressures. Inflationary pressures included growth in prices of raw materials, partly attributable to stepped up economic growth in some countries (in addition to other factors such as reduced supplies, geopolitical instability, climate conditions, and market speculations), while liberalization of world trade, which allowed for imports of larger quantities of goods from those countries (primarily China), and the resultant increase in competition and decrease in prices of manufactured goods, had a disinflationary effect. Movements in prices of raw materials reflected on the growth of Serbian imports of intermediate goods (6.6%), while their secondary effect remains visible not only in the rise of import unit value for other two categories – consumer goods (by 3.2%) and capital goods (by 0.9%), but also in the rise of domestic industrial producer prices (increase in producer prices of clothing, footwear, furniture and household appliances is particularly important in terms of the consumer price growth).

Growth in import prices of consumer and capital goods was slow as a consequence of globalization, although a significant contribution to such developments, at least in terms of capital goods, came from increased imports of cheaper equipment from China. Capital goods from the European Union accounted for a stable 70% of total imports of capital goods. Nevertheless, the past several years have witnessed steady growth in imports of capital goods from China, whose share in total imports of capital goods rose from 3% in 2000 to 11% in 2006.

Table III.2.1

Unit import values by purpose of goods

Classification	Share in total imports (in %) period I-III 07	Indices of unit value of imports for period I-II 07
BY PURPOSE :	100,0	105,1
intermediate goods	62,3	106,6
consumer goods	21,1	103,2
capital goods	16,6	100,9

Note: Serbian Bureau of Statistics calculates unit values of imports and exports in USD for current year period in comparison to the same period a year earlier, whereas the quantities of imports in the period under review serve as weight.

3. Balance of Payments

Balance of payments flows in Q1 point to continuation of the trend from Q4 2006 characterized by high current account deficit due primarily to large trade deficit. The capital and financial accounts reflect the effects of liberalization of transactions. Substantial portfolio investment in domestic investment funds in the period under review is expected to improve efficiency of local investments, increase liquidity and deepen local equity market, as well as induce downward revision in interest rates. Early repayment of the IMF debt in full led to a decline in NBS foreign exchange reserves.

In Q1 2007, **current account** deficit rose slightly on the preceding quarter (by 4.7% or 3.1% excluding grants), while its ratio to estimated GDP remained broadly unchanged from Q4 2006 (around 4.5%). Trade deficit also remained almost equal to its level recorded in a quarter earlier.

Relative to Q1 2006, current account deficit widened by 83.0%, while trade deficit grew by 40.5% as a result of high export growth (by 45.7%) and stepped up imports (43%). In addition to **foreign trade deficit,** net inflow in respect of current transfers that declined by 12.1% from the preceding quarter also contributed to the Q1 2007 current account deficit.

The inflow in respect of current transfers declined as a result of a USD 102 million drop in inflow from exchange transactions. The latter inflow declined most in January (due to uncertainties surrounding parliamentary elections), only to pick up over the next two months. The decline in net inflow in respect of exchange transactions did not result from diminished inflow of remittances, but from increased purchases of foreign exchange and foreign exchange savings. On the other hand, the inflow in respect of foreign currency accounts of non-residents rebounded and served for portfolio investments in investment funds and capital increase of banks.

Data on trade in goods point to continued upswing in exports and accelerated growth in imports. Exports declined by only 5% and imports by 2% from Q4 2006, while higher than seasonally expected year-on-year growth in exports exceeded that in imports. Export to import cover ratio dropped by 1.5 percentage points (from 51% to 49.5%).

Such growth in exports of goods resulted from favourable terms of trade (which improved by 9.3% in the first two months on a year earlier, with

Table III.3.1

Balance of payments of the Republic of Serbia
(in USD mln)

	2006	2007	Change
	Q4	Q1	(in %)
I. CURRENT ACCOUNT	-1.445	-1.513	4,7
Commodity trade, net	-1.842	-1.861	1
Exports, f.o.b.	1.915	1.820	-5
Imports, f.o.b.	-3.757	-3.680	-2
Services, net	-49	-13	73,5
Receipts	622	581	-6,6
Payments	-671	-594	-11,5
Interest, net	-102	-110	-7,8
Current transfers, net	473	416	-12,1
Grants	74	54	-27
II. CAPITAL AND FINANCIAL ACCOUNT	3.115	1.326	-57,4
Capital transfers	430	-421	-197,9
Direct investments, net	1.737	873	-49,7
Portfolio investments, net		353	
Medium- and long-term foreign credits, net	181	398	119,9
of which: early debt repayment	-656	-232	
Foreign lending, net	31	3	
Short-term credits and deposits, net	189	-290	-253,4
Deferred payments for oil and gas	60	50	
Commercial banks, net			
(increase -)	40	2	
Other capital, net	447	359	
III. ERRORS AND OMMISSIONS	-98	-88	
IV. OVERALL BALANCE OF PAYMENTS			
(I + II + III)	1.572	-275	
V. NBS FOREIGN EXCHANGE RESERVES			
(increase -)	-1.572	275	

Chart III.3.1.

Exports and imports
(in USD mln)
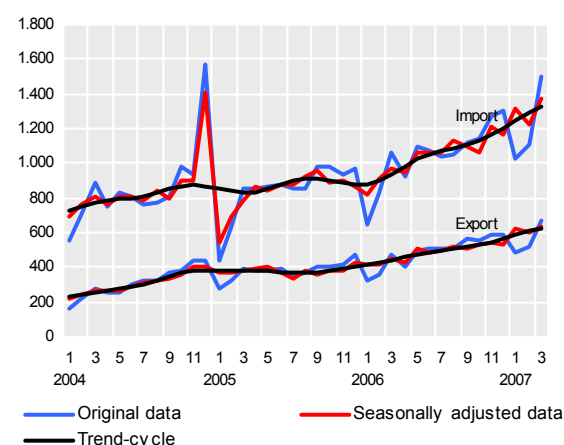
Note: For the purpose of comparability with the preceding period, data for 2005 and 2006 do not include trade with Montenegro.

export unit value rising by 14.9% and import unit value by 5.1%), as well as the effects of greenfield investments from a year earlier. Imports of goods were influenced primarily by a rise in investment and intermediate demand.

In terms of broad economic category, exports of intermediate goods rose by 1.7% in Q1 on the preceding quarter, while imports of capital and intermediate goods rose by 1.6% and 0.1%, respectively. Breakdown by SITC section shows that the largest export growth on a quarter earlier was recorded for mineral ores (as a result of increased exports of zinc), power-generating and specialized machinery, rubber, articles of apparel, footwear, cork and wood, while dominant categories of imports included industrial machinery, telecommunications equipment, iron and steel, gas, electric current and chemicals.

Breakdown by economic region indicates that exports to EU and Central and East European countries and imports from the EU member countries increased the most, year-on-year.

Balance on trade in services improved somewhat on the preceding quarter, with receipts declining less (by 6.6%) than payments (by 11.5%), on account of receipts in respect of investment works abroad.

Table III.3.2

Commodity trade by economic category

(in USD mln)

	2006	2007	
	by quarter		Indices
	Q4	Q1	
EXPORTS	1.899	1.823	96,0
capital goods	116	103	88,8
intermediate goods	1.246	1.267	101,7
consumer goods	537	453	84,4
IMPORTS	3.890	3.826	98,4
capital goods	624	634	101,6
intermediate goods	2.381	2.383	100,1
consumer goods	885	809	91,4

Table III.3.3

Commodity trade by economic group

(in USD mln)

	2006 Q1	2007 Q1	Indices
EXPORTS	1.242	1.824	**146,8**
EU 25	760	1.108	145,9
CEEC	335	514	153,4
CIS	81	109	134,2
EFTA	8	15	178,9
IMPORTS	2.663	3.826	**143,6**
EU 25	1.394	2.050	147,1
CEEC	190	265	139,5
CIS	579	783	135,1
EFTA	30	42	141,2

The volume **of regular interest payments** to foreign creditors matched that recorded in the preceding quarter (USD 161 compared to USD 165 million), while interest receipts declined by USD 11 million, mainly on account of a drop in NBS foreign exchange reserves. Hence, net outflow in respect of interest went up by USD 8 million.

The deficit on goods, services and interest remained practically unchanged from a quarter earlier. As in Q1 2007, **current transfers** managed to offset 21% of the above deficit against 23.7% in Q4 2006, the current account deficit (grants excluded) widened by USD 47 million. However, in view of the causes for the decline in net inflow in respect of exchange transactions in current transfers, current transfers may be said to have offset the deficit on goods, services and interest by the same amount as in the preceding quarter.

Net capital inflow amounted to USD 1,326 million, down by 57.4% from the preceding quarter when it reached the record high of USD 3,115 million.

Foreign direct investment declined by 49.7% to USD 873 million. Of this amount, USD 424 million related to Mobilkom Austria's investment in its Belgrade company, USD 422 million of which was spent for the purchase of license in Austria (as shown on the capital account).

Chart III.3.2.

Current transfers over deficit on the balance of goods, services and interest

(in USD mln)

Deficit on the balance of goods and services
Deficit on the balance of income (interest)
Current transfers
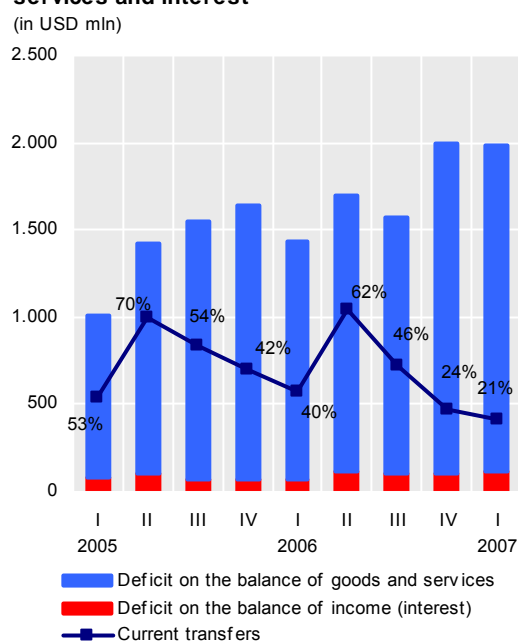
Chart III.3.3.

Current account deficit and net inflow of capital
(in USD mln)

■ Current account deficit

■ Surplus on the capital and financial account (including errors and omissions)
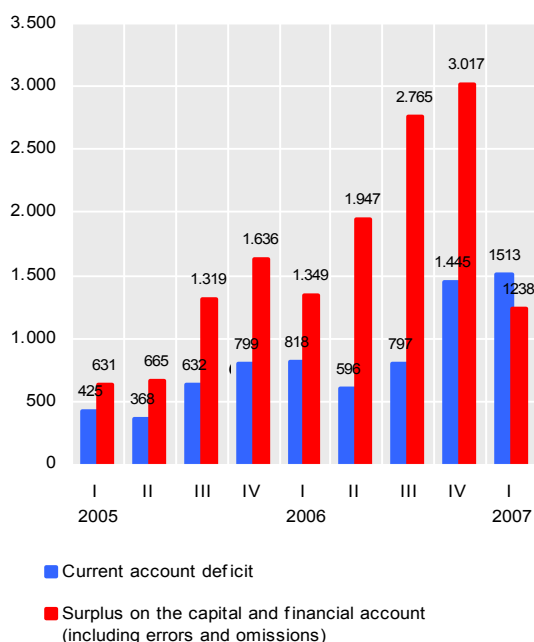
Chart III.3.4.

Structure of capital inflow
(in USD mln)

■ Foreign direct investment, net

■ Borrowing, net (including early repayment of debt)

□ Other inflow, net
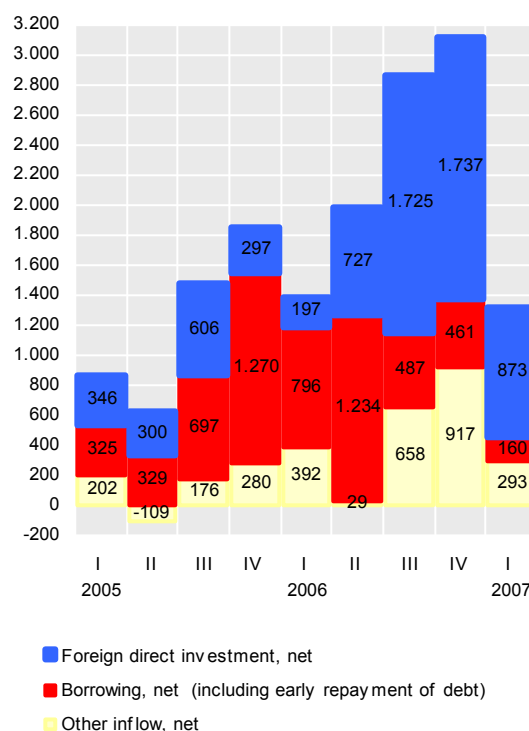
Owing to further liberalization of capital transactions i.e. entry into force of secondary legislation pertaining to the Law on Foreign Exchange Operations early this year, foreign **portfolio investment** in investment funds and capital increase of banks picked up. Such developments are expected to lead to more efficient local investments, growth in liquidity, deepening of the domestic equity market and lowering of interest rates.

Continued downward trends of foreign borrowing represent a positive change on the financial account. Early debt repayment excluded, net **disbursement of foreign long-term credit** declined by USD 207 million or 24.7% from the preceding quarter. The first quarter of 2007 witnessed early repayment of debt to the IMF in the amount of USD 232 million, on account of which external debt of the public sector slid from USD 8.4 billion in Q4 2006 to USD 8.2 billion.

Net long-term borrowing of the private sector was lower by USD 222 million relative to the preceding quarter. Net long-term borrowing by banks continued

Medium- and long-term external credit
(in USD mln)

■ Credit disbursement

■ Early repayment of principal and interest

■ Regular repayment of interest

■ Regular repayment of principal

down and amounted to USD 49 million at end-Q1. Similar trends were also recorded for enterprises, whose net long-term borrowing declined from USD 662 million to 568 million.

Obligations in respect of net **short-term credit and deposit** declined by USD 290 million, mainly due to capital increases of the banking sector, while growth in **new foreign currency savings** continued the brisk pace from Q4 2006 (up by USD 450 million).

Though decline in NBS foreign exchange reserves in the first quarter is seasonally induced, their decrease in Q1 2007 was a consequence of early repayment of debt to the IMF, due to which the balance

on capital and financial accounts was lower by USD 187 million than the current account deficit. It should be noted that an outflow of USD 88 million was recorded in respect of errors and omissions. With inter-currency changes excluded, **NBS foreign exchange reserves** decreased by USD 275 million, or USD 157 with inter-currency changes included.

At end-Q1 2007, NBS foreign exchange reserves stood at USD 11,730.5 million or EUR 8,787.6 million, which represents a negligible drop relative to end-2006. Due to such decline, foreign exchange reserves covered 8 months of imports of goods and services[11] by the end of the first quarter.

Chart III.3.6.

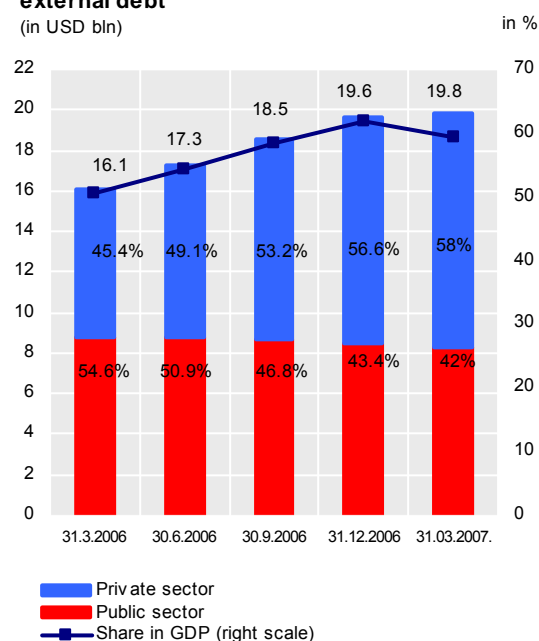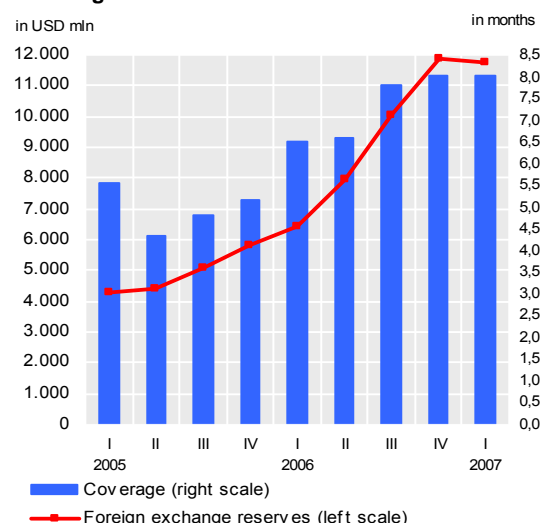**Level and structure of Serbia's external debt**
(in USD bln)

Chart III.3.7.

Coverage of imports by foreign exchange reserves

In Q1, **outflows from foreign exchange reserves** were recorded primarily on account of NBS direct interventions in the foreign exchange market, prompted by particularly pronounced depreciation pressures (5.3 p.p. contribution to the decline in foreign exchange reserves). Apart from this, outflows from foreign exchange reserves were also registered in respect of early repayment of the remaining debt to the IMF and other foreign creditors.

The largest contribution to the increase in NBS foreign exchange reserves came from net purchase of foreign cash from exchange dealers (2.7 p.p.), while allocation of foreign currency required reserves (1.5 p.p.) followed behind.

At end-Q1, the country's overall foreign exchange reserves came to USD 12,483.6 million (EUR 9,351.8 million), of which foreign exchange reserves of authorized banks amounted to USD 753.1 million (EUR 564.2 million).

Table III.3.4

Contribution to NBS foreign exchange reserves growth rate
(in percentage points)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
NBS foreign exchange reserves (growth in %)	**10,5**	**23,6**	**25,6**	**18,7**	**-1,3**
Foreign exchange market	2,0	10,4	6,4	10,0	-2,2
Exchange transactions	*7,3*	*11,0*	*7,0*	*4,8*	*2,7*
Direct NBS interventions in the foreign exchange market	*-7,6*	*-3,6*	*-1,2*	*5,3*	*-5,3*
Temporary payment transactions [1)]	*2,3*	*3,0*	*0,6*	*0,7*	*0,4*
Reserve requirement on foreign currency deposits and credits, and new foreign currency savings deposits	5,6	16,9	4,4	1,1	1,5
Foreign credits to government	0,8	0,3	0,6	0,3	0,4
Grants	0,3	0,3	0,2	0,3	0,2
Frozen foreign currency savings deposits and Economic Development Loan	-0,1	-3,1	-0,8	-0,2	-0,1
Other[2)]	1,9	-1,2	14,8	6,6	-1,2

[1)] Payment transactions with Montenegro (until 26 June) and Kosovo and Metohija.
[2)] Includes privatization receipts, IMF credit, etc.

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[11] Import coverage by foreign exchange reserves is calculated as the ratio of foreign exchange reserves to average quarterly value of imports of goods and services.

4. Monetary Flows and Policy

Monetary flows in Q1 2007 were characterized by an expected seasonal withdrawal of reserve money and dinar component of money supply, continued growth in money supply M3 and intensified lending activity of banks. Increased money supply and intensified lending activity did not, however, trigger a rise in prices.

Monetary Aggregates

Reserve money dropped by over RSD 30 billion in nominal terms since the start of the year. Despite such notable decline, which was partly seasonally induced, the March year-on-year growth rate of reserve money was very high and reached 24.3% in real terms.

In Q1 2007, reserve money was withdrawn primarily against growth in dinar government deposits with the National Bank on account of rising government revenue in respect of collection of VAT and excises. Following amendment to the Decree on Temporary Financing, the government effected two conversions of EUR 150 million each and retained a portion of the resulting dinar funds on its account with the National Bank, which also led to a rise in overall dinar deposits.

Money was also sterilized through outright and repo sale of NBS bills. In an environment of declining inflation, banks continued to invest in repo securities as real yield on these securities remained competitive despite key policy rate cuts. However, as opposed to the trend so far, the volume of the portfolio of securities declined slightly.

Another instrument of money withdrawal was the foreign exchange channel. Early in the year, money was withdrawn through larger interventions of the National Bank taken in response to increased bank demand for foreign exchange. As a consequence, gross foreign exchange reserves declined in January for the first time in several years. This decline, however, is no cause for concern, as gross foreign exchange reserves at present cover eight months of imports. Relative to January, February saw money creation on account of much smaller sized NBS interventions in the interbank foreign exchange market and much higher inflows in respect of foreign cash purchases. In March, inflow in respect of exchange transactions increased, but so did the volume of interventions relative to February. Overall, net foreign assets contributed negatively to the reserve money growth rate in Q1, with 1.3 percentage points (taking into account the effect of the decline in government foreign currency deposits, which were withdrawn in the period under review).

Chart III.4.1.

Reserve money creation
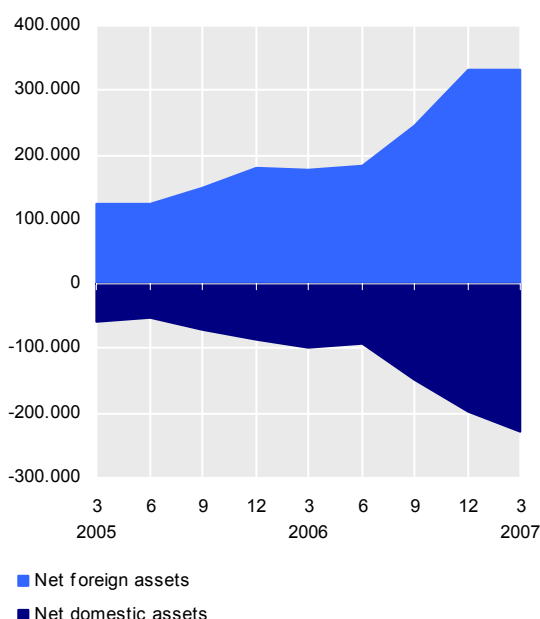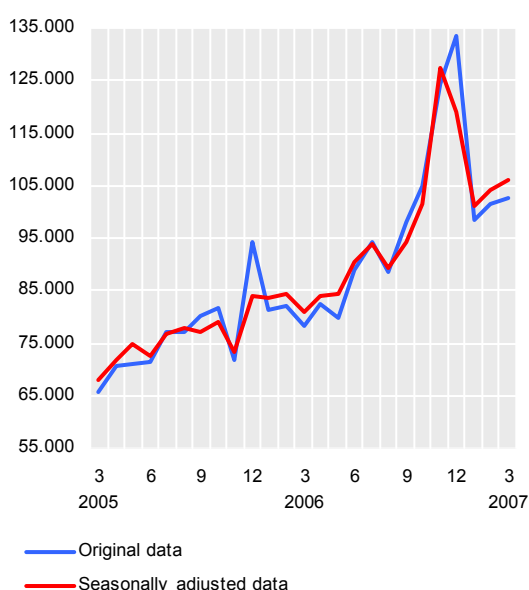(cumulative changes in million dinars)

■ Net foreign assets
■ Net domestic assets

Chart III.4.2.

Reserve money
(in RSD mln)

—— Original data
—— Seasonally adjusted data

Of reserve money elements, both currency in circulation and overall bank reserves have been declining since the start of the year. Overall reserves declined as a result of a drop in excess deposits and a decline in calculated dinar reserve requirement occasioned by a 5-percentage point cut in the reserve requirement ratio. Currency in circulation went down partly on account of growth in dinar government deposits.

The decline in reserve money was followed by accelerated monetary multiplication, as dinar deposits of non-monetary sectors declined less than reserves of banks. Although in Q1 2007 dinar deposits of non-monetary sectors and, consequently, dinar component of money supply, declined, primarily on account of settlement of tax obligations of the enterprise sector to the government, the already high growth rates of all monetary aggregates accelerated still further. Dinar deposits declined compared to end-2006 partly as a result of high interest displayed by households and domestic institutional investors in buying shares of domestic banks.

In contrast to dinar monetary aggregates, strong growth in foreign currency deposits of enterprises and households in Q1 2007, linked in part to nominal depreciation of the dinar, contributed to the rise in overall liquidity (M3).

Money supply M3 was created against net foreign transactions of the banking sector and against growth in bank lending activity, with the credit channel playing a predominant role. Bank lending to enterprises and households contributed 8.8 percentage points to growth in overall money supply (M3), which is a much higher contribution than in Q4 2006 (1.6 percentage points). However, when the effect of net foreign exchange transactions on money supply creation is calculated at the exchange rate valid at the end of the prior year, it becomes clear that the effect of money creation through the exchange rate channel is far smaller and that money creation through the foreign exchange channel is for the major part a consequence of nominal depreciation of the dinar.

Table III.4.1

Contribution of selected assets to reserve money growth rate[1]
(in percentage points)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Net foreign assets	9,7	51,8	21,1	86,7	0,0
Net domestic assets	-26,8	-38,0	-10,8	-50,6	-23,2
Domestic credit	-22,7	-45,1	-24,5	-42,1	-35,7
Net claims on government	-6,7	-12,6	4,1	28,6	-23,7
Net claims on banks	-15,2	-30,4	-28,7	-70,3	-12,2
Net claims on other sectors	-0,8	-2,1	0,1	-0,3	0,3
Other assets (net)	-4,1	7,1	13,7	-8,5	12,5
Reserve money	-17,1	13,8	10,3	36,1	-23,2

[1] Excluding foreign currency government deposits with the NBS.

Table III.4.2

Contribution of selected assets to M3 growth rate[1]
(in percentage points)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Net foreign assets	0,4	26,8	11,4	13,2	3,5
Net domestic assets	1,2	-18,1	-0,7	1	1,3
Domestic credit	8,7	4,6	2,6	7,8	3,1
Net claims on government	-2,4	-3,8	0,8	6,1	-5,1
Credit to other sectors	10,5	8,5	2,5	1,6	8,8
Households	3,7	4,6	3,3	3,1	4,3
Enterprises, in dinars	5,3	4,1	1,2	0,2	4,3
Enterprises, in foreign currency	1,4	-0,2	-1,8	-1,9	0,2
Other	0,1	0	-0,2	0,2	0,0
Redeemed frozen foreign currency savings bonds	0,6	-0,1	-1	0,1	-0,6
Short-term dinar government credit to banks	0	0	0,3	0	0
Other assets, net	-7,5	-22,5	-3,3	-6,8	-1,8
Money supply (M3)	1,7	8,9	10,8	14,2	4,7

[1] Excluding foreign currency government deposits with the NBS.

Chart III.4.3.
Movements in monetary aggregates deflated by retail prices
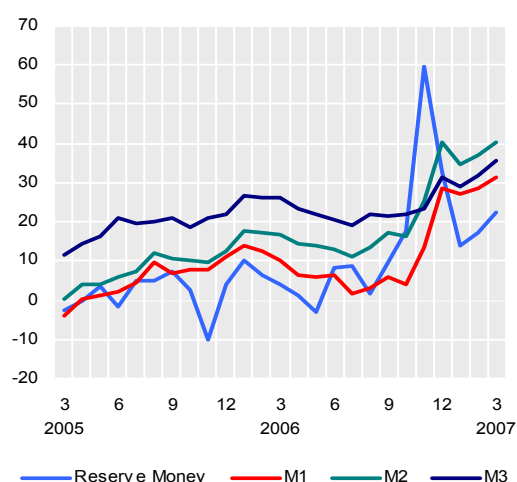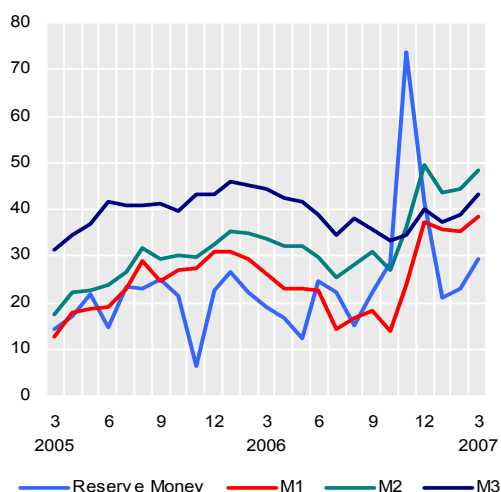(y-o-y growth rates, in %)

Chart III.4.4.
Movements in monetary aggregates
(y-o-y growth, in %)

In contrast to the above factors, money was withdrawn against a rise in government dinar deposits held both with the National Bank and commercial banks after deferral of implementation of the National Investment Plan in the absence of a budget resolution for 2007. Other contributors to money withdrawal included capital increase of banks and exchange rate gains/losses. Redemption of bonds issued against frozen foreign currency savings deposits by banks declined, as banks mostly invested excess liquidity in higher-yielding NBS bills.

Net foreign position of banks deteriorated since the start of the year, as their foreign obligations increased. On the other hand, foreign exchange reserves of banks increased as a result of a rise in foreign currency deposits of enterprises and households and in March reached their December 2006 level.

Bank Lending

By contrast to the latter half of 2006, when lending activity of commercial banks slowed down notably in response to a range of NBS measures, bank credit grew by over RSD 50 billion in the year to date. A major portion of this increase took place in March, but, according to preliminary data, the same growth pace continued into April, indicating a rebound in bank lending activity. Although annual growth rate in nominal credits approved to enterprises and households was lower in March, the real credit growth rate was higher than in late 2006 and equalled close to 20%.

The basic source of increase in bank lending in the period under review were domestic non-banking sector foreign currency deposits and intensified long-term foreign borrowing by banks during March. In Q1 2007, foreign sources contributed 1.87 percentage points to the increase in commercial bank credit, while the contribution of dinar and foreign currency deposits of enterprises and households equalled 7.7 percentage points. Banks also financed new lending by increasing their core capital (which contributed 5.6 percentage points), as banks in majority foreign ownership increased their capital on a continuing basis and banks in majority domestic ownership issued shares.

Breakdown by sector reveals that lending to government declined compared to end-2006. The volume of lending to local governments, however, remained almost unchanged, while lending to public enterprises rose mildly and lending to the private sector increased substantially. Though deficit financing of the budget continued, the government did not resort to any domestic bank credits in the year so far.

In Q1, lending to enterprises and households recorded more or less equal growth, which is a reversion of trend from the preceding two years. Household credits continued to rise unhindered by the fact that households borrowed on less competitive terms in an environment of high credit demand. Lending to enterprises also rose substantially, despite the fact that

Chart III.4.5.

Sources of bank lending growth
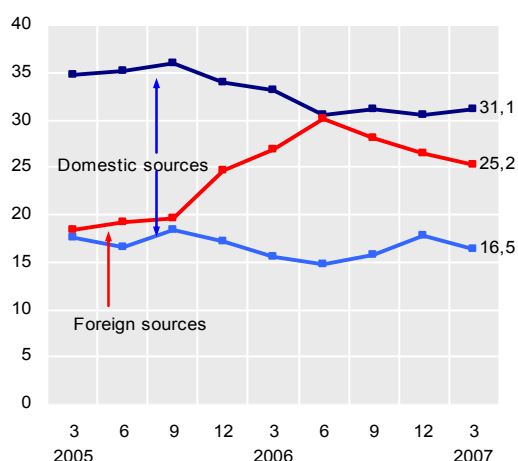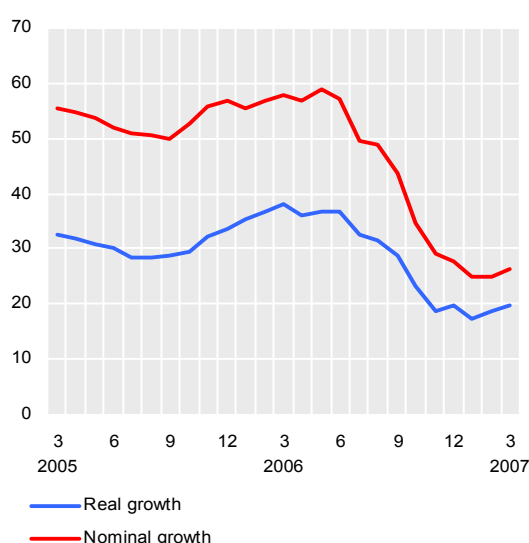(% of balance sheet total of banks)

Chart III.4.6.

Year-on-year growth in credit to enterprises and households
(in %)

many enterprises continued to borrow directly abroad, as instructed by certain domestic banks intent on avoiding allocation of reserve requirement on foreign borrowing. The share of long-term enterprise credits, used mainly for financing long-term investment in equipment, was rising, while the share of short-term credits, to which enterprises usually resort only when unable to fully service their obligations, rose more substantially in March. Foreign currency credits to enterprises recorded minimum growth on account of exchange rate differentials.

Chart III.4.7.
Bank credit by sector

There was no increase in banks' claims on enterprises in respect of issuance of short-term corporate securities purchased by banks.

Long-term credits continued to dominate in the composition of lending to households (81.3%). In Q1 2007, majority of approved credits were housing construction credits (around RSD 8.5 billion), while consumer credits increased by around RSD 3 billion. Of short-term credits, the largest share pertained to overdraft balances on gyro and current accounts of households.

An almost unchanged level of loan loss provisioning in Q1 indicates that credits were serviced regularly, and that, in case of enterprises and households, no new credits were classified as bad or uncollectible according to accounting standards.

The ratio of overall bank credit to GDP of less than 25% is still low compared to the countries of the region and leaves sufficient room for further credit growth, especially in the context of an intensifying catching-up process.[12]

Although intensified first-quarter lending activity did not trigger a rise in inflation, this factor could generate inflationary pressures in the period ahead via its impact on aggregate demand.

Bank Liquidity

After strong money creation in late 2006 occasioned by high net inflow of foreign capital and increased government spending that led to a rise in bank liquidity, a seasonal drop was recorded for bank excess reserves in Q1 2007. Average liquidity ratio, as the ratio of average balance of excess assets to short-term sources of financing, declined by 11 percentage points on end-2006 down to 8.6% in March.

Table III.4.3

Average contribution of excess assets to overall bank liquidity

(in percentage points)

	2006				2007
	Q1	Q2	Q3	Q4	Q1
Excess dinar assets	-19,0	10,8	26,0	35,3	-24,9
Gyro-account balances (net)	-10,5	-3,1	-1,5	0,7	-1,1
Vault cash	6,7	4,7	11,3	1,1	0,8
Callable bank deposits in dinars	-15,2	9,2	16,3	33,4	-24,6

Bank liquidity subsided as a consequence of increased bank demand for foreign exchange and seasonal growth in government deposits resulting from VAT payment by large as well as small taxpayers who submit their tax returns on a quarterly basis. On the other hand, cut in the dinar reserve requirement ratio from 15% down to 10% triggered a rise in bank liquidity.

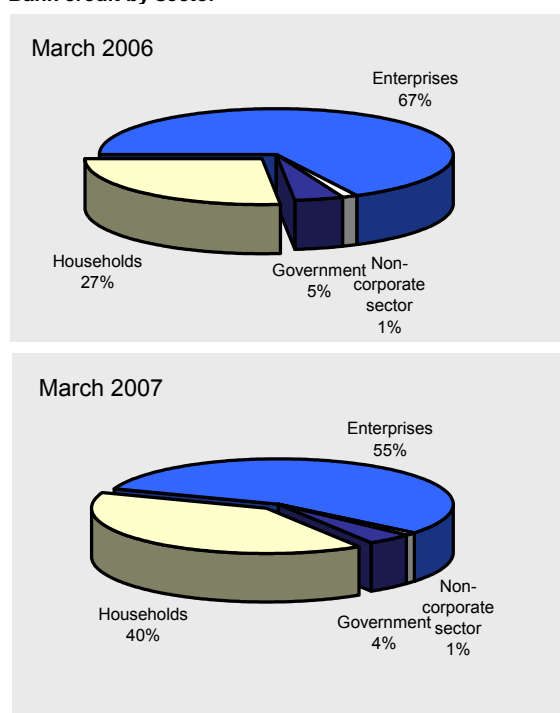[12]*Catching-up* process in transition economies involves the vertical (transformation of state into private) and the horizontal (industry transformation from labour- and resource- to technology-intensive) aspect of convergence of economy to the European Union region.

In January, liquidity hit its trough in the period under review, as bank demand for foreign exchange was to a large part met from direct purchases from the National Bank in the Interbank Foreign Exchange Market, while the use of foreign credits declined. Renewed increase in long-term foreign borrowing by banks gave rise to creation of excess dinar liquidity in February and March.

Overall, despite the decline in excess dinar liquid assets which was to a large part seasonally induced, banks experienced no problems with maintaining their liquidity position. Liquidity levels were satisfactory, as shown by the fact that banks repaid short-term Lombard loans for maintaining liquidity to the National Bank within the same business day.

Average daily balance of excess reserves of banks[13] stood at RSD 18.4 billion, which is a decline by RSD 7.3

Chart III.4.8.

Average bank liquidity ratio
(in %)

billion on a quarter earlier and a rise by 67.4% on Q1 2006. Excess deposits dropped most relative to end-2006. It should, however, be noted that the fourth-quarter movements in excess deposits were determined primarily by the inflow of funds on account of capital increase of individual banks, while in Q1 2007 they were influenced by outflow in respect of partial refunds to market entities participating in share purchases. Exclusion of this category from bank excess reserves shows that bank liquidity diminished minimally.

Banks used excess liquidity to buy repo securities. Despite cuts in the key policy rate and the rate on NBS bills sold in outright transactions, realization percentage was high. It was only in late Q1 that banks cut down on investment in NBS securities in order to settle their clients' obligations to the government.

Household Savings

Household savings continued to grow in Q1. Total household savings increased by RSD 33.8 billion, with foreign currency-denominated savings rising by RSD 32.5 billion.

As at 31 March, dinar savings deposits came to RSD 8,763 million, while foreign currency savings reached RSD 293.2 billion. Compared to end-2006, dinar and

Table III.4.4

Household savings
(in RSD million)

	2006				2007
	Mar	Jun	Sep	Dec	Mar
Dinar savings	3.755	5.000	6.828	7.550	8.763
Foreign currency savings	207.609	222.105	243.422	260.689	293.195
Total savings	211.364	227.105	250.250	268.239	301.958

foreign currency-denominated savings increased by 16.1% and 12.5%, respectively.

With regard to dinar savings deposits, households most frequently opted for term savings deposits with the maturity of up to three months, term savings deposits with the maturity of up to one year and for term savings deposits with the maturity of over one year.

In terms of currency composition of savings deposits, foreign currency savings accounted for 97.1% of total savings.

In euro terms, end-March foreign currency savings reached EUR 3.7 billion. Of this, 45.6% referred to three leading banks in terms of foreign currency savings deposit levels. As much as 91.7% of total savings deposits were denominated in euros, 5.53% in US dollars and 2.1% in Swiss francs.

In terms of maturity, majority of savings deposits were demand deposits (38.28%), followed by term savings deposits with the maturity of up to one year (19.53%) and term savings deposits with the maturity of over one year (17.59%).

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[13] Bank excess reserves comprise: vault cash, callable deposits and banks gyro-account balances less calculated required reserves.

In Q1, another series of **NBS savings bills** was issued. Bills were issued on 5 February and will mature on 31 January 2008. The volume of the issue was RSD 1 billion. End-March savings in respect of this issue came to RSD 278.9 million.

As at 31 March, total dinar savings stood at RSD 8,763 million, of which savings in NBS bills accounted for RSD 2,014 million or 22.98%.

5. Supply and Demand

Supply and Sources of Growth

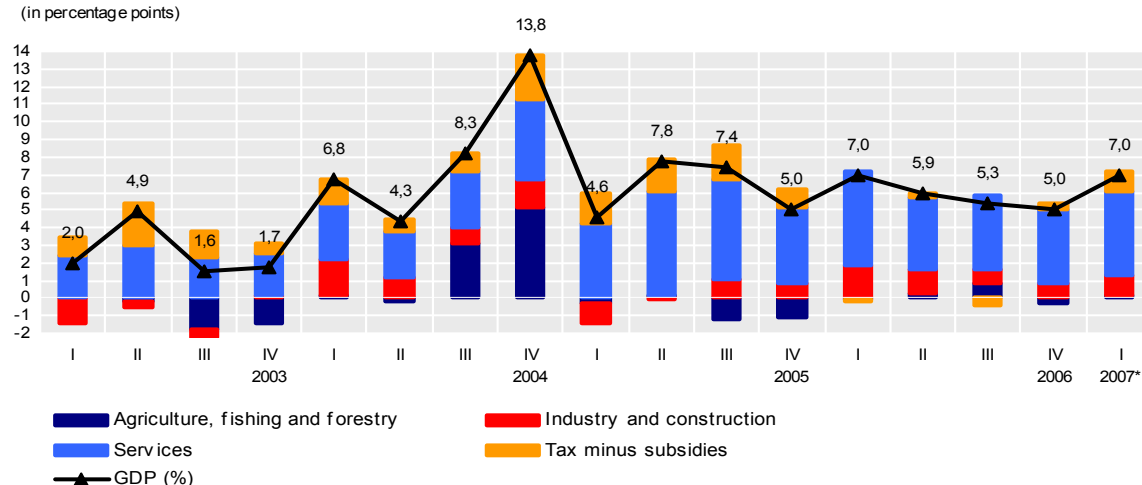Growth in aggregate demand, begun in late 2006, continued into Q1 2007 and led to intensified economic activity and imports without placing any upward pressure on prices for the time being. As a result of accelerated growth in the volume of trade and tax revenue, Q1 2007 estimated growth in GDP is higher than recorded in 2006.

According to the Communication issued by the Serbian Bureau of Statistics[14], the year-on-year growth rate of GDP declined during 2006. In Q2 and Q3, year-on-year GDP growth rates equalled 5.9% and 5.3%, respectively. In Q4, this rate declined further down to 5%, mainly on account of a drop in agricultural production (by 2.1%).

Chart III.5.1.

Contribution to quarterly GDP growth
(in percentage points)

- Agriculture, fishing and forestry
- Industry and construction
- Services
- Tax minus subsidies
- GDP (%)

*Estimate.

Gross value added contributed 4.8 percentage points to the year-on-year GDP growth in Q4 2006, with revenue from taxation (less subsidies) contributing 0.2 percentage points. Within gross value added, a major contributor to the year-on-year GDP growth was the service sector, and in particular transport activity (2.6 percentage points), retail and wholesale trade (1 percentage point) and financial mediation (0.8 percentage points).

Chart III.5.2.
GDP - estimates by quarter
(in RSD mln)

- GDP
- Disposable GDP
- Import
- Export
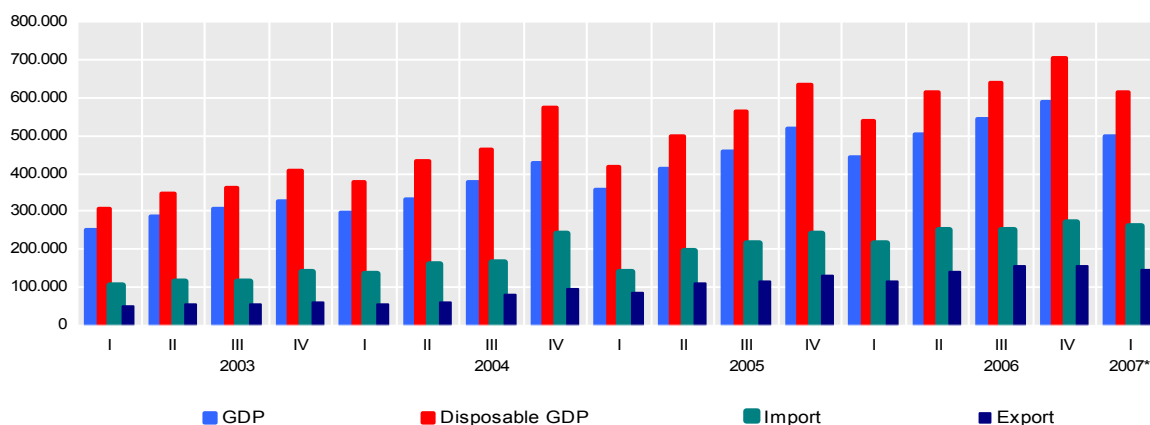
*Estimate.

As estimated in the February issue of the "Inflation Report", rising demand in Q4 2006 reflected on growth in economic activity early this year. Domestic supply, expressed in terms of GDP growth, is estimated to have increased by 7.0%[15], year-on-year, which is an acceleration in growth compared to 2006. GDP estimates are based on available data on industrial production and retail trade, expected continuation of strong upswing in the service sector (primarily transport, trade and construction) and higher tax collection compared to a quarter earlier.

As monthly data of the SBS indicate, industrial production was 4.8% higher in Q1 2007 than in the same period a year earlier, though seasonally adjusted data point to a slowdown in the growth trend in all three months under review. A glance into the composition of industrial production shows an unbroken trend of growth in the processing industry (8.5%), which gave a major contribution to the rise in industrial production. Production and distribution of electricity declined by 5.8% as a result of warm winter weather. Mining and quarrying grew by 2.1% on a year earlier.

Strong growth in retail trade continued from 2006. In Q1 2007, retail trade reached a nominal year-on-year growth rate of 38.1% (32.2% in real terms). Wholesale and retail trade are estimated to have contributed around 1.3 percentage points to GDP growth. Extremely strong growth in trade is indicative of rising aggregate demand, which was in part met from increased imports, but also triggered a rise in production.

Data for other sectors are still not available. Estimates are that transport, warehousing and communications contributed most to GDP growth (around 2.9 percentage points). Construction industry is also likely to have continued growing (by over 11%, year-on-year), as a consequence of extremely favourable weather conditions and a high level of investment (especially government investment). Construction industry is estimated to have contributed around 0.3 percentage points to GDP growth.

Estimates of real GDP and price growth indicate that first-quarter GDP could amount to over RSD 499 billion, which is an increase of around 13.4%. According to balance of payments data, disposable GDP would stand at around RSD 614 billion (122.9% of GDP) with exports and imports of goods and services accounting for 29.3% and 42.5% of GDP, respectively. Year-on-year growth in aggregate demand would come to around 13.9%, which is close to 2.1 percentage points up on a quarter earlier.

Demand and GDP Consumption

First-quarter growth in aggregate demand (13.9%) did not prompt acceleration of inflation, as it was counterbalanced by an increase in supply due primarily to a sudden surge in imports of goods and services. A look into the composition of GDP consumption in Q1 2007 reveals an evident shift from personal to investment consumption. Though evident in all sectors, these structural changes were particularly pronounced in the government sector (with the ratio of government investment to GDP up by 1 structural point on a year earlier) and household sector. This is conclusively confirmed by the majority of available indicators and represents another reason why persistently high consumption growth was not followed by a rise in inflation.

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[14] In the latest SBS Communication (30 March 2007), GDP figures for the first three quarters of 2006 were revised.
[15] Preliminary SBS estimates point to 6.8% GDP growth in Q1 2007.

Indicators of Household Consumption

Household demand, which grew in Q1 2007 as a result of an increase in the wage fund, triggered a rise in the volume of trade, but did not affect the prices. However, as long as real wages remain high, latent inflationary pressures will prevail.

Selected indicators signal an 11.7% rise in the real growth rate of **household demand** in Q1 2007 relative to the comparable period a year earlier. High real growth in household demand resulted primarily from the rise in the wage fund. In Q1 2007 relative to Q1 2006, nominal year-on-year growth rate of household demand came to 18.2%, and was practically unchanged from a quarter earlier. As a result of the decline in retail price growth rate from 8.2% in Q4 2006 to 5.8% in Q1 2007, real year-on-year growth in household demand rose from 9.1% to 11.7%.

Sources of growth in consumer demand were as follows:

Chart III.5.3.

Household demand and GDP
(y-o-y real growth rates, in %)

Household consumption   ■ GDP

Wages

In Q1 2007, the ratio of net wages from the statistical sample to estimated GDP was 14.8%, which is 1 structural point more than in the comparable period a year earlier. Assuming that employees not included in the sample earn on average as much as those included in the sample, the ratio of net wages to estimated GDP was 39.0% or 4.1 structural points more than in the comparable period a year earlier.

Social transfers

In Q1 2007, social transfers accounted for 17.6% of the estimated GDP, which is 0.2 structural points more than in the same period in 2006.

Remittances

In Q1 2007, registered remittances accounted for 4.3% of the estimated GDP or 0.9 structural points less than in the same period in 2006.

Exchange offices

Foreign exchange inflow of households registered through exchange transactions accounted for 3.1% of the estimated GDP in Q1 2007, which is a decline by 2.6 structural points on Q1 2006.

Credits

Borrowing provided households with an additional source of financing consumption, amounting to 5.4% of the estimated GDP or 1.3 structural points more than in Q1 2006.

In the period under review, household savings rose by 7.1% of the estimated GDP, which is 2.9 structural points more than in Q1 2006.

Household revenue, less increase in savings and plus increase in credits, accounted for 62.4% of GDP, which is a decline by 0.7 structural points. First quarter household consumption did not, therefore, have any significant inflationary effects.

Public Consumption

Based on the IMF methodology, the consolidated budget of the Republic of Serbia in Q1 2007 ran a deficit of 0.5% of GDP. Such fiscal result stemmed primarily from a strong rise in expenditure in respect of wages, pensions, payment of frozen foreign currency savings and payout of unemployment benefits.

Total consolidated public revenue, excluding grants, of the budget of the Republic of Serbia reached RSD 220.4 billion in Q1 2007 (up by 20.6% in nominal and 14% in real terms on a year earlier), while total consolidated public expenditure, excluding repayment of foreign debt and debt in respect of frozen foreign currency savings, reached RSD 222.5 billion (up by 21.9% in nominal and 15.2% in real terms on a year earlier). According to the IMF methodology, this resulted in the first-quarter budget deficit of RSD 2.3 billion. The ratio of fiscal deficit to GDP stood at 0.5% in Q1 2007.

Movements in government deposits were consistent with the actual fiscal result. In Q1, government deposits rose by RSD 33.4 billion. However, the fact that extraordinary revenue (primarily from privatization) equalled RSD 35.6 billion means that the government had spent RSD 2.2 billion of privatization receipts.

Table III 5.1 presents calculation of the fiscal result for both 2006 and 2007 according to the IMF methodology. As the IMF and the Ministry of Finance apply different methodologies in fiscal result calculations, such methodological differences are presented in the text box on page 37.

Within total revenue, significant growth relative to Q1 2006 was recorded for revenue in respect of profit tax (47.3% in nominal and 39.2% in real terms), VAT taxation (30.6% in nominal and 23.4% in real terms) and excises (30.2% in nominal and 23.1% in real terms), while a decline was recorded for revenue in respect of income tax (3.6% in nominal and 8.9% in real terms) following a tax rate cut.

In the period under review, budget performance was consistent with the Decree on Temporary Financing of the Republic of Serbia for the period January-June 2007, which essentially allows for deficit budget financing, although this is not evident from the report of the Ministry of Finance which classified and treated proceeds from the sale of the third mobile telephony licence as regular tax revenue.

Treatment of high proceeds from sale of property through either privatization or sale of GSM licences as regular budget revenue, and use of such funds to cover regular outlays, such as transfers to households, proves to be problematic. Over the long run, given the
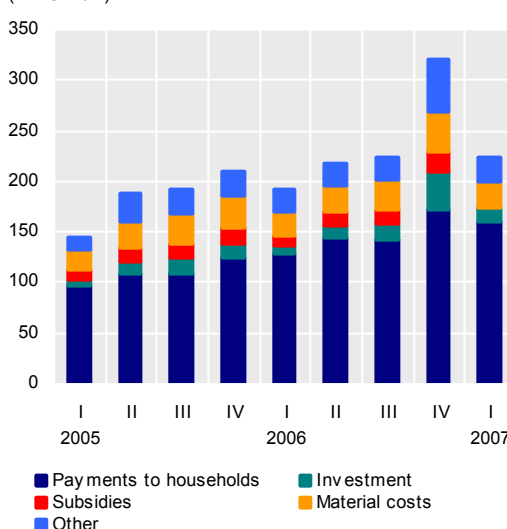
Chart III.5.4.

Public revenue and expenditures (IMF methodology)
(as % of GDP)
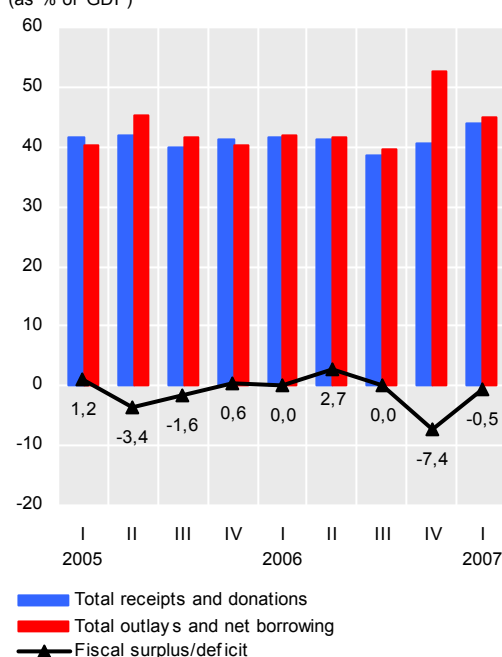
Source: Recalculated based on data provided by the RS Ministry of Finance.

Chart III.5.5.

Structure of public expenditures
(in RSD bln)

Source: Recalculated based on data provided by the RS Ministry of Finance.

downward rigidity of payments to households, it will be necessary to bring regular expenditures down to the level of regular (tax) revenues.

Table III.5.1

Fiscal result
(in RSD billion)

| | 2006, by quarter | | | 2007 | Indices | Indices, real |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q1 2007 | Q1 2007 |
						Q1 2006	Q1 2006
I Total revenue, of which	183,2	209,0	209,3	239,2	220,3	1,20	1,14
Grants	0,5	0,4	0,3	0,2	0,1	0,23	0,22
II Total expenditure and debt repayment, of which	184,3	210,4	214,7	309,9	224,3	1,22	1,15
Foreign debt repayment	1,3	1,2	1,6	12,5	1,3		
Repayment of frozen f/cy savings	0,5	14,0	4,1	1,1	0,6		
Early debt repayment	0,0	0,0	0,0	13,8	0,0		
III Total revenue excluding grants	182,7	208,6	209,0	239,0	220,1	1,21	1,14
IV Total expenditure excluding repayment of foreign debt, frozen f/cy savings and early debt repayment	182,5	195,1	209,0	282,5	222,4	1,22	1,15
Balance - IMF methodology (III - IV)	**0,2**	**13,5**	**0,0**	**-43,5**	**-2,3**	**-14,37**	**-13,59**
GDP	440,6	504,9	543,4	589,4	499,7		
Balance - IMF methodology, in % of GDP	0,0	2,7	0,0	-7,4	-0,5		

Source: Calculation based on RS Ministry of Finance data.

Table III.5.2

Consolidated public expenditure
(in RSD billion)

| | 2006, by quarter | | | 2007 | Indices | Indices, real |
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q1 2007. | Q1 2007. |
						Q1 2006.	Q1 2006.
Total expenditure and debt repayment	**184,2**	**210,4**	**214,7**	**309,9**	**224,4**	**1,22**	**1,15**
Outlays to households:	**127,9**	**129,7**	**134,6**	**158,4**	**150,3**	**1,18**	**1,11**
Net wages	43,9	43,7	45,1	57,8	52,9	**1,20**	**1,14**
Employee contributions[1]	7,5	7,9	8,2	9,8	9,4	**1,25**	**1,19**
Social transfers	76,5	78,2	81,4	90,8	88,1	**1,15**	**1,09**
Pensions and unemployment benefits	60,7	62,9	65,6	69,8	70,3	**1,16**	**1,09**
Social benefits	13,1	12,7	13,1	17,9	15,1	**1,15**	**1,08**
Other transfers to households	2,6	2,5	2,8	3,1	2,7	**1,04**	**0,98**
Subsidies	**10,1**	**13,4**	**13,1**	**19,0**	**9,4**	**0,93**	**0,88**
Material expenses	**23,4**	**26,6**	**30,4**	**39,6**	**27,0**	**1,16**	**1,09**
Investment	**8,1**	**12,7**	**15,6**	**37,6**	**13,6**	**1,68**	**1,59**
Interest expenses	**5,7**	**4,9**	**5,8**	**18,2**	**5,7**	**1,00**	**0,95**
Debt repayment	**1,8**	**15,3**	**9,7**	**26,5**	**15,3**	**8,71**	**8,24**
Payments in respect of frozen f/cy savings and pension arrears	0,5	14,0	8,1	14,0	9,6	**19,30**	**18,24**
Foreign debt repayment	1,3	1,2	1,6	12,5	1,3	**1,04**	**0,98**
Repayment of outstanding internal debt	0,0	0,0	0,0	0,0	4,5	**-**	**-**
Other [2]	**14,7**	**15,6**	**13,7**	**20,4**	**12,3**	**0,83**	**0,79**

[1] Employee contributions are not included in consolidated expenditure and pension arrears.

[2] Item *Other* includes: transfers to Kosovo and Metohija, net borrowing and other current expenses.

Source: Calculation based on RS Ministry of Finance data.

Methodological Differences in Calculating Fiscal Result

Fiscal result – deficit or surplus – is the key indicator of the character of fiscal policy. Also important are sources and manner of financing or allocation of the fiscal result, though the most frequently analysed fiscal policy indicator is the fiscal deficit. It is therefore of high importance to analyze the methodology for its calculation.

The methodology applied by the Ministry of Finance of the Republic of Serbia takes into account regular tax and non-tax revenue, capital revenue and grants, current and capital expenditure, and expenditure and revenue from purchase and sale of financial assets. Revenue from borrowing and expenditure in respect of debt repayment are not taken into account, but are shown as separate items.

In addition to items also included by the Ministry of Finance, the IMF methodology includes expenditure in respect of debt repayment (excluding foreign debt repayment, early debt repayment and repayment in respect of frozen foreign currency savings deposits) in the fiscal result calculation, while at the same time excluding grants from the budget revenue.

The methodology applied by the National Bank of Serbia conforms entirely to the IMF methodology, the only exception being that the NBS includes repayment of debt in respect of frozen foreign currency savings deposits in total expenditure.

The above methodological differences are, therefore, not substantial, as they concern only grants and repayment of internal debt. A far greater difference lies in inadequate classification of certain revenue and expenditure items. For instance, in January 2007 the Ministry of Finance disclosed revenue from sale of GSM license as regular non-tax revenue, instead of disclosing it as privatization revenue and excluding it from fiscal result calculation. The same goes for 2006, when licence sale proceeds in the amount of RSD 69 billion were disclosed as regular revenue, distorting the actual picture of fiscal policy, particularly over the long term.

The problem with presenting revenue from privatization (which the sale of licences essentially is) as regular fiscal revenue becomes apparent when the source of such revenue dries up, i.e. when there is no more state property to sell. At that point, it will be very difficult to bring regular expenditure (wages and social transfers that constitute major budget items on the expenditure side and show pronounced downward inflexibility) down to a level sustainable by regular revenue.

It is for that reason that Serbia should by all means adopt international standards for calculating and disclosing the fiscal result, such as the IMF methodology – GFS 2001. A key characteristic of the GFS 2001 system of calculating and disclosing the fiscal result is separate disclosure of revenue and expenditure from regular operations and revenue and expenditure in respect of sale or purchase of property (including privatization). Application of international standards would not only result in international comparability of data, but would also yield a much more realistic picture of the country's fiscal policy.

Investment Spending Indicators

As signalled by nearly all investment indicators, investment growth recorded in Q1 2006, continued at a brisk pace into this year.

Year-on-year growth in the deficit on foreign trade in capital goods stepped up significantly in the first quarter of 2007 (66.7%), while the decline in the volume of capital goods production slowed down further (2.9%), and stocks were depleted by 4.5%.

Although foreign direct investments fell from the two preceding quarters, their year-on-year growth was exceptionally robust in Q1 2007 (343%) despite elections frenzy.

Investment growth is further confirmed by the increase in medium- and long-term borrowing by enterprises both locally and abroad. Long-term bank credit to enterprises, mainly used for investment in fixed assets, went up by 16% in Q1 2007 relative to the same period a year earlier, which is 7.7 p.p. higher than the year-on-year growth at end-Q4 2006. At the same time, long-term foreign borrowing by enterprises recorded a 120% growth, year-on-year.

A slow-down in the growth of long-term borrowing by households and enterprises from domestic banks recorded in 2006 discontinued at a relatively high level. Namely, in Q1 2007, long-term borrowing by households and enterprises rose by 54.5% year-on-year, which is 2.5 p.p. higher than growth recorded in Q4 2006.

Available data on government investment spending show an upswing in investment activity. Namely, government investment spending increased by 68.0% in the first quarter compared to the same quarter a year earlier.

As signalled by majority of indicators, investment in working assets is also on the rise and increasingly used to finance stocks of intermediate goods. This points to trends that encourage future growth in industrial production.

Year-on-year growth in stocks of finished industrial products was markedly low in Q1 2007. In fact, it was significantly lower than the growth in industrial production, which is reflective of change in the structure of stocks in favour of intermediate goods and shall induce improvement in future growth prospects.

Robust growth in imports of intermediate goods is an indicator of the rise in investment in working assets.

Table III.5.3
Investment indicators

	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q1 2007 / Q1 2006
Real indicators						
Physical volume of industrial production of capital goods, y-o-y indices	107,2	89,4	78	89,7	97,1	97,1
Imports of intermediate goods, in USD million	912,3	1138,5	1249,8	1418,2	1340,1	146,9
Exports of intermediate goods, in USD million	636,6	751	862,3	957,5	965,3	151,6
Stocks of intermediate goods, y-o-y indices	101,2	101,97	104,7	104,4	100,8	100,8
Imports of capital goods, USD million	551,5	753,2	797,1	925,31	925,8	167,9
Exports of capital goods, USD million	130,3	146,1	169,7	214,6	223,6	171,6
Stocks of capital goods, y-o-y indices	101,7	115,1	112,7	107,2	95,5	95,5
Financial indicators						
Short-term credits to enterprises, RSD billion	201,7	214,0	203,2	188,1	200,4	99,4
Medium- and long-term external borrowing by enterprises (net), in USD million	258,0	323,0	637,0	662,0	568,0	220,2
Long-term credits to households, RSD billion	121,5	138,61	152	163,7	187,7	154,5
Long-term credits to enterprises, RSD billion	162,8	172,3	177,9	174,0	189,4	116,3
Government investment spending, RSD billion	8,1	12,7	15,6	37,6	13,6	168,0

6. Labour Market Flows

Wages

Q1 saw further accelerated wage growth begun in Q4 2006. Such growth was particularly strong in public sector wages. However, growth in wages and unit labour costs leads to a loss of competitiveness and the structural mismatch between demand and supply in the labour market.

Average wage growth gathered momentum in Q1 2007. Year-on-year nominal net wage growth amounted to 30.2%, up by 5.3 p.p. on Q4 2006, while real Q1 net growth in wages equalled 24.2% y-o-y, up by 7.5 p.p. on the same period.

Chart III.6.1.

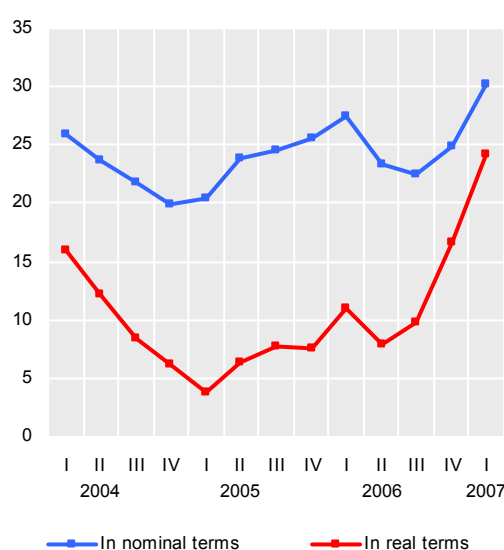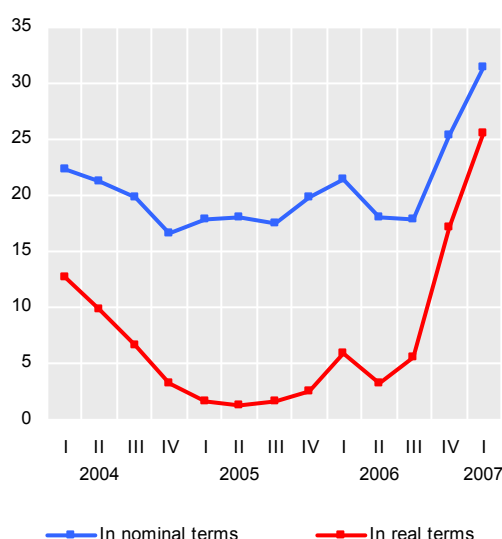**Average net wages**
(y-o-y growth, in %)

Chart III.6.2.

Average net wages in the public sector
(y-o-y growth, in %)

Average **public sector** wages are growing at a brisk pace. Year-on-year nominal net public sector wage growth came to 31.5%, 6.1 p.p. up on Q4 2006, primarily due to a strong increase in wages paid by public employers (public enterprises and services).

Rising by 8.3 p.p. on Q4 2006, real year-on-year growth in public sector wages amounted to 25.5% in Q1 2007.

Public sector wage bill increased by 28.8% in nominal terms and by 22.9% in real terms, while the number of employees declined.

Seasonally-adjusted data also signal acceleration of growth in nominal net wages. Hence, net wages were 10.8% higher than a quarter earlier, while their growth in Q3 and Q4 2006 was 5.6% and 7.3%, respectively.

Unit labour costs in the industrial sector rose by 5.4% compared to the same period a year earlier as growth in real gross wages (18.2%) was not accommodated by productivity gains (11.6%). In the manufacturing industry, unit labour costs declined by 1.2%.

From the aspect of costs, high growth in wages leads to a loss of competitiveness of domestic producers, i.e. it has a limiting effect on growth in exports. On the other hand, as the key component of household inflows, accelerated wage growth pushes up aggregate demand whose inflationary effects could be avoided, in the short run only, by increasing supply of imported goods.

Employment

Rate of unemployment of persons fit to work is stagnating. Based on official records, the number of both employed and unemployed persons is on the decline. Restructuring of the economy feeds through marked mobility of labour.

As indicated by the available incomplete data, total employment in March 2007 amounted to 2,470.3 thousand persons, which is 5.6% down on the same month a year earlier. Employment in the public sector declined to 476 thousand persons.

Total unemployment, excluding persons temporarily incapacitated or unwilling to work[16] amounted to 913 thousand in March, which is 0.7% down on the same month a year earlier. The estimated rate of unemployment came to 27%, while the number of new jobs created points to more positive trends and higher co-relation with GDP. In Q1, 166.8 thousand new jobs were created, which is an increase of 15.9% y-o-y.

According to the Work Force Survey conducted by the Serbian Bureau of Statistics, unemployment rate for persons aged 15-64 was 21.6% in 2006, down by 0.2 p.p. from 2005.

Chart III.6.3.
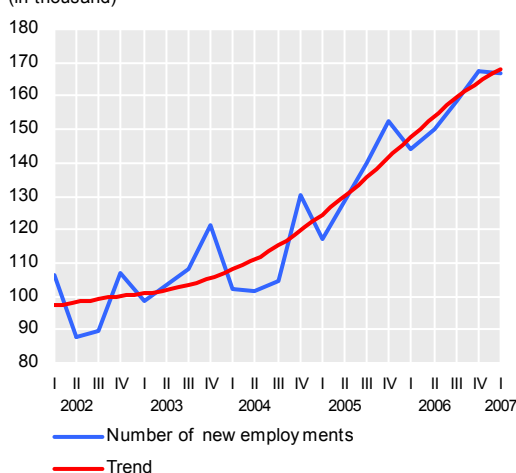
Unemployment
(in thous.)
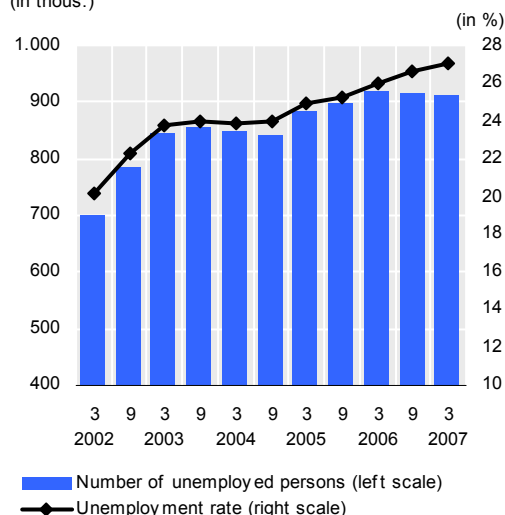
Source: Serbian Bureau of Statistics and National Employment Service.

Chart III.6.4.

New employment
(in thousand)

Source: National Employment Service.

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[16] As of this year, SBS calculates unemployment rate based on the number of unemployed, and not on the number of employment seekers.

IV. Inflation Projection

1. Inflation Expectations

Inflation expectations continue declining, but still run above actual inflation performance.

Findings of the March survey, conducted by *TNS Medium Gallup,* point to a fall in inflation expectations of all four respondent sectors – enterprises, trade unions, financial sector and households.

In the year to date, expectations of the financial sector and enterprises displayed the highest level of stability levelling off at around 0.5% per month (6.2% per annum) and 0.6% per month (12.9% per annum), respectively. Levelled expectations of the financial sector may indicate that banks and other financial institutions are forming their inflation expectations on rational expectations consistent with the NBS forecasts rather than on the actual inflation performance. Expectations of trade unions are somewhat higher, running at a monthly average of 0.7%. Albeit declining, household expectations remain the highest and measure 1% per month. In the year to date, though declining, average inflation expectations have remained above actual inflation figures.

Findings of the Reuters Survey on expectations for end-2007 retail prices, key policy rate and exchange rate movements by two economic institutes and nine banks revealed that these institutions were basing their expectations primarily with regard to retail price movements on the NBS forecasts as set out in the February edition of the Inflation Report (6.7%). The expected exchange rate against the euro averages at RSD 81.9 and the key policy rate at 11.1%.

Chart IV.1.1.

Average inflation expectations for the next three months
(in %)
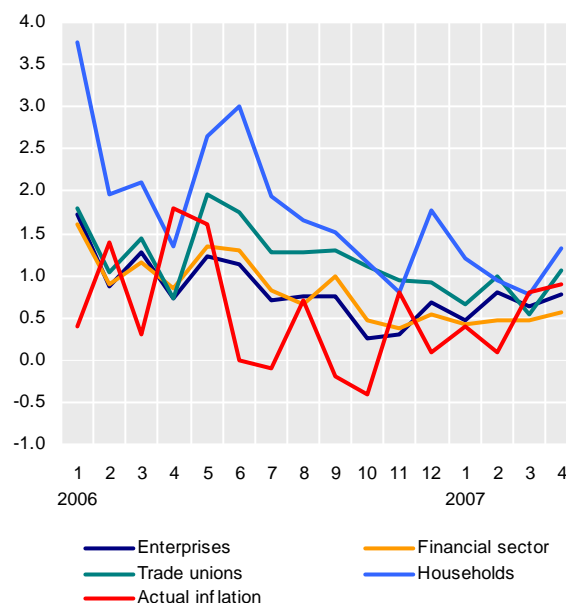
Source: Survey (TNS Medium Gallup).

Table IV.1.1.

Expectations for end-2007 inflation, key policy rate and exchange rate movements according to Reuters Survey

	Retail prices[1]	Key policy rate	RSD/EUR
Economic institutes (average)	8,3	12,5	83,5
Banks(average)	6,6	10,8	81,5
Two economic institutes and nine banks (average)	*6,9*	*11,1*	*81,9*

[1] December 2007/December 2006

Source: Survey (Reuters).

2. Medium-Term Inflation Projection

Medium-Term Projection

Central projection places core inflation for 2007 at around 3% and headline inflation at around 6%. Core inflation will range from 1 to 5%. There is a notable risk that the target corridor (4–8%) will be undershot and practically none that it will be overshot.

National Bank's inflation projection shows the trajectory of inflation assuming the NBS actively responds to expected deviations of inflation from the target by changing its key policy rate. Hence, trajectories of the key policy rate and the exchange rate consistent with the projected inflation also form part of the projection. These projections are an important element of decision-making on changes in the key policy rate. They are based on a combined use of econometric models and staff assessments. Risks relating to interdependence of model variables and adopted assumptions grow as the time horizon of the projection increases, and so does the inflation projection range (see chart IV.2.1). However, as the National Bank's measures work towards containing the effects of possible shocks, the width of the range stabilizes with the extension of the projection horizon, irrespective of the shocks size.

Initial Conditions and Assumptions

Decline in core inflation resulted in a negative quarterly rate in Q1 2007 while its year-on-year measure was at the lower bound of the target corridor (4%) and is certain to drop below the target in Q2 (page 7). The main disinflationary factors were nominal appreciation of the dinar (second half of 2006) and deferred effects of accumulated real appreciation (early 2007). Monetary policy task in the period ahead will be to approach the target inflation from below.

Accumulated real appreciation will continue to have disinflationary effect over the coming period. However, the cost-push effect of the announced hike in electricity prices may yet help bring inflation back to its target level.

Core inflation projection is based on assumptions of stable foreign inflation, moderate rise in ECB's main refinancing rate and a contained increase in world oil prices. It is expected that, this year again, non-core inflation (regulated prices and prices of agricultural products) will by far exceed the level of core inflation.

Assumptions for 2007 used in inflation projection

External	
EU inflation	2%
US inflation	2.5%
End-year EU interest rate	4%
USD/EUR exchange rate (yearly average)	1.36
End-year Ural oil price (in USD)	60
Internal	
GDP growth	5%
Non-core inflation	9%
Republic budget deficit (share in GDP)	–1.5%

Risks Relating to Assumptions

There is a risk that the underlying assumptions may fail to materialize. A major risk relates to movements in world oil prices, which have a decisive effect on prices of domestic petroleum products.

Although petroleum products do not constitute direct input into core inflation[17], in Serbia (more than in developed countries), they represent a significant cost element in prices which are freely formed. There are also uncertainties regarding economic policy to be conducted by the new government which shall affect the volume and structure of the new state budget (a significant determinant of demand), future adjustments in regulated prices and investors' attitude towards Serbia (which may have a strong bearing on exchange rate movements).

Core Inflation Projection

The outlook for core inflation in 2007 is between 1 and 5%, and around 3% in the central projection. According to our projections, there is practically no risk that core inflation in 2007 will overshoot the 4-8% target corridor, but there is substantial risk of its undershooting the target.

Chart IV.2.1.

Core inflation projection
(y-o-y rates, in %)
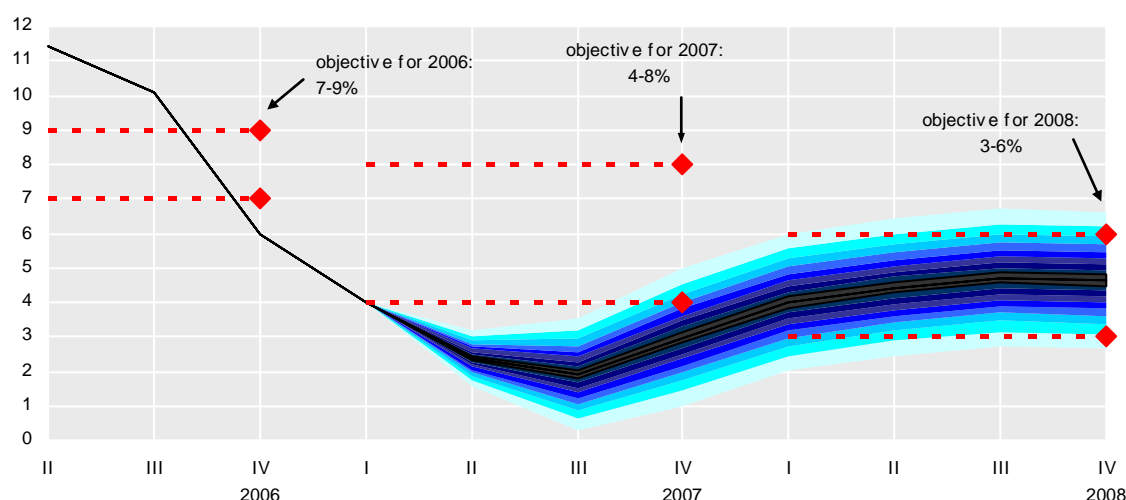
The fan chart depicts the probability of various core inflation outcomes in 2007. Central projection is within the darkest central band and the probability that core inflation would lie within it is only 10%. Outturns of inflation are also expected to lie within each pair of the lighter areas with probability of 10%, implying that inflation is expected to lie somewhere within the entire fan chart with probability of 90%. In other words, the probability that core inflation in 2007 will lie outside the band in the chart is 10%.

As of Q2, quarterly rate of core inflation will pick up mildly as a result of monetary policy easing, nominal depreciation of the dinar, and the cost-push effect of the announced rise in electricity prices. On the other hand, accumulated real appreciation of the dinar from a year earlier will continue for some time yet to act as barrier against a faster growth in inflation. Although quarterly core inflation rate will be on the rise, the year-on-year core inflation will continue declining through to Q4 2007, when it will rebound for the first time after a long period to around 3% (chart IV.2.1.). As our projections indicate, core inflation will lie within the target corridor set for next year (3-6%)[2] as early as in the first half of 2008.

The above inflation projection is consistent with moderate relaxation of monetary policy (key policy rate cuts) over the next two quarters[3]. Even though faster easing of monetary policy would probably bring core inflation to its target corridor even before the year 2007 ends, this projection presupposes a cautious monetary policy which, in addition to targeting current year inflation, also aims at long-term

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[17]Prices of petroleum products are regulated by special government decree, and are based on movements in Ural oil prices, exchange rate and excises.

[2] The current NBS monetary policy regime based on inflation targeting principles allows only for temporary deviations from target inflation.

[3] This inflation projection presupposes an active policy of the NBS that works towards bringing core inflation to the target level by adjusting the key policy rate, which is the essential element of the inflation targeting regime.

macroeconomic stability. Should it be estimated that the achievement of the 2007 inflation target at any cost, i.e. by means of sharp key policy rate cuts, may trigger high inflationary pressures in 2008[4] and thereby prejudice monetary policy stability, slight undershooting of the core inflation target corridor (4-8%) could be acceptable.

Another reason for the monetary authorities to pursue cautious monetary policy is the number of risks involved in monetary policy decision-making. To illustrate, if certain factors such as fiscal policy flows, rise in world oil prices, political uncertainty, etc. should be assessed as having an inflationary effect, the NBS could, contrary to expectations, decide not to lower the key policy rate further and may even decide to raise it. On the other hand, strengthening of disinflationary pressures could lead to a notable easing of the monetary policy stance. In any case, this projection presupposes a monetary policy that will ensure that unforeseen shocks in either direction do not lead to longer term deviations of inflation rate from its target level.

Core inflation in 2007 is 1.7 percentage points lower than projected in the last "Inflation Report". This downward revision is due to the fact that the accumulated appreciation from the prior year has generated stronger disinflationary pressures in early 2007 than assumed by the projection set out in the February "*Inflation Report*".

Projection of Headline Inflation

Central projection of retail price growth for 2007 will move around **6%.** In addition to the outlook for core inflation, this projection also incorporates assumptions regarding prices of agricultural products and regulated prices. As the plan of adjustment in regulated prices in the remaining months of 2007 will not be known until the Memorandum of the new Government is adopted, we have adopted assumptions regarding their future flows. As regards flows in prices of agricultural products, they are not so much determined by the NBS measures as by the supply and weather conditions. These prices are very volatile and can have a strong effect on the headline price index despite their relatively modest share in total retail prices. The outcome for headline inflation will, therefore, depend not only on NBS measures but on other factors as well.

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[4] According to our estimates, the maximum effect of a change in the key policy rate on year-on-year inflation is delayed into next year. Hence, change in the key policy rate today will exert its full effect in 2008.

Table A

Indicators of external position of Serbia

	2001	2002	2003	2004	2005	2006	2007 Q1
EXTERNAL LIQUIDITY INDICATORS (in %)							
Forex reserves/imports of goods and services							
(in months)	3,1	4,5	5,3	4,5	5,9	9,6	8,0
Forex reserves/short-term debt	114,1	223,5	336,3	424,9	385,9	717,3	875,4
Forex reserves /GDP	11,0	14,4	17,5	17,3	22,2	37,4	35,2
Debt repayment/GDP	0,9	1,3	2,0	3,8	4,5	6,4	8,7
Debt repayment/exports of goods and services	3,7	7,1	9,1	16,8	17,9	23,5	29,6
EXTERNAL SOLVENCY INDICATORS (in %)							
External debt/GDP	104,8	70,9	66,7	57,5	58,7	61,7	59,4
Short-term debt/GDP	9,7	6,4	5,2	4,1	5,7	5,2	4,0
External debt/exports of goods and services	456,9	379,2	343,0	253,6	234,2	228,1	211,5
FINANCIAL RISK EXPOSURE INDICATORS (in %)							
Forex reserves/M1	135,9	143,3	195,3	221,0	291,1	356,5	371,1
Forex reserves/reserve money	136,3	132,0	168,0	166,2	170,3	177,8	180,7
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	65,3	56,9	59,1	68,6	70,2	73,9	81,5
CREDIT RATING				November B+, Standard & Poor's	July BB-, Standard & Poor's and Fitch	February BB- (long-term), B (short-term), positive Standard & Poor's, BB- as graded by Fitch	
MEMORANDUM:						**(in USD million)**	
GDP (in USD million)	10.619	15.840	20.340	24.509	26.355	31.760	8.188
External debt	11.125	11.230	13.575	14.099	15.467	19.606	19.833
External debt servicing	91	211	397	935	1.183	2.021	710
Central bank foreign exchange reserves	1.169	2.280	3.550	4.245	5.843	11.888	11.731
Short-term debt	1.026	1.020	1.056	999	1.514	1.657	1.340
Current account balance	-285	-1.247	-1.420	-2.869	-2.224	-3.656	-1.513

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of foreign exchange reserves at end-period to average monthly imports of goods and services.

Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to short-term debt at year end.

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

Debt repayment/GDP (in %) - ratio of annual debt repayment to GDP.

Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services.

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

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

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

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

Notes:

1. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology which apply to all IMF member countries. We have therefore adjusted the financial risk exposure indicator.

2. Trade with Montenegro is registered within relevant transactions as of 2003.

3. Foreign debt repayment does not include early debt repayment.

4. GDP for Q1 2007 as estimated by the National Bank of Serbia.

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007 Q1
Real GDP growth (in %)	4,8	4,2	2,5	8,4	6,2	5,7	7,0[1]
Retail prices (in %, relative to the same month a year earlier)	40,7	14,8	7,8	13,7	17,7	6,6	5,6
Core inflation (in %, relative to the same month a year earlier)	20,5	4,4	6,1	11,0	14,5	5,9	4
NBS foreign exchange reserves (in USD million)	1.169,1	2.280,1	3.550,1	4.244,5	5.842,8	11.887,5	11.730,5
Exports (in USD million)[2]	2.435	2.961	4.358	5.559	6.606	8.593	2.401
- growth rate in % compared to a year earlier	17,9	21,6	47,2	27,6	18,8	30,1	48,4
Imports (in USD million)[2]	-4.499	-6.059	-8.177	-11.853	-11.902	-14.885	4.274
- growth rate in % compared to a year earlier	28,3	34,7	35,0	45,0	0,4	25,1	43,5
Current account balance (in USD million)	-285	-1.247	-1.420	-2.869	-2.224	-3.656	-1.513
as % of GDP	-2,7	-7,9	-7,0	-11,7	-8,4	-11,5	-18,5
Unemployment, official data (in %)[3]	21,8	24,5	26,1	23,9	25,3	25,9	27,0
Unemployment according to the Survey (in %)[4]	12,2	13,3	14,6	18,5	20,8	20,9	…
Wages (average for the period, in EUR)	89,9	151,7	176,7	194,4	210,4	260	306,9
RS budget deficit/surplus (in % of GDP)	-0,2	-4,3	-1,4	-0,1	1,5	1,4	0,7
Consolidated fiscal result (in % of GDP)							
- Ministry of Finance methodology	0,0	-1,9	-2,0	0,5	3,9	-3,1	2,3
- IMF methodology	-0,5	-2,8	-4,3	-1,4	-3,2	-4,7	-0,5
RS public debt (external + internal, in % of GDP)[5]	106,5	73,7	67,9	53,7	46,2	38,8	34,0
RSD/USD exchange rate (average, in the period)	66,68	64,46	57,56	58,39	66,70	67,10	61,03
RSD/USD exchange rate (end of period)	67,67	58,98	54,64	57,94	72,22	59,98	61,11
RSD/EUR exchange rate (average, in the period)	59,78	60,68	65,05	72,57	82,92	84,16	79,99
RSD/EUR exchange rate (end of period)	59,71	61,52	68,31	78,89	85,50	79,00	81,57
Memorandum							
GDP (in USD million)	10.619	15.840	20.340	24.509	26.355	31.760[6]	8.188[1]

[1] NBS estimate.

[2] Trade with Montenegro is registered within relevant transactions as of 2003.

[3] Source: Serbian Bureau of Statistics; before 2003, unemployment rate was calculated based on the number of job seekers, while as of 2004 it is calculated based on the number of unemployed persons.

[4] Source: Labour Force Survey, Serbian Bureau of Statistics.

[5] Source: RS Ministry of Finance Bulletin.

Appendix 1: Memorandum of the National Bank of Serbia on Setting the 2008 Inflation Objective

In line with the principal objective of the central bank to achieve and preserve price stability, as defined in the Law on the National Bank of Serbia, and with respect to the Monetary Policy Framework adopted in August 2006 in which the NBS aims at specific inflation objectives, the NBS Monetary Policy Committee (MPC) has set the core inflation objective for the year 2008 as

- 3-6 % December 2008 to December 2007

The Monetary Policy Committee reiterates the main principles of the New Monetary Policy Framework:
  – The declared inflation objectives are the only numerical guidelines for the monetary policy of the NBS.
  – The NBS achieves the inflation objectives by changing the interest rate on its 2-week (2W) repo operations as its key policy interest rate and main instrument. Other instruments, including foreign exchange interventions, have only supportive roles.
  – The NBS pursues a soft-managed floating foreign exchange regime, retaining at the same time the right to intervene in the foreign exchange market in the event of excessive daily exchange rate fluctuations, threats to financial and price stability and risk to the adequacy of the level of foreign exchange reserves;
  – The Monetary Policy Committee of the NBS takes decisions on changes in the key policy rate at pre-announced dates on the basis of staff economic and inflation outlook.
  – The MPC informs the public regularly about the objectives fulfilment and steps taken to meet them in the future.

The Monetary Policy Committee has decided to set the core inflation objective for end-2008 at this moment in order to help anchor inflation expectations and provide additional support to creating low-inflation environment, and a guideline for current policy actions. The MPC assesses that its policy decisions (such as changes in the key policy rate) have maximum impact on inflation not before three months following their enactment, necessitating a medium-term perspective of inflation objectives.

Compared to the 2007 core inflation objective, the level of the 2008 objective is lower and its width has been reduced on account of favourable macroeconomic developments and low inflation rates:

  – The level of inflation objective for 2008 reflects the desire to achieve price stability by a process of gradual disinflation, not disrupting other macroeconomic processes taking place in the economy. The success in reducing inflation in 2006 and 2007 has paved way for lower inflation objectives and thus continuing with the disinflation process.

  – Following these considerations, the level of the 2008 objective has been set below that of the 2007 objective, but high enough to allow for smooth adjustments in relative prices expected to take place during the process of restructuring of the Serbian economy. In choosing the level, the MPC has also taken into account the assessment of long-term macroeconomic trends so as to put a minimum pressure on the nominal exchange rate and thereby reduce risks of possible adverse short-term implications for competitiveness of the economy.

  – The width of the 2008 objective has been reduced compared to 2007 objective in order to assist better in forming inflation expectations.

Setting of core inflation objective for end-2008 should also facilitate the process of defining the level of inflation consistent with the price stability mandate in a medium-term. In cooperation with the Government of the Republic of Serbia, within whose remit is the revision of regulated prices, the National Bank of Serbia will set the medium-term objective for headline inflation as well, and inform the public thereof.

Appendix 2: Medium-Term Core Inflation Projection Model

The quarterly model is the main instrument of medium-term projection. It relies on the transmission mechanism of the monetary policy through the nominal and real exchange rate channel. Namely, depending on the expected deviation of core inflation from the target, the NBS adjusts the key policy rate, which is its main monetary policy instrument. This adjustment affects both the nominal exchange rate and deviations of the real exchange rate from its trend, which, in turn, influence inflation.

Transmission Mechanism in the Medium-Term Core Inflation Projection Model
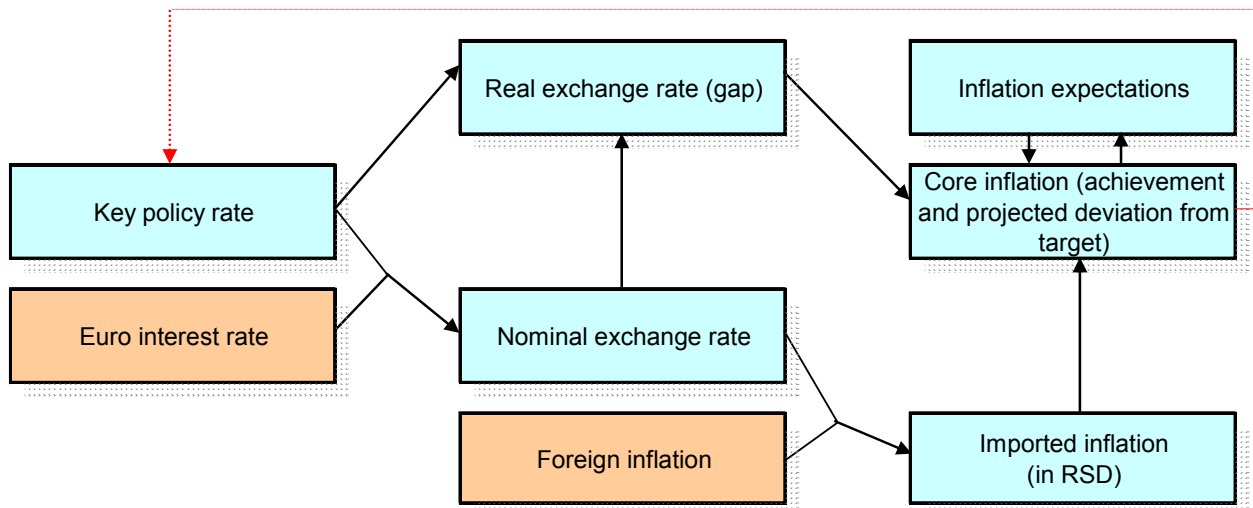
The model comprises three basic equations – inflation equation, exchange rate equation and key policy rate equation – and a number of supporting equations and identities. The main equations are:

1) Inflation – Phillips' Curve

$$\text{inf} = a_1 \cdot \text{inf}_{(-1)} + a_2 \cdot \text{inf.exp.} + (1 - a_1 - a_2) \cdot (\text{imp.inf-real ex. rate trend}) + a_3 \cdot \text{real ex. rate gap}_{(-1)}$$

2) Exchange Rate – Uncovered Interest Rate Parity

$$\text{ex.rate} = \text{ex.rate exp.}_{(+1)} + (-\text{pol.rate} + \text{euro int} + \text{prem})$$

3) Key Policy Rate – Monetary Policy Rule

$$\text{pol.rate} = a_4 \cdot \text{pol.rate}_{(-1)} + (1 - a_4) \cdot [\text{neutr.int} + a_5 \cdot (\text{inflation deviation from target})]$$

1) Inflation – Phillips' Curve

This equation presents movements in core inflation with reference to lagged core inflation movements, inflationary expectations, movements in import prices and real effective dinar exchange rate gap.

$$\text{inf} = a_1 \cdot \text{inf}_{(-1)} + a_2 \cdot \text{inf.exp.} + (1 - a_1 - a_2) \cdot (\text{imp.inf-real ex. rate trend}) + a_3 \cdot \text{real ex. rate gap}_{(-1)}$$

The equation comprises the following elements:

- **Lagged inflation** (**inf**$_{(-1)}$) reflects a degree of inertia in inflation movements. When significant changes to factors influencing core inflation occur, their effect on inflation is felt only after a time lag, due to inertia in the behaviour of business entities.
- **Inflation expectations** (**inf.exp.**) are expectations of business entities regarding price movements in the period ahead. They can have a very important effect on actual inflation movements. High inflation expectations can trigger a rise in inflation, even if there are no real factors that would prompt such a rise.
- **Imported inflation** (**imp.inf**) depends on exchange rate and foreign inflation movements. As the exchange rate customarily oscillates more than foreign inflation, it has a predominant impact on movements in imported inflation.
- **Real exchange rate trend** (**real ex. rate trend**) indicates the average long-term tendency in real exchange rate movements. In other words, it shows how faster domestic prices will grow over the long term compared

to foreign ones (expressed in the same currency). As productivity growth in Serbia is expected to be faster than abroad, domestic prices are likely to rise more quickly than foreign ones (real appreciation).

- **Lagged real exchange rate gap (real ex. rate gap(-1)),** or deviation of the real exchange rate from the trend, is a measure of excessive depreciation or appreciation. The real exchange rate can be understood as an approximation of the real marginal cost, which is the share of the cost (import component) in income (domestic price). In our case, the second half of 2006 saw a decline in the real marginal cost and a rise in marginal profit, as the drop in import prices (cost) did not lead to a corresponding drop in domestic prices (income). That explains why domestic prices are currently running above the level that would be expected based on the long-term real exchange rate trend. In other words, there was an excessive appreciation of the exchange rate. In the period ahead, marginal profit will shrink in response to competition, which means that the gap will close through a slower growth in domestic compared to import prices[7] (exchange rate + foreign inflation). A note should be made that the real exchange rate is indicative of demand for domestic products and of the level of competitiveness of the country's economy. Therefore, if the appreciation gap is not closed over a longer term, this could lead to a slowdown in economic activity.

2) Exchange Rate – Uncovered Interest Rate Parity

The uncovered interest rate parity (UIRP) equation shows that yields on two currencies, adjusted by risk premium, have the tendency to even out. Assuming zero risk premium for the dinar and the euro, the dinar exchange rate is expected to depreciate by 7% against the euro over the next year, which is the level of depreciation needed in order for yields on these two currencies to level off as there is currently 7pp difference between the two relevant key policy rates (10.5% on dinars and 3.5% on euros). This calculation, however, does not take into account the fact that foreign exchange markets demand additional yield, the so-called *risk premium,* on currencies that carry a higher level of risk. Risk premium makes investment in dinars as attractive as investment in euros. Therefore, in order to obtain the expected depreciation, we would need to adjust the two currencies by the risk premium:

expected depreciation = pol.rate – euro int – prem

As expected depreciation equals the difference between the expected exchange rate in the period ahead **(ex.rate exp. (+1))** and the current exchange rate **(ex. rate),** rearranging the equation gives the UIRP form used in the model:

exchange rate = ex.rate exp. (+1) + (-pol.rate + euro int + prem)

The equation comprises the following elements:

- **Interest rates (pol.rate** and **euro int)**. In the model, we use the market counterparts of key policy rates in Serbia and the EU: two-week BELIBOR (for dinars) and one-week EURIBOR (for the euro).
- **Expected exchange rate** (**ex.rate exp. (+1))** shows expectations of business entities regarding exchange rate movements in the period ahead.
- **Risk premium (prem)** depends primarily on the attitude of foreign investors. We estimate risk premium at around 4%.

3) Nominal Interest Rate – Monetary Policy Reaction Function

This equation defines basic elements that inform decision-making on the key policy rate and is essential for stabilizing the economy. Monetary policy rule – deviation of the outlook for inflation from the target – is the key element prompting the decision to change the key policy rate. When the outlook for inflation is below the target, monetary policy needs to be expansionary and the key policy rate below its neutral level. The opposite goes when the outlook for inflation is above the target. However, as, in order to avoid instability, monetary policy should not make any sudden leaps, the equation also includes the lagged policy rate:

pol.rate = a_4· pol.rate(-1) + (1-a_4)·[neutr.int + a_5·(inflation deviation from target)]

The equation comprises the following elements:

- **Lagged policy rate** (**pol.rate (-1))** provides for a certain level of inertia in the model and for stability in the key policy rate movements. The ratio preceding the lagged policy rate can range between 0 and 1. This ratio indicates how likely monetary authorities are to make sudden changes in the key policy rate.
- **Neutral interest rate (neutr.int)** represents the policy rate level that has a neutral impact on inflation. In other words, when the key policy rate is neutral, the monetary policy is neither restrictive nor expansionary.
- **Monetary policy rule (inflation deviation from target)** defines the desired position of the key policy rate relative to the neutral rate. When forecast inflation is below the target, the key policy rate should be below the neutral, and vice versa.

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[7] Adjusted for the real exchange rate trend.

Projections based on the model are not final and can be adjusted by including information that the model does not cover. This model is not used only for projecting inflation flows, but also to calculate exchange rate and key policy rate trajectories that are consistent with achieving the inflation target. The model hence represents a supporting instrument in decision-making.

Appendix 3: Changes in Reserve Requirements

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation (dd/mm/yyyy)	Expected effects
1.	136/04	Dinar base – unchanged	Unchanged 21%	Remunerated		
		Foreign currency base - extended (inclusion of liabilities arising from foreign currency loans from foreign legal entities with maturity up to 4 years and liabilities arising from foreign loans registered by banks after 31 December 2004)	Unchanged 21%	Remunerated	10/01/2005	Sterilization of RSD 0.6 billion
2.	Guidelines No. 12 of 06/04/2005	Dinar base – extended	21%	Remunerated		Sterilization of RSD 0.5 billion
		Foreign currency base - extended (inclusion of liabilities to subordinated and related banks)	21%	Remunerated	10/04/2005	Sterilization of RSD 2.9 billion
3.	46/05	Dinar base – unchanged	Reduced from 21% to 20%	Remunerated		Release of RSD 0.1 billion
		Foreign currency base – unchanged	Increased from 21% to 26%	Remuneration cancelled	10/06/2005	Sterilization of RSD 7.4 billion Net effect: sterilization of RSD 7.3 billion
4.	69/05	Dinar base - unchanged	20%	Remunerated		
		Foreign currency base – unchanged	Increased from 26% to 29%	Unremunerated	10/08/2005	Sterilization of RSD 6 billion
			Minimum foreign currency liquidity against foreign currency savings reduced from 47% to 45%			Release of RSD 0.7 billion
5.	77/05	Dinar base - unchanged	20%	Remunerated		
		Foreign currency base - extended (inclusion of all foreign loans with agreed maturity of over 4 years, provided loan contracts and annexes were registered before 31 December 2004).	Base extension subject to 7% interest Minimum foreign currency liquidity against foreign currency savings reduced from 45% to 43%	Unremunerated	10/09/2005	Sterilization of RSD 5.1 billion Release of RSD 0.5 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
6.	80/05 86/05	Dinar base – narrowed (deduction of: long-term housing loans insured with the National Housing Loans Insurance Corporation) Foreign currency base – narrowed (same as above) Foreign currency base – extended by inclusion of external liabilities arising from bank operations performed in the name and for the account of third parties	20% Unchanged except for the base extension introduced by the earlier Decision (increased from 7% to 18%) Minimum foreign currency liquidity against foreign currency savings reduced from 43% to 42%	Remunerated Unremunerated	10/10/2005	Sterilization of RSD 7.3 billion Release of RSD 0.6 billion
7.	91/05 95/05	Dinar base – reduced by time dinar savings deposited in the period from 31 October until 6 November 2005 Foreign currency base - unchanged Dinar base - unchanged Foreign currency base - unchanged	20% Unchanged except for the base extension (increased from 18% to 29%, i.e. equalized) Minimum foreign currency liquidity against foreign currency savings reduced from 42% to 41% Reduced from 20% to 18% Increased from 29% to 35%	Remunerated Unremunerated Remunerated Unremunerated	10/11/2005	Release of RSD 0.9 billion Allocation reduced by: RSD 1.7 billion Sterilization of RSD 20.4 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
8.	102/05	Dinar base – unchanged Dinar base with foreign currency clause - introduced Foreign currency base - unchanged	18% 35%	Remunerated Remunerated		Sterilization of RSD 2.0 billion
	109/05	Dinar base - unchanged Dinar base with foreign currency clause Foreign currency base: – extended (inclusion of foreign currency savings deposited after 30 June 2001 which previously had different treatment, with concurrent abolition of minimum foreign currency liquidity requirement) and - reduced by the sum of foreign currency savings deposited with banks in the period from 1-7 November 2004 and 31 October – 6 November 2005	Increased from 35% to 38% 38%	Unremunerated	10/12/2005	Sterilization of RSD 14.9 billion
9	28/06	Dinar base – unchanged Dinar base with foreign currency clause - changed Foreign currency base - extended (inclusion of the amount of subordinated foreign currency liabilities)	18% Increased from 38% to 40% Increased from 38% to 40%, except for subordinated liabilities (20%), and from 38% to 100% for deposits of leasing companies with banks	Remunerated Unremunerated	10/04/2006	Sterilization of RSD 1.2 billion Sterilization of RSD 18.7 billion
10	39/06	Dinar base – unchanged Foreign currency base - unchanged	18% 40% - for foreign loans with maturity up to 2 years, the ratio was raised from 40% to 60%	Remunerated Unremunerated	10/05/2006	Sterilization of RSD 35.5 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
11	49/06	Dinar base – unchanged Foreign currency base - unchanged	18% For liabilities in dinars arising from deposits and external loans with maturity up to 2 years the ratio was increased from 18% (40%) to 60%**,** and for liabilities with maturity over 2 years, from 18% (40%) to 40% 40%	Remunerated Unremunerated	10/06/2006	Sterilization of RSD 5 billion
12.	73/06	Dinar base – unchanged Foreign currency base - unchanged Obligation of banks to keep their daily balance of allocated dinar or foreign currency reserve requirement at a level of not less than 80% of calculated dinar or foreign currency reserve requirement is reduced to 50% subject to this decision.	Unchanged Unchanged	Remunerated Unremunerated	11/09/2006	The aim is to facilitate liquidity management for banks
13.	96/06	Dinar base – unchanged Foreign currency base – unchanged Daily balance of allocated dinar or foreign currency required reserves kept by banks may be higher or lower the calculated level of dinar or foreign currency required reserves, i.e. percentual limitation has been cancelled.	Reduced from 18% to 15% Unchanged	Remunerated Unremunerated	10/11/2006	Release of RSD 3.9 billion The aim is to facilitate liquidity management for banks

At its meeting held on 26 December 2006, the NBS Monetary Policy Committee adopted a new Decision on Required Reserves of Banks with the National Bank of Serbia.

Earlier decision on reserve requirements, issued in April 2004, was amended 17 times. The new decision was issued to amend this complicated method of calculating this classic and frequently changed monetary policy instrument. It is similar to the earlier decision in that the reserving base for the calculation of required reserves includes the book value of average daily dinar and foreign currency balances in the preceding calendar month.

However, pursuant to the new decision, banks do not calculate required reserves against special purpose deposits of enterprises and entrepreneurs in respect of exchange transactions; foreign currency required reserves are calculated and allocated in euros, as is the case with the calculation, payment and collection of interest (by way of exception, foreign currency required reserves may be calculated and allocated in US dollars so as to prevent worsening of open foreign currency positions of banks). Ratio on the dinar reserving base is set at 10%, on household foreign currency deposits on 40% and 45% on foreign currency reserving base (external borrowing). Reserve requirement ratio on short-term external borrowing (60%) has been cancelled. All changes in reserve requirements are presented in Appendix 1.

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
14.	New Decision 116/06	Dinar base – unchanged Foreign currency base – unchanged *Calculation of foreign currency required reserves is effected in euros.*	10% On foreign currency clause-indexed dinar deposits and dinar obligations arising from deposits and external credits – 45% 45% On foreign currency savings deposited with banks 40%; on foreign currency subordinated obligations 20%; on leasing companies' foreign currency assets 100%	Remunerated Unremunerated	10/01/2007	Release of RSD 5.8 billion Sterilization of RSD 14.6 billion
15.	3/07	Dinar base – unchanged Foreign currency base – unchanged *By way of exception, due to foreign exchange risk ratio, banks are allowed to allocate foreign currency required reserves also in US dollars.*	Unchanged Unchanged	Remunerated Unremunerated	10/01/2007	
16.	31/07	Dinar base – unchanged Foreign currency base – unchanged *Banks may issue order for allocation, i.e. withdrawal of funds from the foreign currency reserve requirement account.* *Subject to bank authorization, the National Bank of Serbia may credit or debit foreign currency accounts of banks in line with regulations on interbank clearing of payments in foreign exchange.*	Unchanged Unchanged	Remunerated Unremunerated		Applicable as 1 April 2007, just as the Decision on Interbank Clearing of Payments in Foreign Exchange

Appendix 4: Prudential Measures Aimed at Curbing Credit Growth

No.	Legal ref.	Regulation	Description	Previously
1	37/04 86/04 129/04	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	A bank is obligated to classify all claims arising from loans extended to a natural person (with the exception of housing loans) in category E, as top risk-bearing loans, subject to 100% provisioning in cases where total monthly instalment, including previously disbursed loans, exceeds 30% of the borrower's monthly income, and down payment or deposit placed by the borrower is less than 20% of the new loan .	Prior to the amendment to this Decision, loans that failed to meet the criteria were classified in category B subject to 25% provisioning.
2	97/05	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	In cases where the documentation submitted by a natural person applying for a loan does not include a Credit Bureau report on the natural person's liabilities, claims under such loan are classified in category E subject to 100% provisioning.	Prior to the amendment to this Decision, loans that failed to meet the criteria were classified in category B subject to 25% provisioning.
3	51/05	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	The amendment prescribes obligatory inclusion of the analysis of the borrower's dinar exchange rate risk exposure in the credit file in cases where the borrower is a legal entity, and in specific cases where claims on such borrower are to be classified in a category less favourable than they would otherwise have been classified. *(applicable as of 18 June 2005)*	
4	16/06	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	If a loan to a natural person, regardless of its maturity, is collateralized by a mortgage lien, then the base to which provisioning ratio is applied remains unchanged (with the exception of housing loans extended to natural persons, and mortgage backed loans to legal entities, in which case the base is narrowed by 50%, and the mortgage value may not be less than the value of the loan).	Implementation of this amendment to the Decision will prevent banks from evading higher provisioning for mortgage-collateralized cash loans, general purpose loans and consumer loans with longer maturities.
5	49/06	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	Amendment to the Decision has supplemented the provision pursuant to which claims on natural persons, excluding claims in respect of housing loans, are classified in category E if monthly instalment for repayment of the loan approved, including monthly payments of existing loans, exceeds 30% of the borrower's net monthly income, or if the borrower has placed a down payment or deposit of less than 20% of the amount of the loan approved. Subject to this amendment, in addition to obligations in respect of existing loans, monthly repayment obligations will also include obligations under revolving credit cards, activated warranties on loans, 50% of the amount of issued warranties on loans and obligations arising from financial lease contracts. *(applicable as of 1 July 2006)*	

No.	Legal ref.	Regulation	Description	Previously
6	11/05 28/05 108/05	Decision on the Uniform Method of Calculating and Disclosing the Level of Effective Interest Rate on Deposits and Loans	This Decision prescribes the uniform method of calculating and disclosing the effective interest rate used in calculation of total cost of a bank loan or deposit received. This Decision came into force on 15 March 2005.,It has, however, been amended on several occasions with a view to providing greater transparency: e.g. a corrective factor to the effective interest rate was introduced for loans under which the loan deposit exceeds 50% of total loan amount (applicable as of 30 March 2005). Also, the banks are required to submit weighted average interest rate for a) foreign currency clause indexed dinar loans separately for all foreign currencies used, as well as for other indexation criteria, b) dinar loans and c) foreign currency loans. *(applicable as of 7 December 2005).*	
7	57/06	Decision on the Uniform Method of Calculating and Disclosing the Level of Effective Interest Rate on Deposits and Loans	This Decision and the accompanying Guidelines were issued with a view to providing comparable and relevant information regarding the method of calculating and disclosing all costs of a loan/deposit. Pursuant to the Guidelines, banks are obligated to prepare and give to clients an Overview of Basic Data on Deposit/Loan, as well as an overview of data not included in the calculation of effective interest rate (revaluation and indexation criteria, Credit Bureau fees, etc.). In addition to quarterly reports, banks will also submit to the National Bank of Serbia monthly reports on their weighted average nominal and effective lending and deposit rates. *(applicable as of 1 October 2006)*	This Decision was issued pursuant to the new Law on Banks ("RS Official Gazette", No.107/05) With the commencement of its application on 1 October 2006, the earlier Decision on the Uniform Manner of Calculating and Disclosing the Effective Interest Rates on Loans and Deposits (Decision No.6) ceased to be valid.
8	51/05	Decision on the Basic Elements of Procedure for the Approval and Collection of Claims by Bank and Other Financial Organizations	Pursuant to this Decision, banks are obligated to devise methodology for assessment of the borrower's financial standing (borrower's creditworthiness), and particularly for analysis of the borrower's exchange rate risk exposure. In particular, banks are obliged to apply methodology for assessment of the borrower's financial standing and the effects of exchange rate change by 5%, 10% and 15% on the borrower's financial standing, as well as classification of the borrower's obligations in cases where the borrower's total liabilities amount to more than CSD 10 million. Finally, banks are obligated to apply methodology for assessment of their own credit risk exposure resulting from exchange rate risk movements, as well as to disclose the amount of provisions against potential losses.*(applicable as of 18 June 2005)*	

No.	Legal ref.	Regulation	Description	Previously
9	88/05	Decision Amending and Supplementing the Decision on Detailed Conditions and Manner of Conducting Bank Supervision by the National Bank of Serbia	Amendments to this Decision pertain to the implementation of corrective measures in cases where balance sheet assets and off-balance sheet items are not classified in compliance with supervision findings. *(applicable as of 1 January 2006).*	Valid until 1 October 2006.
10	51/06	Decision on Detailed Conditions and Manner of Conducting Bank Supervision by the National Bank of Serbia	This Decision specifies conditions and manner of conducting supervision, especially with respect to issuing orders and taking measures by the NBS and instituting receivership over banks. Pursuant to this Decision, in the event of any irregularities in the classification of claims, banks are obligated to classify balance sheet assets and off-balance sheet items in line with supervision findings, to enter such data in their ledgers and to disclose the amounts of provisions against potential losses. *(applicable as of 1 October 2006)*	
11	16/06	Decision Amending the Decision on Detailed Requirements with Respect to the Implementation of Articles 26 and 27 of the Law on Banks and Other Financial Organizations	This Decision abolishes two exemptions from calculation of the bank's foreign currency position: a) claims arising from long-term foreign currency loans approved under external loans, which were assumed by the Government and converted into capital, b) foreign currency claims and/or foreign currency clause indexed dinar claims – up to the level of shareholder capital paid up in a different currency. A bank is obligated to adjust its operations in line with this Decision by 31 December 2006 and to achieve a 30% foreign exchange risk ratio. When calculating risk-bearing assets, banks are required to apply a 50% weight only to claims on legal entities and housing loans collateralized by a mortgage equalling not less than the value of the claim.	

No.	Legal ref.	Regulation	Description	Previously
12	49/06	Decision Amending the Decision on Detailed Requirements with Respect to the Implementation of Articles 26 and 27 of the Law on Banks and Other Financial Organizations	When calculating risk-weighted assets, banks are obligated to apply a new 125% weight to "claims in foreign currency or in dinars indexed to a foreign currency clause or any other form of indexation equalling not less than the dinar equivalent of EUR 10,000,000 that have not been protected by the borrower against changes in the exchange rate of the dinar vis-à-vis another currency or any other form of indexation (by securing the claims on such borrower under same conditions that the bank secured itself, i.e. same foreign currency, and/or same foreign currency clause or any other type of indexation, same maturity, payment terms and at least the same amount)".	
13	39/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Pursuant to this Decision, a bank is obligated to reconcile gross household dinar lending (short-term and long-term, with allowances for loan impairment excluded, and with calculated interest and fees included) against the level of share capital so that, as of 30 September 2006, such lending at the end of each calendar month is lower than or equivalent to 200% of the value of share capital as at 30 September 2006.	New decision issued in May 2006
14.	49/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	A bank is obligated to reconcile gross household dinar lending against the level of its share capital so that, at the end of each month, such lending is lower than or equivalent to 200% of such bank's share capital (instead of 200% of the bank's share capital as at 30 September 2006).	New provision whereby the level of household lending is reconciled against the amount of share capital at the end of each month was introduced for the purpose of encouraging steady increase in banks' share capital and curbing growth in lending.

No.	Legal ref.	R e g u l a t i o n	D e s c r i p t i o n	Previously
15.	64/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Subject to this amendment, lending to be reconciled against the bank's share capital includes not only dinar lending, but also foreign currency lending (pursuant to the new Law on Foreign Exchange Operations, a bank may approve foreign currency loan to resident-legal entity and entrepreneur for the purpose of importing goods and services and to natural person for the purpose of purchasing real estate in the country). Subject to the adopted Decision, gross household lending does not include loans for direct investment in agricultural production, loans for housing construction supported by the RS Government's program and loans approved to entrepreneurs (natural persons independently performing economic activities for the purpose of making profit) for direct investment in production of goods and services within their line of business. *(applicable as of 31 July 2006)*	
16.	57/06	Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items	For the purposes of adequate and efficient management of risks that the bank is exposed to in its operations, this Decision sets out the conditions under which a bank classifies its balance sheet assets and off-balance sheet items, as well as the manner of covering the provisions against potential losses on balance sheet assets and off-balance sheet items. Provisions against potential losses on bank balance sheet assets and off-balance sheet items are *special provisions against potential losses and provisions against general banking risks*. The Decision also specifies special criteria for the classification of bank receivables from different categories of borrowers: legal entities, budget beneficiaries, entrepreneurs and natural persons. Banks are obligated to classify all receivables into categories A, B, C, D and E depending on the timeliness of collection, past due status of payment, disputable legal grounds or problems in operation.	This Decision (entered into force on 1 October 2006), practically replaced the preceding Decision on the Classification of Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations.
17.	116/06	Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items	Amendment to this Decision prescribes *percentage bands* for the calculation of special provisions against potential losses, whereby banks are given greater independence and responsibility in measuring credit risk. Banks are obligated to define in more detail the criteria and methodology for specifying provisions against potential losses within percentage bands through their internal enactments. The amendment also introduced changes in the manner of classification of receivables from legal and natural persons.	

No.	Legal ref.	R e g u l a t i o n	D e s c r i p t i o n	Previously
18.	57/06	Decision on Capital Adequacy of Banks	This Decision sets out the method of calculating a bank's total qualifying capital and capital adequacy ratio. A bank's total qualifying capital is the sum of its core capital elements (minimum 50% of capital) and supplementary capital elements minus deductions. Banks have to ensure that their capital never drops below the dinar equivalent value of EUR 10,000,000 at the official middle exchange rate. The Decision defines risk-weighted assets of the bank, foreign exchange risk (the risk of negative effects on the financial result and capital of the bank caused by changes in exchange rates), and open net foreign currency position. Open net foreign currency position of a bank may be long (if the amount of receivables in a specific foreign currency exceeds the amount of obligations in the same currency) or short (if the amount of receivables in a specific foreign currency is lower than the amount of obligations in the same currency). Open net foreign currency position of a bank is to be shown separately for euro-, US dollar- and Swiss franc-denominated receivables and obligations, while receivables and obligations in other currencies are to be shown in the aggregate, as well as those in gold and other precious metals. Banks will also include in the calculation of open net foreign currency position their foreign currency clause-indexed dinar receivables. Pursuant to the Decision, capital adequacy ratio is the ratio between the bank's capital and risk-weighted assets. For the purposes of running safe and sound business operations, and/or fulfilment of obligations towards the creditors, bank is obligated to keep its capital adequacy ratio above 12%.	This Decision (entered into force on 1 October 2006) practically replaced the preceding Decision on Detailed Requirements for Implementing Articles 26 and 27 of the Law on Banks and Other Financial Organizations, as well as Section 31 of the Decision that regulated foreign exchange risk ratio.
19.	116/06	Decision on Capital Adequacy of Banks	This amendment introduces a provision pertaining to the 125% risk weight. Namely, the bank is to include in this category of risk also a portion of receivables that have not been protected by the borrower against changes in the foreign exchange risk. Receivables are considered partly protected against changes in the exchange rate of the dinar or changes in form of indexation, if the borrower can rely on inflow in the same currency, and/or with the same form of indexation for the term of such receivable (inflow from abroad, deposit, wages, etc.).	

No.	Legal ref.	Regulation	Description	Previously
20.	31/07	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Subject to this amendment, banks are obligated to pay interest to the National Bank of Serbia on the amount of positive difference between the prescribed and deposited amount of funds, as well as on the amount of positive difference between the correctly calculated and originally calculated amount to be deposited, by applying the interest rate envisaged by the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy ("RS Official Gazette", 73/2006, 103/2006, 110/2006 and 31/2007).	Beginning of application in the period 25 May – 25 June 2007, according to the level of gross household lending and share capital as at 30 April 2007.

List of Tables and Charts

Source of data: National Bank of Serbia and Serbian Bureau of Statistics, unless otherwise specified.

Press Releases from the NBS MPC Meetings

Press release from the MPC meeting held on 10 January 2007

At its meeting today, the NBS Monetary Policy Committee decided to keep the key policy rate at 14%. The reasons behind such decision are high level of dinar liquidity attributable to a notable decline in government dinar deposits unexpected for this time of the year and NBS interventions in the forex market (purchase of foreign exchange) aimed at precluding further appreciation of the dinar by the end of December, as well as the fact that data on market developments in the first half of January are typically less reliable (smaller number of business days). Apart from this, downward revision of reserve requirement ratio on dinar deposits from 15 to 10% is expected to induce additional increase in dinar liquidity. For this very reason, by its decision to keep the key policy rate unaltered, the NBS is trying preclude the pressures of surging dinar liquidity on excessive rise in spending that might spark inflation expectations and inflation rate growth.

The NBS is giving yet another proof to economic stakeholders that the exchange rate is not used as inflation anchor – the main, market-based monetary policy instrument is the key policy rate. Exchange rate of the dinar will continue to be formed with reference to demand and supply, and the NBS will do its best to contribute to its stability.

The National Bank of Serbia will carefully monitor further monetary developments, inflation expectations and changes in the character of fiscal policy, and accordingly take measures so as to keep monetary policy tight enough for achieving core inflation projected for this year.

Press release from the MPC meeting held on 29 January 2007

The NBS Monetary Policy Committee announced today its decision to lower the key policy rate by 1 percentage point down to 13 percent. This is the fifth consecutive reduction effected since 1 September last year when the key policy rate was first introduced as the main instrument of monetary regulation and set at 18 percent.

After reviewing the actual and projected inflation trends, the MPC concluded that there is scope for further relaxation of the monetary policy stance, as headline inflation in 2006, and particularly in Q4 2006, was lower than planned while core inflation even undershot its target rate as defined by the monetary policy framework implemented in the final quarter of 2006.

The latest forecasts for 2007 indicate that the rate of inflation will most likely hover at the lower band of the 2007 target corridor even in a less restrictive monetary policy environment. The MPC also noted that inflation expectations of economic agents have been moving down concurrently with falling inflation. All of the above created room for further gradual lowering of the key policy rate.

Hence, the NBS not only provided yet another signal with respect to economic expectations, primarily inflation expectations, but also confirmed its commitment to a consistent set of monetary policy measures in the immediate future, which are expected to bring about a decline in other banking sector interest rates, support exchange rate stability and improve confidence in the national currency, as well as strengthen market instruments aimed at excess money withdrawal and monetary policy management.

The MPC is committed to monitoring the overall balance of inflationary risks. With respect to upside risks, today's discussion focused mainly on inflationary effects of the current government spending trend and large-scale liberalization of regulated prices. The MPC is of the opinion that the already announced liberalization in electricity prices is unlikely to affect inflation target fulfilment in 2007, and will therefore require no monetary policy action. However, the MPC will closely monitor these developments for their eventual spill-over effect on core inflation and inflation expectations.

Among downside risks, the MPC noted the prospect of continued nominal and real appreciation of the dinar exchange rate and a possible economic slowdown, although signs of the latter are not yet visible and the economy is doing well overall. It has also taken into account a possible fall in oil prices.

The MPC anticipates continuation of gradual relaxation of the monetary policy stance in line with a decline in both inflation and inflation expectations.

MPC's decisions on further easing of the monetary policy stance will be based on continued close monitoring of current economic trends, with particular focus on the achievement of projected core inflation set for 2007, and the degree of fiscal policy tightness.

At its meeting today, the MPC also adopted a decision on the first issue of savings bills in 2007. The bills will be issued on 5 February and mature in 360 days, on 31 January 2008. Total nominal value of the new issue is RSD 1 billion and the interest rate equals 14 percent p.a. The MPC holds that, given the declining inflation trends, this still represents an attractive interest rate. Household demand for savings bills is expected to remain strong also due to expected exchange rate stability and the fact that NBS savings bills represent a safe investment. Household interest in NBS savings bills is best illustrated by the following figures: both first and second issue of NBS savings bills were paid out at maturity, fourth-issue savings bills were sold out in record short time of only one week, while 81 percent of the entire fifth issue was sold out by 24 January 2007.

Press release from the MPC meeting held on 9 February 2007

After reviewing January economic developments at its meeting today, the NBS Monetary Policy Committee decided to keep the key policy rate and interest rates on deposit and lending facilities unchanged. Namely, the key policy rate was last revised on 31 January from 14% to 13%.

Although the publishing of official statistical data on inflation in January 2007 is delayed due to a shift in calculations from base year 2005 to base year 2006 and specific methodological adjustments, the MPC assessments indicate that there was no growth in core inflation in the preceding month.

However, having analyzed the overall balance of inflationary risks, the Monetary Policy Committee concurred that a number of elements pertaining to other economic policy segments affecting core inflation movements is not known, and therefore, decided to wait for the signals which will confirm the latest projections of inflation and economic developments discussed in the previous meeting.

At the same time, the MPC has taken note of the fact that January movements in monetary aggregates were also largely occasioned by seasonal factors, among which foreign debt servicing, which resulted in increased conversion of dinars into foreign exchange, particularly stands out. Due to stronger demand for foreign exchange, the National Bank of Serbia was

impelled to intervene several times in the interbank foreign exchange market. Nevertheless, the MPC holds that such increased demand for foreign exchange was of temporary character, and that the fleeting nature of its impact is further confirmed by the foreign exchange market developments recorded during the last ten days of January and in early February.

There was no revision of inflation projection and risks to its attainment in today's MPC meeting. Core inflation rate is expected to continue falling towards the lower band of the 2007 target corridor 4 – 8%. Nevertheless, there are significant risks to the achievement of the target corridor, with the risk of undershooting stronger than that of overshooting. An in-depth analysis and projections of inflation and economic developments will be published in Inflation Report by the end of February.

The Monetary Policy Committee still sees room for further relaxation of the monetary policy stance in line with a decline in both inflation and inflation expectations. Given that a low inflation rate is expected in early 2007, the pace of monetary policy relaxation will depend on the impact of actual inflation rate on inflation expectations and reduction of risks to the target fulfilment in the period ahead.

Press release from the MPC meeting held on 28 February 2007

After discussing current monetary flows and inflation projections, the Monetary Policy Committee has decided at its meeting today to lower the key policy rate by 1.5 percentage points, i.e. down to 11.5%. This decision of the MPC is based on the fact that core inflation has been below the central target for 2007 for some time now and that its annual rate has declined to 4.7% at end-February against headline inflation of 5.2% p.a. Lower-than-expected inflation, which resulted from a much slower growth in market-determined prices compared to those under administrative control, prompted the NBS to relax its monetary grip.

The MPC assesses that the annual inflation rate will remain low despite the planned and announced increase in selected prices under administrative control, such as the price of electricity. Due to strengthening of the dinar and decline in prices of oil derivatives, no increase in core inflation has been registered for several months now, including the month of February as well.

However, the MPC holds that there are risks to the macroeconomic situation and outlook, primarily in the area of fiscal policy and movements in wages, which may have a sway on inflation expectations.

The NBS wishes to warn that the continuation of growth in wages paid by public employers (public services, state and public enterprises) could give rise to inflation pressures. The same applies to requests for double-digit price adjustments put forward by some public enterprises. In the present conditions of declining interest rates and stability of the general level of prices and exchange rate, there seem to be no grounds for such requests.

Notwithstanding their unquestionable impact on the increase in government spending, Amendments and Supplements to the Decree on Temporary Financing of the RS Budget represent a bad signal against a background of low inflation. Therefore, the MPC is of the opinion that the budget for 2007 should be adopted as soon as possible and government spending adjusted to sustain stability in prices.

The Inflation Report reviewed and adopted by the MPC today contains an evaluation of macroeconomic flows and inflation projections, as well as the analysis of prevailing risks. NBS

Governor Radovan Jelašić shall hold a press conference on 2 March 2007 to give more detailed information to the public regarding the Inflation Report

The NBS shall monitor the balance of risks and adjust its monetary policy measures should it find that such risks pose a threat to the sustainability of core inflation within the projected range for 2007.

Press release from the MPC meeting held on 13 March 2007

After discussing early March economic flows, the Monetary Policy Committee announced today its decision to retain the key policy rate at 11.5%. Although core inflation remains in the lower band of the targeted corridor, leaving scope for further policy relaxation, such decision of the MPC was due to a lack of information on Q1 movements, especially regarding core and headline inflation in March and the fact that temporary budget financing is to be abandoned at the end of this month.

The key policy rate was last cut in early March, as a consequence of negative core inflation rates and a notable decline in inflation expectations. This triggered a further drop in money market interest rates and dampened appreciation pressures on the dinar exchange rate. The MPC expects annual inflation rates to continue low into the second quarter of this year.

Of the potential risks that could affect inflation expectations, the MPC singled out accelerated wage growth in the public sector, especially in state and public enterprises, which could also lead to a rise in government expenditure in the period ahead. Furthermore, since fiscal expansion is already higher than expected for Q1, the MPC holds that the 2007 budget should be adopted as soon as possible to replace temporary financing. The budget should define the amount of government spending that does not threaten price stability. With regard to public enterprises' demands for substantial increase in prices, the MPC invited the government to urgently institute control of financial planning of such enterprises, in order to avoid future "shocks" caused by changes in administered prices. In an environment characterized by price stability, stable dinar exchange rate and gradually declining level of interest rates, all such demands seem completely out of place.

In its next meeting in late March, the MPC will analyze March inflation rate and the alternative to temporary budget financing to decide on whether to adjust monetary policy measures to the Q2 inflation projection.

Press release from the MPC meeting held on 28 March 2007

The NBS Monetary Policy Committee announced today its decision to cut its key policy rate by one percentage point down to 10.5 percent. The MPC based its decision on estimates that end-Q1 inflation at annual level, inclusive of March price flows, will linger at the lower bound of the target corridor of 4 to 8 percent. This created space for further relaxation of the monetary policy stance in order to bring the key policy rate to a level conducive to maintaining core inflation within the band projected for this year.

The MPC also took note of the strategic orientation of the NBS to continue reducing its participation in the foreign exchange market and to formally introduce the inflation targeting regime. Over the past two months, the NBS was active in the foreign exchange market on four days only. As its overall sales of foreign exchange were lower than its purchases of foreign cash

via exchange offices, there were no disruptions to the stability of the exchange rate. It remained stable even after introduction of the new methodology for setting the official middle exchange rate of the dinar against the euro on 5 March, according to which the exchange rate is formed by balancing supply and demand in the entire foreign exchange market.

The MPC holds that interest rate cuts should, however, be gradual, in the face of risks due to which inflation expectations, primarily those of the enterprise sector, still run above actual inflation figures. These risks stem from strong growth in wages, including public sector wages, and the still undefined fiscal policy stance, as no budget or public spending framework for 2007 has been formulated yet. Available data indicate that the first quarter will end in a fiscal deficit, which, together with continuation of temporary financing in the second quarter, may result in further fiscal policy expansion. Any analysis of future flows should focus not only on expenditures, but also on a realistic assessment of achievement of planned budget revenues – so far and in Q2 this year.

Other major risks to the achievement of the core inflation projection in the period ahead are movements in prices under administrative control, such as the rise in prices of postal services and the announced increase in electricity prices, which have already been included in the projection but for which no specific timing has yet been set. The MPC also noted that certain prices which are not fully market-determined, such as, for instance, TV subscription, have risen, despite the fall in core inflation. In projecting future inflation flows, it is necessary to have in mind that international prices of petroleum products, which in late 2006 and early 2007 had a disinflationary effect, reversed their trend in the course of the past two months. Over the short term, this will not affect inflation in any significant way, as prices of agricultural products are expected to record a notable seasonal drop in the same period.

When it was first introduced on 1 September 2006, the NBS key policy rate equalled 18 percent. After seven reductions, it now stands at 10.5 percent. Its lowering has not only triggered a decline in interest rates within the interest rate corridor of the central bank but also in interbank market interest rates. Today's reduction of the key policy rate by one percentage point is expected to have the same effect but the MPC warns that, should there be any change in trend, the National Bank will revise the key policy rate upwards so as to make it consistent with core inflation level projected for this year.

The new key policy rate of 10.5 percent shall apply as of 30 March 2007.