



National Bank of Serbia

2011
May

INFLATION REPORT

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NATIONAL BANK OF SERBIA

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Introductory note

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

Since one of the underlying principles of inflation targeting is strengthening the transparency of monetary policy and improving the efficiency of communication with the public, the NBS prepares and publishes quarterly *Inflation Reports* as its main communication tool. The *Inflation Report* provides key economic facts and figures that shape the Executive Board's decisions¹ and underpin activities of the National Bank of Serbia.

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

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

The May *Inflation Report* was adopted by the NBS Executive Board in its meeting of 12 May 2011.

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

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

¹ In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No. 44/2010), the Executive Board has assumed all powers of the Monetary Policy Committee.

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FDI – foreign direct investment
Fed – Federal Reserve System
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
sa – seasonally-adjusted
SDR – Special Drawing Rights
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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I. Overview

Inflation moved above the target tolerance band in the first quarter.

Due to the robust growth in agricultural product prices, as well as marked food price volatility, inflation was running above the upper bound of the target tolerance band in the first quarter. It measured 14.1% in March compared to the monthly target of $5.6 \pm 1.9\%$. With inflation lying above the target tolerance band for more than six consecutive months, the National Bank of Serbia wrote an open letter to the government in April to explain the reasons for the divergence, propose economic policy action and specify the time needed to bring inflation back within the target.

Consumer price growth was largely driven by the rise in food ...

The strongest pressure on prices came from the increase in processed food production costs, triggered by the leap in primary agricultural product prices worldwide and at home. Nearly two thirds of the 5.5% consumer prices growth registered in the first quarter are attributable to the prices of processed food products and fruits and vegetables.

... and regulated prices.

Regulated prices rose 4.7% in the first quarter, which accounts for two thirds of the growth agreed with the government for the year as a whole (7 ± 2). Regulated prices are most likely to come close to the upper bound of the growth limit already in the first half of the year.

Economic activity picked up ...

Economic activity is estimated to have recorded a recovery in the first quarter – seasonally-adjusted GDP growth came at 1.0%. Year-on-year GDP and NAVA growth equalled 2.4% and 2.8%, respectively.

... and the negative output gap narrowed.

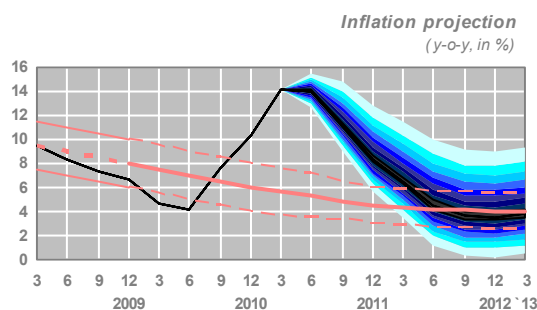
Negative output gap narrowed, signalling a weaker disinflationary impact of aggregate demand.

Aggregate demand strengthened reflecting buoyed domestic demand, notably investment.

Domestic demand is estimated to have recorded a recovery in the first quarter, owing mainly to a private investment upturn. The key contribution to GDP growth came from domestic demand, while the contribution of net exports was negative.

The strengthening of the dinar since late last year will support the process of disinflation.

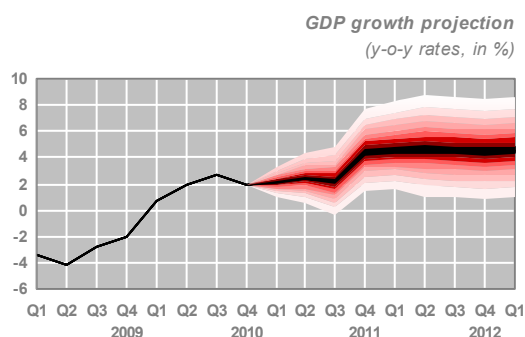
The first quarter saw imported deflation as a result of the stronger dinar. The dinar strengthened in response to monetary policy tightening, significantly lower country



Inflation expectations stabilised at a slightly higher level than a quarter earlier.

Monetary policy tightening...

... is consistent with the need to maintain inflation within the target band in the medium term.



The key risks to inflation projection are associated with the country risk premium, food prices and government spending.

The key policy rate is either close to or may have already reached a peak of its current cycle.

risk premium, improved credit rating, and increased foreign investor interest in domestic securities. Appreciation pressures are a region-wide phenomenon, triggered by increased capital inflows, growing export demand, and monetary policy tightening geared at quelling the heightened inflationary pressure.

Though continuing above the target, inflation expectations did not rise significantly in the first quarter. This could be understood as a sign of market players' confidence that the current inflation pickup will not persist given its root causes and measures taken by the National Bank of Serbia.

The National Bank of Serbia tightened its monetary policy stance with a view to anchoring inflation around the target in the medium term. In the year to date, the key policy rate was raised by 100 basis points, from 11.5% to 12.5%. Furthermore, enactment of the new decision on reserve requirements halted the relaxation of rules in that area.

It is expected that inflation will start retreating towards the target from May or June onwards. It will return within the target tolerance band in the first half of 2012, and come close to the target midpoint in the second half of that year (end-2012 target: $4 \pm 1.5\%$). Inflation will trend downwards in response to gradual easing of the cost-push pressure on food prices, low aggregate demand and strengthening of the dinar. A faster economic recovery and the projected GDP growth of 3.0% this year and 4.5% next year are consistent with the current inflation projection.

The key risks to inflation projection are associated with movements in the country risk premium, food prices and budget deficit. On balance, the risks are skewed to the upside due to the possible loosening of fiscal policy and entrenchment of elevated food prices.

Based on the current inflation projection and its underlying risks, the Executive Board judges that the key policy rate is either close to or may have already reached a peak of its current cycle. To keep inflation within the target band in the medium term, the National Bank of Serbia will probably continue implementing tight monetary policy, using all instruments of monetary regulation available.

II. Monetary policy since the February Report

Monetary policy tightening continued in Q1. The monetary policy stance has become restrictive due to the impact of both MCI components

The NBS continued implementing tight monetary policy measures in Q1 with a view to stabilising inflation around the target in the medium term. The key policy rate was raised by 75 bp – from 11.50% to 12.25%. Another upward revision (to 12.50%) followed in April. In early January, the NBS issued a new decision on reserve requirements, halting the relaxation of rules in that area. The strengthening of the dinar since late 2010 is expected to support the process of disinflation.

The Executive Board decided to further tighten the monetary policy stance primarily in view of the need to rein in inflationary pressures stirred up by the rise in food prices, regulated prices, inflation expectations and global oil prices. The Executive Board's decision was also based on assessment that though weaker than earlier, the disinflationary impact of low aggregate demand would persist despite the unfreezing of pensions and public sector wages. The Executive Board also took into account that import prices have been sending no upward pressure on inflation thanks to the strengthening of the dinar since late last year.

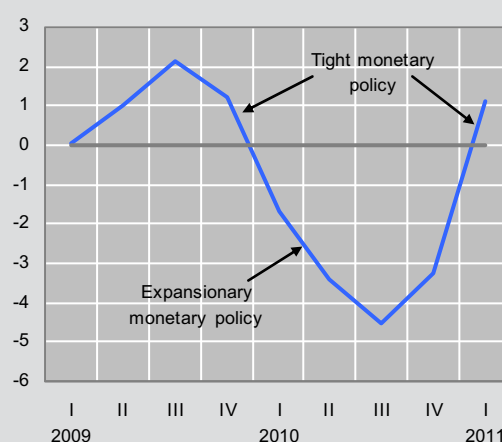
Due to the robust growth in agricultural product prices, as well as marked food price volatility, inflation was running above the upper bound of the target tolerance band in Q1. It measured 14.1% in March compared to the monthly target of $5.6 \pm 1.9\%$. With inflation lying above the target tolerance band for more than six consecutive months, the NBS wrote an open letter to the government in April to explain the reasons for the divergence, propose economic policy action and specify the time needed to bring inflation back within the target (Appendix, p. 42).

The letter stated that barring any unforeseen shocks, inflation would start retreating to the target from May or

June onwards. It would return within the target tolerance band in H1 2012 and revolve around the target midpoint in H2 of that year (end-2012 target: $4 \pm 1.5\%$). Inflation decline from mid-2011 is expected to come about as a result of past monetary policy measures, weakening of the cost-push pressure on food prices, low aggregate demand and stronger dinar. The NBS also expressed its determination to assess in due course whether further monetary tightening is needed, using full array of instruments on hand to bring medium-term inflation back to target.

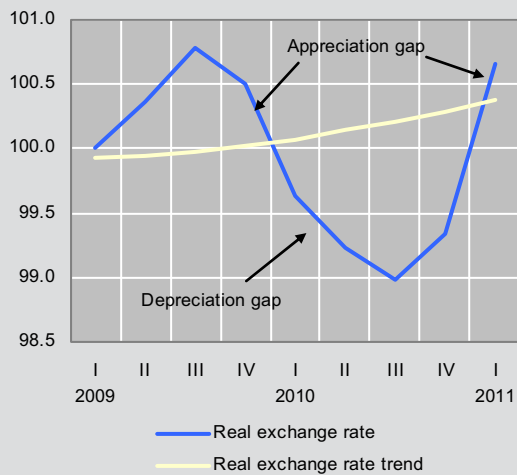
The tightening of monetary policy over the last nine months has led to a change in the monetary stance – as indicated by the real MCI, the increasingly dwindling ease of monetary policy in the second half of 2010 turned into tightness in Q1 2011. The shift in monetary policy was prompted by movement in both MCI components:

Chart II.0.1 Monetary Conditions Index



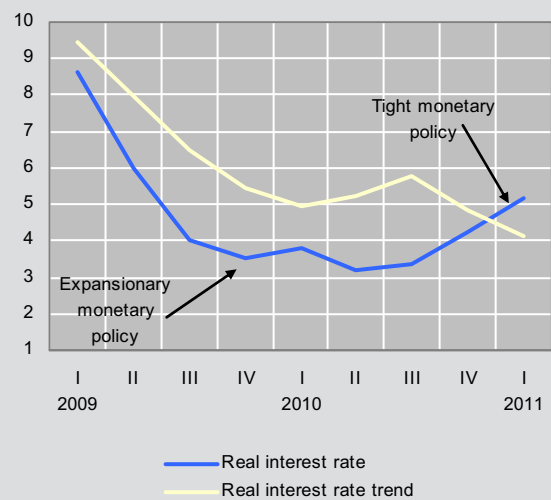
The increasingly dwindling ease of monetary policy in the second half of 2010 turned into tightness in Q1 2011.

Chart II.0.2 Real exchange rate and its trend
(base index, I 2009 = 100)



The opening of the appreciation gap of the real exchange rate in Q1 contributed to the tightness of the monetary policy stance.

Chart II.0.3 Real interest rate and its trend
(in %)



Real interest rate exceeded the neutral level in Q1, contributing to the monetary policy tightening.

appreciation gap of the real exchange rate and the real interest rate running above neutral trend.

The appreciation gap of the real exchange rate opened in Q1 as a result of nominal appreciation of the dinar against the euro and faster growth in domestic relative to eurozone prices. Given the current exchange rate movements, the appreciation gap is likely to widen in Q2.

The second component of the monetary conditions index - the real interest rate, also points to the restrictive character of monetary policy. As the rise in two-week BELIBOR outpaced the rise in inflation expectations, the real interest rate increased. At the same time, its trend continued declining sharply, chiefly in response to lower country risk premium and continuing fall in real money

market rates abroad. Thus, real BELIBOR rate exceeded the neutral trend by around 100 bp on average.

Consistent with the strategic commitment to make use of all monetary policy instruments on hand so as to bring medium-term inflation within the target band, the Executive Board adopted a new decision on reserve requirements in its first January meeting this year. It should be noted that the measures envisaged by the new decision did not imply withdrawal of liquidity from the banking system, but a lower release of liquidity than envisaged by the earlier decision. Key novelties in the reserve requirement policy include: a) differentiation of RR rates by the maturity of liabilities, as practiced by the ECB (up to two years and over two years)² and b) allocation of a portion of FX required reserves in dinars by applying differentiated rates.

² Differentiated rates on dinar RR: 5% on liabilities with maturity up to two years and 0% on those with maturity over two years. Differentiated rates on FX RR: 30% on liabilities maturing up to two years, with 15% allocation in dinars, and 25% on liabilities maturing in over two years, with 10% allocation in dinars.

Box 1: Monetary policy reaction and the speed of inflation retreat within the target band

Inflationary shocks, such as the robust food price growth since last year’s agricultural season, pose a major challenge to keeping inflation within the target band. Though the NBS has tightened its monetary policy stance since August last year, inflation will trend above the upper bound of the target band until end-2011 and is not likely to retreat within the band earlier than H1 2012. This may raise the question as to why the central bank did not react more aggressively.

Firstly, it should be borne in mind that the NBS’s inflation target is set on a continuous basis for each month in the year and not just for a year-end as it is sometimes wrongly understood by the public. Hence, the achievement of targeted inflation, for instance in March or June, is equally important to the NBS as in December.

Besides, the NBS aims not to bring inflation within the target band as quickly as possible and at all costs, but to achieve sustainable inflation over the medium term. Short-sighted monetary policy, set to achieve the fastest possible return of inflation to the target implies an aggressive reaction and more volatile inflation compared to monetary policy focusing on a sustainable retreat of inflation to the target.

Chart O 1.1 Inflation outturn in different monetary policy reaction scenarios
(y-o-y rates, in %)

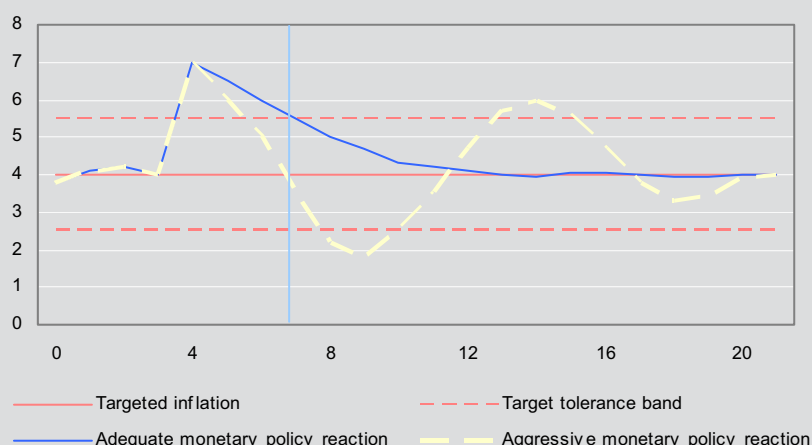
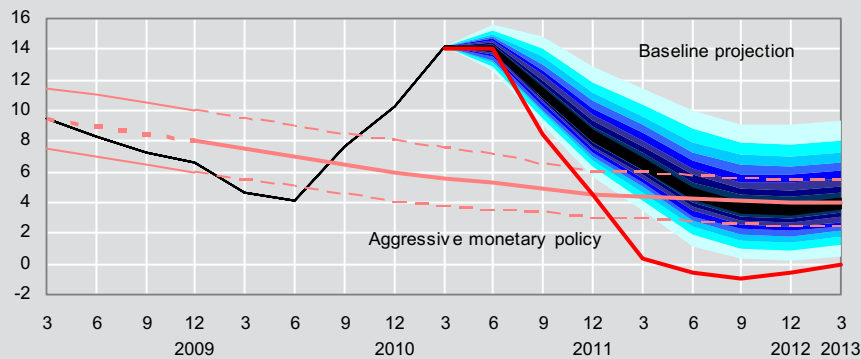


Chart O 1.1. shows a hypothetical discrepancy in inflation arising from different monetary policy reactions to an inflationary shock. The full blue line shows that an adequate monetary reaction would result in inflation returning within the target band four quarters after the initial shock and hitting the target almost a year and a half later, remaining on the target thereafter. In the second scenario (dotted yellow line), monetary policy would respond to the inflationary shock by vigorous tightening, in an effort to bring inflation back to the target as soon as possible. In that case, inflation would indeed return within the target band very swiftly – two quarters later, and to the target three quarters later. However, due to the monetary policy lag, such a reaction would not only contain inflationary pressures, but would also trigger a strong disinflationary effect and afterwards result in target undershooting. This would provoke a renewed, strong central bank reaction – this time in the form of expansionary monetary policy, which would later on lead to target overshooting. Stabilisation of inflation around the target under such monetary policy would be much slower than in the case of an adequate reaction to the initial inflationary shock, and would produce higher costs against the background of unstable production and volatile labour market trends.

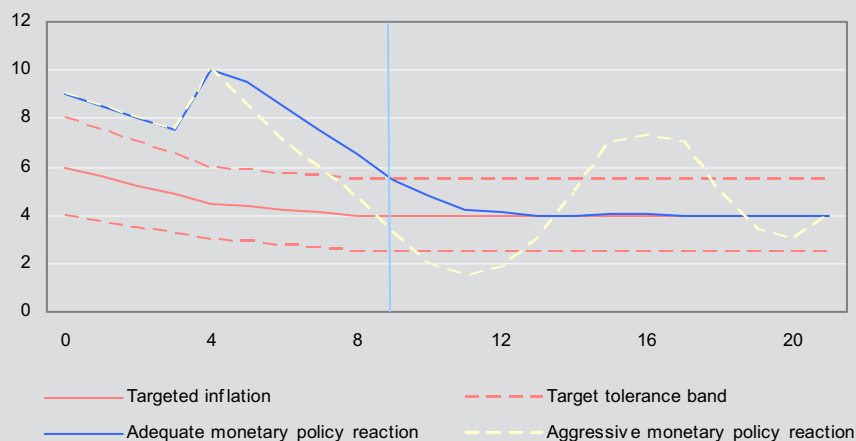
Recently, the NBS has faced vigorous fluctuation of food prices. From H2 2008 to H1 2010, food prices generated disinflationary pressures, bringing inflation below the lower bound in H1 2010. The NBS’s monetary policy at the time was aimed at the sustainable return of inflation within the target band. Though the NBS could have prevented target undershooting by more aggressively lowering the key policy rate in 2009 and early 2010, such a reaction would have triggered comparatively stronger inflationary pressures in H2 2010 and 2011.

Chart O 1.2 Projected inflation under adequate and aggressive monetary policy
(y-o-y rates, in %)



The NBS's reaction to the food price hike in mid-2010 was adequate as well. Had it raised the key policy rate more aggressively in H2 2010 and early 2011, the NBS could have induced inflation's faster return within the target band. However, as the effects of the agricultural shock will gradually wane with the new agricultural season, excessive monetary tightening and inflation's faster return within the target band (end-2011) could produce strong disinflationary pressures and bring about undershooting of the lower band in 2012, as well as possible deflation (Chart O 1.2.), including, on top of that,

Chart O 1.3 Inflation under adequate monetary policy reactions to possible inflationary shocks in the coming period
(y-o-y rates, in %)



rising unemployment and slower economic growth.

Moreover, marked volatility of inflation and a changing monetary policy stance create an unfavourable climate for businesses, instilling a high degree of uncertainty in business decision making.

Further, the disinflationary process in the coming period could be impeded by inflationary or disinflationary shocks. The NBS's reaction will be consistent with the above approach – any excessively strong reaction will be avoided so as not to provoke the instability of inflation and trigger negative repercussions on economic activity (Chart O 1.3.). Hence, the NBS will respond with all available instruments in order to return inflation to the target as quickly as possible, in a sustainable and stable manner.

III. Inflation developments

Y-o-y inflation continued rising in Q1, driven chiefly by the growth in food and regulated prices. Still, the weakening of the cost push pressure on food prices has already begun and is most likely to continue if the agricultural season turns out as good as usual.

According to estimates, y-o-y inflation will peak in Q2 and then start retreating towards the target.

Inflation developments in Q1

Consumer price growth in Q1 was spurred mainly by the rise in food and regulated prices.

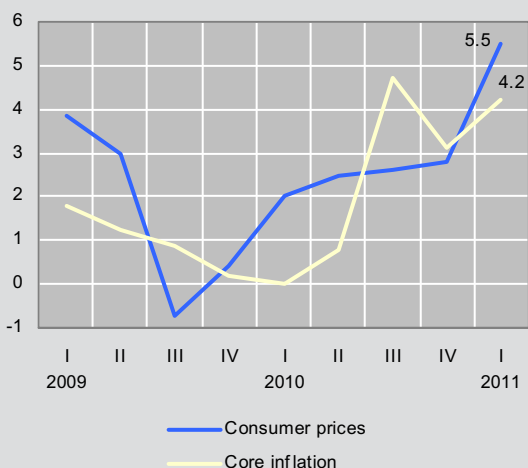
Y-o-y CPI inflation continued rising in Q1, reaching 14.1% at end-March (monthly target: $5.6 \pm 1.9\%$).

Its rise was driven primarily by further growth in food prices, in place since mid-2010. Nearly two thirds of the 5.5% consumer price growth in Q1 are attributable to the prices of processed food products and fruits and vegetables. The rise in food prices reflects last year’s poor

Table III.0.1 Price indicators
(growth rates, in %)

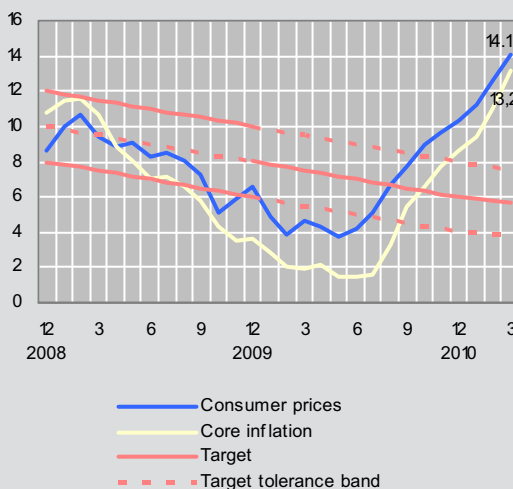
	VI 2010 VI 2009	IX 2010 IX 2009	XII 2010 XII 2009	III 2011 III 2010
Consumer prices	4.2	7.7	10.3	14.1
Core inflation	1.9	5.7	8.8	13.2
Industrial producer prices	11.3	14.0	16.2	17.1
Agricultural producer prices	-3.3	22.8	29.3	39.1

Chart III.0.1 Price movements
(quarterly growth, in %)



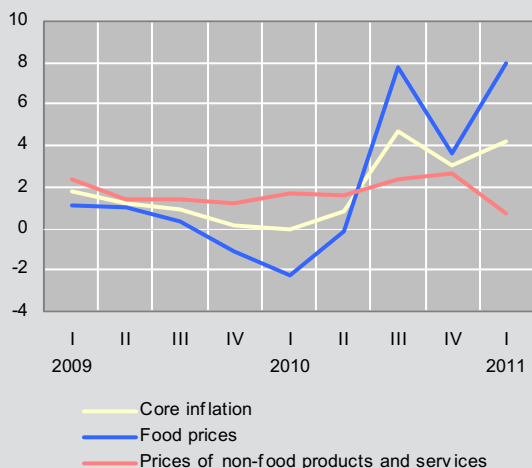
Both headline and core inflation stepped up in Q1. Though lower than that in headline inflation, core inflation growth remains relatively high.

Chart III.0.2 Price movements
(y-o-y growth, in %)



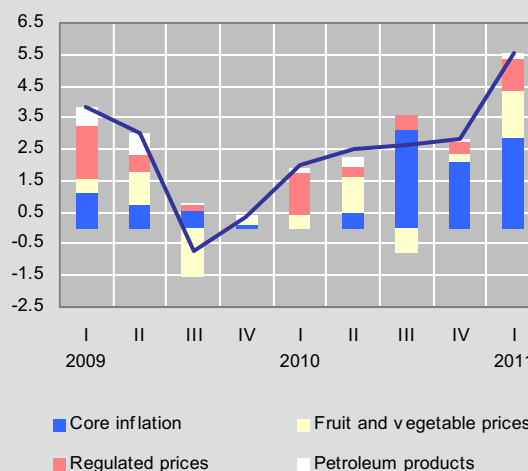
Q1 saw a further rise in y-o-y headline and core inflation.

Chart III.0.3 Core inflation by component
(quarterly growth, in %)



Core inflation growth in Q1 is largely attributable to the robust increase in food prices.

Chart III.0.4 Contribution to quarterly consumer price growth
(in percentage points)



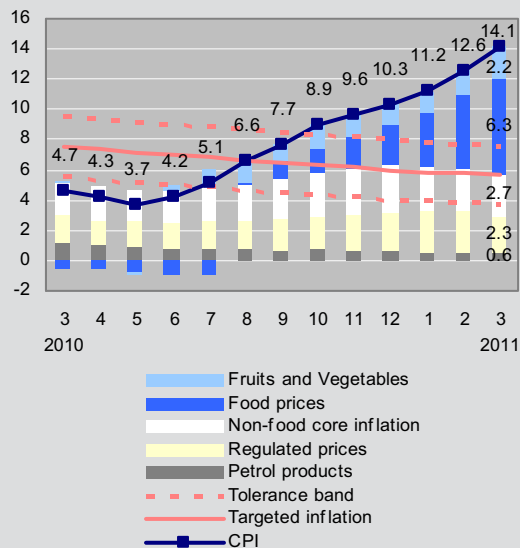
Consumer price growth was for its major part driven by food and regulated prices.

agricultural season, high import levies and stronger exports, propelled by the surging international prices of primary agricultural products (and, consequently, lower supply of those products in the domestic market). Present for quite some time already, in Q1 the cost-push pressure on food producers was largely passed onto consumers.

Core inflation growth (market-based prices) stepped up in Q1 (4.2%, a contribution of 2.9 pp to headline inflation), reflecting significant increase in food prices. Food inflation growth exceeded the growth in non-food inflation by as much as 11 times (8.0% vs. 0.7%). Within food products, the greatest contribution to inflation growth came from the increase in prices of white bread (0.84 pp), eggs (0.19 pp), sugar (0.19 pp), coffee (0.17 pp) and wheat flour (0.17 pp). Non-food inflation³, on the other hand, recorded slower growth in response to the strengthening of the dinar and weakening of the demand for non-food products and services triggered by the drop in disposable income (i.e. higher expenditure on food).

The prices of fruits and vegetables recorded an increase of 25.3% (1.4 pp), which is four times the usual seasonal rise. To illustrate, the prices of cabbage went up by 217%,

Chart III.0.5 Contribution to y-o-y consumer price growth
(in percentage points)



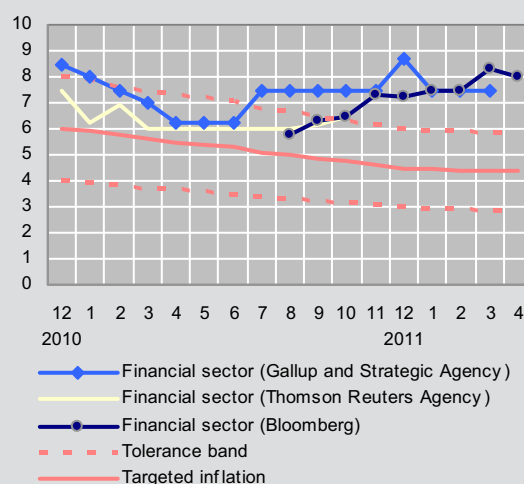
The 9.4 pp rise in y-o-y inflation over the last year (from 4.7% to 14.1%) was due primarily to the growth in food prices (9.1 pp).

³ Non-food core inflation measured 2.6% in Q4 2010.

Table III.0.2 Consumer price growth by component
(by quarter, in %)

	2010				2011
	Q1	Q2	Q3	Q4	Q1
Consumer prices	2.0	2.5	2.6	2.8	5.5
Core inflation	0.0	0.7	4.7	3.1	4.2
Fruits and vegetables	8.3	21.4	-11.7	3.7	25.3
Regulated prices	6.2	1.4	2.2	1.8	4.7
Electricity	11.5	0.0	0.0	0.0	0.0
Gas for households	0.0	0.0	0.0	0.0	0.0
Utility-housing services	4.2	1.3	5.9	9.9	3.3
Social welfare services	3.7	0.3	0.0	2.5	0.0
Transport services (regulated)	2.3	0.2	1.7	0.1	13.1
Postal and telecommunications services	0.0	0.5	0.0	0.0	0.0
Cigarettes	10.2	0.0	5.6	0.0	19.1
Medications	0.2	5.0	1.8	3.0	3.8
Other	0.6	12.6	0.8	0.2	0.2
Petroleum products	3.0	6.8	0.8	1.3	5.1

Chart III.0.6 One-year ahead expected and targeted inflation
(in %)



Inflation expectations did not rise significantly in Q1 despite robust growth in consumer prices.

potato by 63%, and apples by 32% (providing together a 0.91 pp contribution to headline inflation).

Regulated prices rose 4.7% (1.0 pp) reflecting the increase in prices of cigarettes (0.7 pp), transport services, medicaments and utilities (0.1 pp each). The growth recorded in Q1 makes up two thirds of the growth agreed with the government for the year as a whole (7±2%).⁴

Petroleum product prices went up by 5.1% (0.2 pp). The staggering 25.1% growth in Ural oil prices registered in Q1 fed through into domestic prices only in part thanks to the strengthening of the dinar against the dollar and the liberalisation of imports of petroleum products since the beginning of the year.

Inflation expectations

Already relatively high, inflation expectations did not rise significantly in Q1 despite robust growth in consumer prices.

Q1 survey measures of one-year ahead inflation expectations slightly differ. While the Bloomberg poll signals mildly higher inflation expectations of the financial sector, the Gallup survey points to their decrease. Inflation expectations of the remaining three sectors (businesses, trade unions and households) showed a decline.

Inflation expectations reported by respondents to the **Bloomberg** survey (representatives of the financial sector only) in Q1 show a mild increase, while those reported in April reveal a marginal decline. Namely, financial sector expectations rose from 7.2% in December to 8.3% in March, and then drifted down to 8.0% in April.

According to the **Gallup** surveys, inflation expectations of the financial sector fell from 8.7% in December to 7.4% in January, to remain there throughout the quarter. Inflation expectations of households and trade unions also showed a significant decrease (from 15.4% to 11.4% and from 13.4% to 11.4%, respectively). Businesses first expressed higher expectations in January, but then revised them down to 12.7% in March.

⁴ Memorandum on Setting Numerical Guidelines for Growth in Prices of Products and Services under Direct or Indirect Government Regulation for the Period 2009 – 2011 (<http://www.mfin.gov.rs/pages/article.php?id=6906>).

The yield curve in the primary market of government securities also points to a stabilisation of inflation expectations.

Though they did not increase significantly relative to the previous quarter, inflation expectations continue relatively high – still above the upper bound of the target tolerance band. Nonetheless, the fact that vigorous consumer price growth was not accompanied by a major rise in inflation expectations may be regarded as a good sign, i.e. a sign that market players have confidence that the National Bank of Serbia will employ all available instruments in order to bring inflation back within the target band in the medium term.

Inflation outlook for Q2

Inflation is expected to peak in Q2 and then head downwards.

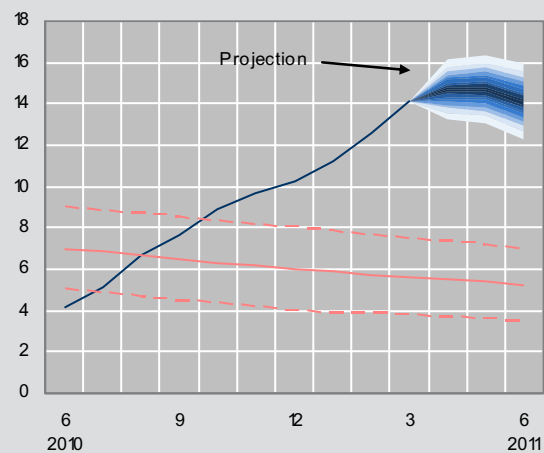
Consumer price growth should slow in Q2 in response to the expected weaker growth in core inflation (more specifically, processed food prices within core inflation) and prices of fruits and vegetables.

These movements and the base effect will cause inflation to trend downwards after peaking in April or May.

The slowdown in quarterly core inflation growth should come about primarily as a result of the weaker cost-push pressure on food prices. Namely, most of the expected food price increases took place by end-Q1, and the prices of primary agricultural products have relatively steadied. Non-food core inflation growth, on the other hand, is likely to be somewhat higher in Q2 than in Q1 as the indirect cost-push effect of the rise in electricity prices is expected to outweigh the disinflationary effect of the current appreciation of the dinar.

The prices of fruits and vegetables should experience a considerably slower growth, or even fall, in Q2. They are currently rather high, but their growth in Q2 is expected to be slightly weaker than typical for the beginning of a new agricultural season.

Chart III.0.7 Short-term inflation projection
(y-o-y growth, in %)



After peaking in Q2, inflation is expected to start retreating towards the target.

The outlook for inflation in Q2 depends chiefly on food and regulated prices.

Within food products, major contributors to inflation growth will be the prices of fresh meat and meat products, non-alcoholic beverages, milk and dairy products.

Regulated price growth will be largely determined by the April increase in electricity prices. The effect of the rise in natural gas prices should be neutralised by the lowering of cigarette prices. Overall, regulated price growth is expected to be slightly lower than a quarter earlier.

It is estimated that the rise in international Ural oil prices in Q2 will overpower the effect of the current appreciation of the dinar against the dollar, leading to another increase in petroleum product prices. This increase is expected to be higher than in the quarter before.

The key risk to inflation projection is associated with the prices of fruits and vegetables, which, as a rule, tend to display significant volatility from one month to the next.

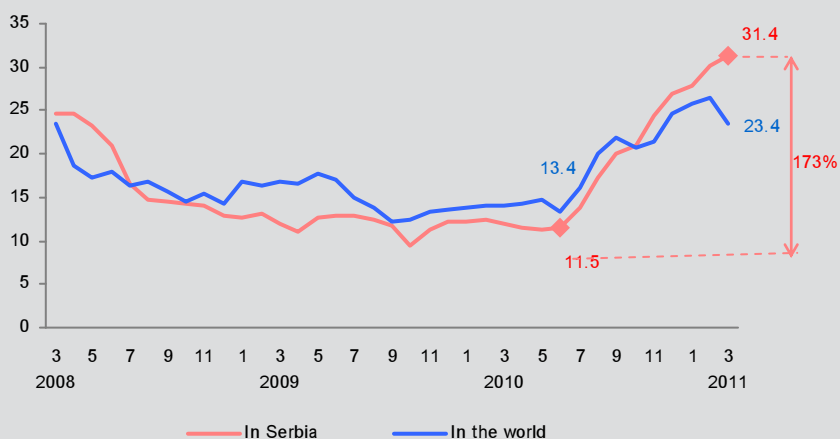
Box 2: Robust growth in prices of primary agricultural commodities – the key generator of inflation

Growth in y-o-y inflation, in train since mid-2010, continued into 2011. Rising food prices – food products and fruits and vegetables accounted for almost 90% of the growth.

Last year’s bad weather in the region and wider caused an exceptionally poor agricultural season, Serbia being no exception. Relatively low yields, together with an inadequate agrarian policy, high customs protection and manifestly higher exports of primary agricultural commodities, stimulated by rising world market prices, resulted in record high agricultural prices in Serbia over the last nine months.

Elevated agricultural prices can produce both direct and indirect impact on headline inflation. To illustrate, prices of fruits and vegetables, built into CPI, have a direct impact. In terms of their indirect impact, however, agricultural prices produce a cost effect on processed food prices and generate inflation expectations driven by food price growth.

Chart O 2.1 Global and domestic wheat prices (RSD/kg)



Source: Novi Sad Commodity Exchange and IMF.

Cereal prices, not directly included in CPI but with a significant weight in food price formation (being one of the main food industry inputs) are exceptionally high in Serbia, trending above world prices. Namely, relatively weak last year’s harvest and insufficient commodity reserves, further aggravated by rising exports (fuelled by high world wheat prices) led to deficits in the domestic market and triggered a wave of price hikes of processed cereal-based foods. Since June 2010, wheat prices in Serbia have risen by as much as 173% and are currently above the global prices.

Being very high at the moment, prices of primary agricultural commodities are likely to fall even in case of an average agricultural performance this year. Moreover, the announced agrarian measures are expected to contribute to the stabilisation of agricultural prices and a reduction in cost pressures on food prices. This is likely to significantly diminish inflationary pressures in the second half of 2011.

IV. Inflation determinants

1. Money market trends

Interest rates

Key policy rate hikes, reduced risk premium and heightened foreign investment in government securities reflected on money market interest rates. Interest rates on corporate and household loans remained broadly unchanged from end-2010.

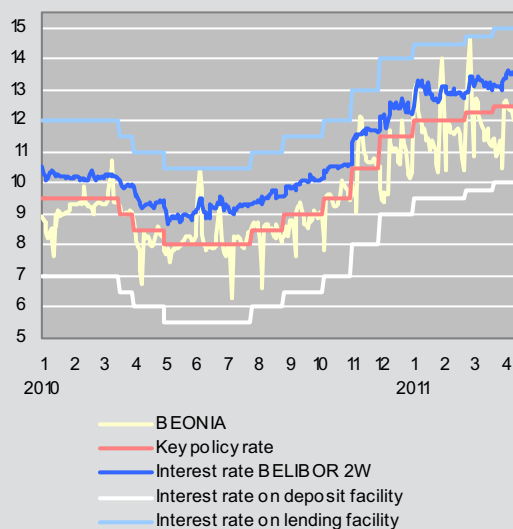
Throughout Q1, BEONIA trended below the key policy rate. It however outstripped the key policy rate by the mid of each month – the end of the required reserves maintenance period when the demand for overnight borrowing usually steps up. Therefore, the average BEONIA outdid the key policy rate by 0.5 pp in quarterly terms, reaching 12.0% in March. The average daily

trading volume amounted to RSD 8.5 bln in Q1 and was slightly higher than the 2010 average of RSD 8.2 bln.

Other rates in the interbank money market rose evenly in early 2011. In February, growth in two-month BELIBOR decelerated, while three- and six-month rates declined. As similar trends were recorded in March as well, the yield curve slope declined sharply by end-Q1. In March, average BELIBOR rates ranged between 12.9% for the shortest and 13.9% for six-month maturity. Given a 2.2 pp range of BELIBOR rates in H2 2010, the end-of-quarter trends may be signalling that the banking sector expects no further growth in interest rates.

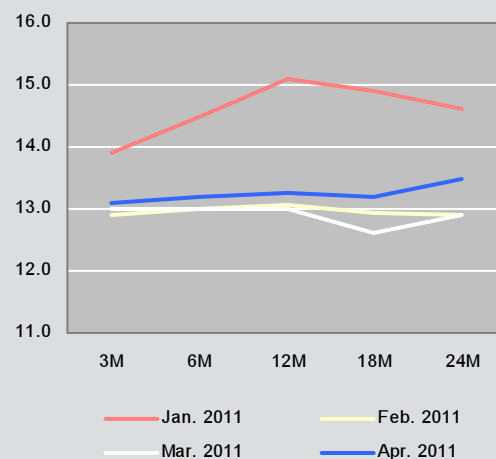
A decline in longer-term rates was largely prompted by movements in the primary market of government securities. After reaching a 15.1% peak in mid-January,

Chart IV.1.1 Interest rate movements
(daily data, p.a, in %)



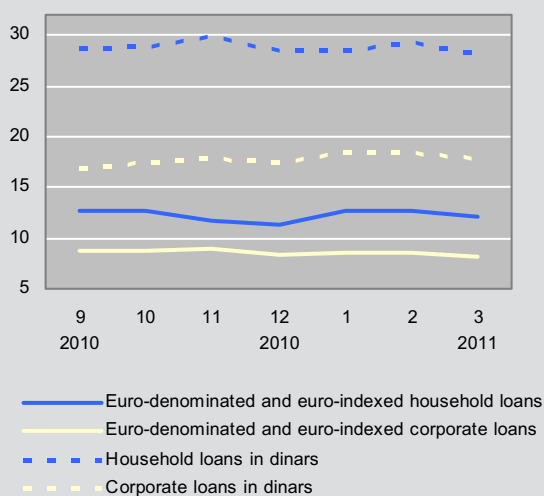
Despite its marked volatility in Q1, average BEONIA trended below the average NBS key policy rate.

Chart IV.1.2 Yield curve in the primary market of government securities
(p.a, %)



Increased foreign investor participation prompted a fall in yields in the primary market of government securities.

Chart IV.1.3 Lending interest rates
(p.a. in %)



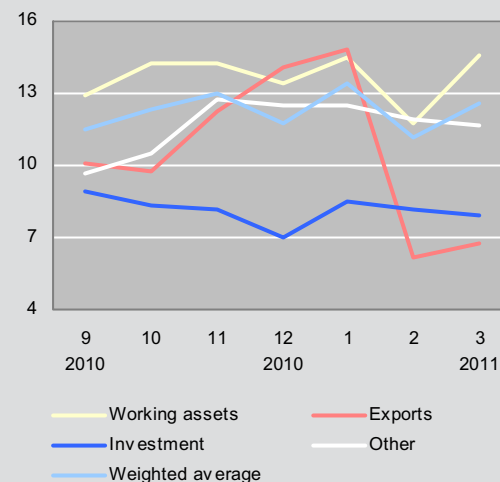
Interest rates on dinar corporate loans increased in Q1, excluding those on export loans that declined drastically.

effective rates tumbled down, notably in February, due to greater foreign investor participation. Increasing investor interest in T-bills reflected a marked reduction in risk premium, greater volume of longer-term issues and high interest rate differentials. Enhanced foreign investor participation spurred a fall in effective rates to 12.5% in early March. However, following the March increase in the key policy rate, effective rates picked up moderately, settling at 13.0% by the quarter-end. A further rise in the key policy rate by 25 bp in April triggered a mild rise in effective rates as well.

Performance at T-bill auctions was relatively high despite substantial supply and plummeting effective rates. Quarterly performance came at 66.8%, fuelling a rise in the stock of sold dinar T-bills by RSD 42.0 bln to RSD 220.0 bln by end-Q1.

Trading in the secondary market amounted to RSD 28.5 bln, nearly 90% of which relating to bills bought in the primary market over the previous seven days, which is why the yield to maturity rates mirrored the primary auction effective rates.

Chart IV.1.4 Interest rates on dinar corporate loans
(p.a. in %)



Interest rates on dinar corporate loans increased in Q1, excluding those on export loans that declined drastically.

In February, the government offered its first time euro-denominated securities at two auctions, worth EUR 400 mln. At the first auction, all 53-week T-bills were sold out at 4.5%. A half of 15-year bills at the 5.85% coupon rate were sold at the second auction. The remaining bills will be offered at the next auction scheduled for early June.

Rates on dinar corporate loans increased by 0.5 pp in response to the key policy rate hike. Rates on FX-indexed and FX corporate loans declined slightly at the quarterly level.

Interest rates on dinar household loans dropped in response to falling interest on current account and credit card overdrafts. However, the weighted average interest rate on total household loans remained at the December level of 24.9% due to rising interest on FX-indexed and FX loans. Interest on euro-indexed and euro-denominated loans rose the most.

Relative to end-2010, the weighted average deposit rate was kept largely unchanged and touched 3.4% in March. Rates on term deposits rose by only 2.0 pp – rates on

corporate deposits equalled 7.7% at end-March and those on household deposits 5.8%.

Monetary aggregates

In Q1, money supply rose at a much slower pace than prices.

In Q1, reserve money declined by 14.3% in real terms. The withdrawal was made via both the dinar and FX channels, with dinar transactions playing a greater role.

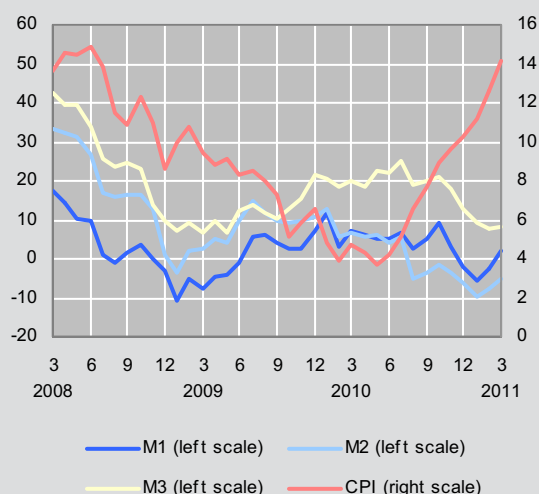
In addition to regular inflows, the government borrowing lent the key boost to FX reserves, notably through the issue of euro bills and, to a lesser extent, via external borrowing. However, total FX inflows did not make up for the outflows prompted by servicing of the maturing government debt, the payback of excess allocations under FX reserve requirements⁵ and valuation losses which resulted in a EUR 83 mln decline in gross FX reserves. Though rising by EUR 68 mln, net FX reserves declined in dinar terms due to dinar's appreciation.

A major part of reserve money was withdrawn by the dinar channel, notably in response to intensified government borrowing resulting in rising balances in dinar and FX accounts with the NBS. Banks' greater investment in repo securities (the repo stock rose by RSD 9.4 bln in Q1) induced a RSD 18.0 bln decline in reserve money.

Other monetary aggregates declined as well. M1 contracted most – 14.0%, M2 lost 11.7% in real terms, while a 8.4% drop in M3 was in part provoked by dinar's appreciation. In the long run, a decrease in money supply against the backdrop of rising inflation continued at a faster pace than earlier. Relative to March 2010, M1, M2 and M3 lost 10.4%, 17.0% and 5.4% in real terms respectively, marking further negative deviation of monetary aggregates from the long-term trend.

The above movements were driven mainly by shrinking balances in enterprise accounts and by weaker household spending, as signalled by a decrease in

Chart IV.1.5 Monetary aggregates and CPI
(y-o-y rates, in %)



Rising much more slowly than prices, money supply did not generate inflationary pressures.

Table IV.1.1 Monetary aggregates
(real y-o-y growth rates, %)

	2010			2011	Share in M3 March 2011 (%)
	June	Sep	Dec	March	
M3	17.2	11.5	2.3	-5.3	100.0
FX deposits	27.6	25.1	12.1	0.4	70.9
M2	0.1	-10.3	-14.8	-17.0	29.1
Time and savings dinar deposits	-0.8	-20.1	-20.1	-25.2	11.6
M1	0.7	-2.4	-11.1	-10.4	17.5
Demand deposits	-1.1	-4.1	-10.1	-6.3	11.3
Currency in circulation	4.0	0.7	-12.9	-17.0	6.2

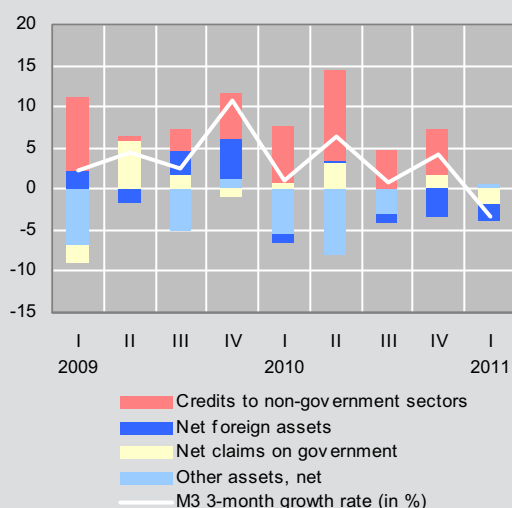
circulating cash. Reduced enterprise inflows, problems in the collection of receivables⁶, and the settlement of due liabilities, mainly tax related, prompted a fall in corporate account balances. Furthermore, despite favourable interest rates offered by banks, dinar household savings did not rise significantly, whereas FX deposits recorded much smaller y-o-y growth.

⁵ In early 2011, the NBS adopted the new Decision on Required Reserves Held with the NBS and halted the process of required reserves relaxation (preventing the release of part of excess liquidity from February to April 2011 as previously

envisaged). The adjustment of required reserves calculation and allocation was made over the three-month transitional period.

⁶ The number of businesses having their accounts blocked rose by 1,573 in Q1.

Chart IV.1.6 Contribution to M3 growth
(in p.p.)



Rising balances in government accounts and a decline in net foreign assets contributed most to the reduction in M3.

The monetary multiplier remained unchanged from Q4 2010 as reserve money and dinar deposits declined in equal proportion.

Economic recovery, together with robust price growth and the seasonal contraction in money supply, accelerated the velocity of circulation.

Rising account balances outstripped the increase in government borrowing, inducing an M3 decline (-2.0 pp). Net foreign assets also provided a negative contribution to M3 growth (-1.9 pp) as bank external claims declined and the dinar strengthened. Due to deceleration, bank lending did not exert any significant pressure on M3.

In April 2011, dinar reserve money rose by RSD 21.5 bln, driven by government deposit spending to a larger and plummeting repo stock to a lesser extent. M1 and M2 rose as well, reflecting an increase in circulating cash. Transaction account balances declined, while savings and term deposits experienced a modest rise. The dinar's manifest appreciation in April weighed down on M3.

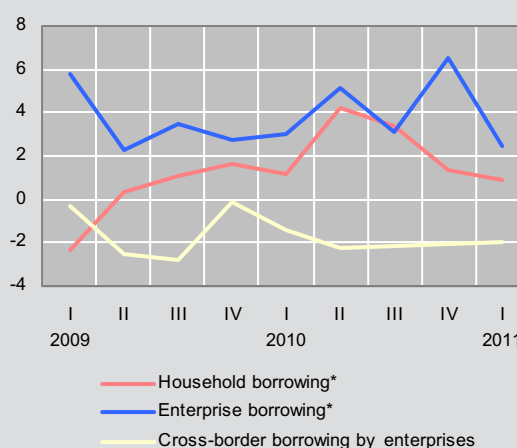
Bank lending

Growth in bank lending decelerated sharply in Q1.

Total corporate and household loans picked up by 1.9% in real terms in Q1 and declined by 2.7 pp q-o-q. A slowdown in lending growth, typical for the beginning of the year, was more pronounced than in earlier years. Corporate and household loans gained 2.5% and 0.9% in real terms respectively. In total, bank loans rose by RSD 4.3 bln nominally or by RSD 31.5 bln excluding the effect of dinar's appreciation. Declining real y-o-y growth rates corroborate the slowdown in lending growth. In March, corporate and household loans rose by 15.3% y-o-y in real terms.

The withdrawal of dinar deposits, notably corporate dinar deposits, induced the contraction in lending. Insurance companies and pension funds invested in 15-year euro-denominated government bills. Shrinking balances in FX accounts of these organisations thus fully offset a modest pick-up in household FX savings and counterweighted the

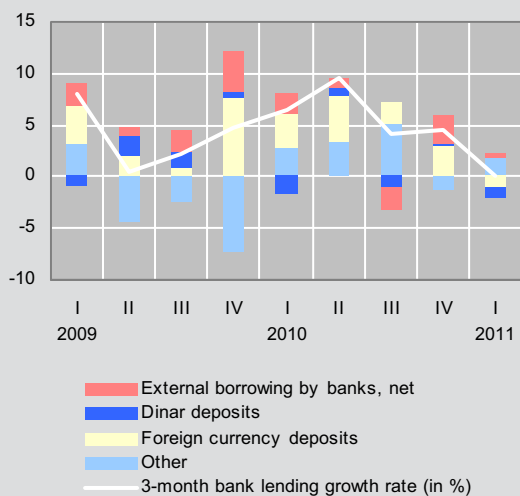
Chart IV.1.7 Bank real loan receivables and cross-border borrowing
(quarterly growth rates in %)



* Deflated by inflation, excluding the effects of valuation changes.

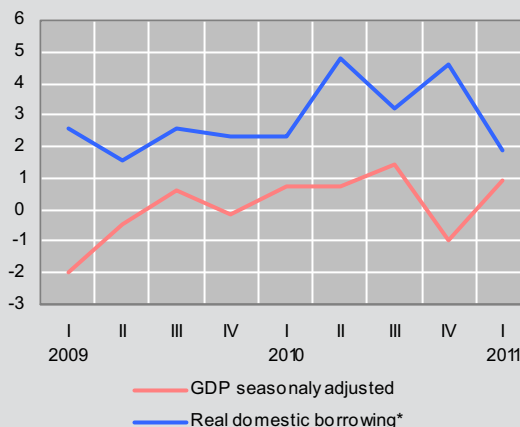
Growth in private sector loans, particularly corporate, decelerated significantly in Q1. A downward trend in cross-border loans continued.

Chart IV.1.8 Contribution to bank lending growth (in p.p.)



Declining dinar and FX deposits played the key role in the slowdown in lending growth in Q1.

Chart IV.1.9 Bank real loan receivables and GDP (quarterly growth rates in %)



* Deflated by inflation, excluding the effect of valuation changes.

Economic recovery did not reflect on lending growth.

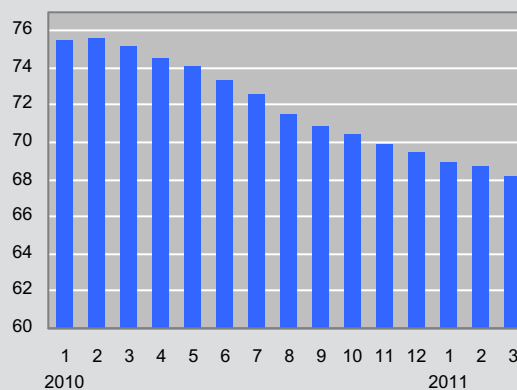
contribution of this category of deposits to financing of lending activity. On the other hand, a boost to domestic lending came from the increase in net external debt driven by a sharper decline in claims than liabilities.

In Q1, corporate loans rose by RSD 9.9 bln nominally or RSD 24.5 bln excluding the effect of exchange rate volatility. In an effort to maintain liquidity, enterprises tapped liquidity loans. In subsector terms, most loans were extended to industrial, trade, transportation and construction enterprises.

Net foreign debt repayment by enterprises continued in Q1. External liabilities under financial loans declined by EUR 213 mln, while trade loans rose EUR 133 mln.

Slowed growth in household loans and a high share of FX-indexed and FX loans (70.6% in March) bore down on household loans even in nominal terms. However, excluding the effect of exchange rate volatility, household

Chart IV.1.10 Share of indexed and FX receivables in total bank receivables from households and enterprises (in %)



The share of FX and FX-indexed receivables in total receivables continued down in 2011.

Table IV.1.2 Subsidised loans in 2010 and 2011

	2010				2011
	Q1	Q2	Q3	Q4	Q1
Government Programme of Measures to Ease the Effects of the Global Financial Crisis					
	(in RSD bln)				
Loans approved	25.6	65.6	56.3	37.6	27.0
Liquidity	22.4	44.6	34.9	22.7	24.3
Investment	0.4	5.0	9.0	9.8	1.8
Consumer	2.8	4.1	0.6	1.7	0.9
Dinar cash	-	11.9	11.8	3.4	-
Subsidised housing loans					
	3.3	3.2	3.7	3	1.3
Subsidised loans for agricultural producers					
	-	3.1	2.6	2.4	-

Source: Ministry of Economy and Regional Development, National Mortgage Insurance Corporation and Ministry of Agriculture, Forestry and Water Management.

lending rose by RSD 5.2 bln. Housing loans were predominant. Restrained household spending resulted in the reduction of receivables under consumer loans, while overdrafts on current accounts increased to a degree.

In April 2011, the Government adopted the Personal Finance Support Programme, envisaging temporary measures for personal debt restructuring. The Programme is voluntary-based and will be implemented over the next 12 months. During the grace period (two years maximum), a borrower will be paying the interest only. To support the implementation of the Programme, the NBS amended its regulatory framework.

In mid-Q1, banks began to approve government-subsidised loans for 2011. Until end-March, RSD 28.3 bln mln were extended, of which RSD 27.0 bln under the Programme of Measures to Ease the Effects of the Global Financial Crisis. Liquidity loans held a dominant 90% share, with investment loans accounting for less than 7%. A significant share of non-FX hedged loans (67.7%) in subsidised loans will certainly buoy up the incipient dinarisation in Serbia.

In terms of total loans, the share of FX and FX-indexed ones continued shrinking. Following a drop of nearly 6 pp in 2010, the share of FX-indexed loans declined further from 69.5% at end-2010 to 68.2% in March 2011.

The debt repayment capacity of corporate and household sectors, measured by the share of NPLs, rose marginally relative to end-2010. Gross NPLs amounted to 17.1% (or 10.0% net). The share of corporate loans in arrears for longer than 90 days went up from 21.8% to 22.1%, while the number of households defaulting on payments rose from 7.9% to 8.0%.

2. Movements in the foreign exchange market and the dinar exchange rate

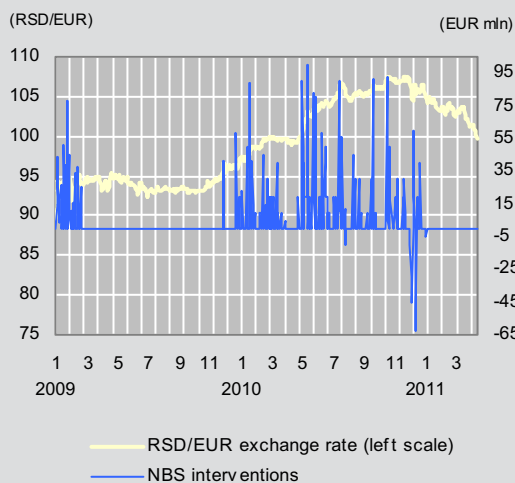
The dinar gained 2.5% on average against the euro in Q1. In the year to date, the NBS has intervened in the foreign exchange market only once.

Appreciation pressures that emerged last December continued into Q1. The dinar strengthened 2.5% on average against the euro, while the exchange rate ranged from 102.6 to 106.5 RSD/EUR.

These movements came largely in response to the lower country risk premium and buoyed capital inflow from portfolio investment. Since December last year, banks purchased substantial amounts of foreign exchange from non-residents, who channeled in Q1 most of the obtained dinars into RS government securities. The strengthening of the dinar was also aided by restrictive monetary policy measures (increase in the key policy rate and changes in reserve requirements). The dinar's rise continued in April, resulting in around 6% appreciation against the euro in the first four months of the year.

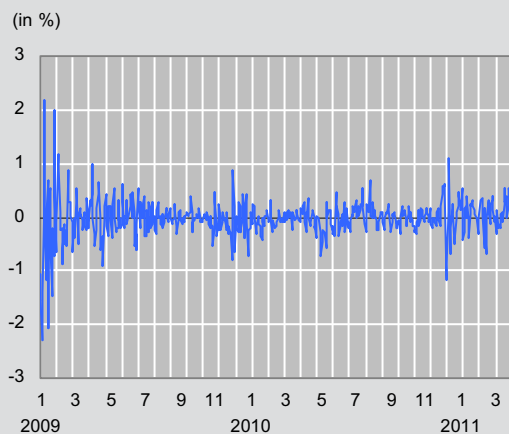
The current appreciation pressure is not a local, but rather a regional phenomenon triggered by buoyed capital inflow, stronger export demand stemming from eurozone recovery, and monetary policy tightening geared at quelling the heightened inflationary pressure. Significant

Chart IV.2.1 Movements in RSD/EUR exchange rate and NBS FX interventions



Since early 2011, the NBS has intervened only once by purchasing EUR 5 mln.

Chart IV.2.2 Daily changes in RSD/EUR exchange rate*



* Negative rates indicate depreciation and positive rates appreciation of the dinar.

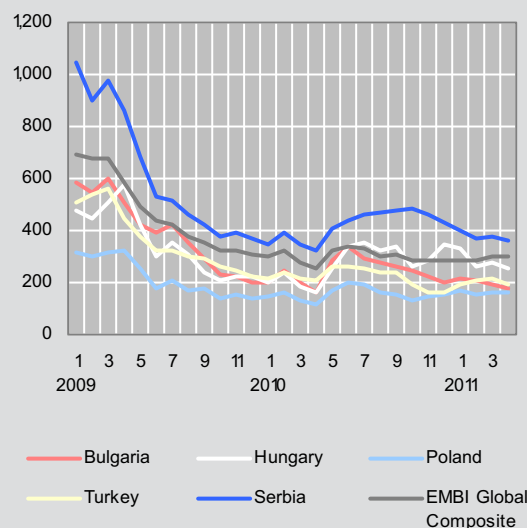
Daily volatility of the dinar has been moderate since early year.

strengthening of the domestic currency against the euro since the beginning of the year has been recorded by Hungary, Romania and the Czech Republic (4–6%).

The NBS intervened in the IFEM only once in the course of Q1. This happened in January, when the NBS bought EUR 5 mln from banks. The volume of direct interbank trading subsided from Q4 2010, averaging EUR 53 mln per day. It remained practically unchanged in April, averaging EUR 54 mln per day. As of 1 March, the NBS has reinstated three-month FX swap auctions to bolster interbank swap trading and the development of FX hedging instruments. The auctions are organised once a week. In March and April, the NBS swap sold/bought a total of EUR 30.5 mln/53.0 mln.

The country risk premium, measured by EMBI, continued down. At end-March, EMBI for Serbia stood at 366 bp. Of other transition countries observed (Czech Republic, Romania, Poland, Hungary), Hungary recorded the sharpest drop in EMBI in Q1. After Fitch upgraded Serbia’s credit rating outlook from negative to stable in November 2010, in mid-March this year Standard&Poor’s raised Serbia’s long-term local and foreign currency sovereign credit ratings from “BB–“ to “BB” while maintaining a stable outlook. EMBI fell further in April.

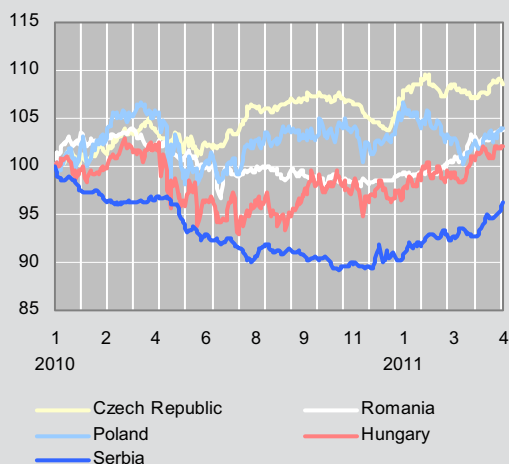
Chart IV.2.3 Risk premium indicator – EMBI by country
(monthly averages, in basis points)



Source: JP Morgan.

Risk premium continued down in Q1 and April.

Chart IV.2.4 Movements in exchange rates of national currencies against the euro
(Jan 4, 2010 = 100)



Since end-2010, national currencies of the majority of countries strengthened appreciably against the euro.

As the dinar strengthened against the euro and the euro strengthened against the dollar⁷ in Q1, the dinar gained an average 3.3% vis-à-vis the dollar.

With a 2.6% appreciation of the nominal effective exchange rate of the dinar⁸ and a faster growth in domestic relative to foreign prices, Q1 saw a 6.1% real effective appreciation of the dinar (6.1% against the euro and 5.9% against the dollar).

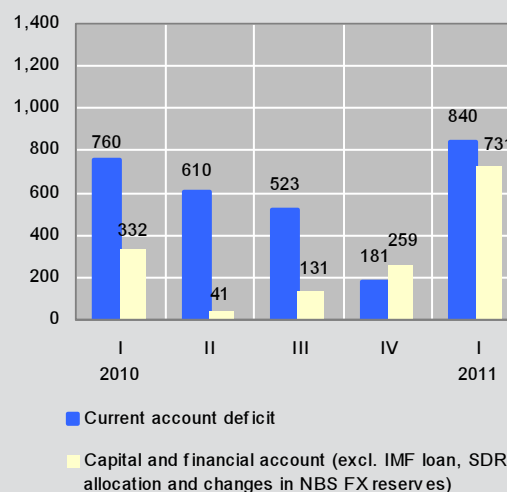
As indicated by the May Bloomberg survey, the financial sector expects that the dinar exchange rate will be stable until the end of June. According to the April *Consensus forecast*, though, after weakening slightly in May, the dinar is expected to hold steady until the end of July.

Foreign capital inflow

Net capital inflow increased relative to the previous quarter, reflecting on movements in the foreign exchange market.

⁷ Average USD/EUR exchange rate in Q1 2011 relative to average exchange rate in Q4 2010.

Chart IV.2.5 Current account deficit and net capital inflow
(in EUR mln)



Though relatively high, capital inflow in Q1 did not suffice to cover the current account deficit.

Substantial portfolio investment (EUR 520 mln) flowed into the country in Q1 as foreign investors' interest in long-term government treasury bills increased thanks to attractive interest rate differential and lower country risk premium. The largest inflow of portfolio investment – around EUR 300 mln – was registered in February.

At the same time, foreign direct investment remained modest – EUR 307 mln in Q1, of which EUR 219 mln in March alone. Most investment was channelled into manufacturing industry (notably iron and steel production), financial sector, information and communications, and trade.

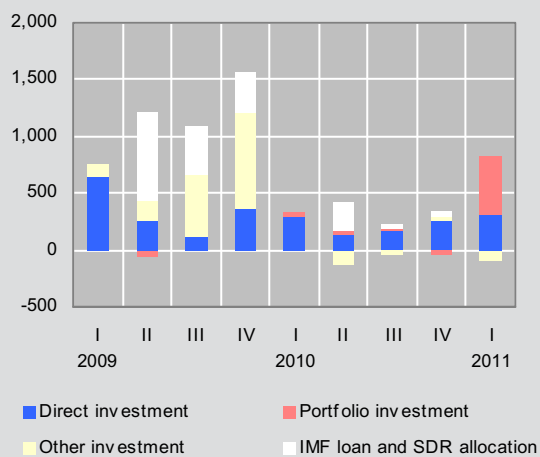
Banks net repaid their foreign debt by EUR 693 mln in Q1. Most of this amount (EUR 605 mln) came through in January, when banks repaid the short-term loans taken in late 2010. Net foreign debt repayment by the corporate sector was lower than a quarter earlier and amounted to EUR 213 mln.

Foreign exchange also flowed in through the Stand-By Arrangement with the IMF. Around 15% of the funds

⁸ Weights used: 0.8 for the euro and 0.2 for the dollar.

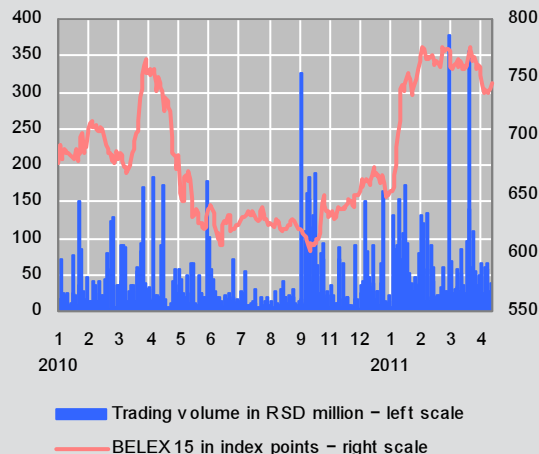
Chart IV.2.6 Structure of the financial account

(in EUR mln)



Q1 saw a significant capital inflow on account of portfolio investment.

Chart IV.3.1 Belex 15



Source: BSE.

Enhanced foreign investor participation prompted a rise in BELEX15 and propped up trading volumes in Q1.

made available under the last seventh tranche was drawn in April, strengthening the NBS foreign exchange reserves by EUR 51.6 mln⁹.

3. Capital market trends

Heightened foreign investor participation pushed up stock prices in Serbia, leading to unprecedentedly high Q1 trading volumes. Most regional stock exchanges recorded similar trends.

Positive assessments of credit rating agencies and declining risk premium resulted in heightened foreign investor participation and a brisk rise in stock exchange indices. The blue-chip index Belex15 upped 16.4% in Q1 to 758.9 points by the quarter-end. BELEXline, the benchmark index, rose by 11.1% from end-2010 to 1,425 points.

Stock exchange indices leapt in January and moderated in February. In March and April, however, they edged down, notably due to the political instability in the Middle East.

Most regional stock indices rose in Q1 as well. Growth on the Sofia stock exchange (SOFIX – 22.8%) and Bosnia and Herzegovina stock exchanges (SASX 10 and BIRS – 17.0% each) outstripped that on the Belgrade Stock Exchange (BSE). In contrast, the Ljubljana (SBITOP) and Montenegro (MONEX 20)¹⁰ indices lost 2.0% and 12.1% respectively.

Notwithstanding the expected seasonal decline, the BSE turnover in Q1 remained unchanged from Q4 2010 at RSD 9.4 bln. In terms of market share, trading in shares was dominant at RSD 8.3 bln. Of total share trading, foreign investors accounted for 42.2% and net purchased RSD 2.5 bln.

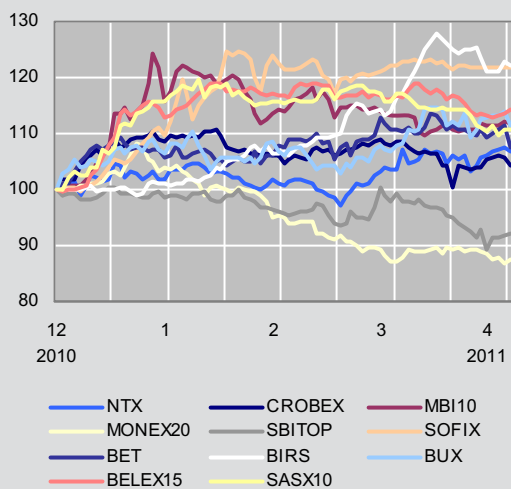
Trading in frozen foreign currency savings bonds amounted to RSD 1.1 bln, down by 34.8% from Q4. Foreign investor participation totalled not more than

⁹ In view of Serbia's broadly comfortable reserve position and the need to minimise the costs of the credit arrangement with the IMF, the authorities decided not to draw the tranches in full. Of the total EUR 2.9 bln available under the SBA, Serbia disbursed around EUR 1.5 bln.

¹⁰ On 31/12/2010, two Montenegrin stock exchanges were merged, producing a joint index MONEX 20.

Chart IV.3.2 Stock exchange indices across the region

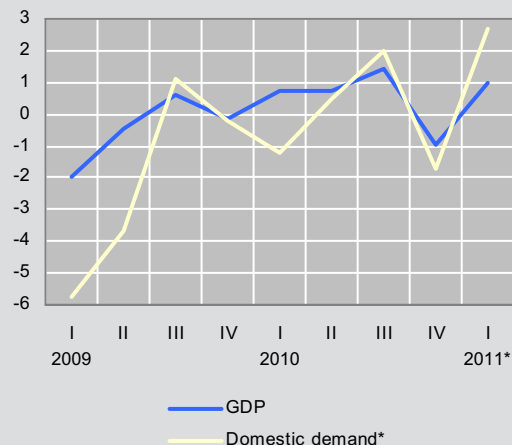
(in index points, normalised, 31. 12. 2010 = 100)



Most regional stock exchange indices picked up in early 2011.

Chart IV.4.1 Growth in GDP and domestic demand

(seasonally-adjusted, quarterly growth, in %)



* NBS estimate.

Q1 saw an increase in GDP and domestic demand.

9.6%. The return on the May 2011-series bonds rose the most – from 4.1% to 7.8% p.a. Other rates of return at end-March ranged between 4.4% and 5.0%.

BSE market capitalisation came at RSD 970.9 bln on 31 March (31.9% of GDP). Relative to end-2010, capitalisation was augmented by RSD 37.4 bln in response to rising share prices. Further, the listing of Nikola Tesla airport shares bolstered overall market capitalisation by RSD 17.6 bln.

4. Aggregate demand

Aggregate demand increased in Q1 thanks to buoyed domestic demand, notably investment.

Domestic demand is estimated to have recorded a recovery in Q1 (2.7%), owing mainly to an investment upturn. On the other hand, net exports declined (14.5%) reflecting faster growth in imports relative to exports.

As the positive impact of increased domestic demand (3.0 pp) outweighed the negative impact of reduced net exports (-2.0 pp), GDP rose by 1%. Within domestic demand, private sector investment rose, while household spending and government investment declined.

Last year's GDP growth (1.8%) was driven by net exports (2.7 pp), while the contributions of total final consumption and investment were negative (-0.3 pp and -0.6 pp, respectively). The expected acceleration in GDP growth to 3.0% this year should come primarily from investment, and to a lesser degree, from net exports and final consumption.

Domestic demand

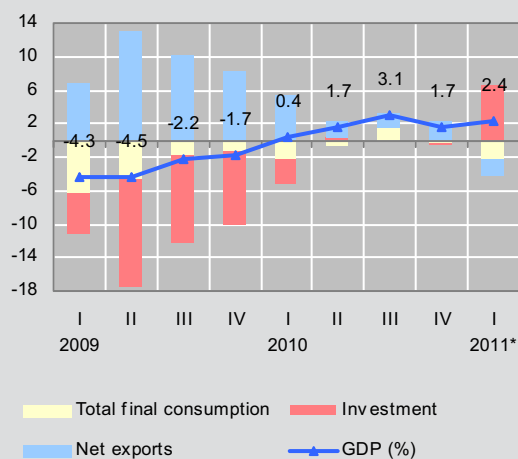
Household spending

Household spending fell further in Q1. This is also indicated by the sharp drop in retail trade turnover.

Household spending is estimated to have weakened q-o-q by 4.8% s-a, providing to GDP growth a negative contribution of 3.6 pp.

Real household income, as the main source of spending, continued down: real income (wages, pensions and social transfers) fell 3.6% s-a. The decline in real household income, in place since mid-2010, is attributable primarily to the drop in pensions and social transfers. Q1 saw a slower growth in consumer and other household loans intended for consumption financing. Household income

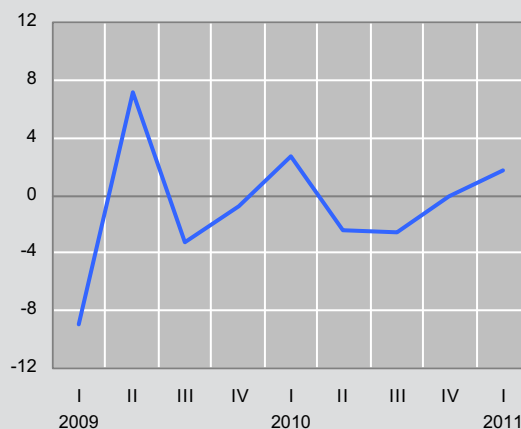
Chart IV.4.2 Contribution to y-o-y GDP growth
(in percentage points)



* NBS estimate.

GDP growth in Q1 was for its major part driven by investment activity.

Chart IV.4.3 Public spending
(seasonally-adjusted data, quarterly growth, in %)



Public spending rose in Q1, mainly as a result of the unfreezing of public sector wages.

was also affected by the net foreign exchange inflow from remittances that touched its lowest level in the last two years. Reflecting movements in the sources of spending, household savings deposits rose at a slower pace than a quarter earlier (3.8% vs. 7.9% s-a).

Retail trade turnover, the most important indicator of household spending, recorded a precipitous decline from the previous quarter (12.0% s-a).

After stagnating last year, household spending is expected to recover in 2011 and grow by around 1.0%, led chiefly by the real growth in wages.

Government spending

Government spending rose relative to the previous quarter.

Data on government outlays for the purchase of goods and services and payment of public sector wages in Q1 point to a 3.8% s-a increase in government spending relative to the previous quarter. Compared to the same period a year earlier, government spending declined by a real 3.3%.

The unfreezing of public sector wages is expected to halt the decline in public consumption. Another two increases of public sector wages are to take place in April and October.

Investment activity

Investment activity is estimated to have stepped up in Q1 on the back of higher private investment and stock-building.

Fixed investment increased in Q1 reflecting primarily the rise in private sector investment. At the same time, government investment, measured by the volume of capital expenditure, recorded a significant decline.

The upturn in fixed investment is signalled by the surging imports and falling exports of capital goods in conditions of their stepped up domestic production. Private investment contributed 3.6 pp to GDP growth in Q1.

Investment growth is in part also due to stock-building, i.e. increased investment into current assets. Namely, following a drop in the last quarter of 2010, a real increase

in stocks was recorded in Q1 2011. Within final industrial products, the strongest stock increase was registered for energy, intermediate and capital goods.

Though growth in corporate lending slowed in Q1, private investment is expected to increase further over the coming period given the current and announced investment projects, which will contribute to overall economic growth in 2011.

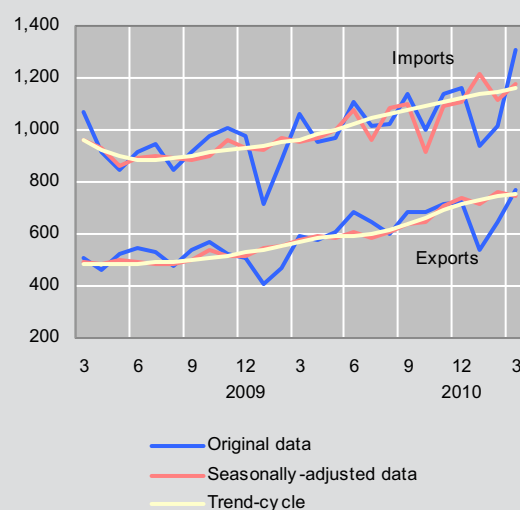
Net external demand

Imports outpaced exports in Q1, exerting a negative impact on overall economic activity.

As s-a imports rose at a faster pace than exports, foreign trade provided a negative contribution to GDP growth in Q1 (-2.0 pp contribution of net exports).

In y-o-y terms, foreign trade also made a negative contribution to GDP growth (-2.0 pp) even though the growth in exports surpassed that in imports (32% vs. 23% y-o-y).¹¹

Chart IV.4.4 **Exports and imports**
(in EUR mln)



The trade deficit widened relative to Q4 as a result of faster growth in imports.

Table IV.4.1 **Investment indicators**

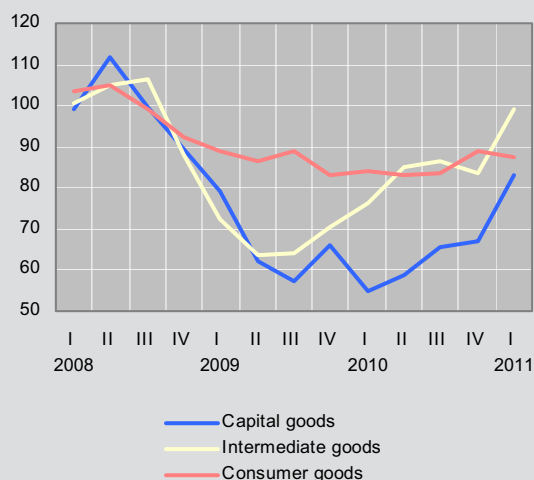
	2005-2008 (average)	2010				2011
		I	II	III	IV	I
Real indicators (seasonally-adjusted, quarterly, growth, in %)						
Construction	2.2	-2.4	-1.9	-0.1	-0.3	-0.2 *
Industrial production of capital goods (physical volume)	-6.5	-7.6	1.8	-6.7	10.5	25.5
Exports of capital goods**	29.3	-16.3	27.1	-9.6	14.7	-16.4
Imports of capital goods**	11.2	-9.9	9.7	15.1	-2.8	11.8
Stocks of capital goods	-1.6	-7.3	13.3	-7.9	-10.6	53.8
Industrial production of intermediate goods (physical volume)	3.9	-5.8	7.8	1.3	-4.4	9.2
Exports of intermediate goods**	17.6	10.1	2.6	1.9	12.1	8.4
Imports of intermediate goods**	15.4	4.7	6.7	12.3	5.1	4.4
Stocks of intermediate goods	0.5	-1.6	-1.8	-0.2	-2.7	3.3
Government investment**	16.2	-7.1	-3.3	20.8	0.0	-17.4
Financial indicators						
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	528.8	-141.0	-270.0	-150.0	-228.4	-214.0
Short-term credits to enterprises (in RSD bln)	51.8	31.8	38.9	19.3	33.0	-2.7
Long-term credits to enterprises (in RSD bln)	43.3	16.7	35.3	13.5	27.1	8.9
Long-term credits to households (in RSD bln)	78.9	23.2	44.3	21.6	12.8	-9.1

* NBS estimate.

** Imports are deflated by the index of producer prices of manufactured products in Germany; Exports are deflated by export producer prices of capital goods; Government investment spending is deflated by the index of producer prices of manufactured products.

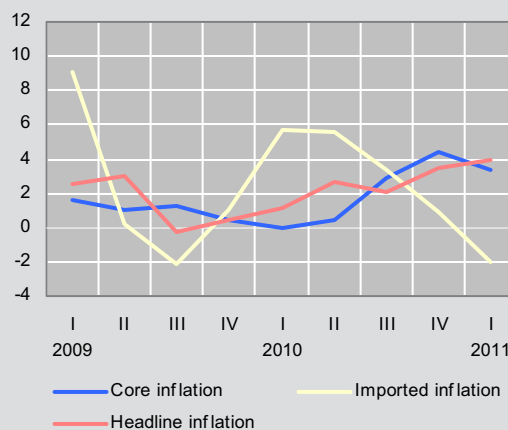
¹¹ The reason behind the negative contribution is that the share of imports in GDP is significantly higher than that of exports.

Chart IV.4.5. Imports by key components
(seasonally-adjusted, 2008 = 100)



Imports of capital and intermediate goods increased strongly, while imports of consumer goods declined.

Chart IV.4.6 Domestic and imported inflation*
(quarterly growth rates, in %)



Source: NBS and Eurostat.

* Ratio of averages for two consecutive quarters.

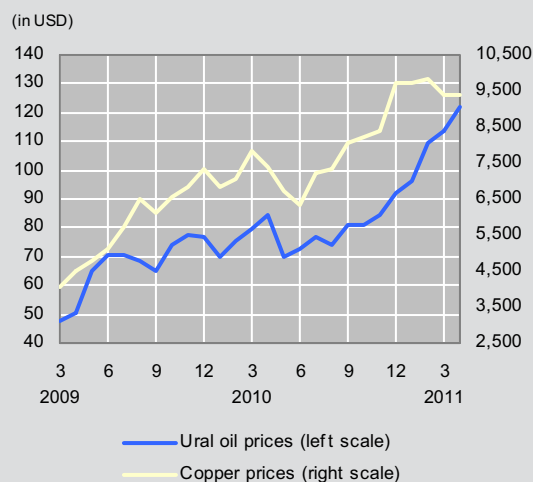
Imported deflation in Q1 resulted from the nominal effective appreciation of the dinar.

Export growth was led by base metals (iron, steel and non-ferrous metals) and food. Exports of agricultural products, however, entered a decline in February, and those of processed food products followed suit already in March. On the side of imports, growth was driven by production inputs (capital and intermediate goods), rather than by consumer goods (down by around 2%), which represents a good signal as regards overall economic recovery prospects.

In late Q1, goods exports were 17% higher s-a than the average January-September 2008 level, while imports remained 14% below the corresponding pre-crisis average.

Imported inflation declined for the fourth quarter in a row. Its negative outturn in Q1 (-2.0%)¹² is, for its major part, attributable to the appreciation of the nominal effective exchange rate of the dinar (2.6%), given that the average price growth in the EU and the USA (0.6%) remained almost flat relative to the quarter before. While imported deflation had no impact on headline inflation due to record high prices of agricultural products, it did act as a damper on core inflation growth.

Chart IV.4.7 Oil and copper price movements

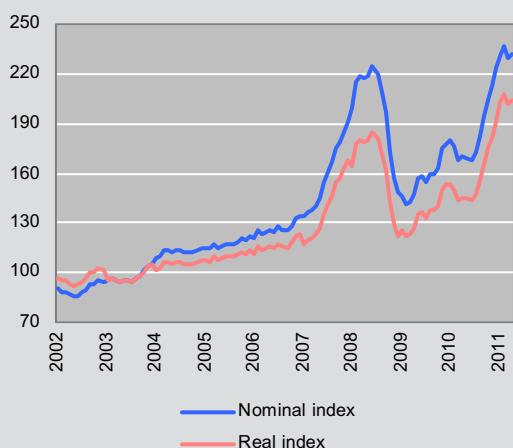


Source: Bloomberg.

Oil prices rose throughout Q1, but most sharply in February. Copper prices, on the other hand, experienced a trend reversal and recorded a mild decline.

¹² Ratio of averages for two consecutive quarters.

Chart IV.4.8 **Index of global food prices**
(2002 - 2004 = 100)



Source: FAO, UN.

After eight months of relentless rise, the global food price index edged down in March.

Uncertainties over the Libyan crisis pushed the oil prices up (by around 23% in Q1). They continued further up in April and shot past USD 120 per barrel.

Oil price growth is also supported by the stronger than expected recovery of the global economy and by the improved global economic prospects. Hence, oil prices are expected to stay elevated for quite some time yet.

On the other hand, following robust growth in 2010, copper prices underwent a trend reversal in mid-Q1. They levelled off at record USD 10,148 per tonne in mid-February and then started falling back amid reduced demand from China (resulting from the government's economy cooling measures) and increased copper stocks.

After hitting its historical high in February, the FAO Food Price Index fell by around 3% in March, reversing the upward trend in place since July 2010. The value of the index remained unchanged in April, possibly signalling a stabilisation of global food prices. International prices of most primary agricultural products are currently very high, perhaps by around 40% higher than in the same period a year earlier.

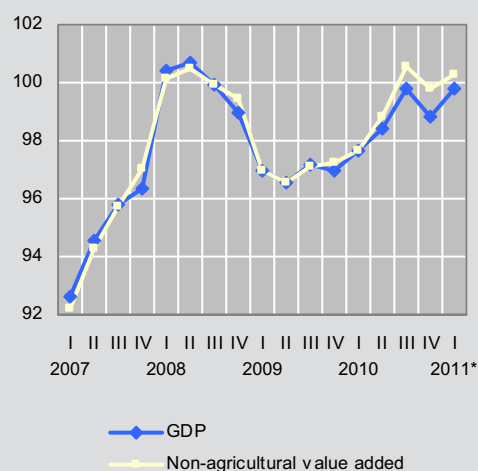
5. Economic activity

Following a Q4 drop, GDP is estimated to have risen in Q1. Negative output gap is narrowing.

A GDP drop of 1.0% s-a (1.7% y-o-y) in Q4 2010 was slightly higher than expected in the February Inflation Report. This outturn resulted from contraction in industrial output, notably manufacturing, as well as declining agricultural output and trade volumes. Non-agricultural value added (NAVA) recorded a milder s-a fall (0.8%), while its y-o-y growth decelerated (2.5% y-o-y).

The economy is estimated to have rebounded in Q1 2011, which corresponds to the assessment expressed in the previous Report of the temporary nature of economic downturn in Q4. Growth in GDP and NAVA is estimated at 1.0% and 0.5% s-a in Q1 respectively. Y-o-y, GDP and NAVA accelerated to 2.4% and 2.8%¹³, coming close to their pre-crisis levels.¹⁴

Chart IV.5.1 **Economic activity indicators**
(seasonally-adjusted data, 2008 = 100)



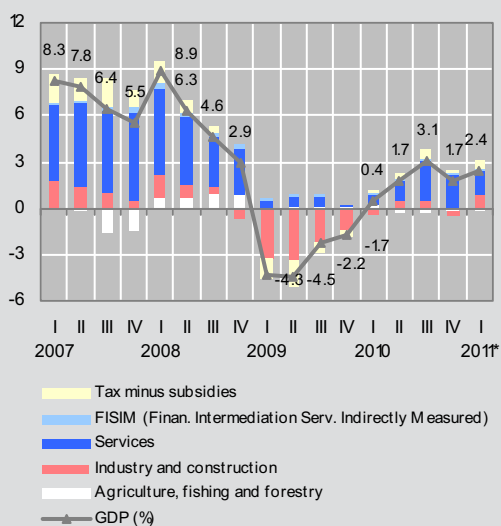
* NBS estimate.

Q1 saw an increase in GDP mainly due to growth in manufacturing.

¹³ According to the Statistical Office's flash estimate, real GDP growth in Q1, at last year's prices and the new classification of activities, amounted to 3.0% y-o-y. The NBS's estimate was made under the old classification and the fixed base (2002 prices).

¹⁴ Pre-crisis period – H1 2008.

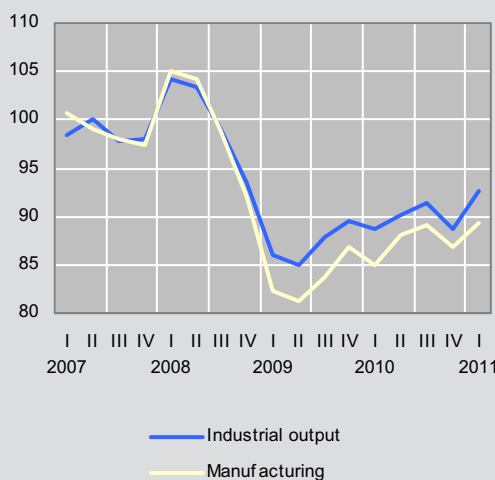
Chart IV.5.2 Contribution to y-o-y GDP growth
(in p. p.)



* NBS estimate.

Economy is expected to rebound in Q1.

Chart IV.5.3 Industrial output
(seasonally-adjusted data, 2008 = 100)



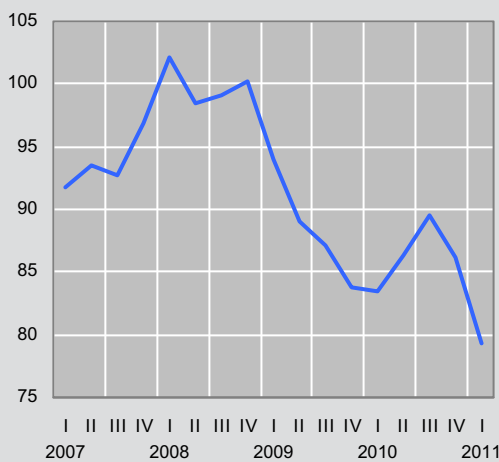
Following a decline in the previous quarter, industrial output recorded an increase in Q1.

Estimated economic growth in Q1 reflected a 3.7% s-a rise in industrial output (0.6 pp), NAVA, the transport, storage and communications sector (0.3 pp each), production and distribution of electricity, gas and water, and the financial intermediation sector (0.1 pp each). By contrast, a negative contribution resulted from falling retail and wholesale trade (-0.5 pp). In y-o-y terms, GDP growth in Q1 was propped up by an upturn in the transport, storage and communications sector (1.2 pp) and industrial output (0.9 pp).

Industrial output picked up in all three sectors. Growth in the sector of electricity, gas and steam supply¹⁵ and the mining sector was particularly robust in February and March.

The main boost to manufacturing came from the production of base metals, motor vehicles and trailers and metal products. An adverse effect, however, resulted from plummeting production of tobacco products, furniture, coke and petroleum products (overhaul of the Pančevo oil refinery, in train since early March, dampened the output of the Serbian Oil Industry).

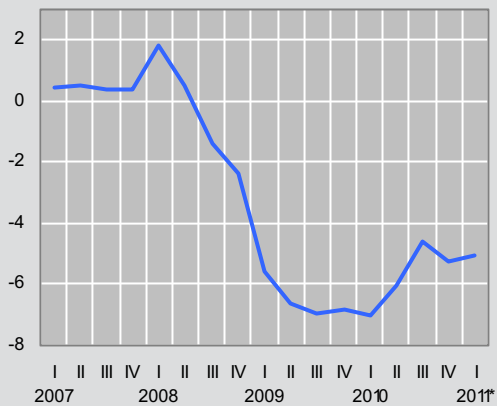
Chart IV.5.4 Retail trade
(seasonally-adjusted data, 2008 = 100)



Retail trade turnover declined further in Q1.

¹⁵ According to the new classification of activities (Sector D – Electricity, gas, steam and air conditioning supply).

Chart IV.5.5 Output gap*
(percentual deviation from the trend)



* NBS estimate.

Negative output gap moderated due to higher economic growth in Q1 than in the previous quarter.

Q1 economic growth was also supported by bolstered activity in the transport, storage and communications sector, reflecting expansion in air transport and

telecommunications. Further, the financial intermediation sector recorded somewhat faster growth in Q1.

Trading volumes shrank further from end-2010. Reflecting a further real drop in wages and slackened lending activity, performance in retail trade in Q1 touched its five-year low.

A downturn was also recorded in the hotels and restaurants sector, as indicated by plummeting catering figures (a 4.6% y-o-y decline in Q1).

A scale-back in construction, observed for three years already, continued in Q1, though at a slower pace (0.2% s-a), in response to growing production of non-metal minerals (production of cement, roof tiles and tiles, glass). Heightened investment, notably private, is expected to bolster construction activity in 2011.

As estimated by the Serbian Statistical Office, 2010 saw 1.8% GDP growth. Our estimates place 2011 GDP growth at around 3%, based on expected faster growth in manufacturing and better agricultural performance.

Economic growth in Q1 points to narrowed negative output gap and weakening of its disinflationary impact. Nevertheless, aggregate demand remains low.

Box 3: Revision of GDP data

By end-March 2011, the Serbian Statistical Office issued revised real GDP growth rates for 2001–2009. Nominal GDP for 2007–2009 was revised as well (in dinar, dollar and euro terms).

The revision was necessitated by:

- a) modified statistical classification of economic activities – the new classification (2010) is harmonised with Eurostat standards and includes a greater number of categories at all classification levels;
- b) a shift from fixed base (2002) calculation to calculation at previous year prices. At fixed base calculation, as the distance from the base year increases, weights become a steadily less accurate reflection of the economic situation of the country. The new calculation method implies a change in the weights each year; and
- c) revision of indicators used for calculation at constant prices – a shift to new, more adequate indicators, in line with recommendations of international statistics authorities.

Chart 1 shows a comparative overview of earlier and the new – revised real GDP growth rates for the 2001–2009 period.

Chart O 3.1 Real GDP growth (y-o-y rates, in %)

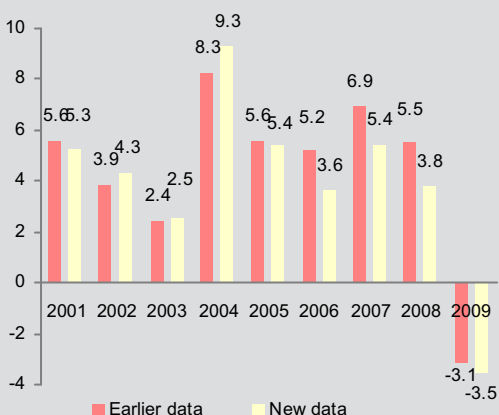
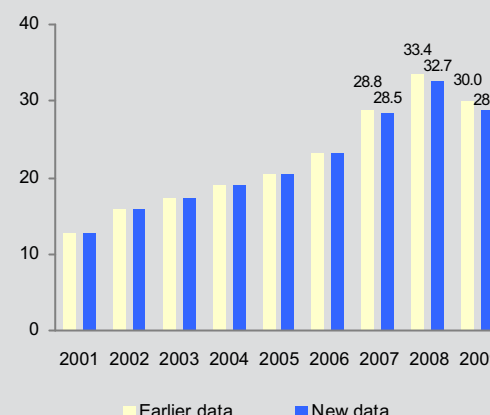


Chart O 3.2 Nominal GDP (in EUR bln)



Calculations of nominal GDP for 2000–2009 under the new classification of economic activities did not show a change from earlier data. However, due to the adoption of the general trade system within the international merchandise trade statistics (a wider coverage concept), GDP figures for 2007 and 2008 were revised in regard to goods and services exports/imports (imports significantly outstripped exports), which resulted in lower nominal GDP in those years (see Chart 2). Revision of the nominal GDP figure for 2009 was made after final calculations for that year were officially announced¹. GDP data on the allocation side (at current prices) for 2007 and 2008 were changed after the introduction of the general trade system. Data on current price GDP distribution for 2009 are published for the first time.

¹ Final GDP calculation for a particular year is published a year after the expiry of the given year (in March), based on annual financial statements of enterprises, while the “previous results” are published nine months after the expiry of the year (in September) and represent an estimate based on given indicators.

6. Labour market developments

Wages

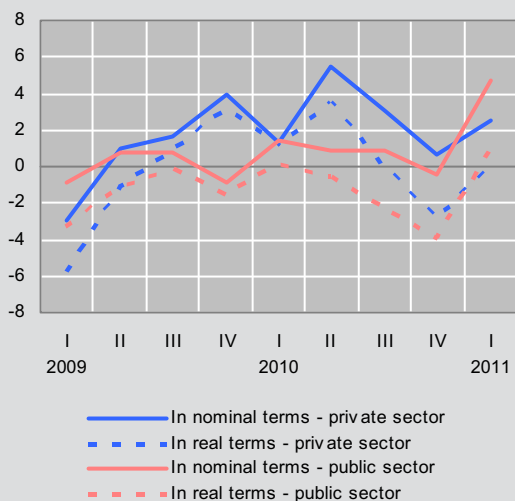
Real wages in the public sector rose in Q1, while those in the private sector remained flat. The fall in industrial unit labour costs gathered pace.

According to seasonally-adjusted data for Q1, wages rose in both real and nominal terms relative to the previous quarter. Nominal wages went up by 6.7% and real by 2.6%.

Nominal and real net wage growth was registered in most industries. The strongest growth was recorded in mining and electricity, gas and steam supply, which coincides with the upswing of production in these two sectors. A notable increase in net wages was also seen in the real estate business and professional, scientific, innovation and technical activities. On the other hand, the sharpest drop was observed in financial intermediation and arts and entertainment.

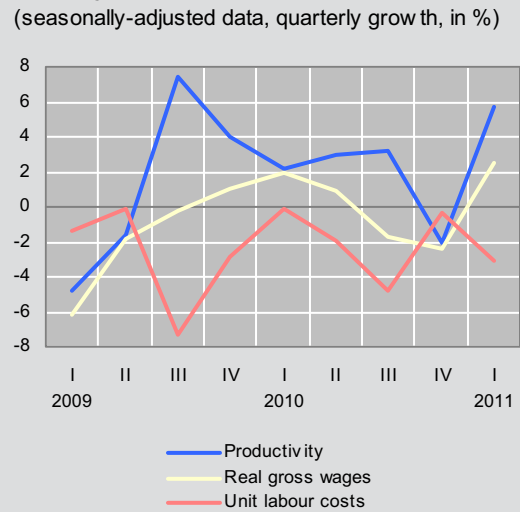
Public sector wages increased 4.7% in nominal and 1.0% in real terms, reflecting wage growth in the sectors of administrative and supporting service activities and state administration and social insurance. Private sector wages rose by a nominal 2.5%, but stagnated in real terms.

Chart IV.6.1 Average net wages
(seasonally-adjusted data, quarterly growth, in %)



Real wages rose in the public and stagnated in the private sector.

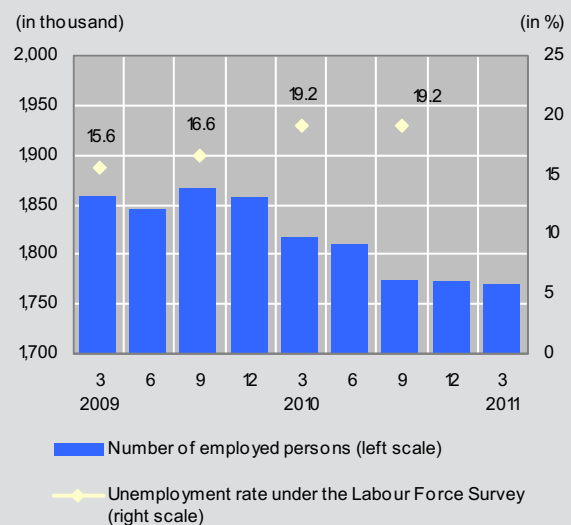
Chart IV.6.2 Movements in productivity, real gross wages and unit labour costs in the industry
(seasonally-adjusted data, quarterly growth, in %)



Unit labour costs declined in Q1 due to faster growth in productivity than gross real wages.

Y-o-y, nominal wages stepped up their growth (10.0%), while real wages stepped up their decline (2.4%). A faster growth in nominal wages was seen in both private and public sectors (12.0% and 5.8%, respectively). The drop

Chart IV.6.3 Unemployment



Source: Serbian Statistical Office.

Following mild recovery in the quarter earlier, employment numbers contracted in Q1.

in real wages lost some pace in the public sector (6.0%), as well as their growth in the private sector (0.2%).

The average net wage paid out in Serbia in Q1 equalled RSD 35,108.

With real wages lagging behind productivity gains, the drop in industrial unit labour costs accelerated on the previous quarter. The same tendency was registered in manufacturing.

Employment

Employment numbers fell slightly in Q1, notably in the manufacturing sector.

Based on official statistics, employment numbers fell slightly relative to Q4 (1,941 persons or 0.1%), notably in the manufacturing sector (-0.1 pp). Contraction was also observed in the sectors of construction, mining, information and communications. A moderate pick-up, however, was recorded in almost all services sectors and in the public sector.

Y-o-y employment fell by 2.6%, reflecting a reduction in the number of entrepreneurs and their employees. However, a decline in y-o-y employment strongly

decelerated due to a slowed decrease in the number of entrepreneurs and employees in manufacturing and construction. On the other hand, a steeper fall in Q1 was observed in trade and slower growth in most catering sectors.

According to the National Employment Service data, February unemployment fell 0.5% y-o-y, while new employment rose by 34.8%.

The National Employment Service has earmarked this year more funds for its employment programmes focusing on entrepreneurs, SMEs and the unemployment amongst the most vulnerable categories. In Q1, it kick-started the “First Chance 2011” programme to employ 15,000 people up to the age of 30 in the private sector, and the “Professional Practice 2011” programme for the vocational training of 5,000 young people in the public and private sectors. In the year to April, more than 5,000 persons were engaged through these programmes.

7. International environment

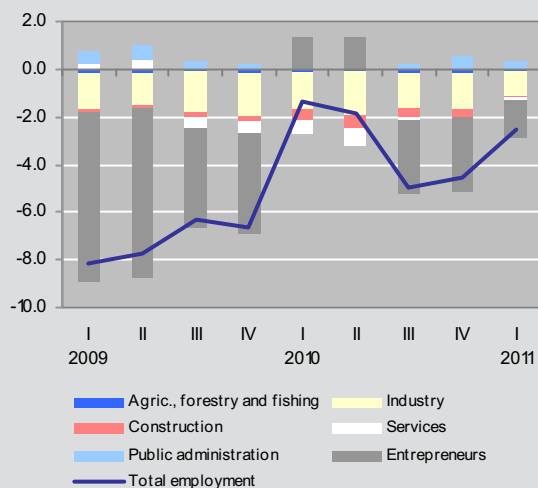
The global recovery advances, but remains uneven. Inflation pressures are broadening. The vigorous rebound of the German economy augurs well for Serbian exports.

The global recovery is proceeding, though still at varying speed. Developing economies have restored their pre-crisis growth rates (and some have even exceeded them), while those advanced are recovering much slower. The difference in the growth rates of these two groups of countries measured as much as 4 pp in 2010.¹⁶ The main concerns for advanced economies include sluggish activity, high unemployment rates and uncertainty in the financial markets.

The eurozone debt crisis not only continued in 2011, but deepened still further. Namely, faced with high cost of new borrowing, Portugal joined Greece and Ireland on the list of users of the European Financial Stability Facility, and there are fears that it would not be long before Spain joins in. Though eurozone periphery’s debt restructuring is increasingly regarded by market players as inevitable, this is still not on the ECB’s agenda.

Preliminary estimates suggest that the eurozone has emerged from the doldrums of the last quarter of 2010 and that its growth picked up in Q1 2011 thanks to

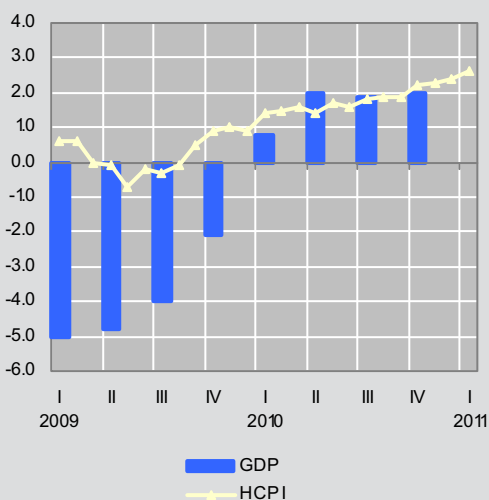
Chart IV.6.4 Employment by sector
(contribution to y-o-y growth in employment, in p.p.)



Source: Serbian Statistical Office.

Q1 experienced a further decline in employment, mainly as a result of a decline in the number of entrepreneurs and employees in the manufacturing sector.

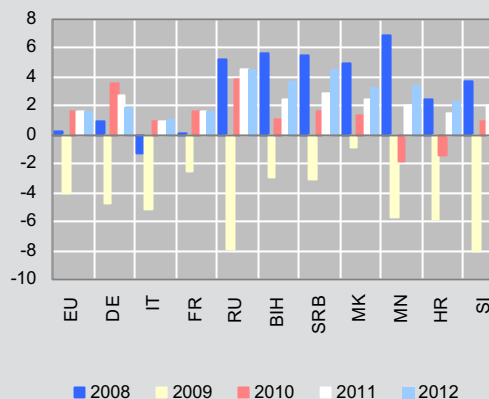
Chart IV.7.1 Eurozone GDP and inflation
(y-o-y growth rates)



Source: Eurostat.

After stagnating in Q4, economic growth is expected to step up in Q1. Inflationary pressures are heightened.

Chart IV.7.2 Serbia's key foreign trade partners - GDP growth rates and their projections
(in %)



Source: Consensus Forecast, April 2011.

The recovery of the above economies in 2011, notably that of Germany, will exert a positive impact on our exports.

surging private investment. The strongest growth is forecast for Germany, one of Serbia's key trade partners, which should reflect positively on our exports.

The eurozone experienced stronger inflationary pressures from robust growth in food and energy prices, pronounced particularly since the start of the year. For the fourth month in a row, inflation in March exceeded the target of below, but close to, 2%. Concerns over a rise in inflation expectations and its second-round effects prompted the ECB to raise the policy rate in early April by 0.25 pp (to 1.25%) for the first time since July 2008.

Faced with heightened inflationary pressures, the central banks of Central and East European countries changed their monetary policy stance. In Q1, policy rates were raised first by the Hungarian National Bank, and then by the National Bank of Poland. Other central banks in the region are expected to follow suit.

The US economic growth is estimated to have slowed down in Q1 2011, reflecting high public debt, large budget deficit, and a lack of adequate fiscal consolidation

measures. Because of this, in mid-April *Standard&Poor's* downgraded the US credit outlook for the first time – from “stable” to “negative”.

Notwithstanding elevated inflationary pressure, the Fed continues implementing a rather expansionary monetary policy along with the program of Treasury bond purchases. The aim is to lower long-term yields on Treasury bonds, which would lead to a drop in other interest rates, and by extension, bolster consumption and economic expansion. The Fed holds that the growth is still weak, unemployment high and price pressures only temporary, which is why no monetary policy tightening is to be expected in the near future.

Despite apprehension over rising peripheral eurozone debt and fears of eurozone contagion, the dollar's slide against the euro continued as the ECB first announced and then implemented a tighter monetary policy. Investor risk aversion continuing, the Swiss franc and the Japanese yen preserved their safe haven appeal, remaining high against both the dollar and the euro in Q1. The outlook for the world's strongest currencies remains uncertain.

¹⁶ IMF World Economic Outlook, April 2011.

V. Inflation projection

After reaching its peak in April or May, inflation will trend downwards in response to gradual easing of the cost-push pressure on food prices, low aggregate demand and strengthening of the dinar. Its return within the target band is expected in H1 2012. Economic recovery will accelerate in 2011 and in 2012. The NBS Executive Board judges that the key policy rate is either close to or may have already reached a peak of its current cycle. To keep inflation within the target band in the medium term, the NBS will probably continue implementing tight monetary policy, using all instruments of monetary regulation available.

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

Initial conditions

Consumer price growth stepped up in Q1, pushing the y-o-y inflation rates significantly above the upper bound of the target tolerance band. Again in this quarter, the strongest pressure on prices came from the increase in processed food production costs, triggered by the last year's leap in primary agricultural product prices worldwide and at home.

International agricultural product prices (corn, wheat, sugar, coffee, etc.), which started rising in mid-2010, stabilised above their pre-growth levels. Domestic agricultural product prices continued up in Q1 2011.

In the year to date, global crude oil prices have recorded a robust increase (30%) under the impact of ongoing political tensions in North Africa and the Middle East. The prices of base metals (copper, aluminium, iron) and industrial raw materials (cotton, wool, rubber, leather) have also risen since the beginning of the year, generating cost-push pressure on prices of final products.

Appreciation pressures that emerged in late 2010 continued in the first four months of 2011. The strengthening of domestic currency is also observed in other East European countries operating a flexible exchange rate regime as a result of lower country risk premia and stronger foreign investor confidence in their

economies. The strengthening of the Serbian currency was also aided by restrictive monetary policy measures implemented by the NBS since last August.

Nominal appreciation of the dinar against the euro in Q1 and higher domestic inflation relative to that in the eurozone resulted in real appreciation of the dinar and subsequent opening of the appreciation gap of the real exchange rate. This is indicated by the drop in net importers' real marginal costs and weaker upward pressure on their domestic prices in the medium term.

Despite a hefty rise in consumer prices, inflation expectations did not rise significantly in Q1. This may be understood as a sign of market players' confidence that inflation will return within the target band over a medium term horizon.

Low aggregate demand continues to be the key medium-term disinflationary factor. This is also suggested by the negative output gap in Q1.

Following a decline in Q4 2010, economic activity picked up in Q1 2011, reflecting the rise in domestic demand (notably investment).

Eurozone recovery proceeded in Q1, led by demand from developing economies. Fiscal consolidation measures enacted in H2 2010 by debt-ridden eurozone members

will have no major impact on external demand for Serbian exports, especially as our most significant trading partners (Germany and Italy) are poised for solid growth in the coming period.

Upward revision of the key policy rate from 11.5% to 12.5% since the beginning of the year and real appreciation of the dinar signalled that, after quite a while, Serbia moved to a restrictive monetary policy stance in Q1.

Projection assumptions

Already in H1, regulated prices will come close to hitting the upper end of the growth range planned for the year as a whole (7±2%) and are expected to exceed it by end of the year. A somewhat lower growth in regulated prices is anticipated in 2012.

The prices of fruits and vegetables are currently much above their multi-year averages, while the prices of primary agricultural products (corn, wheat, sunflower, etc.) are close to their historical highs. For this reason, these prices are expected to record slower growth compared to other prices even in the event of an average agricultural season.

The appreciation trend of the real exchange rate of the dinar against the euro reflects continuing moderate convergence of prices in Serbia to those in the eurozone. The projection also assumes that the country risk premium will drift down further with the rebuilding of foreign investor confidence, which will lead to a gradual decline in the real interest rate trend.

The eurozone has faced mounting inflationary pressures since the beginning of the year. As these pressures are

likely to persist throughout the year, the ECB raised the policy rate by 25 bp already in April and will most probably continue tightening its monetary policy in the coming period.

Inflation projection

Inflation will reach its peak in April or May, and then start retreating towards the target. It is expected to return within the target band in H1 2012 and come close to the target midpoint in H2 of that year.

As in the quarter before, consumer price growth in Q2 will be driven by food and regulated prices.

The rise in food prices will continue on the back of persistent cost-push pressure. In fact, it is our estimate that though processed food prices recorded a hefty rise, higher input costs (prices of corn, wheat, sunflower, etc.) have not been fully absorbed yet, and may hence be expected to generate inflationary pressure in the coming period. Nonetheless, these pressures should weaken significantly from the quarter before.

Regulated price growth in Q2 will be almost entirely attributable to electricity, while the effects of the increase in natural gas prices and a cut in prices of cigarettes will offset each other. Given the dramatic leap in global crude oil prices, further growth in petroleum product prices appears rather likely.

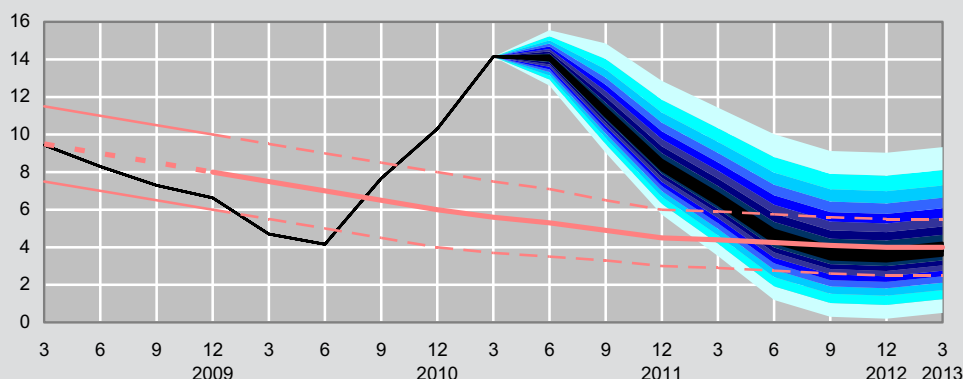
The rise in food and regulated prices in Q2, and low inflation rates from the same period last year, will cause y-o-y inflation to peak in April or May, and then to gradually retreat towards the target.

Though the economy is set for moderate recovery in 2011, aggregate demand will continue to produce disinflationary

Table V.0.1 **Projection assumptions**

	2011	2012
External assumptions		
EU inflation (Q4 to Q4)	2.1%	1.8%
ECB policy rate (year-end)	1.75%	2.50%
Euro area GDP growth	1.7%	1.7%
Ural oil price per barrel (year-end, USD)	120	125
Internal assumptions		
Regulated prices (Dec to Dec)	12.1%	7.0%
Prices of fruits and vegetables (Dec to Dec)	6.2%	5.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.6%	2.1%
Real interest rate trend (average)	4.0%	3.6%

Chart V.0.1 Inflation projection
(y-o-y rates, in %)



After peaking in April or May, inflation will start retreating towards the target. It is expected to return within the target band in H1 2012. The risks to the projection are skewed to the upside due to the possible increase in government spending and entrenchment of elevated food prices.

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%.

pressures in the medium run. As the economy recovers, the disinflationary pressures generated by aggregate demand will grow weaker.

In the near term, the disinflation process will also be aided by the current nominal appreciation of the dinar (via import prices). In the medium term, disinflationary effects will come from the appreciation gap of the real exchange rate. This factor is an indicator of the fall in net importers' real marginal costs, which means that the pressure for price increases on these grounds will lessen.

A trend reversal in food prices, dampened aggregate demand and low net importers' marginal costs will be the key factors leading to a drop in monthly inflation rates in H2 2011, and, coupled with the high base from the same period last year, to a significant fall in y-o-y inflation (see Text box 4, p. 38).

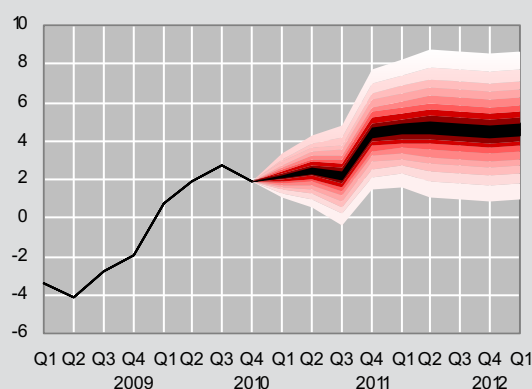
The Serbian economy is poised for moderate recovery. Its growth in 2011, driven primarily by domestic investment activity, is estimated at 3.0%. Improved economic prospects and government employment subsidies to investors are expected to give a boost to foreign investment. On the other hand, despite the unfreezing of public sector wages, high unemployment will hold back household spending, making its contribution to GDP rather modest.

Though remaining positive, the contribution of net exports will decline due to the appreciation of the dinar against the

euro and the expected increase in imports of capital and intermediate goods that will accompany economic growth.

A higher GDP rate in 2011 will be also underpinned by the low agricultural production base. Namely, after a poor agricultural season in 2010, agricultural output will increase this year even in the event of average agricultural performance. Besides, agricultural product prices are

Chart V.0.2 GDP growth projection
(y-o-y rates, in %)



Economic activity will accelerate in 2011 and 2012, driven by the recovery in demand (notably investment).

nearing their historical highs, which could encourage farmers to invest more in production.

Risks to the projection

The key risks to inflation projection are associated with the country risk premium, food prices and budget deficit.

Movements in the risk premium and foreign investor sentiment towards Serbia will largely determine the duration of appreciation pressures that emerged late last year. If, for instance, appreciation pressures build up further, importers may tend to perceive them as more enduring, and may therefore decide to lower their prices. If, however, appreciation pressures prove to be short-lived and the exchange rate movements suddenly reverse, we will see a resurgence of inflationary pressures generated by imported inflation.

If this year's domestic and global agricultural output reach or exceed the average volume, the prices of primary agricultural products will experience a relative decline and the cost-push pressure on food prices will lessen. On the other hand, robust growth in global food demand (especially in developing countries), and alternative use of some primary commodities (corn in biofuel production), coupled with below-average agricultural

output volumes, may lead to a stagnation, or even a rise, in prices of primary agricultural products and, by extension, prices of food.

A more expansionary fiscal policy than planned may give rise to additional inflationary pressure in the coming period. A larger budget deficit would spark aggregate demand, dampen foreign investor interest and weaken the domestic currency. It is therefore essential that fiscal authorities do everything they can in order to contain the budget deficit within the level planned for this year.

On balance, the risks to the inflation projection are skewed to the upside due to the possible loosening of fiscal policy and entrenchment of elevated food prices.

Comparison with the previous projection

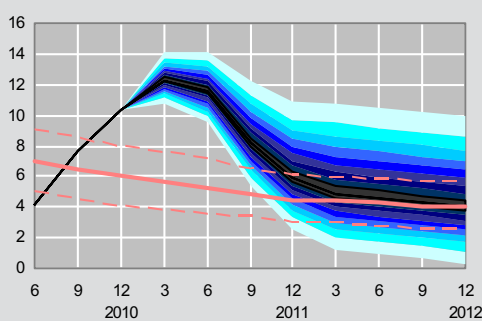
The current inflation projection for 2011 and early 2012 is higher than the February projection, while projections for the remainder of the forecasting period are approximately the same.

Compared to the previous projection, the current projection assumes a stronger inflationary impact of the growth in food prices and a stronger disinflationary impact of the exchange rate.

Chart V.0.3 **Current vs. previous projection**

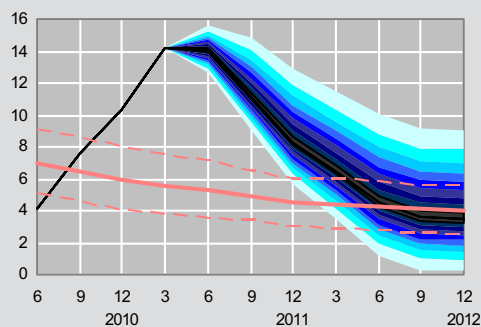
February projection

(y-o-y rates, in %)



May projection

(y-o-y rates, in %)



The current inflation projection for 2011 and H1 2012 is higher than the February projection, while projections for the remainder of the forecasting period are approximately the same.

The inflationary effect of food prices is expected to strengthen due to higher than expected growth in primary agricultural product prices in Q1 and a robust growth in prices of fruits and vegetables.

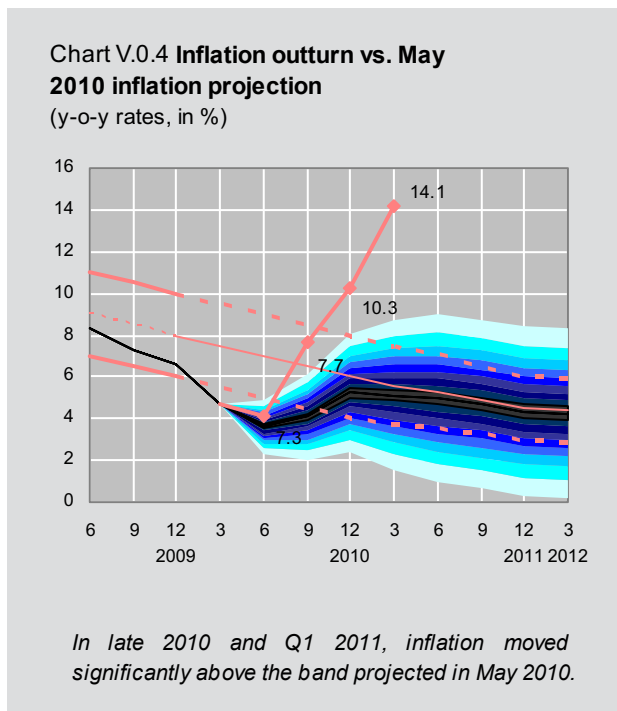
On the other hand, lower inflationary pressures are likely from import prices thanks to the fact that the dinar appreciated reflecting a sharper than expected fall in the risk premium and increased investor interest in domestic securities.

As the inflationary effect of food prices in the first half of the year will outweigh the disinflationary effect of the exchange rate, the 2011 profile for inflation is higher than in February.

In late 2010 and Q1 2011 inflation moved above the upper bound of the target tolerance band stated in the May 2010 *Inflation Report*. The main reasons for this deviation were robust growth in food prices in H2 2010 and early 2011 and higher than planned growth in regulated prices.

Outlook for the key policy rate

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the key policy rate is either

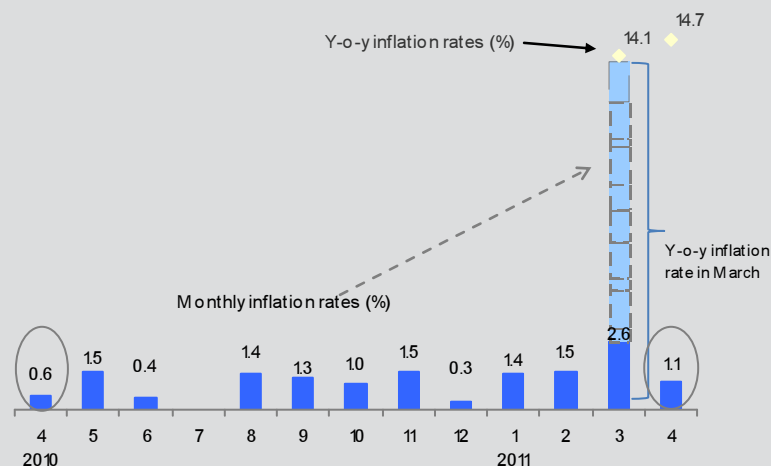


close to or may have already reached a peak of its current cycle. To maintain inflation within the target band in the medium term, the National Bank of Serbia will probably continue implementing tight monetary policy, using all instruments of monetary regulation available.

Box 4: Base effect and trends in y-o-y inflation

Inflation targets of the National Bank of Serbia are set in terms of a y-o-y percentage change in CPI. While the monthly inflation rate reflects a rise in prices in the current relative to the previous month, the y-o-y rate reflects price growth relative to the same month a year before, i.e. cumulatively over the last 12 months.

Chart O 4.1 Relation between y-o-y and monthly inflation rates



For instance, y-o-y inflation in March 2011 reflects the cumulative price growth from April 2010 to March 2011. As we proceed to the next month (in this case: April 2011), April 2010 price growth is excluded from y-o-y inflation calculation and April 2011 growth is included. Hence, each monthly price growth affects y-o-y inflation for the duration of one year.

Monthly and y-o-y inflation rates imply the following correlation:

$$\pi_{12,t} \approx \pi_{12,t-1} + (\pi_t - \pi_{t-12})$$

– where $\pi_{12,t}$ and $\pi_{12,t-1}$ relate to y-o-y inflation rates in the current and previous month respectively, and π_t and π_{t-12} are monthly inflation rates in the current and the same month of the previous year.

As shown above, y-o-y inflation will rise if the current month inflation exceeds inflation from the same month a year before, and vice versa – even in case of progressively declining monthly inflation. Namely, y-o-y inflation rates are affected by both current price movements and by the base effect, i.e. price trends in a given month of the previous year.

The base effect plays a very important role in the latest inflation projection as monthly inflation rates in H2 last year and Q1 this year were exceptionally high due to rising food prices. As the effect of these price hikes gets progressively excluded from y-o-y inflation, it is almost certain that y-o-y inflation will precipitate down. A decline would not take place only if price growth from H2 2010 were to occur again, which is rather unlikely.

Table A
Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011
EXTERNAL LIQUIDITY INDICATORS (in %)										
Forex reserves/imports of goods and services (in months)	4.1	4.8	3.9	6.2	9.1	7.2	5.2	9.4	8.1	7.7
Forex reserves/short-term debt	364.3	539.0	708.3	522.5	943.9	920.0	382.1	528.8	546.4	888.8
Forex reserves /GDP	13.8	16.5	16.5	24.4	38.8	33.9	25.1	36.7	34.7	34.0
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.1	10.6	11.5	11.8	14.5
Debt repayment/exports of goods and services	7.0	9.0	16.4	17.7	23.5	33.2	34.0	39.1	33.8	39.7
EXTERNAL SOLVENCY INDICATORS (in %)										
External debt/GDP	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.9	82.5	77.8
Short-term debt/GDP	3.8	3.1	2.3	4.7	4.1	3.7	6.6	6.9	6.4	3.8
External debt/exports of goods and services	300.9	251.6	211.5	228.9	204.1	197.3	207.6	265.3	236.2	213.0
FINANCIAL RISK EXPOSURE INDICATORS (in %)										
Forex reserves/M1	144.8	196.3	222.0	292.1	357.0	307.6	301.4	393.4	416.6	268.5
Forex reserves/reserve money	133.3	168.9	166.9	170.8	179.9	174.3	141.1	190.5	196.4	202.5
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP										
	59.3	63.9	73.7	73.6	81.2	85.8	86.8	73.6	86.4	91.0
MEMORANDUM: (in EUR million)										
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,815	7,090
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	23,786	22,672
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,314	3,403	1,026
Central bank foreign exchange reserves	2,208	2,854	3,131	4,952	9,041	9,660	8,190	10,602	10,002	9,919
Short-term debt	606	529	442	948	958	1,050	2,143	2,005	1,830	1,116
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-839
			Nov. 2004	July 2005	Feb. 2006	June 2007	March 2008	Dec. 2009		
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 and Fitch: BB-/negative	Standard & Poor's: BB-/stable	Standard & Poor's and Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable

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

2. 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 harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.

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

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

5. GDP for 2010 as estimated by the National Bank of Serbia.

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

7. As of 01.01.2010 Statistical Office, according to UN recommendations, applies general trade system which is broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using special trade system.

8. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 443.5 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 86.4 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 875.4 mln, of which EUR 397 mln related to domestic banks and EUR 478.4 mln to domestic enterprises).

9. Data for January are based on GDP for Q4 of the previous year, and those for February on GDP estimated for Q1.

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011
Real GDP growth (in %)	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.8	2.4 ¹⁾
Consumer prices (in %, relative to the same month a year earlier) ²⁾	14.8	7.8	13.7	17.7	6.6	11.0	8.6	6.6	10.3	14.1
Core inflation (in %, relative to the same month a year earlier) ²⁾	4.4	6.1	11.0	14.5	5.9	7.9	10.8	3.6	8.6	13.2
NBS foreign exchange reserves (in EUR million)	2,208	2,854	3,131	4,952	9,041	9,660	8,190	10,602	10,002	9,919
Exports (in EUR million) ³⁾	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	10,070	2,583
- growth rate in % compared to a year earlier	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-16.5	18.8	28.5
Imports (in EUR million) ³⁾⁷⁾	-6,387	-7,206	-9,543	-9,613	-11,971	-16,016	-18,843	-13,577	-14,838	-3,868
- growth rate in % compared to a year earlier	27.2	12.8	32.4	0.7	24.5	33.8	17.7	-28.0	9.3	20.3
Current account balance ⁴⁾⁷⁾ (in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-839
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-7.2	-7.2	-11.8
Unemployment according to the Survey (in %) ⁵⁾	13.3	14.6	18.5	20.8	20.9	18.1	13.6	16.1	19.2	/
Wages (average for the period, in EUR)	152.1	176.9	194.6	210.4	259.5	347.6	358.4	337.9	330.1	338.3
RS budget deficit/surplus (in % of GDP) ⁶⁾	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.9	-3.3	-3.4	-3.8
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	0.9	-1.9	-2.0	-2.5	-4.5	-4.6	-3.2
RS public debt (external + internal, in % of GDP) ⁶⁾	71.9	63.7	50.9	50.6	40.1	31.8	26.9	34.1	42.2	43.5
RSD/USD exchange rate (average, in the period)	64.70	57.56	58.44	66.90	67.01	58.39	55.76	67.47	77.91	75.92
RSD/USD exchange rate (end of period)	58.98	54.64	57.94	72.22	59.98	53.73	62.90	66.73	79.28	73.22
RSD/EUR exchange rate (average, in the period)	60.66	65.13	72.70	83.00	84.10	79.96	81.44	93.95	103.04	103.95
RSD/EUR exchange rate (end of period)	61.52	68.31	78.89	85.50	79.00	79.24	88.60	95.89	105.50	103.60
<i>Memorandum</i>										
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,815 ¹⁾	7,090 ¹⁾

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: Labour Force Survey, Statistical Office.

⁶⁾ Source: RS Ministry of Finance Bulletin.

⁷⁾ As of 1 January 2010, the Statistical Office, according to UN recommendations, applies the general trade system which is a broader concept and includes all goods entering/exiting the country's economic territory, apart from goods in transit. The Statistical Office published comparable data for 2007, 2008 and 2009. Previous years are disseminated under a special trade system.

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

Table C
IMF's projection for key macroeconomic indicators (April 2011)
(IMF Country Report No. 11/95, April 2011)

	2007	2008	2009	2010 (Estimate)	2011 (Projection)
Output, prices and labor market (change in percent)					
Real GDP growth	6.9	5.5	-3.1	1.8	3.0
Real domestic demand (absorption)	11.5	6.3	-8.7	-1.5	0.2
Consumer prices (average)	6.5	12.4	8.1	6.2	9.7
Consumer prices (end of period)	11.0	8.6	6.6	10.3	6.0
Nominal gross wage	22.4	16.9	7.4	7.3	8.6
Real net wage	19.9	4.9	-0.7	1.1	-1.0
General government finance (in percent of GDP)					
Revenue	43.5	41.9	40.7	40.3	38.9
Expenditure	45.4	44.5	45.0	44.8	42.9
Fiscal balance	-1.9	-2.6	-4.3	-4.5	-4.1
Public debt	35.2	33.4	36.8	44.0	41.1
Monetary sector (end of period 12-month change, in percent)					
Money (M1)	25.3	-3.8	8.7	-2.2	23.7
M3 ¹⁾	44.5	9.6	21.8	13.9	26.7
Domestic credit to non-government	36.9	35.0	15.9	29.0	14.5
Balance of payments (in percent of GDP)					
Current account balance	-15.9	-20.9	-6.9	-7.1	-7.4
Export of goods	22.2	22.2	20.0	25.2	27.9
Import of goods	45.2	47.6	37.1	41.4	42.0
Trade of goods balance	-23.1	-25.4	-17.1	-16.2	-14.1
Capital and account balance	18.4	16.3	10.7	2.4	7.6
External debt	61.8	65.2	76.5	80.7	75.6
of which: Private external debt	39.5	46.1	52.0	52.4	48.4
Gross official reserves (in billions of euro)	9.5	8.2	10.6	9.7	10.0
REER (annual average change, in percent; + indicates appreciation)	7.4	4.5	-5.0	-7.7	6.5

¹⁾ Excluding frozen foreign currency deposits.

Appendix: National Bank of Serbia's Letter to the Government of the Republic Serbia on Reasons Why Inflation Departed from the Target

NATIONAL BANK OF SERBIA

12 April 2011

GOVERNMENT OF THE REPUBLIC OF SERBIA

Mirko Cvetković, President

As inflation has trended for six consecutive months above the target tolerance band, we address you in accordance with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting* (Section 6, paragraph 4) in order to explain why inflation has moved away from the target tolerance band, the period within which we expect inflation to return within the target tolerance band, and on the appropriate policy action to be taken.

Why inflation has moved away from the target tolerance band

Y-o-y inflation rose sharply in Serbia in H2 2010 and early 2011 - from 4.2% in June 2010 to 14.1% in March 2011.

The NBS Executive Board assesses that the rise in inflation over this period was mainly driven by exceptionally high food price growth and, to a lesser extent, by dinar's depreciation and sharp growth of regulated prices.

Of the 9.9 percentage point rise in y-o-y inflation from June 2010 to March 2011, food contributed as much as 9.0 percentage points. Therefore, that the key determinant of inflation were rising food prices, prompted by weak agricultural output last season and considerable growth in global food prices. Given a high share of food in CPI - 37.8%, inflation in Serbia is particularly sensitive to food price shocks. Moreover, due to the existing systemic solutions, food prices in Serbia are much more volatile compared to the neighbouring countries, which spurred their growth in the last three quarters.

Though to a lesser extent and via rising import prices, inflation was temporarily driven by weakening of the dinar in the May-July 2010 period, which was largely a consequence of escalation of public debt crisis in some of the neighbouring eurozone countries and the ensuing elevation of risk premium in the South-East European region, Serbia being no exception.

Regulated price growth, fairly robust since early 2011, stood as another generator of high inflation. After April adjustments (notably of electricity prices), regulated price growth will already in the first four months move around the upper bound of the growth limit envisaged for the whole year (7±2%).

To contain inflationary pressures in the last eight months, the NBS tightened its monetary stance. However, given the strength and nature of the food shock and existing volatility of food prices, inflation persisted above the upper bound of the target tolerance band.

The period within which we expect inflation to return within the target tolerance band

The NBS Executive Board will take all actions under its remit to bring medium-term inflation within the target tolerance band. If no unexpected shocks take place, we expect inflation to gradually retreat to target starting from Q3 2011, to move back within the target tolerance band in H1 2012, and come closer to the midpoint by late 2012 (target for end-2012: 4%).

The speed at which inflation will come back to target will largely depend on success of the 2011-2012 agricultural season. In case of an average season, inflation is expected to subside already in mid-2011. An agricultural season weaker than last year could postpone and slow the decline in inflation.

Economic policy action to bring inflation back within the target tolerance band

Since August 2010, the NBS has been taking restrictive measures reflected in successive increases in the key policy rate - from 8% to 12.5%, and amendments to the decision on required reserves that halted the process of relaxation of the rules in that area. Also, with declining risk premium and more favourable credit rating, the dinar strengthened against the euro in late 2010 and early 2011, which will help bring down inflation.

Bearing in mind that food market volatility is the key factor behind current inflationary pressures, we believe you share our opinion that systemic measures and activities should be established and implemented without delay, which would contribute to food market stabilisation and significant reduction in food price volatility. Assuming we pursue the planned income policy, this would contribute to the effectiveness of monetary policy measures and help avoid sudden changes in the policy stance triggered by fluctuations in inflation and inflation expectations. Ultimately, this would contribute to macroeconomic stability and sustained economic and employment growth.

As the full effect of past monetary policy measures on inflation is yet to be felt, the NBS will assess whether further monetary tightening is needed, using full array of instruments on hand to bring medium-term inflation back to target.

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Executive Board* Meetings and Changes in the Key Policy Rate

2010

Date	Key policy rate (p.a., in %)	Change (in basis points)
12 January	9.50	0
21 January	9.50	0
4 February	9.50	0
22 February	9.50	0
5 March	9.50	0
23 March	9.00	-50
8 April	8.50	-50
20 April	8.50	0
11 May	8.00	-50
19 May	8.00	0
7 June	8.00	0
22 June	8.00	0
2 July	8.00	0
22 July	8.00	0
5 August	8.50	+50
19 August	8.50	0
7 September	9.00	+50
14 October	9.50	+50
11 November	10.50	+100
9 December	11.50	+100

2011

Date	Key policy rate (p.a., in %)	Change (in basis points)
17 January	12.00	+50
10 February	12.00	0
10 March	12.25	+25
7 April	12.50	+25
12 May		
9 June		
7 July		
11 August		
8 September		
6 October		
10 November		
8 December		

* In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No. 44/2010), the Executive Board has assumed all powers of the Monetary Policy Committee.

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 10 February 2011

After reviewing current economic developments and the February inflation projection, the NBS Executive Board voted to maintain the key policy rate at 12 percent.

In its meeting today, the Executive Board also adopted the February 2011 Inflation Report, which will be available in print form and officially presented to the public during a press conference on 16 February.

The next rate-setting meeting is scheduled for 10 March 2011.

Press release from Executive Board meeting held on 10 March 2011

After reviewing current economic developments in its meeting today, the NBS Executive Board voted to raise the key policy rate by 25 basis points to 12.25 percent.

The rise in agricultural product prices, at home and worldwide, and the resulting cost pressure on processed food prices is currently the key generator of inflationary pressures. Global oil and base metal prices are also on the rise. The impact of growth in import prices on inflation has been eased over the last three months by the strengthening of the dinar, prompted by the drop in Serbia's risk premium and by the effects of monetary policy measures.

In the first months of 2011, consumer price growth will also be spurred by the rise in regulated prices, notably prices of electricity, utilities and city transport service.

On the other hand, given the still relatively modest recovery of economic activity and soaring unemployment figures, demand will continue to produce disinflationary pressures despite the lifting of the freeze on public sector wages and pensions in early 2011. Further, the full effect of past monetary policy measures is yet to materialise in the coming period.

In view of the above, by raising the key policy rate by 25 basis points the NBS aims to bring medium-term inflation within the set targets (4.5±1.5% for end-2011 and 4±1.5% for end-2012).

The next rate-setting meeting of the NBS Executive Board will take place on 7 April 2011.

Press release from Executive Board meeting held on 7 April 2011

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to raise the key policy rate by 0.25 percentage points to 12.50 percent.

The key generator of inflation is still the unexpectedly high food price hike, spurred by global developments and the existing systemic solutions in the field. At the same time, prices of non-food products are stable and consistent with the inflation target.

One-off inflationary pressures driven by robust food price growth are likely to subside with the start of the new agricultural season in July 2011, which will generate disinflationary effects. Aggregate demand will be another disinflationary factor in the coming period.

By raising the key policy rate by 0.25 percentage points the NBS aims to bring medium-term inflation within the set targets.

The next rate-setting meeting of the NBS Executive Board will take place on 12 May 2011.

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