National Bank of Serbia

May 2009

INFLATION REPORT

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Introductory note

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

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

Inflation Report aims to cover information on the current and expected inflation movements and to provide analysis of underlying macroeconomic developments. It also aims to explain reasoning behind MPC's decisions and to provide an assessment of the monetary policy effectiveness during the previous quarter. Also integral to this report is inflation projection for at least four quarters ahead, assumptions on which the projection is based and an analysis of key risks to the achievement of inflation target.

The information contained in this report will help raise public understanding of the monetary policy implemented by the central bank and its commitment to achieving the inflation target. Moreover, it will play a role in containing inflation expectations, as well as in achieving and maintaining price stability, which is the main task of the NBS.

The May Inflation Report was adopted by the NBS Monetary Policy Committee in its meeting of 22 May 2009.

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

Monetary Policy Committee of the National Bank of Serbia:

Radovan Jelašić, Governor

Ana Gligorijević, Vice-Governor

Mira Erić-Jović, Vice-Governor

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I. Overview

Inflation target for Q1 has been met.

Though moving within the target range in Q1 2009, inflation rose on end-2008 due to the substantial increase in regulated prices and the effects of the depreciation of the dinar, which outweighed the disinflationary effects generated by the sharply reduced demand.

Disinflationary pressures are expected to prevail in the coming period.

We expect the disinflationary factors to prevail already in Q2, most notably the drop in aggregate demand and economic activity. Of regulated prices, only petroleum product prices are likely to record a significant rise. At low demand, this should result in a slower price growth in Q2, placing the y-o-y inflation rate by mid-2009 closer to the lower bound of the targeted range. After January weakening, the exchange rate of the dinar stabilised (no NBS interventions since late February). Most effects of the depreciation on inflation came through in the first two months of the year.

Falling demand and illiquidity in the economy have led to a sharp decline in output.

Output entered a sharp decline as a consequence of low domestic and foreign demand, drop in lending activity, formation of illiquidity chains and additional burden on debtors stemming from depreciation of the dinar. The drop in demand was sustained by cautious spending and investment decisions of economic entities uncertain of the depth and duration of the crisis.

According to March data on exports and industrial output, the crisis is not deepening further.

March data paint a slightly more optimistic picture showing a pick up in industrial output after its collapse in January. This could signal a recovery of foreign demand, playing a key role in the recovery of our economy. The weakening of the dinar, most pronounced against the currencies of Serbia's main foreign trade partners (euro area and CEFTA members) could provide some impetus to growth in our exports.

The disinflation process will be aided by new fiscal measures.

Disinflationary factors will prevail over the medium run. In addition to low demand, as the most significant factor, the disinflation process will also be aided by the new fiscal policy measures. From the aspect of monetary authorities, these measures are positive as they rely on expenditure cuts rather than revenue hikes, hence inducing a negligible impact on price growth. Add to this the Government's announcement of a much slower regulated price growth in the period ahead, inflation decline appears rather probable. The only medium-term factor producing inflationary effects is the recently opened depreciation gap of the real exchange rate. Its effects, however, are not expected to put the disinflation process in serious jeopardy.

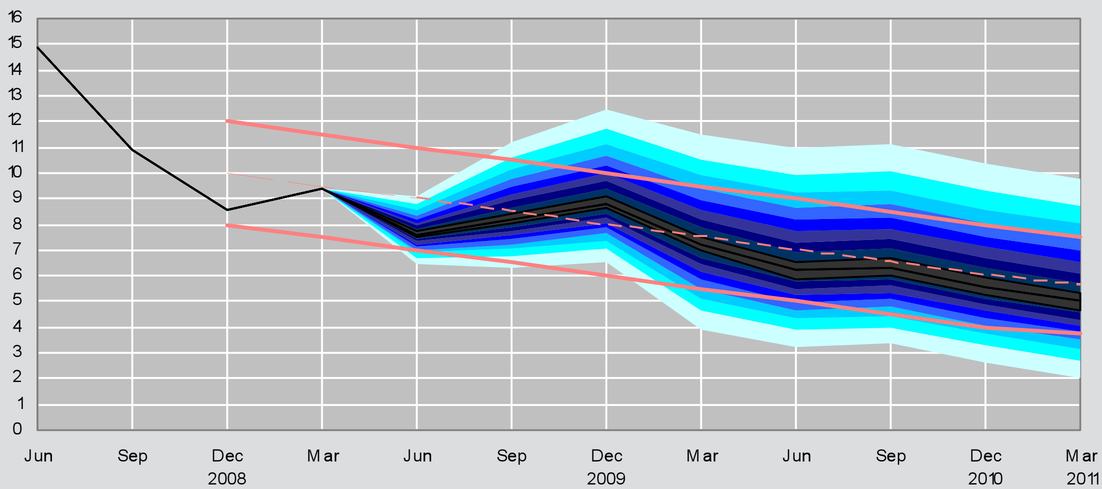
Arrangement with the IMF will help decrease the risk premium.

Arrangement with the IMF is expected to lead to a drop in the risk premium, which should, together with the agreement reached with banks on the maintenance of their exposure to Serbia, moderate depreciation pressures.

This year's inflation will move within the target band.

Inflation is most likely to move within the target band in the period ahead. The central projection places end-2009 inflation at 8.8%, within the band of 6.5–12.5%, while the central projection for 2010 revolves around the midpoint of the target band.

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



Key risks to the projection include the rise in VAT rate, higher than assumed growth in regulated prices and low agricultural performance.

Risks to the projection are tilted to the upside mainly by the potential increase of the VAT rate in the event of fiscal revenue underperformance, faster than expected growth in regulated prices and bad harvest. In terms of regulated prices, there is a risk that local government bodies could respond to lower transfers from the budget by raising the prices of their services.

Monetary policy has been expansionary.

The NBS has loosened its grip on the monetary reins since the beginning of the year in response to lower inflationary pressures. Our monetary policy can now be defined as expansionary. Taking into account the current projection and underlying risk factors, the NBS Monetary Policy Committee holds that the key policy rate is more likely to be lowered in the next period than raised or kept on hold (14%).

II. Inflation developments

A relatively high Q1 inflation was mainly due to a notable regulated price growth and effects of dinar depreciation that overpowered the disinflationary pressures generated by a drastic fall in demand. Further, the growth in unit labour costs induced a slowdown in disinflation. However, observed by month, both headline and core inflation point to a greater-than-expected slowdown.

Y-o-y consumer price growth at end-Q1 revolved around the midpoint (9.4%), but is expected to go down in Q2 (7.6%).

The outset of 2009 was marked by high consumer price growth. The January and February growth of 2.1% and 1.2% respectively was expected both owing to the announced increase in prices under direct or indirect government regulation and the spillover effects of depreciation of the dinar in 2008 on market-determined prices. Weakened inflation pressures of the above factors that largely determined headline inflation in the first two months of the year, dragged down on March inflation (0.4%).

In quarterly terms, headline inflation accelerated to 3.8%. However, such an outturn is lower than assumed in the February *Report* (4.4%) because of lower-than-expected growth in core inflation.

Table II.0.1 **Indicators of price growth**
(growth rates in %)

	VI 2008 / VI 2007	IX 2008 / IX 2007	XII 2008 / XII 2007	III 2009 / III 2008
Consumer prices	14.9	10.9	8.6	9.4
Core inflation	14.2	11.4	10.3	10.2
Retail prices	12.1	9.9	6.8	9.9
Cost of living	15.9	10.6	7.9	9.1
Industrial producer prices	13.1	13.2	9	4.9
Agricultural producer prices	48.8	25.3	13.5	0.2

Y-o-y price growth at end-Q1 was higher than at end-2008 (producer prices excluded due to rising illiquidity pressure).

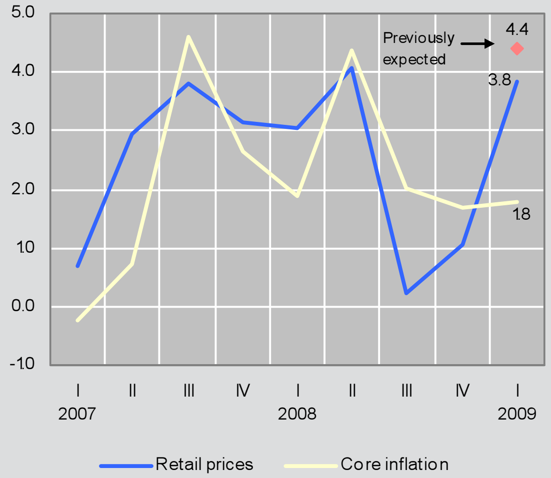
Inflation target was met for all three months of Q1. The y-o-y consumer price growth in March revolved around the midpoint (9.4%).

Depreciation of the dinar placed the strongest upward pressure on inflation in January, with a strong stimulus provided by growth in prices of tradeables (petroleum products excluded). As spillover effects of depreciation from 2008 and early 2009 petered out, the impact of growth in prices of tradeables on headline inflation became weaker.

Mainly aided by rising prices of petroleum products and cigarettes, regulated price growth reached 9.1%. Increased excise duties on petroleum products and cigarettes contributed 0.8 pp to total consumer price growth. Utility prices also hiked (central heating and water bills), as well as prices of medicaments, postal and telecommunications services (telephone impulses) and transport services (city transport). Y-o-y regulated price growth reached 10.6% by quarter-end.

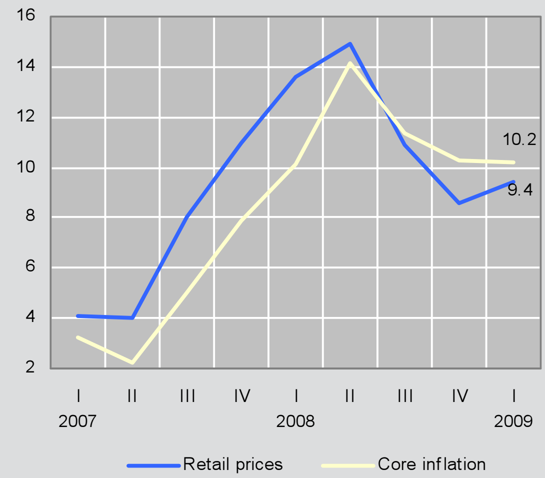
Although Q1 core inflation remained almost unchanged from Q4 2008 (1.8%), it was on the decline month-to-month. Y-o-y core inflation continued to slow, only to reach 10.2% by end-Q1. Core inflation was determined by strong depreciation of the dinar from the previous months, as well as dampened

Chart II.0.1 **Movements in prices**
(quarterly grow th, in %)



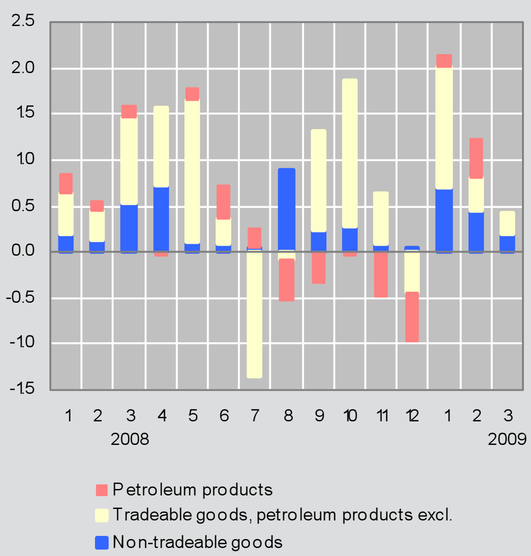
Headline inflation recorded accelerated quarterly growth, while core inflation was on a mild increase. Headline inflation was determined by regulated price growth.

Chart II.0.2 **Movements in prices**
(y-o-y grow th, in %)



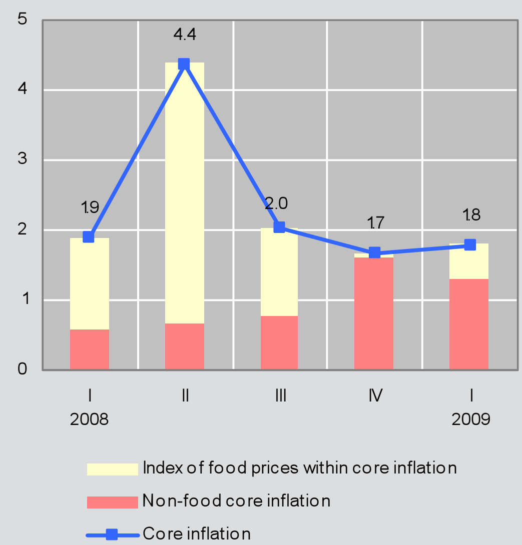
Y-o-y , headline inflation was on the rise, while core inflation slowed down.

Chart II.0.3 **Contribution to monthly consumer price growth**
(in percentage points)



The contribution of prices of tradeables to headline inflation growth weakened as the effects of dinar depreciation wore off.

Chart II.0.4 **Contribution to core inflation**
(in percentage ponts)



The input of food to core inflation growth was on a mild increase in Q1.

Table II.0.2 **Consumer prices growth by component**
(by quarter, in %)

	2008				2009
	Q1	Q2	Q3	Q4	Q1
Consumer prices	3.0	4.1	0.2	1.1	3.8
Core inflation	1.9	4.4	2.0	1.7	1.8
Prices of agricultural products	14.9	7.1	-20.1	11.4	4.7
Regulated prices	2.7	2.4	2.1	-3.1	9.1
Electricity	3.4	0.0	8.9	0.0	0.0
Petroleum products	10.0	9.5	-11.2	-24.2	16.9
Gas for households	0.1	1.1	-0.2	55.6	-0.8
Utilities	0.3	0.6	1.1	4.5	12.8
Social welfare services	0.6	0.2	1.1	2.9	0.9
Transport services (regulated)	2.0	0.4	5.1	0.4	26.6
Postal and telecommunications services	0.0	0.0	0.0	0.7	10.1
Bread	2.9	15.7	-1.2	-0.8	-0.7
Cigarettes	0.0	0.0	10.4	0.0	15.0
Medications	0.2	0.1	0.0	-3.2	10.1
Other	-0.2	9.2	0.8	0.0	0.7

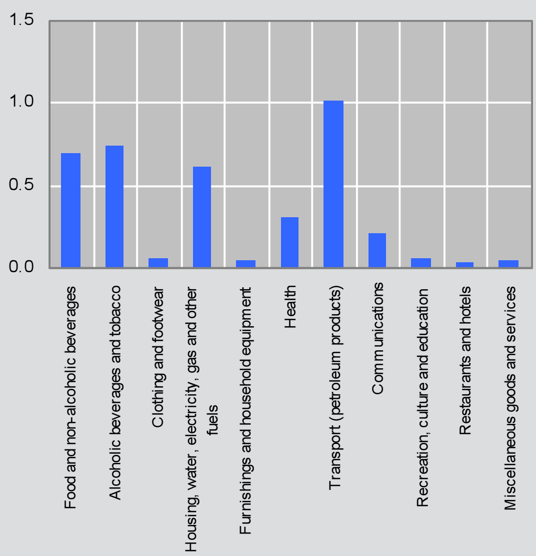
The strongest growth in Q1 was registered with prices of petroleum products and transport services. Prices of cigarettes and utility-housing services were also on the rise.

Table II.0.3 **Contribution to consumer prices growth**
(by quarter, in percentage points)

	2008				2009
	Q1	Q2	Q3	Q4	Q1
Consumer prices	3.0	4.1	0.2	1.1	3.8
Core inflation	1.2	2.9	1.3	1.1	1.2
Prices of agricultural products	1.2	0.6	-1.8	0.8	0.4
Regulated prices	0.7	0.6	0.5	-0.8	2.3
Electricity	0.2	0.0	0.6	0.0	0.0
Petroleum products	0.5	0.5	-0.6	-1.1	0.6
Gas for households	0.0	0.0	0.0	0.2	0.0
Utilities	0.0	0.0	0.0	0.1	0.4
Social welfare services	0.0	0.0	0.0	0.0	0.0
Transport services (regulated)	0.0	0.0	0.1	0.0	0.3
Postal and telecommunications services	0.0	0.0	0.0	0.0	0.2
Bread	0.0	0.1	0.0	0.0	0.0
Cigarettes	0.0	0.0	0.4	0.0	0.6
Medications	0.0	0.0	0.0	-0.1	0.3
Other	0.0	0.1	0.0	0.0	0.0

Regulated price growth provided a 60% contribution to consumer price growth.

Chart II.0.5 **Contribution of individual commodity groups to consumer price growth rate in Q1**
(in percentage points)



The strongest contribution in Q1 came from excise products (petroleum products, alcoholic beverages and cigarettes).

aggregate demand and lower growth in food prices. Almost three fourths of Q1 core inflation growth are attributable to the rise in prices of non-food products and services (1.3 pp). Of food products included in the calculation, the major contributor was the growth in prices of non-alcoholic beverages (0.3 pp) and fresh and processed meat (0.1 pp each).

The expected seasonal growth in prices of agricultural products reached 4.7% at end-Q1, while at the same time, their y-o-y growth rate was a negative 0.2%.

Expectations for Q2 2009

Our estimates show that the quarterly headline inflation will slow down to around 2.3% in Q2, mainly on account of slower regulated price growth, but also on account of deceleration in core inflation. The y-o-y consumer price growth is likely to reach around 7.6% by end-Q2 and move closer to the lower bound of the targeted range.

The estimated regulated price growth will reach around 3.8%, contributing around 1.0 pp to total consumer price growth. The deferral of electricity price increase is expected to stimulate further disinflation (-0.6 pp).

The strongest growth is anticipated with prices of petroleum products (on the back of rising crude oil prices, increase in excise duties and depreciation of the dinar), medicaments (due to weakening of the dinar), and housing and utility services. Higher excise taxes on petrol and diesel by RSD 2 and RSD 4 respectively will add around 0.6 pp to regulated price growth. The announced increase in excise duties on cigarettes by RSD 1 is not likely to push cigarette prices up, in view of the cigarette pricing structure and the impact of this increase on retail prices.

Quarterly growth in market-determined prices is likely to slow down in response to subsided depreciation pressures. According to our estimates, quarterly core inflation growth will equal around 1.2% and contribute around 0.8 pp to headline inflation. The announced 10% increase in taxes on mobile telephony services will add around 0.1 pp to core inflation growth.

Seasonal growth in prices of agricultural products is likely to reach around 7.0%, contributing close to 0.5 pp to total consumer price growth.

Table II.0.4 **Major revisions of regulated prices expected in Q2**

	Growth rate (in %)	Contributions to retail price growth (p.p.)
Petroleum products	12,8	0,5
Medications	9,5	0,3
Utilities	4.0	0.1

Regulated price growth is expected to be much smaller compared to a quarter earlier. The strongest impetus to growth will come from prices of medicaments and petroleum products.

Inflation expectations

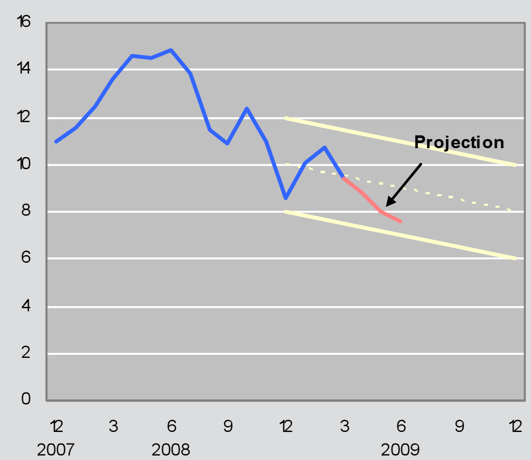
Although significantly below their March levels, one year-ahead inflation expectations reported in April remain above the upper bound of the targeted range.

According to the results of the April survey conducted by Strategic Marketing Research agency, one year-ahead inflation expectations of all sectors declined from a month earlier, and are now closer to the upper bound of the inflation band targeted for the next year. The sharpest drop in inflation expectations was recorded for the trade unions, from 14% to 10%, while expectations reported by the financial sector, enterprises and households revolve around 12%.

The latest *Reuters* survey shows that the banking sector expects a 9.0% consumer price growth in April 2010, or 0.9 pp less than reported in March.

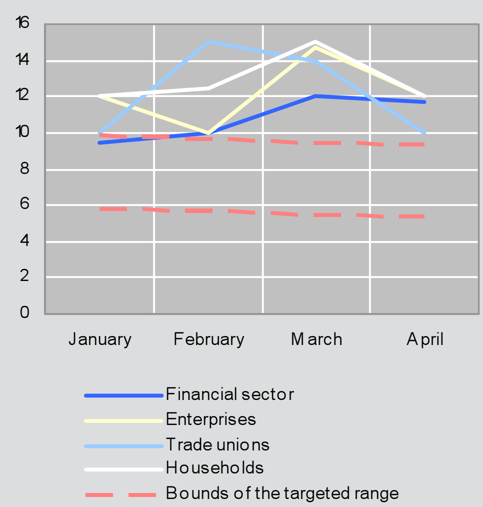
The main reasons behind lower inflation expectations are dampened aggregate demand and economic downturn, as well as stabilisation of the exchange rate and lower consumer price growth reported in March.

Chart II.0.6 **Short-term inflation projection**
(y-o-y growth, in %)



Y-o-y inflation growth is expected to slow down in the course of Q2.

Chart II.0.7 **Expected and targeted inflation in 2010**



Source: *Strategic Marketing*

After their March rise, inflation expectations subsided in April in all sectors observed.

New survey of inflation expectations

In cooperation with the *Strategic Marketing Research* agency, the NBS piloted in January this year a new survey of expected movements in prices, output, exchange rate of the dinar, wages, interest rates and growth in lending.

The survey is based on a random sampling in four target groups: financial sector, businesses, trade unions and households.

In the trade unions sector, a minimum of 10 respondents are surveyed, primarily those in top management positions, such as presidents or secretaries general. In the household sector, more than 1,000 adults are surveyed, while target respondents from the financial sector (minimum 20) include chief economists, financial directors, heads of research and analysis departments, etc. Survey of the businesses covers at least 100 out of 200 businesses included in the territory and sector-specific representative sample. Respondents from this sector include CEOs, financial directors, line managers, etc.

Each target group is surveyed with a different questionnaire. Households are surveyed through face-to-face interviews, while telephone surveys are conducted in case of other sectors. The new survey is carried out between the 10th and 14th of each month.

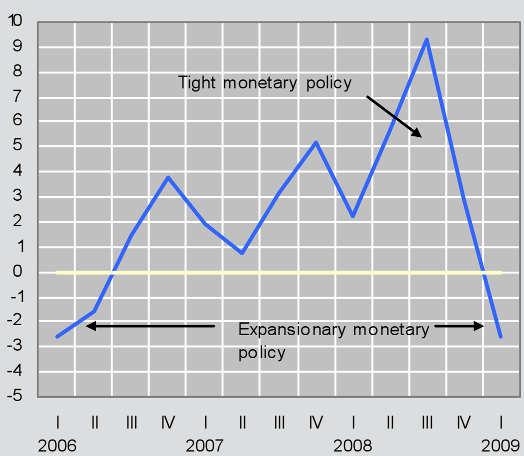
III. Inflation determinants

1. Monetary conditions

Monetary policy was further relaxed in Q1 2009. The monetary conditions index points to the expansionary character of monetary policy. The real exchange rate has shifted from the excessive appreciation phase to that of excessive depreciation, while the real interest rate had a neutral effect.

Escalation of the global economic crisis that impacted on the economic downturn and pushed the Serbian economy into recession, created the need for additional monetary easing during Q1 2009. Estimating that disinflationary effects (resulting from contracted economic activity and weaker aggregate demand) would persist over the mid-term despite strong nominal depreciation of the dinar and higher than expected regulated price growth, the NBS Monetary Policy Committee revised the key policy rate down to 16.5% in January.

Chart III.0.1 **Monetary Conditions Index (MCI)**



Monetary policy was expansionary in Q1 2009.

Monetary policy thus assumed an expansionary character for the first time since the (implicit) inflation targeting regime was put in place. Both RMCI[1] components – the real exchange rate gap and real interest rate, confirmed this trend.

Consistently with our expectations from the February *Report*, the depreciation gap of the real exchange rate opened in Q1. Despite faster growth in domestic relative to foreign prices, the depreciation gap of the real exchange rate opened on the back of nominal depreciation of the dinar by 9.6%. This factor will continue to produce inflationary pressures in the period ahead.

By contrast to the preceding quarter when it produced inflationary pressures, the real interest rate had an almost neutral effect in Q1 (it revolved around the trend). This was due to a slide in inflation expectations, and much less to the downward trend in the real interest rate which, despite the cut in global interest rates, remained relatively high (around 6%) as depreciation pressures and high risk premium persisted.

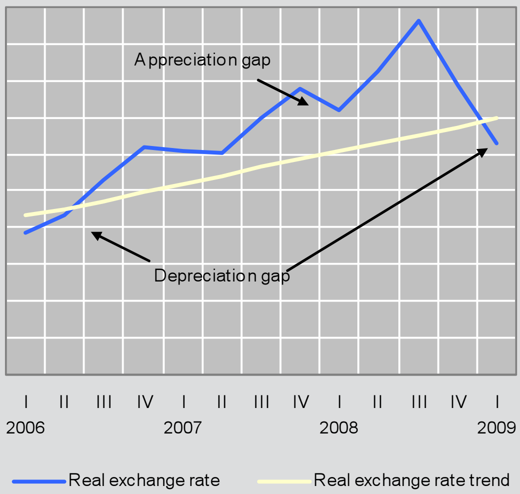
Following April revisions of the key policy rate (down to 15% and subsequently to 14%), monetary policy became even more expansive – the real interest rate is currently running below the trend by around 370 basis points.[2]

To what extent more expansive monetary policy will influence economic growth and inflation in the coming period depends primarily on its impact on further strengthening of depreciation pressures and reduction in bank interest rates, and consequentially on economic growth. For the time being, the cut in the key policy rate has not resulted either in strengthened depreciation pressures or a reduction in interest rates.

[1] Real Monetary Conditions Index.

[2] Based on results of the Strategic Marketing survey on inflation expectations that equal on average 11.75% for the financial sector.

Chart III.0.2 **Real exchange rate and its trend**



The recently opened depreciation gap of the real exchange rate is expected to produce inflationary pressures in the coming period.

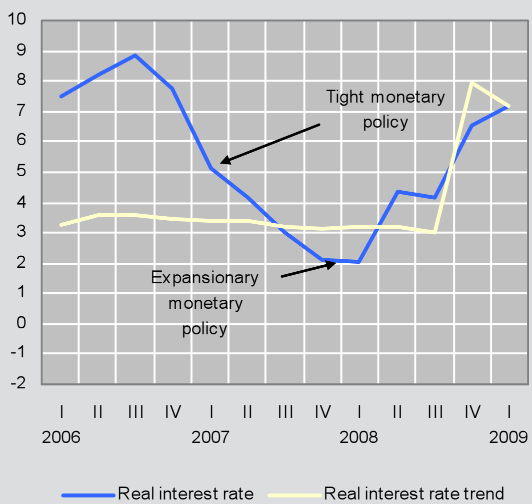
The key policy rate will probably be further reduced in the coming period. Provided the rate is kept unchanged, the degree of expansiveness would be lessened in the coming period primarily due to the expected reduction in risk premium and foreign interest rates. According to the April Reuters survey, banks are also expecting a further cut in the key policy rate (medium end-2009 level is 11.75%).

Interest rates

Somewhat stronger variations in money market interest rates in January and February were occasioned by variations in bank dinar liquidity levels. Lending interest rates were cut mainly in response to application of government's measures aimed at easing the negative effects of the global economic crunch, while the rising trend of deposit interest rates continued.

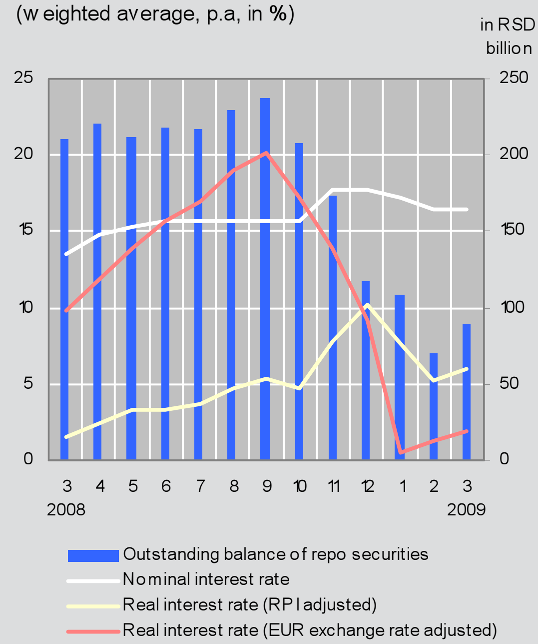
In the first four months of 2009, the NBS lowered its key policy rate on three occasions, by 3.75% in total – from 17.75% down to 14% p.a.

Chart III.0.3 **Real interest rate on repo operations and its trend**



The real interest rate revolves around the trend.

Chart III.1.1 **NBS key policy rate**
(weighted average, p.a, in %)

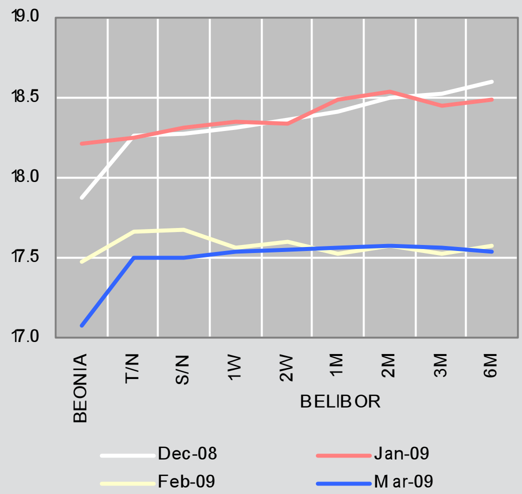


Despite its nominal decrease, the real key policy rate recorded a mild increase due to lower inflation and stabilisation of the dinar exchange rate.

At the last auction of six-month NBS bills held in January, the interest rate applied was 17.92% on average. As these securities are longer term investments, application of a higher interest rate than the key policy rate is not unusual. Still, the spread between these two rates was lower compared to the December auction, which shows that banks were expecting a cut in interest rate.

Money market interest rates did not follow movements in the key policy rate to the full. On average, BEONIA trended above the key policy rate (17.55% p.a), whereas BELIBOR hit the lowest level in terms of Spot/Next maturity (17.79%), and the highest in respect of six-month maturity (17.86%). Relative to the previous quarter, BELIBOR recorded growth for shorter maturities. However, its growth declined commensurately with longer maturity. Albeit still positive, the slope of the curve yield on BELIBOR was lowered, which is mainly interpreted as an indicator of reduction in interest rates and a slowdown in inflation and economic activity.

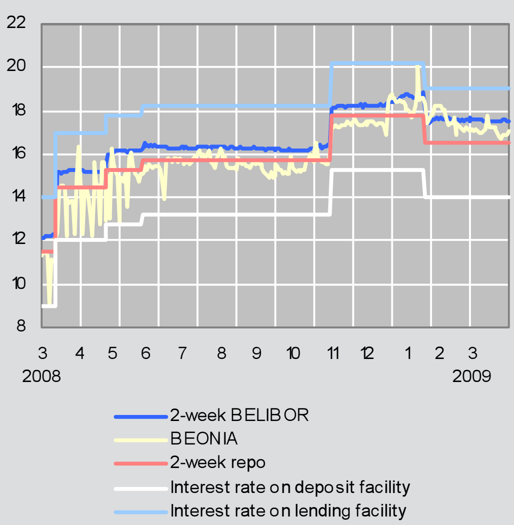
Chart III.1.3 **Interbank money market yield curve**
(monthly average, p.a, in %)



Source: National Bank of Serbia and Reuters.

Following a mild decrease in February, the yield curve recorded stagnation in March.

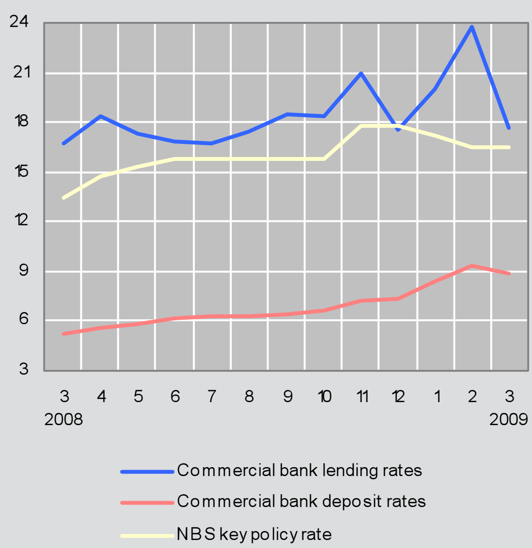
Chart III.1.2 **Interest rate movements**
(daily data, p.a, in %)



Source: National Bank of Serbia and Reuters.

Amid reduced bank liquidity, BEONIA and BELIBOR did not follow the movements in the key policy rate in January and February.

Chart III.1.4 **NBS key policy rate and commercial bank interest rates**
(weighted average, p.a, in %)

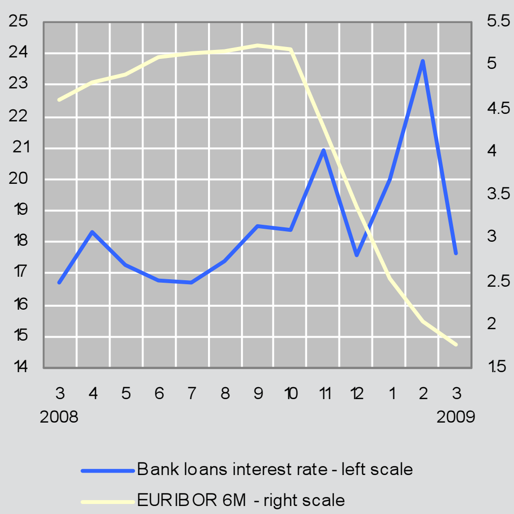


Growing risk premium gave strong impetus to the rise in lending and deposit interest rates in Q1.

Despite the mild fall in the key policy rate, the average increase in BEONIA and BELIBOR can be ascribed to a decline in bank dinar liquidity resulting from the NBS rule that banks allocate 40% of their foreign currency required reserves in dinars. Because of their particularly low liquidity in January and February, banks borrowed more in the money market, and BEONIA, despite its relatively shorter maturity, rose above the NBS key policy rate. In February, when bank liquidity was at its lowest, the spread between BEONIA and the key policy rate came to 1 pp on average, while the average daily volume of lending reached record RSD 13.8 billion. In March and April, bank liquidity improved, leading to a gradual reduction in the volume of overnight interbank lending, and narrowing of the spread to 5 bp in April.

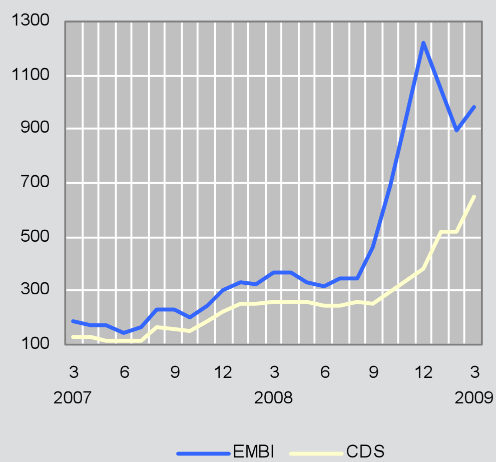
Despite the cut in the key policy rate and the relatively low level of EURIBOR and LIBOR, banks raised their interest rates in January and February. In March, interest rates were lowered after the government decided to subsidise loans under its Programme aimed at easing the effects of the global economic crisis. Deposit interest rates followed a similar trend.

Chart III.1.5 **EURIBOR 6M and bank loans interest rates**
(monthly average, p.a, in %)



Interest rates on bank loans rose despite a drastic cut in EURIBOR 6M.

Chart III.1.6 **Risk premium indicator - EMBI and CDS**
(monthly averages, in basis points)



Source: JP Morgan and Bloomberg.

Measured by EMBI, the risk premium decreased in Q1.

Belgrade Stock Exchange

Trends on the Belgrade Stock Exchange have been characterised by slumping indices and a low turnover volume for two years already. The same tendency continued into the first quarter of 2009.

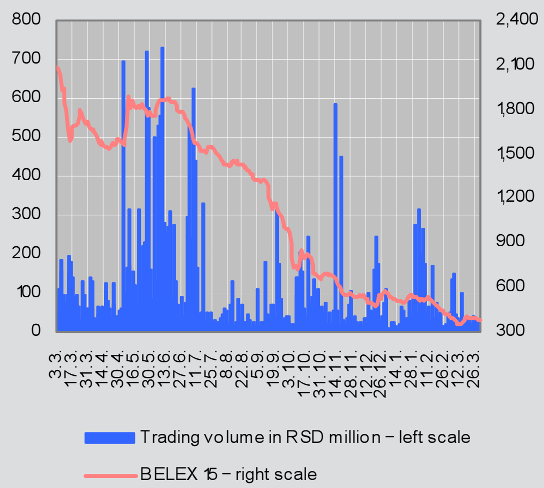
Belex15 and *Belex line* indices of the Belgrade Stock Exchange (BSE) recorded a drop of 32.6% and 29.5% respectively. Compared to slumping indices of other stock exchanges in the region, *Belex15* and *Belex line* fared the worst. The *MBI10* index of the Macedonian Stock Exchange declined the least (9.1%), while *Sofix* of the Bulgarian Stock Exchange, apart from the two domestic indices, fell most steeply (22.4%).

Following a slump in their prices, capitalisation of shares listed on the BSE declined to RSD 689 billion (EUR 7.3 billion) by end-March. Such negative trends were fuelled by further liquidity squeeze – stock trading throughout the quarter amounted to mere RSD 4.2 billion, around 56% down from a quarter earlier.

The share of foreign investors in stock trading declined from Q4 2008. Unlike the previous quarter when foreign investors were net buyers of stock, they sold around RSD 587 million net in Q1 2009, thus aiding the decline in stock prices.

By contrast to stock trading, trading in RS frozen foreign currency bonds saw a relatively more moderate decline in the volume (6.3%) and number of executed transactions (7.1%) owing to the relatively lower risk (bonds were issued by the government) and the non-existence of currency risk. Of total volume of trading of around EUR 15.9 million, A2016 (47%) and A2010 (16%) series accounted for almost 50%, while other series had a much lower share in trading. Following the cut in the key policy rate, the yield on RS frozen foreign currency savings bonds declined for all bond series, apart from the A2009 series, which is typical of those bond series that mature first.

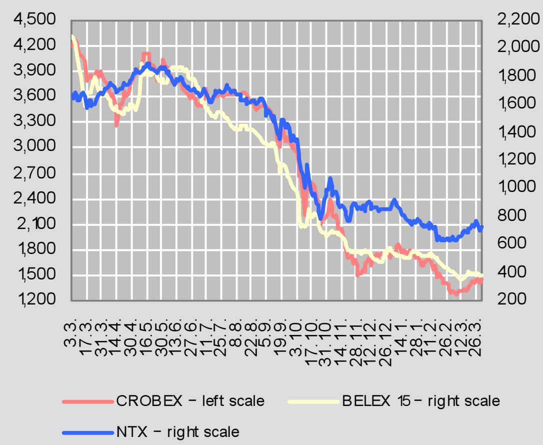
Chart III.1.7 **Belex 15**



Source: BSE.

A slump in BELEX 15 was followed by reduced trading volumes on the BSE.

Chart III.1.8 **BELEX15, CROBEX and NTX**
(in index points)



Source: BSE, Zagreb Stock Exchange and Bloomberg.

Indices of regional stock exchanges hit their historical lows in Q1.

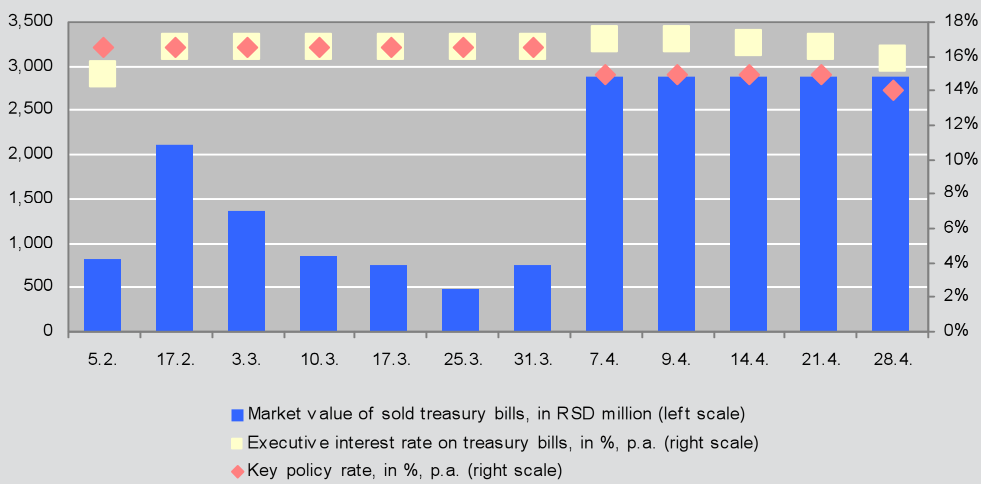
New issues of RS treasury bills

Having stepped up its primary issue of treasury bills this year, the government has created a scope for further development of the financial market. As defined by the Decision on General Conditions for Issue and Sale of Short-Term Government Securities in the Primary Market, adopted by the RS Government, treasury bills are dinar-denominated with the maturity of up to one year, and can be sold in single or multiple price auctions.

In a *single-price auction*, all successful competitive bidders and all noncompetitive bidders are awarded securities at the price equivalent to the highest rate or yield of accepted competitive tenders. The main downside to such an auction are relatively high interest costs borne by the issuer and the fact that the interest rate is not wholly market-determined, which to a certain extent diminishes the primary role of this instrument, i.e. financial market promotion and development. The upside, on the other hand, is a relatively more successful primary sale. The issuer's decision to engage in this type of auction can be interpreted as his willingness to pay a relatively high price in order to collect the funds needed.

In a *multiple price auction*, investors making competitive bids specify the rate or yield they are willing to receive for the use of their funds. Successful competitive bidders pay the price lower or equivalent to the rate or yield they bid. Compared to the single price auction method, interest costs borne by the issuer are lower. On the other hand, the interest rate is fully market-determined, which contributes to the formation of the money market yield curve, financial market development and promotion of new financial instruments.

Auctions of RS treasury bills and NBS key policy rate



In the year to April, the Ministry of Finance Treasury Administration applied the single price method in 12 auctions of treasury bills with a 91-day maturity. The average yield was much higher than recorded in the December 2008 auction (from 10.45% to 15%). As the sales volume in the first auction was unsatisfactory (42% of total issue value), the government raised the executive interest rate to the level of the NBS key policy rate (16.5%), which encouraged some banks and natural persons to invest in this type of securities, hence increasing the volume of primary sale to around 73% of the total issue. In the following five auctions, the executive rate remained unchanged, which led to weakened interest of banks, investment funds and other investors. Sales hit the rock bottom (17% of issued value) in the fourth auction in March, only to rebound in the last auction in the same month (26%). The appeal of treasury bills (mainly to banks) greatly improved after the executive rate was raised to 17.5% in the first April auction and the NBS key policy rate cut from 16.5% to 15%. The further reduction in the key policy rate to 14% by end-April contributed to the continued trend of 100% realisation, despite the cut in the executive interest rate to 15.8% p.a. (in the last April auction).

Government's participation in the securities market this year contributed to financial market development. From February to end-April, it collected around RSD 20.1 billion, of which RSD 14.4 billion in April alone. If the government's active participation in the financial market is observed in light of current budgetary difficulties, we cannot claim with certainty that it did not resort to this relatively expensive source of finance (and, according to popular belief, a costlier auction method) with the sole purpose of collecting as much funds as needed to finance fiscal expenditure.

On the other hand, government borrowing in the domestic market will also create long-term advantages, one of them being reduced exposure to currency risk in respect of public debt as bonds are dinar-denominated. Finally, if the Ministry of Finance soon launches the announced primary issue of treasury bills with the maturity of up to one year, it will set the benchmark interest rate in the domestic financial market, and will thereby not only encourage market development, but also strengthen the monetary policy transmission mechanism.

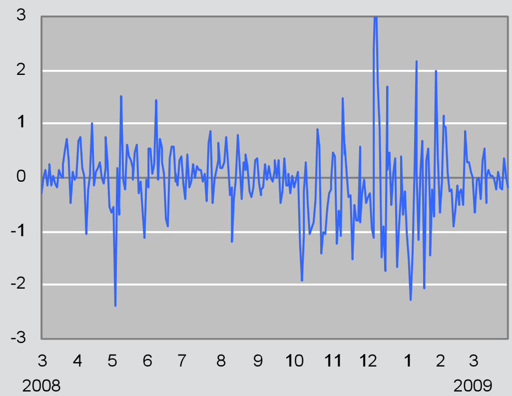
Exchange rate

The dinar depreciated against all major world currencies in Q1. Although the NBS intervened heavily in the IFEM in January, the dinar weakened against the euro by around 7% on average. However, daily volatility subsided and the RSD/EUR exchange rate stabilised in late February and March, ending the need for NBS interventions. Trading volumes in the foreign exchange market remained low.

The dinar weakened against the euro by around 9.6% in Q1. Although the exchange rate moved within a rather wide band of 89.5 to 96.3 RSD/EUR, it averaged 94.4 RSD/EUR since end-February. The dinar weakened as a result of sluggish inflow of foreign capital and tighter access to foreign sources of finance for banks and enterprises. The strongest pressure on the dinar was recorded in January (7% average depreciation) amid buoyant demand for foreign exchange by both banks and their clients. Namely, banks needed foreign exchange for the repayment of short-term credits taken in late 2008.

The weakening of the dinar was also precipitated by the rise in risk premium, and to a lesser degree, by the lowering of the key policy rate. The pressure on banks' foreign exchange liquidity, however, subsided in March. Enterprises managed to refinance their foreign debt, banks stepped up their short-term foreign borrowing, and net purchase of foreign exchange from exchange offices reached substantial levels. As a result, the exchange rate stabilised despite downward revision of the key policy rate.

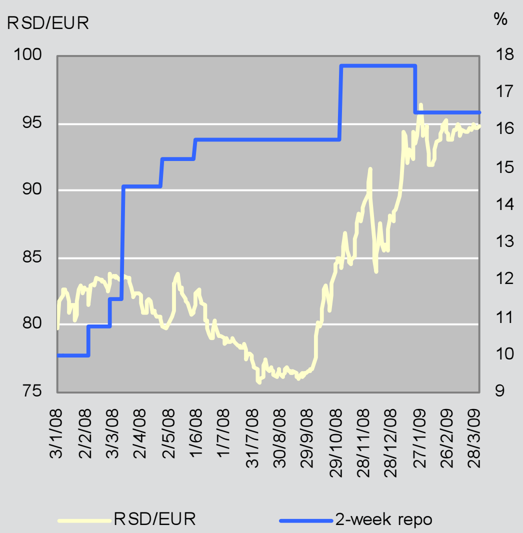
Chart III.1.10 **Daily changes in RSD/EUR exchange rate**[1)]
(in %)



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

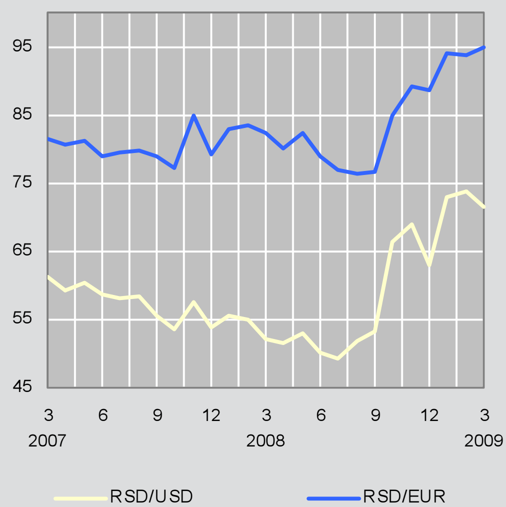
The exchange rate of the dinar displayed significant daily volatility throughout January and for the greater part of February.

Chart III.1.9 **Movements in RSD/EUR exchange rate and 2W repo rate**



The exchange rate of the dinar was relatively stable despite downward revision of the key policy rate.

Chart III.1.11 **Nominal exchange rate of the dinar**
(in dinars, end of period)



Depreciation of the dinar continued in Q1.

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

			EUR
	Q3 2008	Q4 2008	Q1 2009
IFEM	5,814,909,352	6,531,011,455	2,095,304,299
NBS - Banks	9,000,000	933,500,000	556,400,000
Bank - bank	5,805,909,352	5,597,511,455	1,538,904,299
			(in % of total trade)
	Q3 2008	Q4 2008	Q1 2009
IFEM	100.00	100.00	100.00
NBS - Banks	0.15	14.29	26.55
Bank - bank	99.85	85.71	73.45

The NBS stepped up its participation in the IFEM trading in Q1.

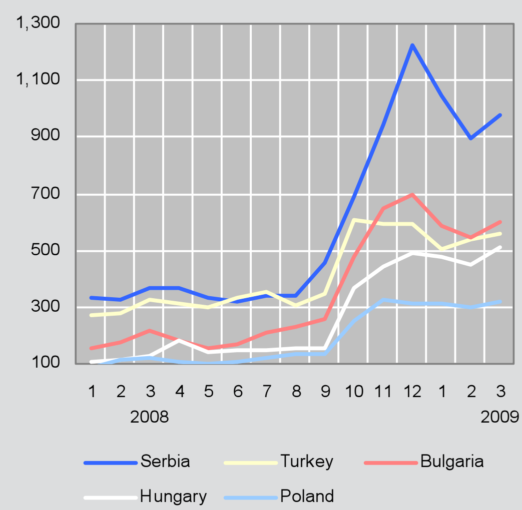
The volume of trading in the IFEM was very low throughout Q1. Average daily turnover, excluding the National Bank's interventions, was around EUR 25 million. In order to ease excessive daily volatility of the exchange rate, prevent its sharp weakening and boost foreign exchange liquidity of the market, the National Bank sold EUR 556.4 million in the IFEM in the course of January and February. Nevertheless, the dinar fluctuated heavily on a daily basis all through to late February. From end-February to end-Q1, the NBS did not intervene in the IFEM as the volatility eased and the exchange rate stabilised.

The dinar lost even more against the dollar than against the euro as the ECB trimmed its policy rate in Q1 in two instances (by 1.0 percentage point in total) and the FED kept its rate unchanged.

Depreciation of the nominal effective exchange rate of the dinar and faster growth in domestic relative to foreign prices resulted in 4.4% depreciation of the real effective exchange rate in Q1 (3.0% v. the euro and 9.8% v. the dollar).

After record high levels registered in the first half of December (1,350 basis points), EMBI headed down on

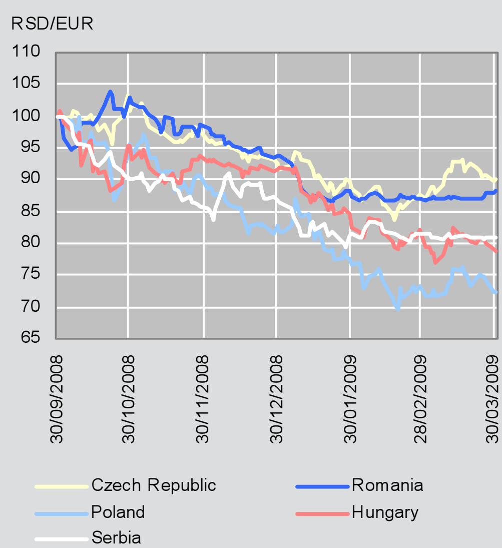
Chart III.1.12 **Risk premium indicator - EMBI**
(monthly averages, in basis points)



Source: JP Morgan.

Even though it declined, risk premium for Serbia remains the highest among countries observed.

Chart III.1.13 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



Most currencies stabilised from mid-February onwards.

announcements of an arrangement with the IMF. In early February, EMBI spread fell to around 850 basis points above the yield on US Treasuries. However, from mid-February, EMBI spread started picking up. Arrangement with the IMF is expected to lead to a decrease in the value of this index, which will, together with the agreement with banks on the maintenance of their exposure to Serbia, help ease the pressures on the dinar.

April survey carried out by the Strategic Marketing Research agency indicates that all sectors expect further depreciation of the dinar. Accordingly, the financial sector expects the dinar to depreciate by around 5% over the next one-year period. Results of the April survey conducted by Reuters show that the financial sector anticipates weakening of the dinar by around 3% until the end of the year (97.5 RSD/EUR).

Similar movements were recorded for the currencies of other transition economies: they kept depreciating throughout January and for the greater part of February, after which they picked up or stabilised. As in the case of Serbia, risk premium for other transition countries measured by EMBI decreased in January and February, and increased slightly in March.

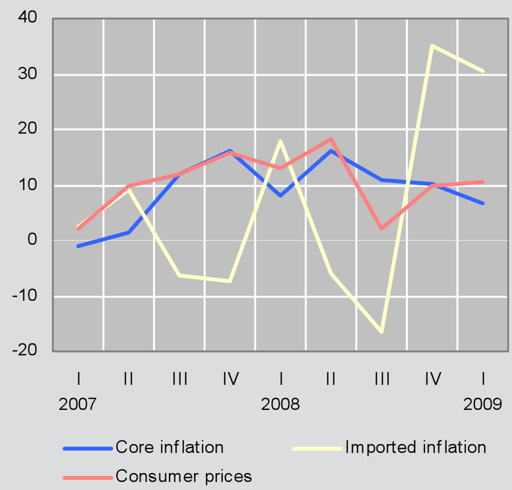
2. Import prices

Imported inflation in Q1 recorded somewhat lower growth than in Q4 2008, but nonetheless remained high due to the weakening of the dinar. It is expected to continue down in Q2 on the back of the current stabilisation of the exchange rate and in the face of the rising global oil and commodity prices.

Imported inflation in Q1 measured 30.5% at annual level[3]. Notwithstanding the 2.4% price drop in the EU and USA[4] (per annum average), imported inflation remained high as a result of a 33.7% depreciation of the nominal effective exchange rate of the dinar (per annum average)[5]. As strong depreciation pressures were registered in early Q1, the growth in imported inflation came as no surprise. However, contrary to expectations, imported inflation did not exert any major impact on core inflation, and the effects of its rise wore off already in the first two months of Q1.

Given the current exchange rate movements and the likelihood of continued decline in the EU and USA prices, imported inflation is expected to continue slowing down over the coming period. Disinflationary pressures are expected in this respect.

Chart III.2.1 **Core and imported inflation**
(average annualized quarterly growth rates)



Source: NBS and Eurostat.

Imported inflation recorded strong growth as the nominal efective exchange rate of the dinar declined.

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

[4] Weighted average inflation figures for the EU and USA (80:20) are used in the calculation of world inflation.

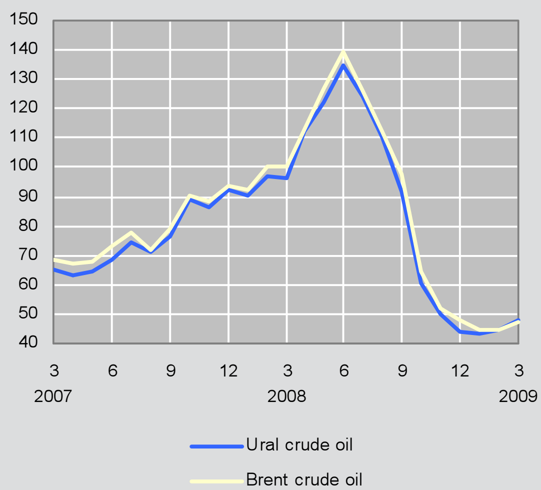
[5] EUR 80%, USD 20%.

Oil and commodity prices

Oil prices were relatively stable in Q1 2009, ranging between USD 40 and USD 50 pb. By contrast to Q3 and Q4 2008 when oil prices precipitated down (from USD 147 to USD 91 in Q3 and then to USD 44 in Q4), Q1 2009 saw a halt in their downward trend.

The deep global recession forced OPEC countries to give up on planned scaling down of oil production until oil prices picked up and stabilised between USD 75 and USD 80 pb. At the Vienna meeting of 15 March 2009, OPEC countries agreed not to cut oil production until further notice in light of the drop in demand for oil and the likely disruption that an increase in prices could have on the attempts of developed countries to overcome the financial crisis. Instead, OPEC management appealed to its members to abide by their previous decisions on cuts in output quotas.

Chart III.2.2 **Oil prices**
(in US dollars)



Source: Bloomberg.

The downward trend in oil prices was halted.

Although OPEC countries gave up on further output cuts, oil prices surged in the second half of March (20% between 15 and 26 March). On the last day of the quarter, prices retreated to USD 47 pb (our estimate for end-Q1, presented in the latest *Report*, was around USD 42). The main impetus leading to this unexpected hike came from the notable weakening of the dollar over the period under review (10% against the euro) and effects of previous production cuts by OPEC members.

Oil prices went up again by end-April. By mid-May, they touched their six-month high of USD 59 pb.

We expect no major surges in oil prices over the coming period. According to estimates of the International Energy Agency (IEA), demand for oil will further contract, implying two successive years of declining demand. In view of the IEA estimates of a slump in global demand for oil in 2009 relative to 2008, as well as the expected sharp and long-term recession in the most advanced world economies, together with reduced economic output in China and India, oil prices are not likely to rise substantially over the coming period. The average price of Ural oil will probably range between USD 50 and USD 55 pb in 2009. Further, we expect the price of Ural oil to reach around USD 55 pb by the end of Q2 2009.

In terms of other commodities, copper prices rose to USD 4,000 per tonne by the end of Q1 2009 from around USD 3,300 a quarter earlier. Demand for copper is expected to decline by around 6% from 2008 and remain flat until year-end.

Gold as a safe haven is also on an upward path, ranging between USD 910 and USD 925 per troy ounce. By end-2008, its price ranged between USD 830 and USD 850 per troy ounce.

3. Balance of payments

International economic flows contracted mainly on account of reduced global demand and tight access to funds used for financing current expenditure. This contributed to strengthened depreciation pressures and wider negative output gap.

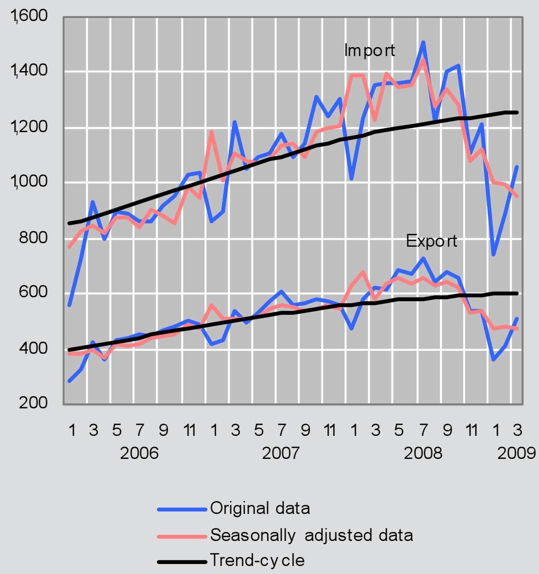
Current account

Current account deficit in Q1 (EUR 797.8 million) fell by as much as 38% on Q1 2008, primarily due to the narrowing of the foreign trade deficit by EUR 526.9 million.

Consequences of the global and domestic economic crisis were most evident in reduced foreign trade: in Q1 2009, euro-denominated imports and exports fell by 26.0% and 23.8% y-o-y respectively. As a result, foreign trade deficit shrank by 29.1%. The export/import cover ratio rose to 47.8%, 1.4 pp up on Q1 2008.

The decline in euro-denominated exports and imports was recorded with all types of goods, most notably intermediate

Chart III.3.1 **Exports and imports**
(in EUR mln)



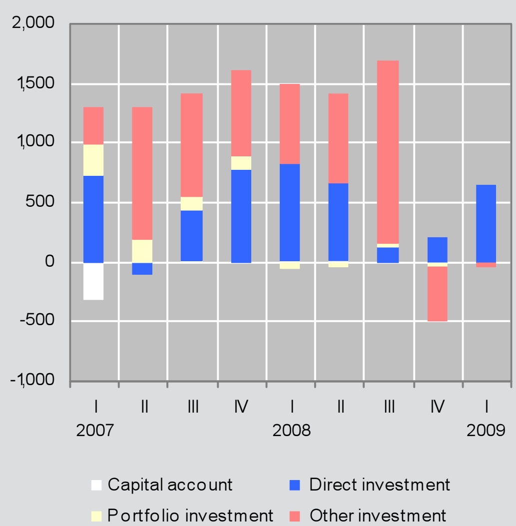
Following a precipitous drop in January, exports and imports rose in February and March.

Table III.3.1 **Balance of payments in % of GDP**

	IV 2007	IV 2008	I 2008	I 2009
Current account	-16.2	-14.8	-18.0	-12.4
Balance of goods and services	-24.4	-21.9	-24.5	-20.5
Income	-2.6	-4.1	-1.9	-1.9
Current transfers	10.8	11.2	8.4	10.1
Capital account	0.0	0.0	0.1	0.0
Financial account (excluding changes in foreign exchange reserves)	18.6	-3.2	19.7	9.3
Direct investment - net	9.1	2.4	11.3	10.0
Portfolio investment - net	1.2	-0.4	-0.7	-0.1
Commercial credits - net	1.8	2.5	1.4	1.4
Financial credits - net	15.2	8.3	3.2	-10.9
Currency and deposits - net	-8.8	-16.0	4.8	8.8
Other	0.1	0.0	-0.2	0.0
Errors and omissions - net	-0.4	-1.6	-1.3	-0.6
Overall balance	2.0	-19.6	0.4	-3.7

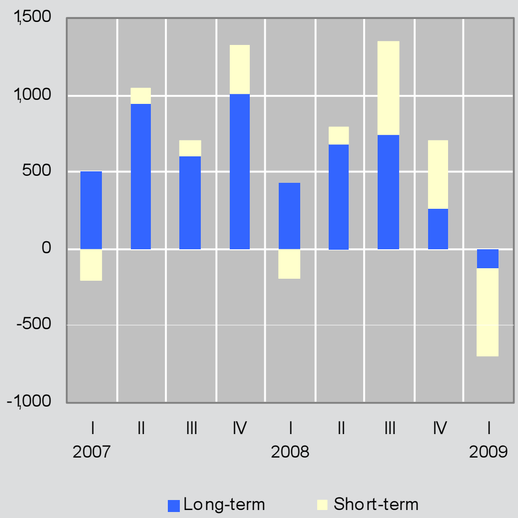
The current account deficit narrowed to 12.4% of GDP in Q1.

Chart III.3.2 **Composition of net capital inflow**
(in EUR million)



Privatisation of NIS provided the strongest contribution to FDI inflow.

Chart III.3.3 **Net disbursement of financial loans**
(in EUR million)

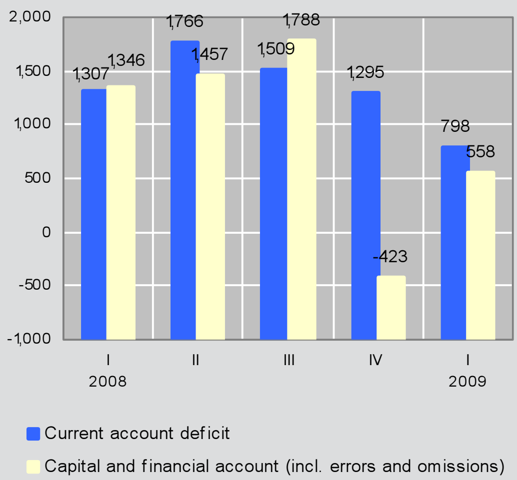


Q1 saw repayment of foreign debt by banks and enterprises.

goods and equipment. A sharper fall of imports (27.8% y-o-y) than exports of equipment (15.2% y-o-y), coupled with a marked reduction in domestic production of capital goods (27.9% y-o-y) and a weaker decline in inventories of these goods (15.8% y-o-y) point to the continued decline in investment activity[6]. The slump in imports of intermediate goods (29% y-o-y) was much sharper than the decline in GDP and industrial production, which, together with a decline in inventories of finished goods, can be related to the liquidity crunch in the economy. This is further substantiated by the appreciable decline in domestic production of intermediate goods (34.9% y-o-y).

The reduction in imports and exports was the smallest with consumer goods, most notably non-durable consumer goods whose imports fell by 11.2% and exports rose by 0.4% y-o-y. At the same time, production and inventories of finished products shrank by 11.3% and 2.3% respectively. Durable consumer goods recorded a significant fall both in terms of imports (18.7%) and exports (5.0%). In an environment of significantly reduced production volumes (a 26.1% fall), such export performance, which may be ascribed to the pressure on liquidity arising from 7.1% y-o-y growth in inventories, can be regarded as favourable.

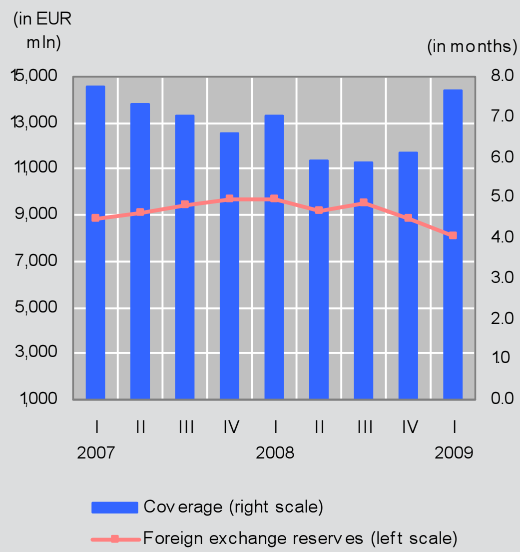
Chart III.3.4 **Current account deficit and net capital inflow**
(in EUR million)



Note: Financial account without changes in foreign exchange reserves.

International economic flows contracted in response to dampened global demand and tight strains on funding current expenditure.

Chart III.3.5 **Coverage of imports by foreign exchange reserves***



* Quarterly data.

Coverage of imports by foreign exchange reserves rose.

[6] Data on Q1 were taken from the website of the Serbian Statistical Office.

The surplus on current transfers was negligibly higher relative to the comparable period of 2008 (by 3.8% or EUR 23.6 million), while the deficit on income balance was lower by EUR 14.1 million or 10.2%.

As the current account deficit narrowed and economic activity subsided in Q1, the current account deficit to GDP ratio fell to 12.4%[7]. However, current account trends were unfavourable as they reflected sharply deteriorating global economic flows.

Capital and financial account

While movements in the capital account were almost insignificant (a EUR 0.6 million deficit), the surplus on the financial account came to EUR 837.8 million. With changes in NBS foreign exchange reserves excluded, financial transactions showed a comparatively low surplus – 43.8% of Q1 2008 levels.

The most significant net inflows on the financial account came from FDIs (EUR 643.3 million) after the sale of a portion of capital of the Oil Company of Serbia (NIS) in February (EUR 400 million). This provided sources for covering 80.6% of current account deficit. The most dominant item in the FDI structure were investments into the mining and quarrying sector (59.2%), which also includes crude oil and natural gas mining, real estate activities (10.1%), manufacturing (9.3%), transport and financial intermediation (6% each) and retail trade (5.1%). A negligible net outflow was recorded with portfolio investments (EUR 4 million).

Bank and enterprise debt repayments rose in net terms. During the first two months, banks repaid EUR 668.9 million, almost exclusively in respect of short-terms loans (EUR 661.6 million) disbursed by end-2008. In March, banks were modest short-term net borrowers (EUR 123.1 million), while enterprises repaid around EUR 144 million net.

As surplus on the financial account (EUR 597.8 million), foreign exchange reserves excluded, did not suffice to cover deficit on the current and capital account, NBS foreign exchange reserves declined by EUR 240 million.

Table III.3.2 **Contribution to NBS foreign exchange reserves growth**
(in percentage points)

	2008				2009
	Q1	Q2	Q3	Q4	Q1
NBS foreign exchange reserves (growth in %)	6.1	-4.7	-3.1	-17.6	-6.5
Foreign exchange market	-1.3	0.7	1.5	-5.2	-6.5
Exchange transactions	1.3	1.4	0.9	1.6	0.5
NBS's foreign currency net-sale in the IFEM	-3.0	-1.2	0.0	-7.4	-7.6
Temporary payment transactions[1)]	0.4	0.5	0.6	0.6	0.5
Reserve requirement on foreign currency deposits and credits, and new foreign currency savings deposits[2)]	0.0	-2.5	1.5	-11.4	-0.9
Foreign credits to government	0.1	0.4	0.0	0.2	0.2
Grants	0.1	0.3	0.2	0.2	0.1
Frozen foreign currency savings deposits[3)] and Economic Development Loan	-0.1	-1.7	-0.4	-0.1	-0.1
Other[4)]	7.2	-1.8	-5.9	-1.3	0.6

1) Payment transactions with Montenegro (until 26 June) and Kosovo and Metohija.

2) Savings from 2003 onwards.

3) Savings up to 2003.

4) Includes privatization receipts, IMF credit, etc.

NBS interventions in the IFEM had the strongest effect on foreign exchange reserves.

By end-Q1 2009, NBS foreign exchange reserves came to EUR 8,113 million. The decrease in Q1 may be put down to the NBS's interventions in the IFEM (contribution of 7.6 pp), lower allocations of foreign currency required reserves of banks (0.9 pp), and the repayment of obligations in respect of frozen foreign currency savings.

The main contribution to growth in NBS foreign exchange reserves came from net foreign exchange purchases in respect of exchange transactions of the NBS (0.5 pp), foreign exchange inflow from transactions with Kosovo and Metohija (0.5 pp) and foreign credits to government and grants (0.2 pp and 0.1 pp respectively).

[7] In Q4 2008, the current account deficit to GDP ratio equalled 14.8%.

Enhanced Stand-By Arrangement with the IMF

On 15 May 2009, the Executive Board of the International Monetary Fund (IMF) increased its financial support to Serbia under the Stand-By Arrangement (SBA) designed in November 2008 and approved in January 2009. The enhanced SBA will support the government's programme amid a sharper than expected impact from the global financial crisis. The financial assistance envisaged by the arrangement will amount to around EUR 2.94 billion or SDR 2.62 billion. The Board also extended the SBA by one year to mid-April 2011. The first tranche of around EUR 788 million was drawn on 19 May, with two more tranches to be drawn until end-2009 (total funds disbursed under the SBA in 2009 will come to around EUR 2.15 billion). The funds under the enhanced SBA are intended exclusively for strengthening NBS foreign exchange reserves and maintenance of macroeconomic stability.

Under the enhanced SBA, the government has revised its strategy in three key respects:

- The fiscal targets for 2009-10 have been raised, but additional fiscal adjustment measures (mainly cuts in recurrent expenditure and freezes of public sector wages) will also be taken, with the goal of avoiding excessively procyclical fiscal policies and rebalancing of the economy over the medium term. At the same time, the projected budget deficit of 3% of GDP in 2009 is the maximum level that can be financed through non-inflationary sources. Success of the arrangement will depend on implementation of the agreed fiscal adjustment measures. Furthermore, short-term adjustment measures should pave the way for fiscal reforms toward greater efficiency of the public sector and more durable consolidation of public finance.

- Following a successful financial sector coordination meeting, ten largest foreign parent banks agreed to maintain their exposure to Serbia and keep their subsidiaries well capitalized and liquid, as well as to take part in the planned stress testing exercise conducted in line with the IMF methodology and aimed at assessing banks' resilience to possible deterioration in domestic and external environment in the next few months. Banks are also expected to commit to facilitating the restructuring of corporate and household loans. In this regard, the NBS has designed, in cooperation with the IMF, special facilities to support the country's financial stability. Banks will be able to use these facilities as of mid-May.

- The authorities have requested additional financial support from international financial institutions and the European Union to close the projected external financing gaps in 2009-11.

The policies envisaged under the SBA are aimed at maintaining macroeconomic and financial stability of the country. The spending boom in the public and private sectors that drove Serbia's economic growth and external imbalances in recent years is being reversed sharply. The augmented SBA is designed to smooth, not prevent, the inevitable contraction in economy-wide spending to more sustainable levels. The macroeconomic framework (Table C, p. 59) reflects economic and fiscal adjustments likely to take place over SBA duration:

a) Real GDP will drop around 2% in 2009 and recover probably in 2010. Due to uncertainties regarding the duration and depth of the crisis, the projection remains subject to downside risks;

b) Inflation will revolve around 10% in 2009, drifting down to 8% (±2 pp) in late 2010. The target band for end-2009, agreed upon with the IMF, is somewhat higher (10±2%), but inflation looks increasingly likely to settle within the original target established by the NBS (8±2%) as the disinflationary effects of dampened domestic demand are set to outweigh inflationary effects generated by the recent depreciation of the dinar;

c) The current account deficit will narrow significantly – to around 13% of GDP (v. 17% last year). Exports are expected to recover only in 2011, while the current account deficit is likely to normalize at around 5% of GDP in the medium run;

d) The availability of external financing will drastically decline relative to the previous year. With lower FDIs and foreign credits, net capital inflow is to reach mere 2% of GDP in 2009 (v. 12.5% in 2008).

Despite the sharp drop in domestic demand, the financial gap is projected at around EUR 2.3 billion (7.5% of GDP) in 2009 and EUR 1 billion in 2010 (3.3% of GDP). Compared to the previous IMF projection, the financial gap is now lower because of the lower current account deficit and net capital inflow. However, the cut in the financial gap is not equal to that in the current account deficit due to increased repayments of foreign debt enabled by the stepped up short-term borrowing.

Why Serbia needs an arrangement with the IMF? First, it will enable the financing of the current account deficit, which was financed from foreign exchange reserves in the previous six months as the capital flows dried up. This will help ease the pressure on the exchange rate of the dinar, which will continue to be "managed floating". The NBS will intervene in the foreign exchange market only to smooth out the shocks and preserve financial stability, in the manner consistent with the achievement of the inflation target. In order to maintain an adequate level of foreign exchange reserves, the NBS shall not allow its net foreign assets (at programme exchange rate) to fall below EUR 2.5 billion at end-2009.

Second, arrangement with the IMF also implies a more responsible fiscal policy, i.e. significantly lower public consumption. Considerable fiscal adjustment measures (based on spending cuts rather than consumption growth) are needed due to the decrease in tax revenue precipitated by the downturn in trade and economic activity.

Third, agreement with commercial banks reached in the context of arrangement with the IMF, will most certainly lessen the depreciation pressures on the exchange rate of the dinar.

Fourth, arrangement with the IMF will help lower the risk premium and reassure foreign and domestic investors, exerting a positive impact on the volume of investments and facilitating access to cheaper sources of finance. Its contribution to potential upgrade (or maintenance) of the country’s credit rating should not be disregarded either. Furthermore, arrangement with the IMF will enable access to additional funding from the World Bank, EU and other international institutions.

Implementation of the programme will be monitored through quantitative performance criteria. There will be quarterly reviews of the arrangement by the IMF, the next one to be completed by mid-August 2009, to assess progress in implementing the programme and reach understanding on any additional measures that may be needed to achieve its objectives.

4. Monetary flows

Amid economic downturn and increased interest rates money demand continued declining in Q1, while credit activity came to a standstill. Tighter access to foreign capital led to a reduction in enterprise foreign debt.

Monetary aggregates

Monetary flows in Q1 were under the influence of slowing economy and limited inflow of foreign capital on the one hand, and NBS measures for boosting foreign exchange liquidity of banks, on the other. As the impact of the first group of factors was stronger, monetary aggregates recorded a higher than seasonally expected decline.

In early 2009, the banking sector was awash in dinar liquidity. Most of excess liquidity was absorbed already in the course of January through the National Bank's interventions in the IFEM. Though to a lesser degree, excess dinar liquidity was also drained through open market operations and widening of the base for the calculation of the dinar share of foreign currency required reserves.

Reserve money declined by around 16% (to RSD 260 billion) in Q1 due to the above factors and to the increase in government deposits, stemming from significantly lower spending relative to end-2008.

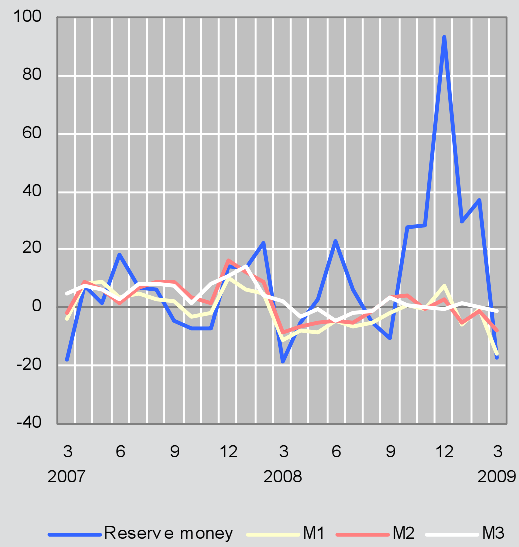
After sharp decrease in January and February, the stock of NBS securities purchased in repo transactions rose to around RSD 98.6 billion at end-March. Higher investment in repo securities by banks can be put down to an increase in their real yield caused by slowing inflation and stabilisation of the exchange rate, as well as to general preference for highly secure investments in times of crisis.

Other dinar monetary aggregates (M1 and M2) also showed a decline in Q1 relative to end-2008. As income and liquidity levels declined, the rise in dinar term deposits was fully off-set by the drop in currency in circulation and corporate gyro-account and household

Table III.4.1 **Growth rates of monetary aggregates**
(in percent)

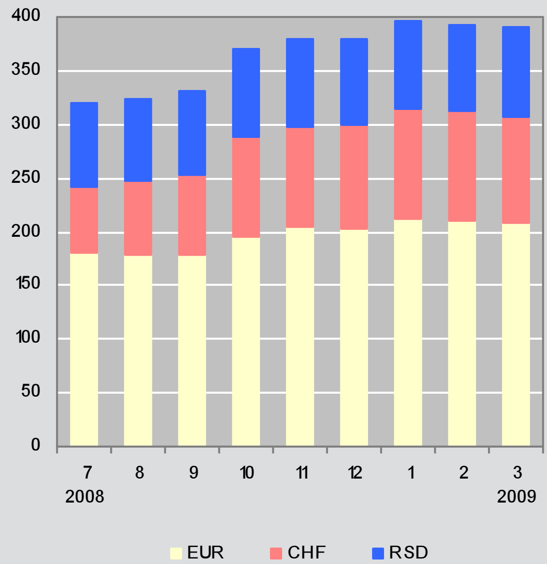
	2008				2009	Share in M3 (Mar)
	I	II	III	IV	I	
M3	5.5	-0.7	4.0	0.8	2.3	100.0
Foreign currency deposits	14.1	-0.8	4.1	-1.3	6.7	62.8
M2	-5.8	-0.5	3.9	4.0	-4.4	37.2
Dinar time deposits	-0.8	-0.1	12.6	-2.4	8.8	16.5
M1	-8.7	-0.8	-1.6	8.6	-12.8	20.7
Demand deposits	-8.7	-0.6	-3.6	0.4	-12.5	13.0
Currency in circulation	-8.7	-1.2	3.0	25.9	-13.3	7.7

Chart III.4.1 **Movements in monetary aggregates deflated by consumer prices**
(quaterly grow th rates, in %)



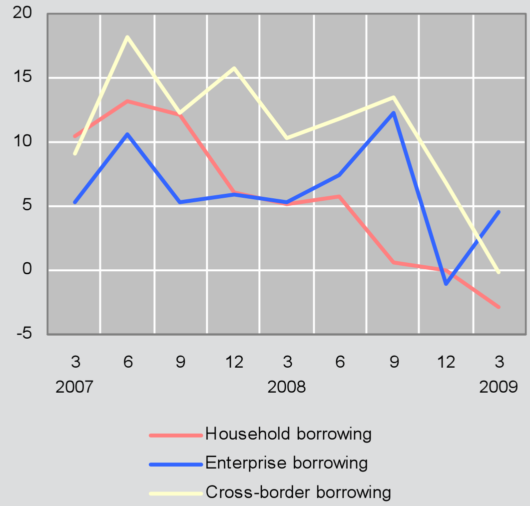
The slowdown in money demand continued. Reserve money growth produced no inflationary effect as it resulted from increased dinar share of foreign currency required reserves.

Chart III.4.2 **Currency structure of household loans**
(in RSD billion)



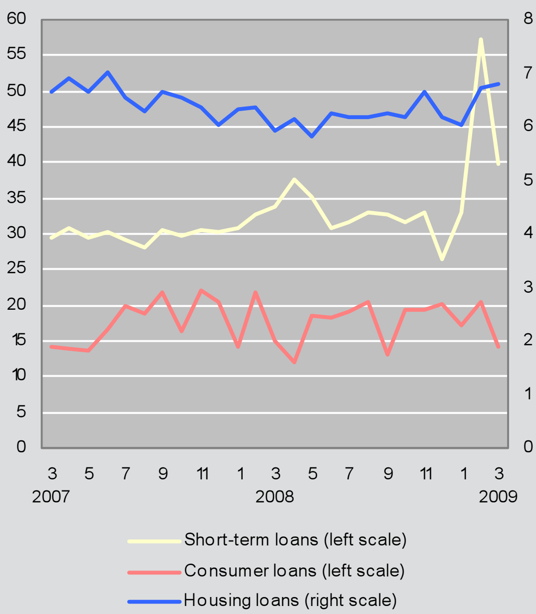
The currency structure of household loans did not change significantly. The share of Swiss franc-indexed loans was around 25.6%.

Chart III.4.4 **Real domestic and cross-border borrowing**
quaterly grow th rate (in %)



Enterprise borrowing recorded real quarterly growth, while cross-border borrowing declined.

Chart III.4.3 **Household dinar lending interest rates**



February leap in short-term loan interest rates is attributable to the rise in interest rates on unauthorized overdraft sparked by higher January inflation.

current account holdings. Although household foreign currency savings increased in Q1, the nominal rise in total liquid assets within M3 is primarily attributable to exchange rate gains/losses. The Government's decision to increase the level of guaranteed deposits and temporarily lift the capital gains tax on savings deposits brought the withdrawal of household foreign currency savings to an end. However, as opposed to the first two months of the year that witnessed positive developments in this respect, March saw a mild decline in household foreign currency savings deposits as a result of NBS decision to exempt natural persons from the obligation to place a 30% deposit of the loan amount for loans approved from the start of the year.[8]

The slowdown in real money, started early last year, continued into Q1 2009 primarily as a result of a drop in money demand prompted by economic downturn. The deceleration in M3 was mainly due to the slowdown in credit activity, NBS interventions in the forex market and lower government spending.

[8] See text box on p.35.

Bank lending

Significant slowdown in bank lending from early last year continued into Q1 2009. Lending to enterprises recorded minimum real growth, while lending to households went down even in nominal terms. Since the start of the year banks approved RSD 36.3 billion in loans to the private sector, and the share of loans in GDP rose 5.9%.

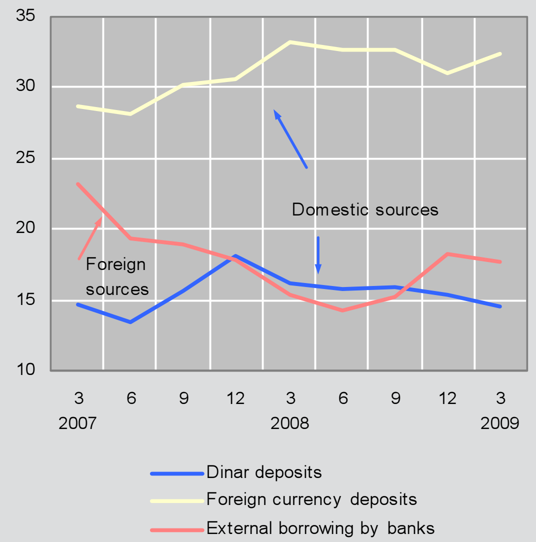
Cut back in lending is particularly pronounced for the household sector, where real y-o-y lending growth rate slumped from 11.8% last December to 3.3% in March. Such movements are for their major part attributable to household demand dampened by fears of further worsening of credit repayment terms (continued depreciation of the dinar and rise in interest rates), but also to banks' determination to moderate lending to the private sector and preserve their liquidity and solvency against the backdrop of economic crisis of highly uncertain duration and intensity.

Lower availability of the sources of finance also played a significant role in the slackening of bank lending. Namely, from the beginning of the year, banks cut their foreign debt by around EUR 297 million (in the face of short-term borrowing in March), capital remained broadly unchanged, enterprise deposits with banks fell by RSD 13 billion, while foreign currency savings rose mere EUR 95 million.

Loan demand also subsided under the influence of an interest rate hike on nearly all types of loans (with the exception of subsidized interest rates on consumer loans under the Government Programme of Measures). Driven by the rise in risk premium, interest rates edged up in the teeth of a downward revision of the NBS policy rate and record low levels of EURIBOR and LIBOR (6-month rates standing at 1.59% and 0.53%, respectively).

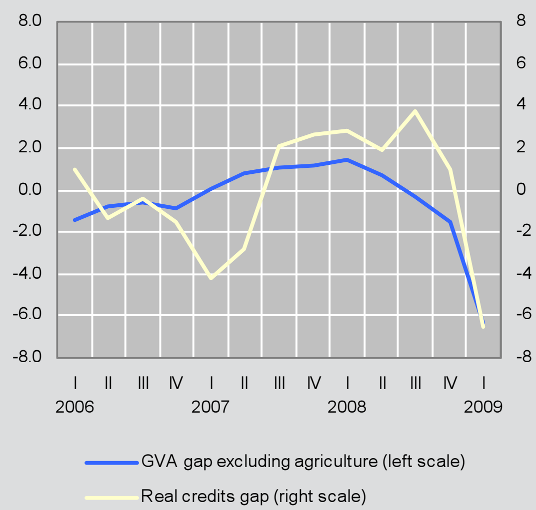
In real terms, lending to enterprises went up by 4.6% relative to end-2008, while lending to households recorded a 2.9% decline. Observed March-to-February, lending to households also recorded a nominal drop, although the dinar weakened by 1% in March and the government subsidized consumer loans were launched under the Programme of Measures to Ease the Effects of the Global Economic Crisis.

Chart III.4.5 **Sources of bank lending growth**
(% of balance sheet total of banks)



The share of foreign sources of financing declined.

Chart III.4.6 **Relationship between real credits to the private sector and economic activity**



Negative real credit gap widened mirroring movements in output gap.

Upward trend in NPLs, set in motion last year, continued into Q1 2009. Preliminary data indicate that the share of NPLs in total loans rose from 5.2% at end-2008 to 8.11% in March 2009.

Cross-border borrowing by enterprises nearly came to a halt amid tighter access to foreign capital, while the demand for domestic loans strengthened. In Q1 enterprises borrowed abroad around EUR 282 million. At the same time, the sum total of their foreign loan repayments reached around EUR 408 million. In 2009, enterprises have been mainly taking short-term loans from domestic banks, which can be explained by their lower liquidity, as well as by the banks' precaution with regard to the share of short-term sources of funds in financing their lending activity.

As the negative real credit gap (including both enterprise and household borrowing from domestic banks, and enterprise cross-border borrowing) is widening and mirroring the movements in output gap, it may be expected that the strongest disinflationary pressures in the coming period will originate from dampened aggregate demand.

Government measures to ease the effects of the global financial crisis

Following the first set of measures designed to boost domestic savings and stock trading (e.g. raising of the limit on guaranteed deposits from EUR 3,000 to EUR 50,000 and waiving of taxes on capital gains and interest earnings in respect of foreign currency savings), adopted by end-2008, the Serbian Government brought, in January and February, additional measures to ease effects of the global economic crisis and revive economic activity. The overriding aim is to encourage lending activity and further realization of the Corridor 10 Action Plan. The measures are expected to halt economic recession and maintain macroeconomic and financial stability.

In this issue of the *Inflation Report*, we shall focus only on measures designed to boost lending activity. The overview of these measures (along with types of loans and detailed extension criteria) is presented in table below.

Programme of measures to ease the effects of the global financial crisis

TYPE OF LOAN	Financing structure	Terms	Purpose	Total amount of loan
SUBSIDIZED LOANS FOR LIQUIDITY MAINTENANCE AND FINANCING OF DURABLE WORKING ASSETS	● RSD 2 billion in government interest subsidies ● RSD 80 billion from bank lending (total support planned: RSD 80 billion)	● Interest rate up to 5.5% p.a. (1 m EURIBOR + 3%) ● Repayment period up to 12 months ● Currency clause	● At least 50% of interest subsidies is allocated to export loans ● The rest is allocated to interest subsidies in respect of loans for other business activities, of which up to 30% may be used for rescheduling of loans with the same bank	● Entrepreneurial shop: up to EUR 20,000 ● Small-sized enterprise (up to 50 employees): up to EUR 50,000 ● Medium-sized enterprise (50-250 employees): up to EUR 0.5 million ● Large enterprise (more than 250 employees): up to EUR 2 million
INVESTMENT LOANS WITH PARTICIPATION OF THE DEVELOPMENT FUND	● The Development Fund provides RSD 5 billion to cover 30% of each loan ● Banks lend RSD 12 billion to cover 70% of each loan (the Guarantee Fund guarantees 75% of bank's loan) (total support planned: RSD 17 billion)	● Interest rate up to 3 m EURIBOR + 4% p.a. ● Repayment period: 3-5 years ● Grace period: 6-12 months ● 3-month repayment after expiry of grace period ● Currency clause	● For investment co-financing	● Entrepreneurial shop: up to EUR 30,000 ● Small-sized enterprise (up to 50 employees): up to EUR 0.2 million ● Medium-sized enterprise (50-250 employees): up to EUR 1.5 million ● Large enterprise (more than 250 employees): up to EUR 4 million
SUBSIDIZED CONSUMER LOANS AND FINANCIAL LEASING FOR PURCHASE OF DOMESTIC PRODUCTS	● The state provides RSD 1 billion in interest subsidies ● Banks and leasing companies invest RSD 20 billion in loans and financial leasing (total support planned: RSD 20 billion)	● Fixed interest rate up to 4.5% p.a., for "Punto" produced in Kragujevac, and up to 6% p.a. for other products ● Repayment period up to 7 years for cars and up to 5 years for other products ● Currency clause	● For purchase of some durables produced in Serbia	
INTERNATIONAL LOANS	● EIB: EUR 250 million ● KfW: EUR 100 million ● EBRD: EUR 100 million ● Loan of the Italian Government: EUR 30 million (total support planned: EUR 480 million (c. RSD 45 billion))	● Under the terms more favourable than the prevailing market terms	● For SMEs	

The above measures aim to reduce financing costs, keep the existing employment levels and stimulate further employment, as well as bolster demand for products of domestic labour-intensive sectors, including maintenance of export growth dynamics against the backdrop of contracted foreign demand. Financing costs can be lowered via direct interest subsidies i.e. via co-financing of a portion of the loan. Current employment levels are maintained by obligating loan beneficiaries to keep at least the same number of employees over the period of loan disbursement, i.e. employers cannot shed permanently employed staff and those employed for a period longer than one year. Further, state-subsidized interest rates on consumer loans for purchase of domestic products (cars, agricultural machinery, household appliances and furniture, carpets and flooring) are expected to boost demand for domestic products. Under the Programme, total financial support to the economy and households will amount to RSD 162 billion, of which EUR 282.6 million (c. RSD 26.7 billion) were granted until 6 May.

NBS adopts measures to boost financial sector liquidity

It was in early October 2008 that the first effects of the global financial turmoil spilled over to Serbia. Reduced inflow of foreign capital impacted directly on foreign exchange liquidity of the banking system and generated depreciation pressures. Banks were at the same time faced with substantial withdrawals of household foreign currency savings. To alleviate the pressures and boost foreign exchange liquidity of banks, the NBS adopted a range of measures in late 2008 and early 2009. First, it amended the Decision on Required Reserves of Banks with the National Bank of Serbia so that: a) banks can now choose a preferable date when calculating the reserving base in respect of foreign currency savings, b) banks are exempt from allocating required reserves on new deposits and foreign borrowing, c) the dinar's share of reserves allocated in respect of reserve requirements against foreign currency transactions was raised from 20% to 40%. Second, to bolster foreign exchange liquidity of banks and moderate excessive daily fluctuations of the dinar, the NBS sold EUR 895 million in the IFEM in Q4 2008. Third, in order to encourage bank lending, the NBS abolished, over the period of the next two years, mandatory formation of general banking risks reserves, when balance sheet assets and off-balance sheet items rise by more than 15% in the course of the year. Fourth, banks are exempt from payment of penalties if their gross household lending to share capital ratio is overshot (150%) as a result of dinar depreciation. At the same time, loans for agricultural production and entrepreneurs were excluded from the gross household loans category. Fifth, the exchange rate risk ratio was lowered from 20% to 10%, i.e. the total open foreign currency position (bank foreign exchange assets to liabilities ratio) may not exceed 10% of bank's capital at the end of each business day. This measure, along with easing depreciation pressures on account of greater foreign currency supply in the IFEM, was aimed at lowering the bank's exposure to exchange rate risk.

As similar tendencies continued into early 2009, i.e. insufficient foreign exchange liquidity of the banking sector coupled with capital outflow for foreign debt repayment, the NBS adopted additional measures.[1] To support and cut the costs of bank foreign borrowing, the NBS abolished, as of March 2009, reserve requirements on all foreign borrowing by banks from October 2008 to end-2009. Furthermore, banks can apply the September 2009 base (established as the minimum base) in calculation of foreign currency required reserves, until end-2009. In January and February, the NBS additionally boosted foreign exchange liquidity by selling EUR 556 million in the IFEM.

To bolster bank lending, the NBS adopted another set of measures in February this year. First, it raised the gross household lending to share capital ratio from 150% to 200%. Second, in support of the Government's Programme of measures to ease the effects of the global economic crisis, the NBS took a decision to allow banks to exclude from their reserving base the loans granted under the Programme to enterprises (for investments) and citizens (for the purchase of durables produced in Serbia). Third, banks can now extend the repayment period of cash loans approved prior to 30 September 2008, by up to 12 months from their original maturity date, on condition such loans are converted into dinars and carry no additional costs to borrowers relating to the extension of the repayment period or their conversion into dinars. Fourth, being exempt from obligation to classify into lower category the loans approved with no downpayment made, banks are no longer obligated to require natural persons to make a downpayment of 30% of the loan value (on loans disbursed since early 2009).[2]

In May, the NBS adopted additional measures to support financial sector stability. It offered to banks additional dinar and foreign exchange liquidity facilities that include approval of dinar loans with the maturity of up to one year and foreign exchange swap transactions in the IFEM. Short-term dinar liquidity loans will be approved against collateral of NBS and RS securities, excess foreign exchange that a bank deposits on a special account with the NBS, bank's receivables in respect of approved mortgage loans, as well as receivables from the Republic of Serbia and budgetary beneficiaries. To this effect, the NBS will organise auctions and set the interest rate paid by banks at least at level of

[1] Chronological overview of these measures is given on page 58.
[2] With the exception of disbursed housing loans, dinar loans not indexed to foreign currency clause and obligations in respect of credit cards.

the key policy rate increased by 1.5 pp. Another set of measures envisages provision of both foreign exchange and dinar liquidity. Through swap sales of foreign currency[3] (for dinars), the NBS will provide for bank foreign exchange liquidity, while swap purchases of foreign currency (for dinars) will boost banks' dinar liquidity. In line with market conditions and their liquidity position, banks will be able to renew their swap transactions on the maturity date, i.e. conclude a new swap agreement with the NBS. Banks may conduct swap foreign currency purchases and sales in NBS auctions or bilaterally at bank's request.

Although it may be too early to assess with any certainty the effects of the measures adopted, the first positive results are already evident. Bank's foreign exchange liquidity improved in March, making NBS interventions in the IFEM unnecessary for the first time since the global financial crisis affected Serbia.

[3] Foreign exchange swap transactions imply simultaneous contracting of swap (current date, date of transaction initiation) purchases/sales of foreign currency for dinars and forward (future date, date of transaction conclusion) sales/purchases of foreign currency for dinars at the forward rate.

5. Supply and demand

Economic activity

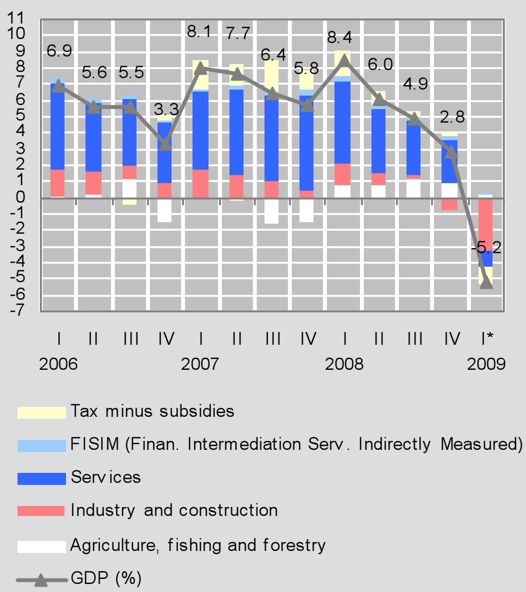
The first quarter saw a precipitous drop in economic activity, most notably in industry and retail trade. Output gap was markedly negative with a strong disinflationary effect.

A drop in economic activity in Q1 is likely to reach 2.8% (around 11% p.a). This is somewhat surprising because Serbia has a relatively low exports-to-GDP ratio and is poorly integrated in global financial markets, meaning that it should have been less severely hit by the world economic crisis than some more open economies. In addition, since the start of the global downturn, the dinar has strongly depreciated against the currencies of major importers of Serbian goods, which should have dampened a decline in exports.

The reasons for the economic downturn should be sought not only in contracted global demand and falling domestic exports, but also in a high level of euroisation of the Serbian economy and the effect of structural factors. Depreciation of the dinar has pushed up the costs and reduced liquidity of those companies that directly borrowed abroad or took foreign currency clause-indexed loans from domestic banks. Another reason could be the troublesome intercompany debt collection, typical of our economy, which invariably triggers the "illiquidity chain" and further aggravates the situation. A decreased propensity of economic entities to invest and spend, now that the duration and depth of the economic crisis remain highly uncertain, only further amplifies the downturn.

Therefore, the depreciation of currencies of highly euroised economies, such as the Serbian economy, is first manifested in a drop in economic activity (due to higher corporate and household debt), but, positive effects of depreciation may be expected in the later phases through the recovery of exports.

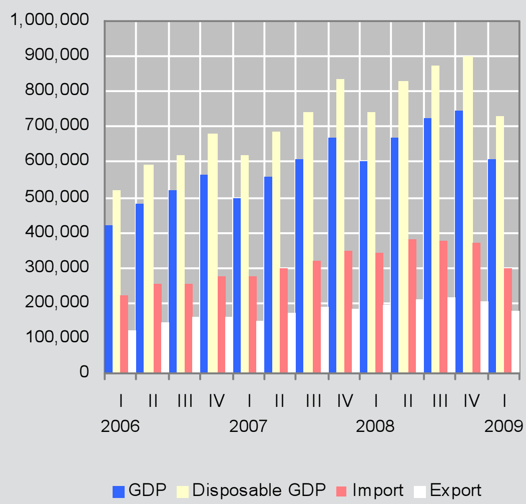
Chart III.5.1 **Contribution to y-o-y GDP growth**
(in percentage points)



* Estimate of NBS.

Q1 is likely to see a precipitous y-o-y fall in GDP (5.2%). Industrial production and taxes minus subsidies were on the steepest decline.

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



As the fall in imports outpaced that in exports, disposable GDP declined more sharply than GDP.

Fourth quarter of 2008

Judging by available data, a slowdown in economic growth continued in Q4 2008. Real y-o-y GDP growth touched 2.8%, almost completely in line with our estimates in the February *Report* (2.9%) The GDP growth rate for 2008 was revised slightly downwards to 5.4%. Measured by non-agricultural value added (NAVA), y-o-y economic growth reached 2.5%, 2.5 pp down on a quarter earlier.

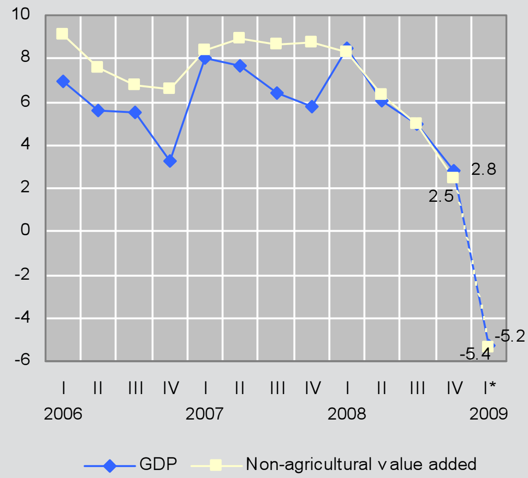
The GDP composition shows a slowdown in services and material production growth (4.9% and 0.4% y-o-y respectively). However, note that owing to the high y-o-y growth in agricultural output, material production picked up (13%). With agricultural production excluded, material production recorded a 3.7% decline, for the first time since 2005.

Seasonally-adjusted data suggest a negative quarterly GDP growth (6.3% p.a), while NAVA saw a drop (2.7%), by contrast to its hike in Q3 2008.

First quarter of 2009

The available data show that Q1 is likely to see a real y-o-y decline in GDP of 5.2%, which corresponds to a 5.4%

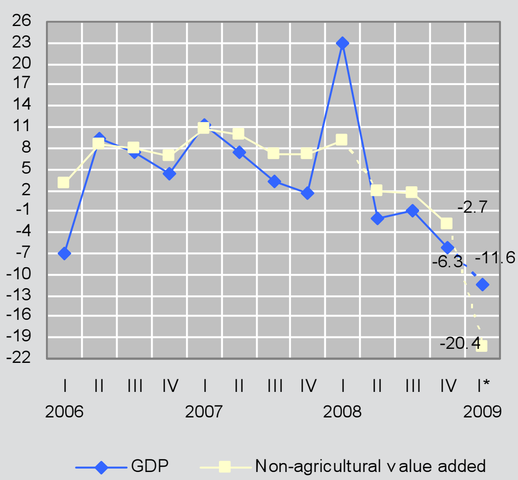
Chart III.5.4 **Growth in economic activity indicators**
(year-on-year growth rates)



* Estimate of NBS.

Y-o-y GDP and NAVA growth rates turned negative in Q1, with NAVA recording a sharper decrease than GDP.

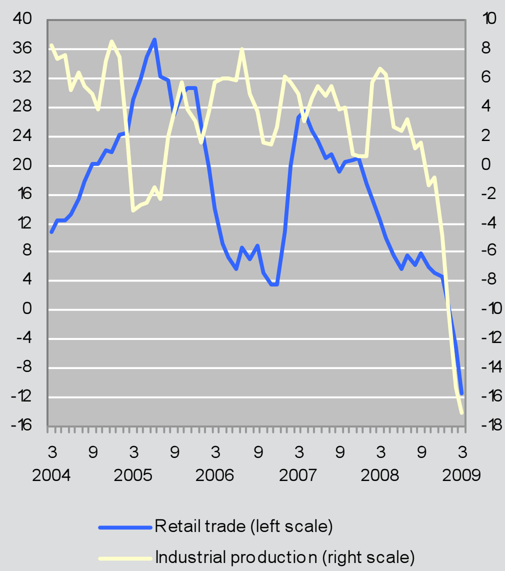
Chart III.5.3 **Growth in economic activity indicators**
(seasonally adjusted quarterly growth rates, at annual level)



* Estimate of NBS.

A decline in NAVA was unprecedented since availability of GDP data.

Chart III.5.5 **Quarterly moving averages of industrial production and retail trade**
(y-o-y, in %)



Both industrial production and retail trade fell sharply in Q1.

decline in NAVA. Seasonally-adjusted data suggest that GDP will continue to slide in Q1 (11.6% y-o-y), while NAVA will decline by 20.4%, marking the highest drop ever calculated from GDP data. This estimate is based on the assumption of the y-o-y decline in services and material production by 1.7% and 10.3% respectively. Within material production, the greatest negative contribution is expected from a drop in industrial production (17%). Within the services sector, wholesale and retail sale are likely to see the sharpest fall (14%). In terms of seasonally-adjusted data, wholesale and retail trade almost halved (a 47.8% fall y-o-y on the previous quarter). The decline in retail trade by 15.4% y-o-y is the highest on record.

Industrial production continued down (17% y-o-y) in Q1. Manufacturing recorded a particularly steep decline (21.9%) primarily as a result of reduced demand. This is evidenced by the March shortening of the working week to four days by the US Steel and suspension of its primary production in April.

Monthly data paint a somewhat more optimistic picture of industrial production – after declining until January, mild improvement was registered in February and March. Such movements can partly be attributed to the low January base induced by the gas crisis.

The y-o-y real decline (around 15.5%) in budgetary inflows from customs duties and VAT (minus subsidises) will bear down on GDP growth in Q1.

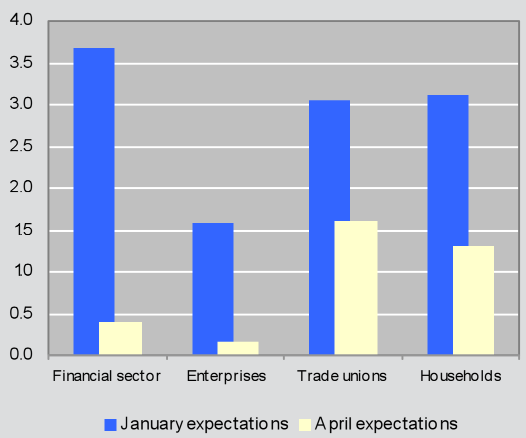
In line with the decline in industrial production in Q1, the negative gap of NAVA relative to its long-term trend is estimated to have risen even despite reduction in potential output. Output gap of around minus 6.1% points to stronger demand-side disinflationary pressures.

In terms of GDP spending composition, investment consumption fell more sharply than personal and public consumption.

Balance of payments data indicate that the disposable GDP could equal around RSD 730 billion (120.7% of GDP), with exports and imports of goods and services accounting for 29% and 50% of GDP respectively.

According to our estimate, real GDP will decline by around 3% in 2009.

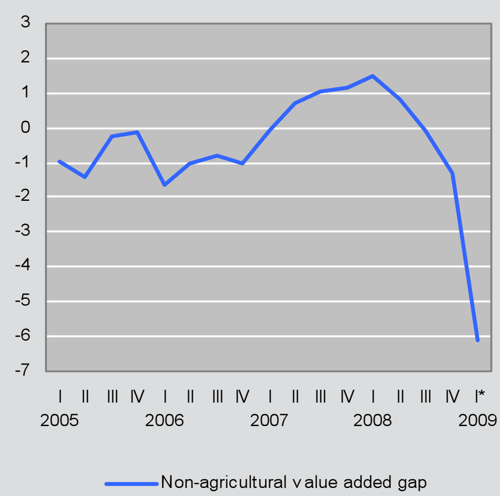
Chart III.5.6 **Expected economic growth in Serbia in 2009**



Source: *Strategic Marketing Research*.

Economic growth expectations of all sectors are significantly lower than those reported three months ago. Still, they remain within the zone of positive growth.

Chart III.5.7 **Output gap**



*Estimate of NBS.

In Q1, negative output gap widened significantly relative to its long-term trend.

Foreign demand

All major international institutions forecast a sharp drop in economic activity in 2009. The IMF's April projection envisages a 1.3% contraction of the global economy vs. 0.5–1% contraction envisaged by the March projection. A much more pessimistic forecast was released by the OECD in March, announcing that the global economy is to shrink by 2.75%, while the World Bank foresees a 1.7% contraction.

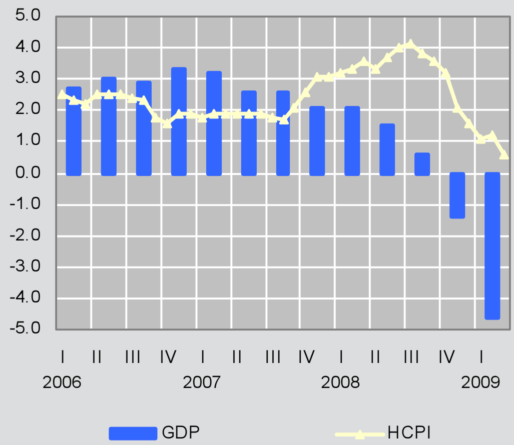
The IMF expects advanced economies to shrink by 3.8%, and emerging and developing economies to pick up by 1.6%. As the average growth of these economies ranged from 5% to 8% in the period since 2000, such a low rate of growth could also be defined as recessionary.

According to the IMF's forecast, the euro area is expected to contract by 4.2% and the United States by 2.8%. In terms of advanced European economies, the sharpest downturn will be recorded in Germany (5.6%). OECD forecast is much along the same lines. Germany is likely to face a severe economic downturn due to rapid softening in demand in emerging markets. Such a situation is particularly unfavourable for Serbia whose exports witnessed a major decline already in the first quarter of 2009.

Outside of the euro area, the consequences of the financial crisis spill-over into the real sector are also felt in the neighbouring countries where economic growth has either significantly slowed down or even turned negative. These unfavourable trends are expected to weigh down heavily on the volume of Serbia's foreign trade. It should be noted that the IMF expects the Serbian economy to shrink by 2% in 2009.

The IMF envisages a mild recovery of global economy in 2010, its key drivers, however, being emerging and developing rather than advanced economies. The former are projected to grow 4% in 2010, while the latter will most likely stagnate. Global economy is projected to grow 1.9% subject to implementation of the financial system stabilisation policies of advanced economies, most notably the agreed fiscal stimulus packages and measures geared at bolstering credit activity in the financial markets. The OECD also forecasts a recovery in 2010 provided stabilisation measures kick in. Advanced economies and the United States are projected to stagnate, while the euro area is expected to shrink for the second year in a row (0.3%).

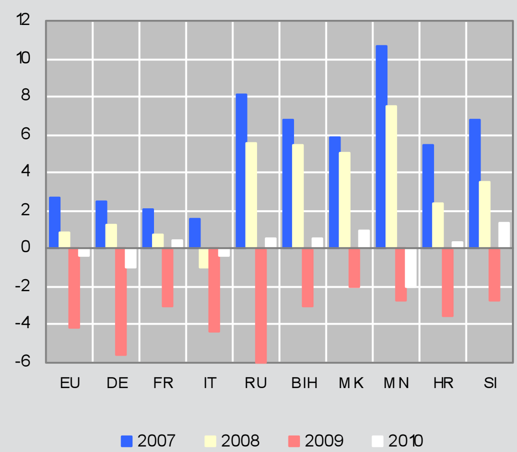
Chart III.5.8 **Euro zone GDP and inflation**



Source: *EUROSTAT.*

Inflation continues down, while GDP is expected to record negative growth for the second quarter in a row.

Chart III.5.9 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Source: *IMF World Outlook, April 2009.*

Economic activity of Serbia's key foreign trade partners is expected to face a sharp drop in 2009, recover mildly only in 2010.

Indicators of household consumption

Despite income growth, household demand experienced a sharp decline in Q1 as a result of abstinence from consumption caused by uncertainties regarding the depth and duration of the crisis.

Based on selected indicators, household consumption (excluding savings) is estimated to have decreased in Q1 2009 relative to the same period a year earlier by 3.1% in real terms.

The decline in household demand is also indicated by a significant downturn in the volume of retail trade, as well by the wage drop in the sector of services. Although the sources of consumer demand are not on the decline, household appetite for consumption has decreased due to uncertainties regarding future macroeconomic developments. In Q1 household consumption was under the dominant influence of the following factors:

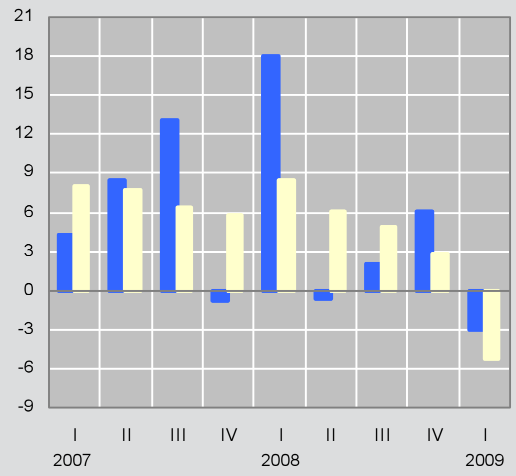
Wages. The share of net wages from the statistical sample in estimated GDP rose on the comparable period a year earlier by 0.9 structural points to reach 16.3%. Assuming that employees not included in the sample (excluding farmers and labour active members of their households) earned on average as much as those included in the sample, the ratio of net wages to estimated GDP was 32.2% or 3.2 structural points higher than in the same period a year earlier.

Social transfers accounted for 21.2% of estimated GDP, which is 3.3 structural points more than in the same period in 2008. The largest nominal increase was recorded in pension payments (25%).

Remittances and exchange offices. Registered remittances and net inflow from exchange transactions accounted for 7.2% of estimated GDP, 1.3 structural points more than in Q1 2008.

Savings and credits. As household deposits withdrawn from bank accounts in the last quarter of 2008, are estimated to have ended in large part as mattress money, changes in the stock of savings were not taken into account when assessing the Q1 dynamics of consumption. The share of credit in GDP fell by 2 structural points in Q1, or 4.5 structural points relative to the same period a year earlier. By contrast to savings, credit growth was taken into account in the estimation of personal consumption.

Chart III.5.10 **Household demand and GDP**
(y-o-y real grow th rates, in %)



Sharp decline in demand generated disinflationary pressures in Q1.

The share of household income in GDP, excluding savings where movements can be described as incidental rather than regular, rose by 3.4 structural points (from 55.2% to 58.6%)..

Public consumption

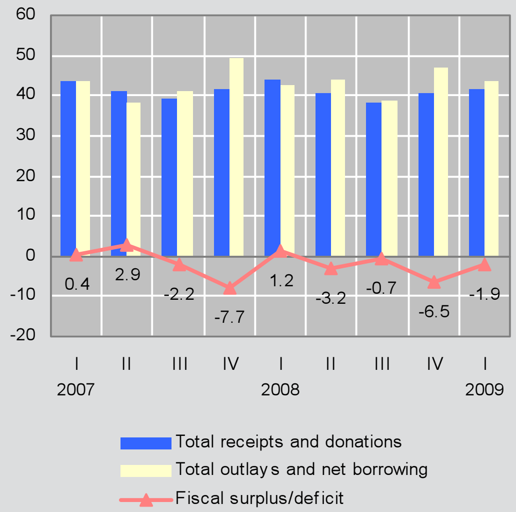
Calculated by the IMF methodology, Q1 2009 recorded a consolidated budget deficit of RSD 11.7 billion, resulting in creation of RSD 7.8 billion.

Given a steep decline in demand and the fact that Serbia has fallen into recession, the country's fiscal policy may not be qualified as expansionary even despite a RSD 11.7 billion deficit in Q1 (1.9% of GDP).

The effect of budgetary flows on demand, equivalent to RSD 7.8 billion, was somewhat lower than the deficit, mainly on account of foreign debt repayment.

Mirroring the economic downturn, all revenue categories were on a real y-o-y decline. Customs

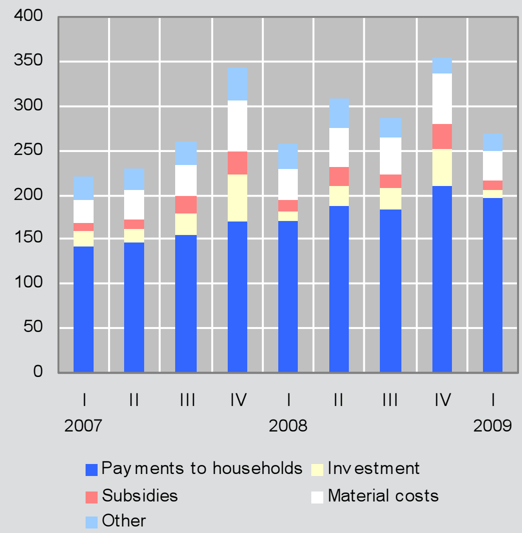
Chart III.5.11 **Public revenue and expenditures (IMF methodology)**
(as % of GDP)



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

Reflecting the effects of the global financial and economic crisis, consolidated fiscal deficit reached 1.9% of GDP.

Chart III.5.12 **Structure of public expenditures**
(in RSD bln)



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

Relative to Q1 2008, all expenditure items were cut to the benefit of outlays to households, mainly on account of a significant increase in pensions.

revenue fell most sharply (29.3%), partly as a result of amended regulations, i.e. application of the Stabilisation and Association Agreement. It should be noted, however, that the Government did not anticipate such a fall and therefore revised customs revenue down by as much as 40.7% in its latest budget revision for 2009. Profit tax revenue was also on a steep y-o-y real decline (22.6%). The most important revenue items – VAT and excise duties, were on a somewhat lower decline (13.6% and 8.5% respectively).

On the other hand, income tax revenue and social insurance contributions were the only revenue category that did not go down in nominal terms (nominal growth of 4.2% and 5.6%, and a real decline of 5.1% and 3.9% respectively), pointing once again to weak downward wage flexibility.

On the expenditure side, real growth was recorded only with social security outlays, most notably pensions (13.7% y-o-y). By contrast, real y-o-y decline was observed with employee salaries (2.5% y-o-y), subsidies (24.6%) and capital expenditure (21.3%).

Assuming fiscal receipts in the next quarter remain at the Q1 level and, as envisaged by the most recent budget revision, total expenditure in nominal terms grows by 2.2% relative to 2008, the deficit in Q2 will probably be somewhat higher than in Q1. Furthermore, the effect of budgetary flows on aggregate demand is likely to be higher than the deficit due to the payout of frozen foreign currency savings deposits, which are exempted from the calculation of the deficit but result in money creation.

Table III.5.1 **Fiscal balance**
(by quarter, in RSD billion)

	2007				2008				2009	Indices	Indices, real
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q1 2009 / Q1 2008	Q1 2009 / Q1 2008
I. Consolidated revenues and grants	220.36	232.94	240.56	281.74	263.58	273.39	275.21	303.32	251.07	95.3	86.7
o/w grants	0.13	0.27	0.35	0.42	0.16	0.52	0.30	0.32	0.19	117.5	106.9
II. Consolidated expenditures and debt repayments	219.91	230.14	259.82	343.19	258.05	308.83	286.53	353.90	266.82	103.4	94.1
foreign debt repayment	1.32	0.47	2.07	0.81	1.30	2.01	2.84	1.54	3.81	294.1	267.8
frozen foreign currency savings repayment	0.59	13.19	3.75	8.94	0.50	12.71	3.56	1.20	0.42	83.5	76.1
debt pre-payment	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
III. Consolidated revenues without grants	220.23	232.67	240.21	281.32	263.41	272.87	274.91	303.00	250.88	95.2	86.7
IV. Consolidated expenditures (excluding foreign debt repayments, pre payments and FFCD repayments)	218.01	216.48	254.00	333.44	256.26	294.12	280.12	351.17	262.59	102.5	93.3
Fiscal balance - IMF methodology (III - IV)	2.23	16.19	-13.79	-52.13	7.15	-21.24	-5.21	-48.17	-11.72	-163.8	-149.1
GDP	503.40	565.60	616.50	677.40	601.30	671.20	723.20	745.40	605.60	100.7	91.7
Fiscal balance - IMF methodology in % of GDP	0.44	2.86	-2.24	-7.70	1.19	-3.17	-0.72	-6.46	-1.93	-162.6	-148.1

Source: Calculation based on RS Ministry of Finance data.

Table III.5.2 **Consolidated public expenditure**
(by quarter, in RSD billion)

	2007				2008				2009	Indices	Indices, real
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q1 2009 / Q1 2008	Q1 2009 / Q1 2008
Total expenditure and debt repayment[1)]	220.0	230.1	259.9	342.1	258.1	308.8	286.5	353.9	266.8	103.4	94.1
Outlays to households:	150.5	156.4	167.1	183.6	182.7	200.7	197.0	224.0	209.3	114.5	104.3
Net wages	53.1	57.5	59.4	69.7	63.9	71.3	68.6	78.9	68.4	107.0	97.5
Employee contributions	9.4	10.5	10.8	12.3	11.2	12.4	12.5	13.9	12.5	110.9	101.0
Social transfers	88.0	88.4	96.9	101.6	107.6	117.0	116.0	131.2	128.4	119.3	108.7
Pensions and unemployment benefits	70.2	72.0	74.6	79.4	84.8	91.7	93.8	105.6	105.9	124.9	113.7
Social benefits	15.1	13.7	19.4	18.3	19.1	20.7	17.3	20.5	18.1	94.6	86.1
Other transfers to households	2.7	2.7	2.8	3.9	3.6	4.6	4.9	5.2	4.4	121.1	110.2
Subsidies	9.5	11.8	20.0	26.5	13.3	22.2	13.9	28.3	11.0	82.8	75.4
Material expenses	27.1	32.8	36.4	56.6	34.3	43.0	42.5	56.6	33.2	96.9	88.2
Investment	17.9	15.3	22.2	50.6	10.6	21.1	24.2	40.8	9.1	86.5	78.7
Interest expenses	5.8	3.1	4.2	2.9	5.3	2.5	4.8	3.3	5.6	104.5	95.1
Debt repayment	10.9	13.8	5.8	14.2	7.0	18.2	9.2	5.5	4.2	60.4	55.0
Payments in respect of frozen f/c savings and pension arrears	9.6	13.3	3.8	13.4	5.7	12.7	3.6	1.2	0.4	7.4	6.7
Foreign debt repayment	1.3	0.5	2.1	0.8	1.3	2.0	2.8	1.5	3.8	294.1	267.8
Repayment of outstanding internal debt	4.5	0.3	3.1	-1.6	4.4	3.5	2.8	2.8	0.0	0.0	0.0
Other[2)]	7.7	7.4	14.9	20.0	16.1	16.9	10.0	11.9	8.5	52.7	47.9

[1)] The sum does not include employee contributions and repayment of outstanding internal debt.
[2)] Item Other includes: other transfers, net purchase of financial assets and other current expenses.
Source: Calculation based on RS Ministry of Finance data.

Government's fiscal policy in conditions of economic crisis

The April budget revision envisages a reduction in revenue from RSD 698.8 billion to RSD 649.4 billion and a cut in expenditure from RSD 748.7 billion to RSD 719.9 billion, resulting in widening of the fiscal deficit from RSD 49.9 billion to RSD 70.5 billion. The budget was revised because of the lower than planned budgetary revenue resulting from the global economic downturn, and the cap on consolidated deficit agreed with the IMF at 3% of GDP.

Since early 2009, customs revenue fell most sharply and was revised down by 40.7% (RSD 29.2 billion), while the strongest negative impact on total planned budgetary revenue came from the value added tax proceeds – their annual levels were revised down by 11.7% (RSD 40.2 billion). The planned excise revenue remained almost unchanged (it was lowered by mere 0.4% or RSD 500 million) because excise duties were raised relative to those originally taken into calculation in the 2009 budget. The state coffers will be topped up from additional taxation revenue (e.g. on reregistration of foreign-owned and company cars), allowing for upward revision of non-tax revenue from RSD 50 billion to RSD 63.1 billion (a 26.2% increase). Revenue from income tax and corporate gain taxation was slashed by RSD 9.3 billion (7.1%).

Regrettably, capital expenditure was trimmed most – by as much as RSD 15.9 billion (36.4%). Expenditure on goods and services was revised by RSD 13.8 billion (27.8%), subsidies by RSD 8.8 billion (20.5%) and employee expenditure by RSD 8.5 billion (4.5%). On the other hand, outlays for repayment of interest were raised (pursuant to plans for deficit financing via increased borrowing), as well as transfers to other levels of government (as some, such as social insurance funds, will not be able to compensate for lowered revenue in 2009 by amending their regulations).

Table 1. **Fiscal deficit and real GDP projections by country**

	Estimate for 2009	
	Budget deficit to GDP ratio (%)	Real GDP growth (%)
Denmark	0.5	-0.8
Italy	4.7	-4.6
Hungary	2.6	-3.2
Germany	3.9	-5.0
Poland	3.2	0.8
Russia	7.9	-2.9
Slovakia	2.8	3.0
Great Britain	10.8	-3.7
France	4.8	-2.1
Czech Republic	3.8	-3.3
Switzerland	1.5	-1.0
Sweden	1.4	-1.7
Spain	1.4	-2.9

Source: *Bloomberg.*

Application of these measures in 2009 should result in a consolidated deficit of 3% of GDP, which according to the Maastricht criteria represents the upper cap on fiscal deficit. It would be logical to ask whether the planned budget deficit of 3% of GDP is set too low and whether it could have been set at a higher level. Table 1 contains an overview of envisaged fiscal deficits and real GDP growth of selected European countries in 2009.

Achievement of the fiscal deficit target of 3% in Serbia as well as in other European countries, especially the Eastern European ones, appears to be a matter of wishful thinking rather than a realistic possibility. Interestingly enough the US budget deficit for 2009 is projected at 11.2% of GDP.

A closer look at the expenditure categories which were most slashed shows that it is exactly those categories that should be most helpful in overcoming the current crisis (capital expenditure and subsidies). In terms of movements of the deficit-to-GDP ratio relative to real GDP growth over the last six years (Table 2), note that the RS budget practically never played an anti-cyclical fiscal role as deficits were recorded in years of both high and low GDP growth, as well as in 2009 now that the GDP growth has turned negative.

Table 2. **Budget deficit-to-GDP ratio and real GDP**

	2003	2004	2005	2006	2007	2008	2009*
Fiscal result as percentage of GDP	-3.1	0.8	0.7	-2.0	-2.0	-2.5	-3.0
Real GDP growth (%)	2.4	8.3	5.6	5.2	6.9	5.4	-1.7

* Estimate.

Given the uncertainties as to the duration and depth of the current economic downturn, including the speed and the extent of recovery, financing of a limited deficit without jeopardising the country's debt credibility seems an unavoidable evil. Still, over the years to come, the budget should finally resume its logical role of the economic stabiliser. This means that in years of strong growth, if not a surplus, it should record at least a more balanced result. Had Serbia pursued such policy in the past, it would now be able to conduct an anti-cyclical fiscal policy which would be highly desirable in times of recession.

Investment spending indicators

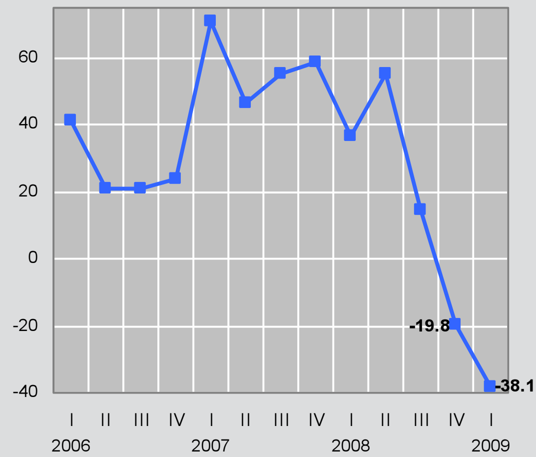
Nearly all available indicators show that the decline in investment activity, begun in Q4 2008, deepened further in early 2009.

Investment into fixed and working assets in Q1 shows markedly negative trends resulting primarily from worsening economic crisis.

Y-o-y drop in the production of capital goods (27.9%) is for its major part attributable to dampened domestic and foreign demand, evidenced by the sharp contraction in both exports and imports of these goods. Lower investment into fixed assets can also be put down to tightened access to foreign long-term credit. Still, the fact that domestic long-term lending to enterprises has remained broadly unchanged from a quarter earlier is sending some positive signals.

Inflow from FDI fell by 13% in Q1 from the same period a year earlier. The picture is even bleaker when one considers that the majority of this inflow were privatisation receipts from the sale of NIS (EUR 400 million).

Chart III.5.13 **Growth in imports of capital goods**
(year-on-year grow th rates)



Import of capital goods has a significant share in investments in Serbia. Its sharp y-o-y fall in Q1 is indicative of declining investment activity.

Table III.5.3

Investment indicators
(growth rates in %)

	Q1 2008 / Q1 2007	Q2 2008 / Q2 2007	Q3 2008 / Q3 2007	Q4 2008 / Q4 2007	Q1 2009 / Q1 2008
Real indicators					
Physical volume of industrial production of capital goods	7.8	18.4	3.6	-7.3	-27.9
Construction	4.8	5.7	-0.2	-3.4	-5.0*
Imports of intermediate goods	31.2	35.0	21.8	-13.6	-39.3
Exports of intermediate goods	33.0	43.1	28.4	-26.6	-49.8
Stocks of intermediate goods	-2.4	-2.3	-1.3	-0.3	0.0
Imports of capital goods	36.7	55.4	14.3	-19.8	-38.1
Exports of capital goods	66.9	66.4	59.0	16.0	-21.2
Stocks of capital goods	-4.4	-5.3	-5.3	-8.7	-17.5
Financial indicators					
Medium- and long-term external borrowing by enterprises (net)	49.7	62.7	20.2	-63.8	-116.3
Short-term credits to entreprises in RSD billion	39.2	32.0	42.6	39.7	45.9
Long-term credits to households in RSD billion	46.9	35.2	22.0	30.8	24.7
Long-term credits to enterprises in RSD billion	29.0	26.9	33.2	43.1	42.5
Government investment spending	-40.8	37.5	9.0	-18.9	-13.5

* NBS estimate.

Note: As the USD 806 million credit approved to Telekom Srbije a.d. by Citygroup in June 2007 was intended for purchase of Telekom Republike Srpske and did not induce a rise in investment activity in the country, it has been excluded from the calculation of long-term external borrowing by enterprises.

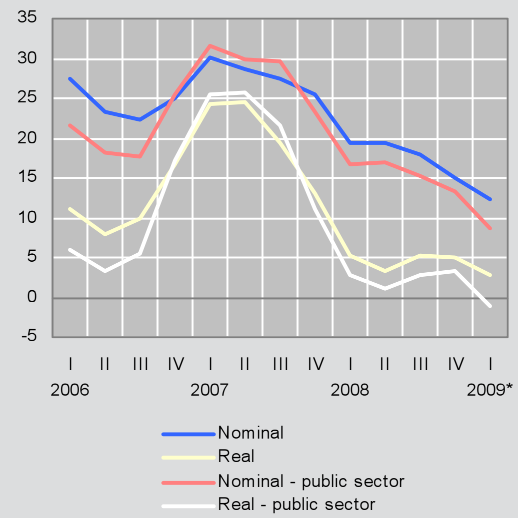
The majority of indicators point to a substantial decline in investment activity in Q1.

Downward trend in the construction activity, dating back to mid-2008, continued into Q1 2009. Construction activity is estimated to have declined in Q1 by 5% y-o-y.

Decline in the production, exports and imports of intermediate goods, as well as in inventories of finished goods, points to slumped investment into working assets. Although the supply of short-term corporate credit increased in Q1, these credits were used for the settlement of credit obligations rather than for investment in working assets.

Data on government investment spending also point to a downturn in investment activity. Namely, such spending was cut by 13.5% in Q1 relative to the same period a year earlier.

Chart III.6.1 **Net average wage - all sectors vs. public sector**
(y-o-y growth, in %)



* Q1 growth in both nominal and real gross wages is calculated based on the new methodology.

A markedly slower wage growth was due not only to economic downturn, but to changes in the wage calculation methodology as well.

6. Labour market developments

Wages

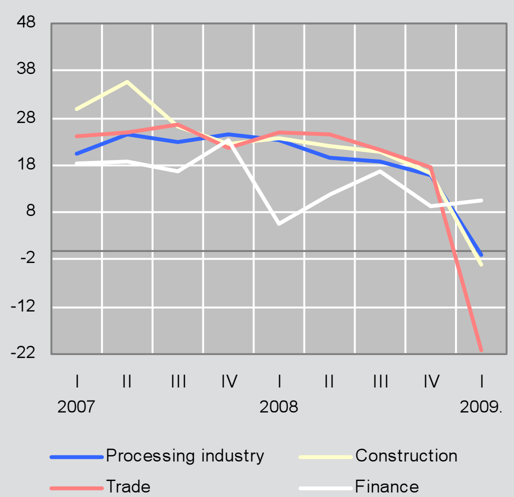
Economic downturn induced a slowdown in the y-o-y wage growth. Unit labour costs in the industrial sector stepped up significantly as the decline in labour productivity outpaced the drop in real gross wages.

As of January 2009, new methodology for the calculation of average wages is applied. The changes refer to the broadening of the coverage of observation units. Namely, in addition to data on wages of persons employed with legal entities as derived from the regular monthly statistical survey, the sample for average wage calculation has been extended to include data on wages paid to persons employed with natural persons (entrepreneurs) and obtained from the Tax Administration records. Inclusion of wages paid to persons employed with natural persons resulted in the lowering of the average wage figure.

As the economy softened, y-o-y net wage growth reached 12.3% in nominal terms or 2.7% in real terms, which is its lowest level in the last several years (caused in part by the above methodological changes in terms of observation unit coverage).

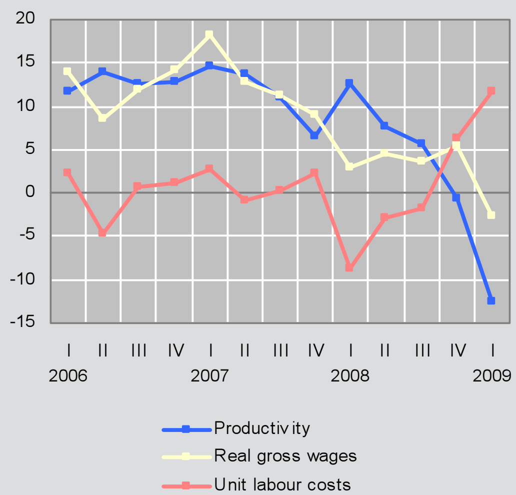
Real wages went up only in the sectors of finance (1.0%), mining and quarrying (2.7%) and electricity production (2.7%), while all other sectors faced a decline. The sharpest

Chart III.6.2 **Net average wages**
(y-o-y growth, in %)



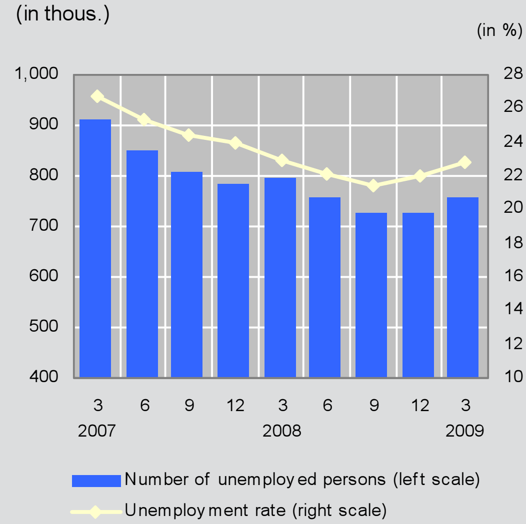
The strongest decline was recorded for wages in the trade sector.

Chart III.6.3 **Movements in productivity, real gross wages and unit labour costs in the industrial sector**
(y-o-y growth, in %)



As the weakening of industrial production in Q1 was not off-set by the decline in real gross wages and employment in the industrial sector, y-o-y growth in unit labour costs came out very high.

Chart III.6.4 **Unemployment**
(in thous.)



Source: Statistical Office and National Employment Service.

Both the number of unemployed and the unemployment rate rose against the backdrop of economic downturn.

drop in real wages was recorded for trade (27.9%), hotels and restaurants (21.2%), real estate (18.5%) and construction (11.5%).

Below-average public sector wage growth equalled 8.6% y-o-y in nominal terms (1% decline in real terms). The average public sector net wage amounted to 37,400 dinars, exceeding the average net wage in Serbia of 30,120 dinars calculated by the new methodology. Due to the application of the Law on Temporary Salary Decrease in State Administration and Public Sector, public sector wages are expected to decline in real terms in the coming period.

As the weakening of industrial production in Q1 was not off-set by the decline in real gross wages and employment in the industrial sector, y-o-y growth in unit labour costs came to 11.6%. This was mainly due to movements in the processing industry, where unit labour costs rose 18.3%.

Employment

Effects of the economic crisis are also evident in the labour market. Both employment and new employment are on the decline, while unemployment has risen significantly.

March-over-December, employment in legal entities declined by around 11.5 thousand. The steepest drop was recorded in the processing industry, transport and construction. Data on employment in the sector of entrepreneurs (natural persons) are not available as yet.

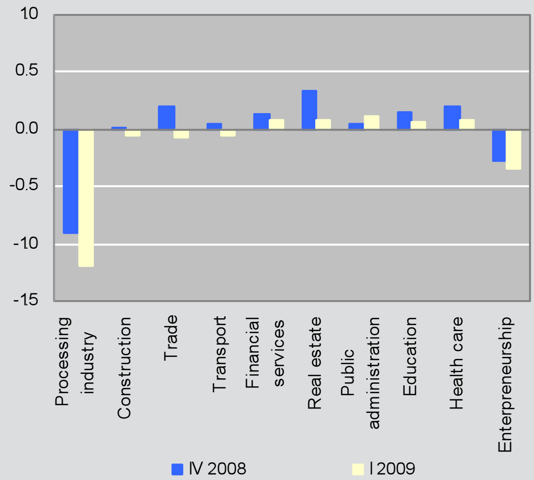
The decline in employment was also recorded in the public sector, most notably in public enterprises. Similar movements are likely to continue in the near future as the Government's economic stability support plan envisages state administration reform and staff downsizing. The plan envisages a 10% cut in the state administration staff

Chart III.6.5 **New employment**
(in thous.)

* Estimate of NBS.
Source: Statistical Office and National Employment Service.

The drop in new employment contracts is in line with economic softening.

Chart III.6.6 **Employment by sector**
(contribution to y-o-y employment growth, in pp)



Source: Statistical Office.

Lower employment figure was mainly due to employment drop registered in the processing industry.

numbers by the end of the year, whereas a ban on new employment is already in force.

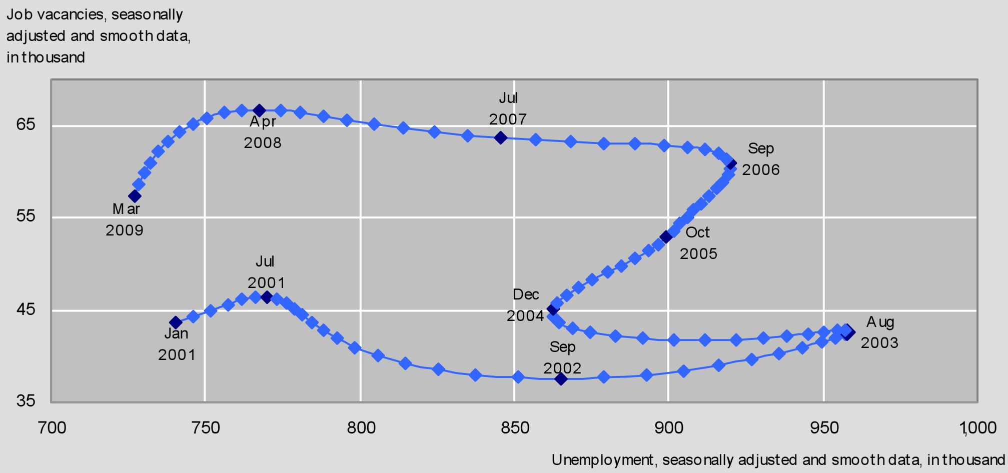
Unemployment is rising against the backdrop of economic downturn. Relative to end-2008 unemployment is higher by 30 thousand. The official unemployment rate increased from 22.0% in December to 22.8% in March.

The drop in new employment contracts and job vacancies also testifies to the spill-over of effects of the economic crisis on the labour market. However, it is expected that these effects will be eased by the measures the Government adopted with a view to encouraging new employment. These measures include budget allocations for traineeship/apprenticeship schemes, implementation of public works and supply of credit for start-up businesses, small and medium-sized enterprises.

Beveridge curve

Beveridge curve is a graphical representation of the relationship between unemployment and the job vacancy rate. The position on the curve indicates the current state of the economy in the business cycle.

Beveridge curve, 2001-March 2009



The above Beveridge curve points to structural changes and worsening conditions in the labour market from early 2001 to mid-2003 that came about as a result of privatisation processes and layoffs. The rise in both unemployment and job vacancy rate from December 2004 to September 2006 can be put down to inefficient labour market and labour force immobility. The curve shows an increase in labour market efficiency from Q4 2006 to end-Q1 2008. Lower job vacancies and higher unemployment in Q1 this year point to deterioration in the labour market conditions against the backdrop of economic downturn. The trend started already in the last quarter of 2008, but became particularly pronounced since the beginning of this year.[1]

When creating the Beveridge curve for Serbia, account should be taken of a number of constraints, the most important being the fact that there are two different unemployment rates. The first rate is the official unemployment rate, showing the so-called registered unemployment at monthly level. It is calculated from data on the number of unemployed persons supplied by the National Employment Service and data on the number of employed persons derived from the LABOUR Survey conducted by the Statistical Office. The second (significantly lower) rate is derived from a semi-annual Work Force Survey of the Statistical Office, which captures both formal and informal employment. Another very important limiting factor is the reliability of data on job vacancies as employers, under the current legislation framework, have the right to hire staff without intermediation by the National Employment Service. It should also be taken into account that the unemployment drop in some periods (2004 and 2007) was due primarily to methodological changes, and that the unemployment rate ran high in all the years observed. Therefore, there can be no talk of economic expansion.

[1] Due to the use of the Hodrick-Prescott filter for data smoothing, the rise in unemployment is still not visible on the Beveridge curve.

IV. Inflation projection

Inflation is most likely to move within the target band in the period ahead. The central projection places end-2009 inflation at 8.8%, within the band of 6.5–12.5%, while the central projection for 2010 revolves around the midpoint of the target band. Prices are expected to stabilise under the impact of dampened demand, tight fiscal measures and slower growth in regulated prices. The easing of inflationary pressures opens the scope for further monetary policy relaxation in the near future.

The medium-term inflation projection shows expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed as both a range and a central projection figure. This projection presupposes an active monetary policy which aims to keep inflation within the target band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Background information

Even though inflation was relatively high in Q1, inflationary pressures are subsiding: a) the exchange rate stabilised, and most effects of the January depreciation have already worn off; b) demand is on a steep decline; c) agreement with the IMF has been signed and it includes new fiscal policy measures; d) the Government has announced slower growth in regulated prices in the coming period. The only two factors producing inflationary effects are surging world oil prices and the recently opened depreciation gap of the real exchange rate.

Notwithstanding a dramatic decline in demand, inflation edged up in Q1 relative to end-2008, but still remained within the target band. Inflation growth was driven primarily by the significant increase in regulated prices and inflationary effects from the depreciation of the dinar. However, as most effects of the depreciation and regulated price growth came through in the first two months of the year, March saw inflation heading down.

Although foreign prices are declining, depreciation of the dinar from the beginning of the year triggered a rise in imported inflation, which spilt over into domestic inflation in January and February. However, as the exchange rate stabilised in late February, no inflationary pressures in this respect are anticipated in the short run.

Regulated price growth was exceptionally strong in Q1, but is expected to slow down over the coming months. In the short-term, only prices of petroleum products are likely to record significant growth on account of both increased excise duties and surging world oil prices. The Government has recently announced it will put a freeze on electricity prices and keep it throughout this and maybe even the next year. On the other hand, there is a certain risk that local governments will compensate for lower budget allocations by raising the prices of their services.

The most significant disinflationary factor at this point, however, is the drastically reduced demand. Judging by all indicators, the decline in economic activity in Q1 was very steep and output gap (demand-side) markedly negative. The drop in demand is also evident in the sharp decrease in the volume of retail trade.

Demand will plunge further under the impact of tight fiscal measures envisaged by the IMF arrangement. From the monetary aspect, these measures are positive as they are based on expenditure cuts rather than revenue hikes, which makes their impact on price growth negligible.

Arrangement with the IMF is expected to lead to a drop in the risk premium, which should, together with the agreement reached with banks on the maintenance of their exposure to Serbia, moderate depreciation pressures.

As inflationary pressures eased, the NBS Monetary Policy Committee lowered the key policy rate by 125 basis points in Q1, thereby bringing it in real terms close to the neutral level.

The real exchange rate depreciated below the neutral level, i.e. depreciation gap opened, which means that this factor could after quite a while start producing inflationary effects. Hence, after a fairly long time, monetary policy stance in Q1 could be described as expansionary.

Monetary easing continued in April when the key policy rate was trimmed down by 250 basis points to reach 14%.

Projection assumptions

The projection is based on the assumption that the 2009 growth in regulated prices, excluding the prices of petroleum products, will be close to the planned 13%. The projection also assumes that the Government will go through with the announced freeze on electricity prices this year, as well as that the agricultural performance will be average, with a neutral effect on price growth.

We expect that the risk premium will decrease thanks to the recently signed agreement with the IMF, and that the appreciation trend of the real exchange rate will increase over time, which will, according to the uncovered real interest rate parity, lead to the real interest rate trend decline.

In terms of external factors, the projection assumes euro zone inflation and GDP decline, and consequently, expansionary monetary policy by the ECB.

International recession and other factors will continue to exert recessionary effects on our economy.

Inflation projection

The central projection places end-2009 inflation at 8.8%, within the band of 6.5–12.5%, while the central projection for 2010 revolves around the midpoint of the target band.

Short-run inflationary pressures are declining. Following depreciation in January, the exchange rate stabilised, while most effects of the weakened dinar on inflation wore off in the first two months of the year. These factors, coupled with low demand and slower regulated price growth, are likely to result in a slower price growth in Q2, placing the y-o-y inflation rate by mid-2009 closer to the lower bound of the targeted range.

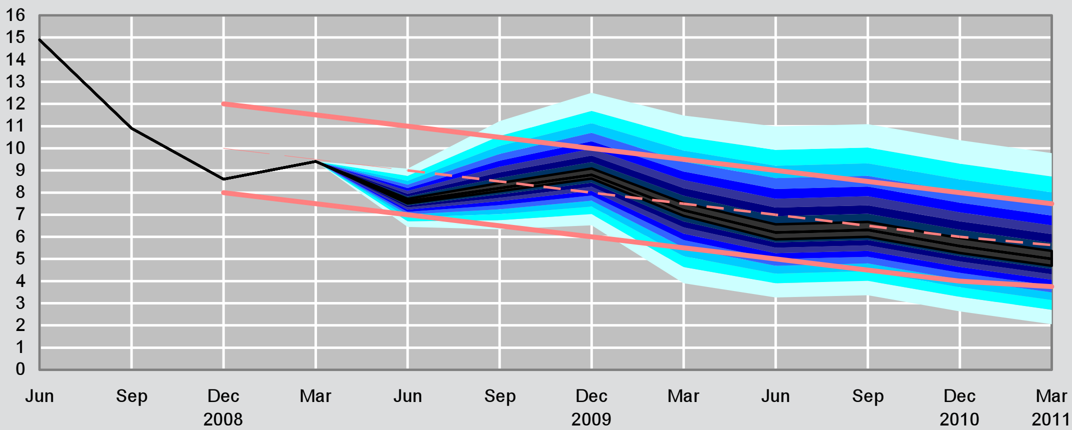
Over the medium-term, low demand will be the main determinant of a slowdown in market-based prices (core inflation). In light of global recessionary tendencies, output gap (demand side) is likely to remain negative throughout the projection horizon. Domestic demand will decline further on account of new fiscal policy measures, above all a cut in public sector wages in both nominal and real terms.

The exchange rate is likely to be much more stable over the coming period than in the last two quarters. Even though some depreciation pressures from reduced capital inflow are still likely, they could turn out more moderate

Table IV.1.1 **Projection assumptions for 2009**

External assumptions	
EU inflation (Dec to Dec)	1.0%
ECB policy rate (end-year)	1.0%
Euro area GDP growth	-4.1%
Ural oil price per barrel (Dec to Dec)	45%
Internal assumptions	
GDP growth	-3.0%
Regulated prices excl. petroleum products (Dec to Dec)	13.8%
Prices of agricultural products (Dec to Dec)	9.4%
Fiscal budget deficit (share of GDP)	-3.0%
Trends	
Real exchange rate trend (average)	0.5%
Real interest rate trend (average)	6.4%

Chart IV.1 **Inflation projection**
(y-o-y rates, in %)



Inflation is most likely to move within the target band in the period ahead. By end-2009 CPI growth is expected to settle at 8.8%, within the band of 6.5-12.5%.

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

owing to the agreement with the IMF and banks' commitment to maintain their level of exposure to Serbia. At any rate, we expect no inflationary pressures from the exchange rate and imported inflation.

The disinflation process could be somewhat slowed by the recently opened depreciation gap. Real depreciation from end-2008 and early 2009 is expected to bring about a recovery of economic activity, i.e. demand. Furthermore, real depreciation weighed down heavily on the margins of importers[9] who could, given the right conditions, raise domestic prices in the coming period, but not high enough to halt the decline in core inflation.

In addition, regulated prices are expected to grow at a much slower pace. Such an expectation is based on the Government's announcement that there will be no increase in electricity prices in 2009.

All of the above is expected to lead to a drop in quarterly headline inflation growth rates in the coming period. Nevertheless, y-o-y inflation growth rates could show a rise in H2 due to the low base, i.e. low quarterly inflation rates prevailing in the same period a year earlier. Therefore, y-o-y inflation is likely to temporarily level off closer to the upper bound of the targeted range by the end of 2009. Its decline, however, can be expected already in early 2010.

The projection is consistent with continued monetary policy relaxation over the coming period. A cut in the key policy rate could induce moderate weakening of the dinar, which, however, would not threaten the fulfilment of inflation target.

A relatively wide projection band, mildly asymmetrical to the upside, reflects our perception of the risks underlying the projection.

Risks to the projection

Albeit lessened by the agreement signed with the IMF, risks to the projection remain relatively high. Again they are tilted to the upside due to the possible increase in VAT, faster than assumed growth in regulated prices and bad harvest.

The key risk to the projection relates to growth in regulated prices. The projection assumes 13.8% rise in

[9] The growth in domestic prices was slower than that in import prices.

regulated prices in 2009. Upside deviations from this figure are possible, especially when it comes to prices under local government regulation. We can not rule out the possibility that faced with lower transfers from the budget, local governments would not resort to increasing the prices of their services. The possibility that the Government could revise electricity prices in the course of the year despite its announcements should not be excluded either.

Plus, if tax revenues underperform, the Government could resort to VAT increase, which would lead to a one-off rise in prices and upside deviation from the projection.

Deviation from the projection could also result from higher/lower than assumed growth in the prices of agricultural products, holding a relatively high share in the consumer price index. As such prices are highly dependent on weather conditions, their movements are volatile and unpredictable. The experience of 2007 shows that drought could push the prices of agricultural products up significantly, and, apart from directly feeding through into inflation, have an impact on the prices of processed food as well.

Comparison with the previous projection

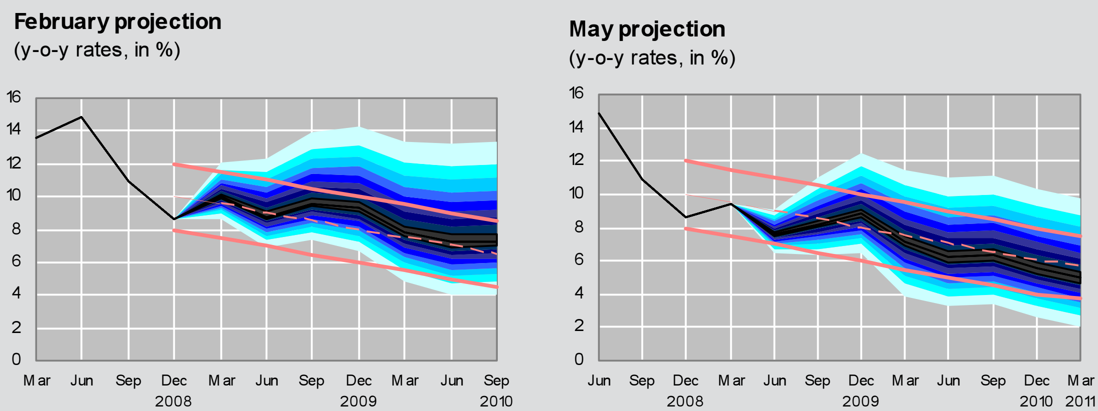
The new inflation projection is somewhat lower than the one published in the February Inflation Report. The key reason is a steeper fall in demand underlying the new projection, resulting mainly from downward revision of the global economic growth forecasts, as well as a faster than expected drop in our GDP in Q1.

On the other hand, only world oil prices, soaring in late Q1 and early Q2, are producing stronger inflationary pressures than a year earlier.

The band of the new projection is narrower and less tilted to the upside as the risks of fiscal expansion and significant departure of regulated price growth from the projected path have lessened in the wake of supplementary budget adoption.

For the same reasons, the new projection is based on a more expansionary monetary policy stance. It assumes a cut in the key policy rate, as opposed to the previous projection that envisaged no changes in that respect.

Chart IV.1.2 **Current v. previous projection**



The new central projection is slightly lower than the previous one due to the higher than expected drop in demand, while the projection band is narrower and less asymmetrical to the upside owing to the adopted supplementary budget and signed arrangement with the IMF.

Table IV.1.2 **Changes in projection assumptions for 2009**

	February projection	May projection
	2009	2009
External assumptions		
EU inflation (Dec to Dec)	1.5%	1.0%
ECB policy rate (end-year)	1.5%	1.0%
Euro area GDP growth	-1.0%	-4.1%
Ural oil price per barrel (Dec to Dec)	3%	45%
Internal assumptions		
GDP growth	1.8%	-3.0%
Regulated prices excl. petroleum products (Dec to Dec)	13.0%	13.8%
Prices of agricultural products (Dec to Dec)	12.0%	9.4%
Budget deficit (share of GDP)	-1.75%	-3.0%
Trends		
Real exchange rate trend (average)	1.4%	0.5%
Real interest rate trend (average)	8.0%	6.4%

Outlook for the key policy rate

Taking into account the current projection and underlying risk factors, the NBS Monetary Policy Committee holds that the key policy rate is more likely to be lowered in the next period than raised or kept on hold (14%).

There is scope for monetary easing given the sharp decline in demand, new fiscal policy measures, anticipated stabilisation of the exchange rate and the Government's announcement of slower growth in regulated prices in the coming period.

However, monetary policy relaxation may not take place if the growth in regulated prices shoots past the planned level (13±2%) or if depreciation pressures turn out higher than expected. Tighter than projected monetary policy stance could also be occasioned by a bad harvest, i.e. its implications for the inflation target.

Table A
Indicators of Serbia's external position

	2001	2002	2003	2004	2005	2006	2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009
EXTERNAL LIQUIDITY INDICATORS (in %)												
Forex reserves/imports of goods and services (in months)	3.1	4.5	5.2	4.3	5.9	9.5	8.3	7.1	6.0	5.8	6.3	7.7
Forex reserves/short-term debt	113.9	223.5	336.2	424.9	385.9	717.4	729.7	892.0	792.4	505.7	336.4	412.7
Forex reserves /GDP	10.1	14.9	18.0	17.9	23.0	40.2	35.7	35.3	31.1	28.0	23.5	22.8
Debt repayment/GDP	0.8	1.4	2.0	3.9	4.7	6.9	9.8	11.9	10.0	7.8	12.7	10.5
Debt repayment/exports of goods and services	3.7	7.1	9.1	16.8	17.9	23.1	33.4	37.0	31.8	26.3	46.1	36.607
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	96.9	74.3	69.0	59.5	61.1	66.5	64.9	66.3	63.7	59.4	62.1	60.3
Short-term debt/GDP	8.9	6.8	5.4	4.2	6.0	5.6	4.8	4.0	3.9	5.5	6.9	5.5
External debt/exports of goods and services	456.9	379.3	311.5	253.7	234.2	223.7	220.0	187.0	194.2	194.7	204.9	204.34
FINANCIAL RISK EXPOSURE INDICATORS (in %)												
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	346.1	319.0	334.5	299.8	365.85
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	185.8	166.4	176.9	140.7	161.0
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	60.4	59.7	63.7	73.5	73.2	80.9	82.4	89.0	87.9	81.7	77.1	77.6
				Nov	July	Feb	June					
CREDIT RATING				Standard & Poor's: B+	Standard & Poor's and Fitch: BB-	Standard & Poor's: BB-/positive; Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's: BB-/negative; Fitch: BB-/stable			Standard & Poor's and Fitch: BB-/negative	
MEMORANDUM: (in USD million)												
GDP (in USD million)	11,485	15,108	19,676	23,711	25,300	29,492	40,423	10,910	12,932	14,097	11,540	8,494
External debt	11,125	11,230	13,575	14,099	15,467	19,606	26,236	28,356	29,447	29,516	30,708	28,391
External debt servicing	91	211	397	935	1,183	2,021	3,977	1,302	1,295	1,106	1,467	888
Central bank foreign exchange	1,169	2,280	3,550	4,245	5,843	11,888	14,216	15,084	14,383	13,936	11,494	10,743
Short-term debt	1,026	1,020	1,056	999	1,514	1,657	1,948	1,691	1,815	2,756	3,417	2,603
Current account balance	280	-650	-1,532	-3,281	-2,194	-2,986	-6,334	-1,954	-2,757	-2,300	-1,710	-1,054

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 end-period.

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

Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review.

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

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

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

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

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

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; net changes in short-term debt have been excluded from foreign debt servicing in Q1 and Q2 2008.

4. GDP for 2008 as estimated by the National Bank of Serbia.

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

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009
Real GDP growth (in %)	5,4	3,6	2,8	8,2	6,0	5,6	7,1	8.5	6.3	4.9	2.9[1]	-5.2[1]
Consumer prices (in %, relative to the same month a year earlier)[2]	40.7	14.8	7.8	13.7	17.7	6.6	11.0	13.6	14.9	10.9	8.6	9.4
Core inflation (in %, relative to the same month a year earlier)[2]	20.5	4.4	6.1	11.0	14.5	5.9	7.9	10.2	14.2	11.4	10.3	10.2
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	14,215.8	15,084.1	14,382.6	13,935.8	11,494.4	10,742.7
Exports (in USD million)[3]	2,435	2,961	4,358	5,557	6,605	8,763	11,923	3,522	4,074	4,210	3,184	2,426
- growth rate in % compared to a year earlier	17.9	21.6	47.2	27.5	18.9	32.7	34.6	42.6	42.6	29.9	-5.1	-31.1
Imports (in USD million)[3]	-4,499	-6,059	-8,177	-11,863	-11,901	-15,086	-21,401	-6,184	-7,294	-7,306	-5,717	-4,166
- growth rate in % compared to a year earlier	28.3	34.7	35.0	45.1	0.3	26.8	36.9	37.8	45.6	32.7	-10.6	-32.7
Current account balance[4]												
(in USD million)	280	-650	-1,532	-3,281	-2,194	-2,986	-6,334	-1,954	-2,757	-2,300	-1,710	-1,054
as % of GDP	2.4	-4.3	-7.8	-13.8	-8.7	-10.1	-15.9	-18.2	-21.6	-16.6	-15.0	-12.4
Unemployment, official data (in %)[5]	21,8	24,5	26,1	23,9	25.3	26.6	24.0	22.9	22.1	21.4	22.0	22.8
Unemployment according to the Survey (in %)[6]	12.2	13.3	14.6	18.5	20.8	20.9	18.1	13.3	/	14	/	/
Wages (average for the period, in EUR)	89.9	151.7	176.7	194.4	210.4	260	347	365	400	428	418	321
RS budget deficit/surplus (in % of GDP)[7]	-0.2	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-0.1	-2.8	1.6	/	/
Consolidated fiscal result (in % of GDP)												
- Ministry of Finance methodology	0.0	-1.8	-2.1	1.1	1.2	-1.1	-1.4	2.1	-3.1	-0.7	-6.5	-1.9
- IMF methodology	-0.5	-2.6	-2.7	0.7	0.7	-2.0	-2.1	1.2	-3.2	-0.7	-6.6	-1.9
RS public debt (external + internal, in % of GDP)[7]	97.6	76.4	69.9	55.4	48.0	41.6	33.7	29.8	26.9	25.4	/	/
RSD/USD exchange rate (average, in the period)	66.68	64.46	57.56	58.39	66.70	67.10	58.44	55.11	51.89	51.27	64.44	72.12
RSD/USD exchange rate (end of period)	67.67	58.98	54.64	57.94	72.22	59.98	53.73	52.13	50.01	53.28	62.90	71.59
RSD/EUR exchange rate (average, in the period)	59.78	60.68	65.05	72.57	82.92	84.16	79.98	82.65	81.08	77.14	84.95	93.93
RSD/EUR exchange rate (end of period)	59.71	61.52	68.31	78.89	85.50	79.00	79.24	82.31	78.98	76.60	88.60	94.78
Memorandum												
GDP (in USD million)[8]	11,485	15,108	19,676	23,711	25,300	29,492	40,423	10,910	12,932	14,097	11,540	8,494

1) NBS estimate.
2) Retail prices until 2006.
3) Trade with Montenegro is registered within relevant transactions as of 2003.
4) In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
5) Source: Statistical Office; 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.
6) Source: Labour Force Survey, Statistical Office.
7) Source: RS Ministry of Finance Bulletin.
8) GDP in 2008 - NBS estimate.
9) Data on wages for 2008 were re-calculated in accordance with the new methodology.

Table C
IMF's projection for key macroeconomic indicators

	2007	2008 (Estimation)	Projection 2009	Projection 2010
Output, prices and labor market (change in percent)				
Real GDP	7.1	5.6	-2.0	1.8
Real GDP excluding agricultural sector	8.9	5.2	-2.2	2.0
Real domestic demand (absorption)	11.6	5.9	-6.0	-2.4
Consumer prices (average)	6.5	11.7	10.0	8.2
Consumer prices (end of period)	11.0	8.6	10.0	8.0
Nominal gross wage	21.9	17.8	6.3	6.2
Real net wage	19.9	5.4	-3.4	-1.9
General government finance (in percent of GDP)				
Revenue	43	40.9	39.2	39.1
Expenditure	44.9	43.1	42.2	40.4
Fiscal balance	-1.9	-2.3	-3	-1.3
Gross debt	34.2	31.6	33.1	34.1
Monetary sector (end of period 12-month change, in percent)				
Money (M1)	25.3	-3.8	-6.1	11.3
Broad money (M2)[1)]	44.5	9.6	2.5	16.1
Domestic credit to non-government	36.9	35	6.3	15.7
Balance of payments (in percent of GDP)				
Current account balance	-15.5	-16	-13.0	-10.0
Export of goods	22.3	21.7	20.5	21.5
Import of goods	44.9	43.9	38.1	36.0
Trade of goods balance	-22.6	-22.3	-17.6	-14.4
Capital and account balance	18.1	12.4	1.9	8.4
Private external debt	40.0	46.2	52.6	56.9
Gross official reserves (in billions of euro)	9.5	8.1	7.0	7.6
REER (annual average change, in percent; + indicates appreciation)	7.2	5.8	-9.1	-2.4

[1)] Excluding frozen foreign currency deposits.

APPENDIX 1. Changes in reserve requirements and prudential measures relating to lending activity

A chronological overview of changes in reserve requirements, temporary measures, prudential measures relating to lending activity and special measures is available on the NBS website, under *Publications – Inflation Report.*

A) Changes in reserve requirements

Legal ref.	Reserve base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
12/2009	Dinar reserve base Dinar reserve base is narrowed Required reserves are not calculated on liabilities in dinars in respect of deposits and loans received from abroad between 1 October 2008 and 31 December 2009 for the duration of the original life of such liability. The dinar reserve base is reduced by the amount of loans extended by banks under the Government Programme to the corporate sector for investment financing, and by the amount of consumer loans extended by banks under the Government Programme for the purchase of durable consumer goods made in the Republic of Serbia. Dinar reserve base Dinar reserve base is changed By way of exception, beginning from the maintenance period 18 December 2008 – 17 January 2009 and ending with the maintenance period 18 December 2009 – 17 January 2010, dinar reserve base on liabilities in respect of deposits and loans received from abroad shall be calculated as the average daily book value of such liabilities in September 2008 if their average daily book value is lower than the corresponding value from September 2008.	Unchanged	Remunerated	17/3/ 2009	Dinar required reserves are reduced by RSD 365.7 million, and foreign currency required reserves by EUR 12.7 million.
	Foreign currency reserve base Foreign currency reserve base is narrowed Required reserves are not calculated on the amount of liabilities in foreign currency in respect of deposits and loans received from abroad between 1 October 2008 and 31 December 2009, for the duration of the original life of such liability. Foreign currency reserve base is reduced by the amount of loans extended by banks under Government's Programme to the corporate sector for investment financing, and by the amount of consumer loans extended by banks under Government's Programme for the purchase of durable consumer goods made in the Republic of Serbia. Foreign currency reserve base Foreign currency reserve base is changed By way of exception, beginning from the maintenance period 18 December 2008 – 17 January 2009 and ending with the maintenance period 18 December 2009 to 17 January 2010, those portions of foreign currency reserve base on liabilities in respect of deposits and loans received from abroad and foreign currency subordinated liabilities shall be calculated as the average daily book value of these obligations in September 2008 if their average daily book value is lower than the corresponding value from September 2008.	Unchanged	Unremunerated		

B) Prudential measures relating to lending activity

Legal ref.	Regulation	Description	Previously
12/2009	Decision on the Reconciliation of Gross Household Lending and Share Capital of Banks	As of 28 February 2009, a bank is required to adjust its gross household lending to its share capital so that at the end of each calendar month such lending is lower than or equivalent to 200% of the value of share capital.	Banks are required to submit the first report on 20 March 2009
12/2009	Decision on Temporary Measures for Preserving Financial Stability in the Republic of Serbia	This Decision amends the Decision on Classification of Balance Sheet Assets and Off-Balance Sheet Items of Banks as follows: when classifying receivables from natural persons, approved and disbursed after 1 January 2009, a bank is not required the apply the criteria under Section 10, paragraph 2, subparagraph 1, item 2 of the Decision (e.g. receivables from natural persons shall not be classified into the category D if the person that received the loan made the downpayment or deposit lower than 30% of the amount of loan, apart from the approved housing loan and obligations in respect of credit cards).	Effective as of 14 February 2009

APPENDIX 2. Temporary measures

The Decision on Amendments to the Decision on Temporary Measures for Preserving Banking Sector Stability in the Republic of Serbia entered into force on 14 February 2009 ("RS Official Gazette", No. 12/2009).

Under Section 3 of the Decision, at borrower's request, banks may extend the repayment period of cash loans disbursed prior to 30 September 2008 by up to 12 months from the originally contracted maturity date, on condition such loans are converted into dinars, without charging any extra fee on the repayment period extension and/or loan conversion into dinars.

Borrowers may apply for the extension of loan repayment period from paragraph 1 hereof until 31 December 2009.

APPENDIX 3. Special measures

The Decision on Special Facilities Supporting the Country's Financial Stability came into effect on 8 May 2009 ("RS Official Gazette", No. 34/2009).

Pursuant to Section 3 of the Decision, special facilities for banks offered by the NBS in support of the country's financial stability include:

1) lending facility aimed at providing dinar liquidity – short-term loans with a repayment period of no longer than 12 months;

2) foreign exchange swap transactions with the NBS.

Pursuant to Section 8 of the Decision, for the purpose of utilizing special facilities from Section 3 of the Decision, a bank is required to submit to the NBS, not later than 10 May 2009, the following:

1) a written statement signed by members of the bank's executive board, expressing commitment to:

- enable borrowers to convert their foreign currency loans and foreign currency clause-indexed loans into dinar loans – without charging any additional fee, in line with bank's regulations and risk management procedures,

- reschedule repayment terms of receivables in line with bank's regulations and risk management procedures, by extending the repayment period by at least 12 months, or by at least one fifth of the remaining repayment period if the extension is longer, so as to ensure the reduction in the borrower's monthly obligation, or by altering the repayment terms by reducing the borrower's monthly obligation by at least 20%,

- notify the NBS of the level of exposure of the banking group it belongs to, in the manner and within deadlines established by the NSB, based on the obligation undertaken by bank shareholders;

2) a written statement of its majority shareholders expressing commitment to:

- maintain the exposure of the banking group to the Republic of Serbia over 2009 and 2010 at least in the amount as at 31 December 2008,

- provide for maintenance of the bank's capital adequacy and liquidity ratios at the levels prescribed, and in the event these ratios fall below the prescribed levels, undertake all necessary measures, within the shortest possible time and in line with regulations,

- if results of stress tests conducted by the NBS show that the bank's capital adequacy ratio might fall below the prescribed level, analyse the causes of such results together with the NBS, and if necessary, examine the possibility of pre-emptive recapitalisation.

Pursuant to Section 9 of the Decision, a bank may use the special facilities as of the date of receipt of the NBS notice of the fulfilment of terms from Section 8 of the Decision, until 31 December 2010 at the latest, and/or until receipt of the NBS notice of bank's default.

The Decision on Supplements to the Decision on Special Facilities Supporting the Country's Financial Stability ("RS Official Gazette", No. 36/2009) came into effect on 18 May 2009. In Section 3, after item 2, item 3 is added to read: "Banks can allocate dinar countervalue of 35% of their foreign currency required reserves calculated in euros, instead of 40% envisaged by the Decision on Banks' Required Reserves with the National Bank of Serbia".

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Source of data: National Bank of Serbia and Statistical Office of the Republic Serbia, unless specified otherwise.

Meetings of the Monetary Policy Committee of the National Bank of Serbia and key policy rate changes

Date	Key policy rate (annual level, in %)	Change (in basis points)
MPC meetings held		
2008		
17 January	10.00	0
6 February	10.75	+75
18 February	10.75	0
28 February	11.50	+75
13 March	14.50	+300
28 March	14.50	0
17 April	14.50	0
24 April	15.25	+75
15 May	15.25	0
29 May	15.75	+50
12 June	15.75	0
1 July	15.75	0
17 July	15.75	0
29 July	15.75	0
2 September	15.75	0
16 September	15.75	0
1 October	15.75	0
17 October	15.75	0
31 October	17.75	+200
18 November	17.75	0
1 December	17.75	0
8 December	17.75	0
22 December	17.75	0
2009		
22 January	16.50	-125
29 January	16.50	0
12 February	16.50	0
2 March	16.50	0
20 March	16.50	0
6 April	15.00	-150
22 April	14.00	-100
5 May	14.00	0
22 May	14.00	0
Scheduled MPC meetings		
4 June		
25 June		
6 July		
23 July		
6 August		
21 August		
4 September		
24 September		
6 October		
22 October		
5 November		
20 November		
4 December		
24 December		

Press Releases from the NBS Monetary Policy Committee Meetings

Press release from the MPC meeting held on 12 February 2009

After looking at its regular basket of factors, the Monetary Policy Committee decided to keep the key policy rate at 16.5%.

In addition to Inflation Report – February 2009, the MPC adopted amendments and supplements to the following regulations: Decision on Temporary Measures for Preserving Financial Stability, Decision on Temporary Measures for Preserving Banking Sector Stability, Decision on Required Reserves of Banks with the National Bank of Serbia and Decision on Adjusting Gross Household Lending to Share Capital of Banks.

Governor Jelašić will explain the newly enacted measures tomorrow in a press conference.

Press release from the MPC meeting held on 2 March 2009

Following discussion of current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate at 16.5 percent.

The MPC assessed there is no scope for further monetary easing amidst persistent inflationary pressures intensified by high inflation expectations. Apart from this, the first two months of the year saw high inflation rates mainly due to a hefty rise in regulated prices. At end–February, growth in prices under government regulation reached nearly 9 percent and threatened the achievement of the 13±2 percent growth planned for the whole year.

In today's meeting, the Committee noted that inflationary pressures from the last year's high fiscal deficit continue, and that uncertainties regarding future expenditure financing are growing against the backdrop of low budget revenue in the first two months of 2009. Uncertainties also stem from the continued indecision of fiscal authorities whether to give priority to addressing issues fostered by the world financial turmoil or to high spending requirements of budget beneficiaries.

The MPC will continue to keep a close eye on economic movements and adjust its measures and the level of monetary policy restrictiveness accordingly.

Press release from the MPC meeting held on 20 March 2009

Following discussion of current economic developments, the NBS Monetary Policy Committee decided to keep the key policy rate at 16.5 percent.

The next meeting of the NBS Monetary Policy Committee is scheduled for 6 April 2009.

Press release from the MPC meeting held on 6 April 2009

Following discussion of current economic developments, the NBS Monetary Policy Committee decided today to lower the key policy rate from 16.5% down to 15%.

The MPC assessed that the scope for easing monetary policy restrictiveness has been created by deceleration of inflation in March and low inflation expectations over the coming period, as well as by the pending conclusion of an arrangement with the IMF that should contribute to the maintenance of macroeconomic equilibrium.

Deferral of the announced increase in electricity prices and implementation of the Government Memorandum on Movements in Regulated Prices (maximum 15% growth in 2009) will also contribute to keeping the monthly inflation rates at a low level. The downturn in economic activity and the liquidity squeeze have already induced contraction in demand. The announced fiscal policy restrictiveness will further reduce consumption and inflation pressures.

Monetary policy restrictiveness may be further eased only on condition that Serbia concludes a new arrangement with the IMF that will secure external sources of financing as well as guarantee an adequate degree of fiscal policy tightness.

Press release from the MPC meeting held on 22 April 2009

Having reviewed current economic developments, the NBS Monetary Policy Committee has decided today to cut the key policy rate by one percentage point. The new rate, applicable as of today, is 14 per cent.

The rationale behind this decision will be detailed by NBS Governor Radovan Jelašić in a press conference scheduled for later in the day.

Press release from the MPC meeting held on 5 May 2009

After reviewing its regular basket of factors, the NBS Monetary Policy Committee decided to keep the key policy rate unchanged at 14 per cent.

The MPC adopted two decisions, which in line with the Vienna Initiative, provide for special facilities to support the country's financial stability and obligate banks to maintain their exposure toward Serbia, ensuring at the same time the quality and solvency of their assets. These two decisions – Decision on Special Facilities Supporting the Country's Financial Stability and Decision on Terms and Conditions of Extending Short-Term Dinar Loans to Banks will enter into force on the day following their publication in the "RS Official Gazette".

The MPC stated that the majority shareholders of nine banks which attended the Vienna meeting held on 27 March have also confirmed in writing their acceptance of the terms defined by the Vienna Initiative. As a prerequisite for using the special facilities, banks must submit their letters of commitment and the documentation prescribed by 10 May 2009.

Press release from the MPC meeting held on 12 May 2009

To boost dinar liquidity of the banking system, the MPC adopted at today's extraordinary session Supplements to the Decision on Special Facilities Supporting the Country's Financial Stability.

Pursuant to the Supplements, banks participating in the Financial Sector Stability Programme can lower the dinar share of their foreign currency required reserves. As of 18 May 2009, banks will be able to allocate 35% of their foreign currency required reserves in dinars instead of the current 40% envisaged by the Decision on Banks' Required Reserves with the National Bank of Serbia.