National Bank of Serbia

2012

May

INFLATION REPORT

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Introductory note

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

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

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

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

The May *Inflation Report* was adopted by the NBS Executive Board in its meeting of 10 May 2012.

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

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Diana Dragutinović, *Vice Governor*

Mira Erić Jović, *Vice Governor*

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EFSF – European Financial Stability Facility
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
EMU – Economic and Monetary Union of the EU
FDI –foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NPLs – non-performing loans
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Inflation has been moving within the target tolerance band since the start of the year.

Consistent with the National Bank of Serbia's earlier projections, year-on-year inflation continued down and has been moving within the target tolerance band since the start of the year. It fell to 3.2% in March close to the lower bound of the target tolerance band, owing chiefly to the drop in unprocessed food prices. Inflation reached 2.0% in the first quarter, as a result of rising prices of fruit and vegetables and petroleum products.

All sectors revised their inflation expectations downwards.

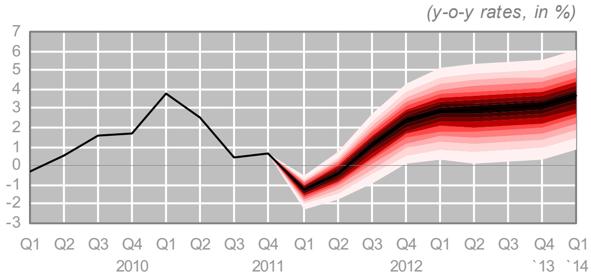
As inflation declined and trended closer to the target, so did the inflation expectations of economic agents. Inflation expectations of all sectors fell, while those of the financial sector settled within the target tolerance band.

Aggregate demand is estimated to have declined.

Aggregate demand is estimated to have declined in the first quarter, due primarily to the drop in net exports, but also due to weaker domestic demand attributable to a decrease in private investment. Household and government consumption increased, while government investment stagnated.

The continuing fall in economic activity is expected to be compensated for in the second half of the year.

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



The fall in economic activity continued in the first quarter, reflecting for its major part the downturn in industrial production caused by the extremely cold weather in February and the one-month suspension of operations of the Smederevo Steel Plant. According to our estimates, the fall in economic activity will be compensated for in the second half of the year by the recovery of industrial production, led primarily by the start of production in the black metallurgy and automotive industry. A positive impact on GDP movements in the short term will also come from the fiscal stimulus in the first half of the year. On the other hand, fiscal consolidation, expected after the formation of the future Government of the Republic of Serbia, may have a negative impact on GDP movements. Taking all of the above into account, the National Bank of Serbia decided to keep its GDP growth projection for 2012 unchanged. GDP growth is projected to reach 0.5% as a result of a rise in net exports in the second half of the year. In 2013, it is expected to accelerate to 3%, thanks again to net exports. The projection band for GDP growth is tilted to the downside due to the possibly higher than expected short-term effect of fiscal consolidation.

Movements in the international environment have slightly improved.

Slightly more favourable movements in the international environment in early 2012 may be put down to the debt swap agreement between Greece and private investors and the measures implemented by the European Central Bank in order to reduce the yields on peripheral sovereign bonds. At the same time, the continuing fall in economic activity gives no reason for optimism, and the euro area is expected to record negative growth this year. Still, the International Monetary Fund has recently revised its 2012 and 2013 growth forecasts for the euro area slightly upwards.

The temporary build-up in Serbia's external imbalances in the first quarter gave rise to depreciation pressures.

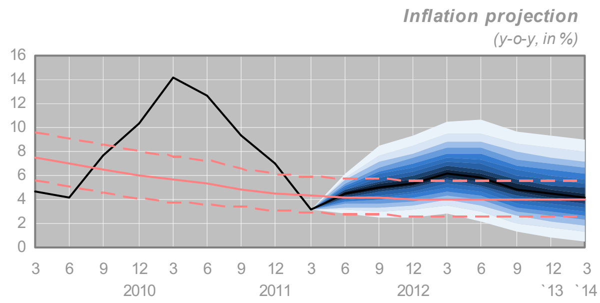
Modest capital inflow in the first quarter was not sufficient to cover the growing current account deficit. Increased external imbalances weighed down on the dinar. The foreign exchange demand of bank clients gathered pace, as did government spending. Depreciation pressures were also fuelled by the negative news such as postponing of the review of the arrangement with the International Monetary Fund and the US Steel's departure from Serbia. Depreciation pressures were to a degree moderated by the positive news of the EU candidate status for Serbia and affirmation of the country's credit rating by Standard&Poor's.

Monetary policy measures support macroeconomic stability and will enable the future Government of the Republic of Serbia to resume and intensify fiscal consolidation and structural reforms.

The monetary policy stance became expansionary in the first quarter of 2012. Still, following a cut to 9.5% in January, the key policy rate has not been lowered further given the steady rise in inflationary pressures. These pressures are largely driven by uncertainties underlying the current phase of the political cycle in Serbia. The National Bank of Serbia intervened in the Interbank Foreign Exchange Market by selling foreign exchange from February onwards and amended the Decision on Banks' Required Reserves in April by lowering the foreign exchange reserve requirement ratios and raising the share of foreign exchange required reserves to be allocated in dinars. These measures support macroeconomic stability and will enable the future Government of the Republic of Serbia to resume and intensify fiscal consolidation and structural reforms. In view of the expected fiscal consolidation and structural reforms that will help reduce the external imbalances, we are likely to see a weakening in depreciation pressures in the coming period, but also lower demand-side pressures in the short run, i.e. a short-term slowdown in the expected economic growth.

Inflation will move within the target tolerance band over the forecast period, temporarily overshooting its upper bound in the first half of 2013.

Based on the May projection, year-on-year inflation is expected to revolve around the lower bound of the target tolerance band in the early second quarter of this year and rise steadily thereafter, temporarily overshooting the



upper bound of the target tolerance band in the first half of 2013. Inflation is expected to return within the target tolerance band in the second half of 2013. Inflation growth from the second half of 2012 onwards will be driven chiefly by the new agricultural season, rising import prices and the expected faster growth in administered prices following the formation of the future Government of the Republic of Serbia. Working in the opposite direction will be low aggregate demand as the key disinflationary factor.

The future path of the key policy rate will depend primarily on the pace and intensity of fiscal consolidation and the continuation of the arrangement with the International Monetary Fund.

Taking into account the inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the future path of the key policy rate will depend primarily on the pace and intensity of fiscal consolidation and the continuation of the arrangement with the International Monetary Fund. The risks are also associated with food and administered prices and developments in the international environment.

II. Monetary policy since the February *Report*

Following a cut to 9.5% in January, the key policy rate has been kept on hold. The NBS intervened in the IFEM by selling foreign exchange from February onwards and amended the Decision on Banks' Required Reserves in April.

The key policy rate has been kept on hold since January, when it was lowered by 25 bp to 9.5%. While the sluggish economic recovery and falling inflation expectations support further monetary easing, uncertainty over international developments, rising import prices and domestic fiscal policy urge caution in deciding on the level of the key policy rate.

In line with earlier NBS projections, y-o-y inflation continued down and has been moving within the target tolerance band since the start of the year. As set out in the February Report, inflation was projected to temporarily subside in early Q2 to around the lower bound of the target tolerance band, and then trend up within the tolerance band. Inflation was projected to peak close to the upper bound of the target tolerance band in H1 2013, and then gradually fall back to the target.

The analyses underlying policy decision-making in March indicated that the consumer price growth would be driven primarily by the prices of fruit and vegetables and non-food products and services. At the same time, depreciation pressures gathered pace amid stronger demand for foreign exchange, increased government spending since late last year, growing foreign trade deficit, dampened capital inflows, and psychological factors induced by unfavourable news (postponed review of the arrangement with the IMF and the US Steel's departure from Serbia). The depreciation pressures were to a degree moderated by the EU's positive decision on candidate status for Serbia and affirmation of the country's credit rating by Standard&Poor's. On the other hand, Serbia was facing a probable downward revision of real GDP growth for 2011 and a likely drop in real GDP in Q1 on account of the emergency situation caused by the extremely cold weather in February and poor economic activity indicators.

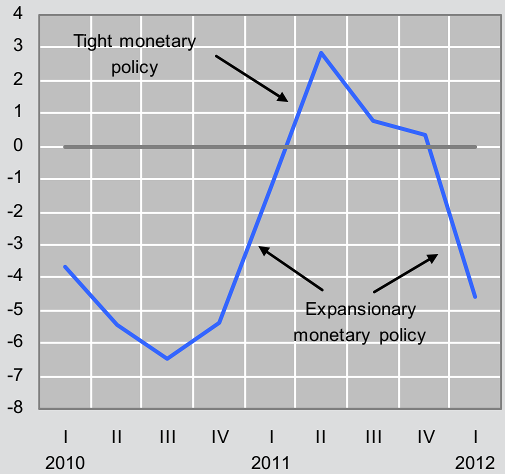
Notwithstanding the disinflationary impact of low aggregate demand, the NBS Executive Board voted at its March meeting to keep the key policy rate unchanged given the rising import prices and the risks stemming from international environment and the fiscal policy at home. The Executive Board noted again that compliance with the fiscal responsibility rules was critical to safeguarding the country's macroeconomic stability.

At the time of its April meeting, the Executive Board was aware that March inflation had fallen to 3.2% y-o-y and approached the lower bound of the target tolerance band. Nearly all sectors reported lower inflation expectations. The estimate for real GDP growth was revised down for 2011 (from 1.9% to 1.6%), but remained unchanged for 2012 (0.5%) consistent with the assumption that the almost certain drop of real GDP in H1 would be compensated for in H2. Serbia's risk premium continued to fall under the impact of somewhat eased tensions in the euro area and the affirmed credit rating by Standard&Poor's.

Deciding to keep the key policy rate on hold, the Executive Board expressed its expectation of inflation reaching its minimum level in April (around the lower bound of the target tolerance band), and subsequently rising back towards the target. Low aggregate demand was cited as the key disinflationary factor in the coming period. The decision to keep the key policy rate unchanged was determined by the uncertain outlook for import prices and the new agricultural season, and by the likely faster growth in administered prices in the second half of the year.

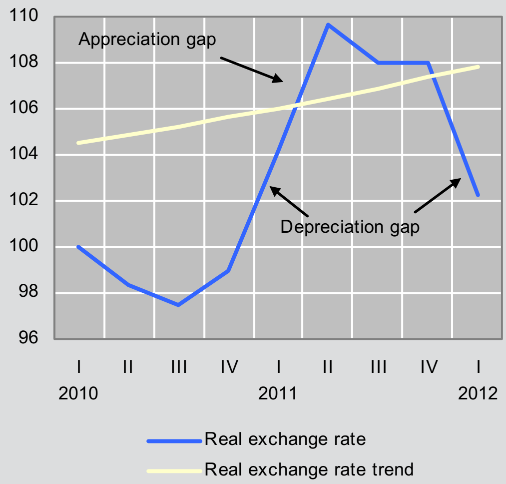
At its April meeting, the Executive Board also adopted amendments to the Decision on Banks' Required

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



Monetary policy tightness decreased from Q2 2011 and turned into expansion in Q1 2012.

Chart II.0.2 **Real exchange rate and its trend**
(base index, Q1 2010 = 100)



The depreciation gap of the real exchange rate opened in Q1.

Reserves with the National Bank of Serbia. The amendments envisaged lowering of the FX reserve requirement ratio by 1 pp to 29% for funding sources of up to 2 years and by 3 pp to 22% for sources of over two years. Also, the share of FX required reserves allocated in dinars was raised by 5 pp – to 20% for funding sources of up to two years, and 15% for sources of over two years. The measure aims to contribute to the stabilisation of inflation and foreign exchange market movements, to support moderate lowering of borrowing costs and facilitate refinancing, and to additionally stimulate banks to use longer-term sources of funding.

After reviewing current economic developments and the latest inflation projection at its meeting in May, the Executive Board voted to keep the key policy rate unchanged. The Board highlighted that y-o-y inflation continued down. In line with earlier announcements, it was expected to trough in April at around the lower bound of the target tolerance band. However, in light of the expected moderate rise in y-o-y inflation from May onwards on the back of the new agricultural season, past growth in import costs, and the anticipated rise in administered prices in the second half of the year, the Executive Board decided to keep the key policy rate on hold.

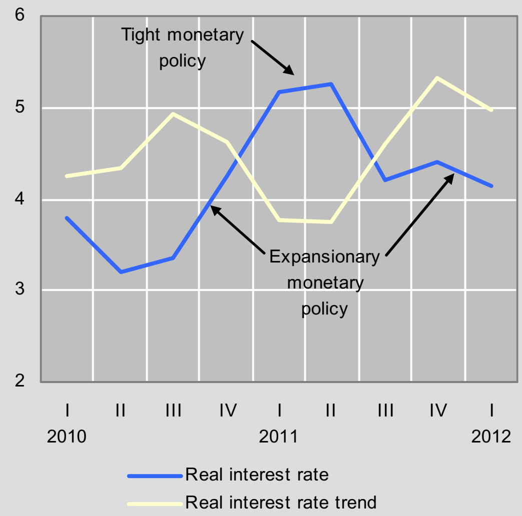
Based on the May projection, y-o-y inflation will record a steady rise in H2 2012, briefly overshoot the upper bound of the target tolerance band in H1 2013, and return within it in H2 2013. Low aggregate demand will continue to be the key disinflationary factor.

The Executive Board underlined that that the future path of the key policy rate would largely depend on the speed and intensity of fiscal consolidation to be undertaken by the future Government, as well as on the continuation of the arrangement with the IMF. Price and financial stability can be delivered at a lower level of monetary restrictiveness if the efficiency of fiscal consolidation and structural reforms improves.

The real Monetary Conditions Index (MCI) suggests that monetary tightness weakened as inflationary pressures receded in H2 2011 and that it turned into expansion in Q1 2012.This is indicated by both MCI components – opening of the depreciation gap of the real exchange rate and the real interest rate running below the neutral level (trend).

The depreciation gap of the real exchange rate opened in Q1 as average nominal depreciation of the dinar against the euro exceeded the difference between domestic and euro area inflation.

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



The real interest rate has been running below its neutral level since Q3 2011.

Similar to the previous quarter, real two-week BELIBOR rate was running below its neutral level by around 85 bp. It fell in Q1 as its nominal average decline outpaced the drop in inflation expectations. Real interest rate trend also fell due to the drop in country risk premium and the continuing downward trend of real interest rates in international money markets.

To ease excessive daily volatility of the exchange rate and ensure smooth operation of the foreign exchange market, the NBS intervened in the IFEM by selling EUR 498.5 mln in Q1. The Executive Board judges that the Q1 depreciation pressures were temporary and that the expected fiscal consolidation and structural reforms in the coming period will contribute to the stabilisation of the exchange rate of the dinar.

III. Inflation developments

Y-o-y inflation returned within the target tolerance band in early 2012, chiefly on the back of a y-o-y decline in unprocessed food prices.

It is expected to trough at around the lower bound of the target tolerance band in early Q2 and to gradually rise thereafter, but will stay within the target tolerance band until end-Q2.

Inflation developments in Q1

Q1 inflation reached 2.0%, chiefly on the back of rising prices of unprocessed food and petroleum products.

Consistent with our expectations, y-o-y inflation continued down and returned within the target tolerance band already in January. At 3.2% in March, it was moving above the lower bound of the target tolerance band (2.9%). In quarterly terms, y-o-y inflation declined by 3.8 pp, of which falling food prices accounted for 3.5 pp.

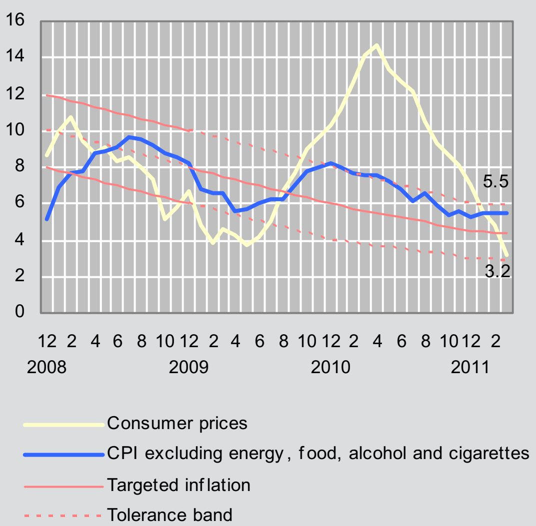
Consumer prices rose by 2.0% in Q1, chiefly on the back of rising prices of unprocessed food, petroleum products, cigarettes, automobiles and flat rentals. The increase was higher than expected in the past *Inflation Report*, largely owing to a higher rise in prices of unprocessed food and petroleum products.

Prices of food and non-alcoholic beverages were up by 2.0%, almost wholly reflecting a rise in **unprocessed food prices** (7.5%). Prices of fresh fruit and vegetables and eggs accounted for the major part of the unprocessed

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

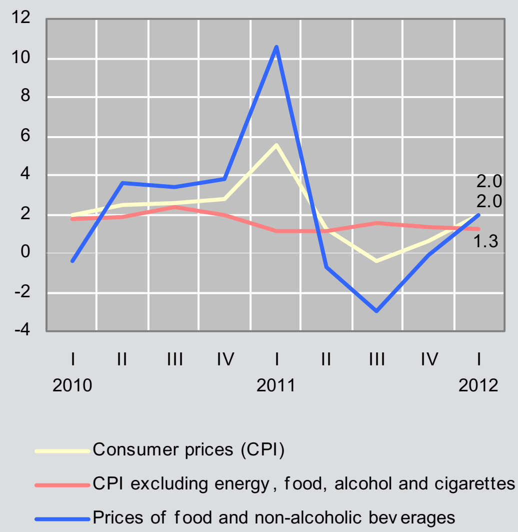
	2011				2012
	I	II	III	IV	I
Consumer prices (CPI)	5.5	1.2	-0.4	0.6	2.0
Unprocessed food	14.0	-5.4	-8.3	0.7	7.5
Processed food	8.9	1.8	-0.4	-0.5	-0.7
Industrial products excluding food and energy	3.3	0.9	0.8	1.1	2.1
Energy	1.8	6.9	1.0	1.1	2.9
Services	1.6	0.6	2.1	1.0	1.2
Core inflation indicators					
CPI excluding energy	6.3	0.1	-0.7	0.5	1.8
CPI excluding energy and unprocessed food	4.9	1.2	0.7	0.5	0.8
CPI excluding energy, food, alcohol and cigarettes	1.1	1.1	1.6	1.4	1.3
Administered prices	4.7	4.1	0.4	0.9	1.3

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



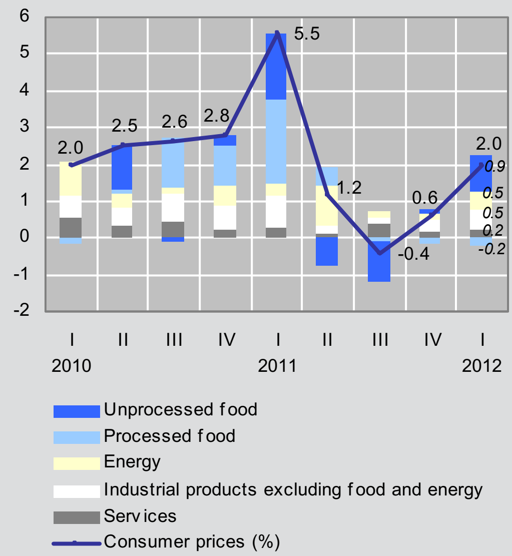
Y-o-y inflation continued down and moved within the target tolerance band in Q1.

Chart III.0.2 **Price movements**
(quarterly rates, in %)



Prices of food and non-alcoholic beverages rose in Q1.

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



The main boost to consumer price growth in Q1 came from unprocessed food prices.

food price growth. A sharper than seasonal rise in prices of eggs was prompted by extremely cold weather, rising prices of fodder and the application of new EU regulations making it impossible to compensate for the drop in supply through imports.

Processed food prices were cut (as expected) by 0.7% in Q1, thanks mainly to lower prices of products with margins capped by the government decree.

Prices of industrial products, excluding food and energy were up by 2.1% of which the strongest growth was recorded for passenger vehicles (exchange rate indexed) and cigarettes (due to regular adjustment of excises for inflation).

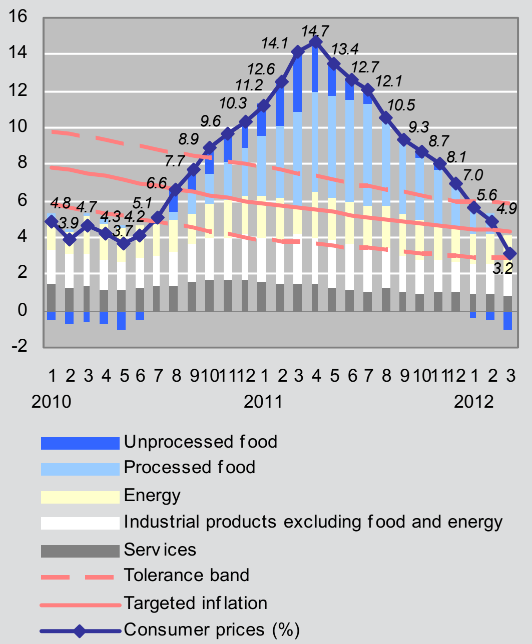
In regard to **energy**, the sharpest rise was noted for fuel, lubricants and coal. As global oil prices hiked and the dinar went up against the dollar, petroleum product prices jumped by 8.9%. Cold weather in February brought about a 5.1% rise in coal prices.

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

	VI 2011 / VI 2010	IX 2011 / IX 2010	XII 2011 / XII 2010	III 2012 / III 2011
Consumer prices	12.7	9.3	7.0	3.2
Domestic industrial producer prices	15.8	12.3	9.7	5.9
Agricultural producer prices	28.6	11.6	3.0	0.9

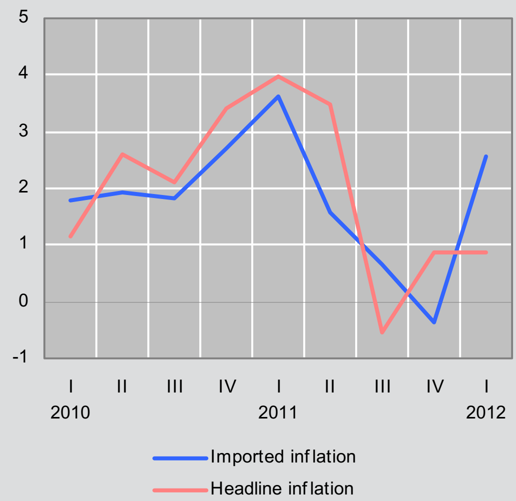
A rise in **services prices** (1.1%) was driven mainly by higher prices of flat rentals (exchange rate indexed). An increase was also observed for prices of transportation services, water and waste disposal.

Chart III.0.4 **Contribution to y-o-y consumer price growth**
(in percentage points)



A y-o-y drop in unprocessed food prices gave the key contribution to a decline in Q1 inflation.

Chart III.0.5 **Domestic and imported inflation***
(quarterly rates, in %)



Sources: NBS and Eurostat.

* Ratio of averages for two consecutive quarters.

A rise in import prices in Q1 did not largely spill over to consumer prices.

Consumer price index, excluding energy, food, alcohol and cigarettes, commonly used to measure core inflation, rose somewhat less (1.3%) than in Q4. In y-o-y terms, it accelerated mildly to 5.5%. This indicates that this component of inflation (on which monetary policy has the strongest impact) has been stable for quite a while. The strongest contribution to this component came from prices of flat rentals, household chemicals and passenger vehicles.

Administered prices were up by 1.3% in response to rising prices of cigarettes and utilities services. Administered prices added mere 0.3 pp to headline inflation in Q1. In y-o-y terms, they decelerated to 6.9%.

Domestic industrial producer prices sped up to 3.0%[1] in Q1 reflecting a rise in prices of energy and intermediate goods. The major boost came from the sectors of crude oil and natural gas exploitation, and the production of chemicals and chemical products. Y-o-y growth in domestic industrial producer prices slackened to 5.9% by end-Q1.

Agricultural producer prices[2] also increased in Q1 (9.8%), chiefly due to rising prices in the field of farming (13.9%), and to a lesser degree in the sector of cattle breeding. The strongest contribution to the quarterly growth came from prices of cereals, notably corn and wheat, accounting for a half of the price hike. In March, agricultural producer prices gained 0.9% y-o-y.

We estimate **import prices**[3] to have risen by 2.6%[4] in Q1, primarily owing to higher energy prices (oil and natural gas). Further, import prices of production inputs (equipment and intermediate goods) went up, making room for strengthening of cost-push pressures on domestic producers of finished products. A positive contribution to a rise in import prices was also provided by a hike in global food prices. Much of the growth in import prices in Q1 has not yet spilled over to consumer prices as low aggregate demand does not leave much scope for importers to compensate for elevated costs by greater price adjustment.

[1] Domestic industrial producer prices rose by 0.4% in Q4 2011.

[2] Producer prices in agricultural and fishery sectors.

[3] Used as an indicator of import prices is the weighted average of global oil and food prices, the index of industrial producer and consumer prices in Germany which is our major foreign trade partner.

[4] The ratio of two consecutive quarter averages.

Inflation expectations

Inflation expectations were declining throughout Q1. In March, one-year ahead expectations of the financial sector entered the target tolerance band.

Concurrent with inflation lowering towards the target, expectations of economic agents continued to decline in Q1 and came close to the inflation target.

According to the Bloomberg survey, in the first two months of 2012, inflation expectations of the **financial sector** remained at the December 2011 level (6.0%), but were revised down by 0.2 pp in March. Expectations temporarily picked up in April to 6.2%, only to enter the target tolerance band in May (5.5%).

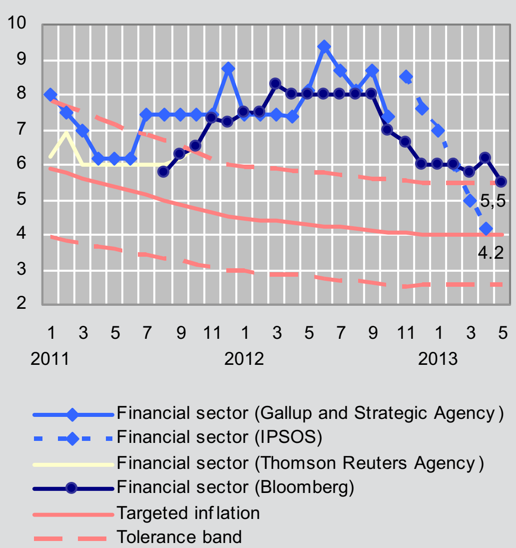
The Ipsos survey also indicates a decline in inflation expectations of all sectors. **Financial sector** representatives were revising down their expectations throughout Q1 – at 5.0% in March, expectations entered the target tolerance band. Relative to end-2011, a downward revision was observed for the **corporate sector** (2.9 pp) – 5.6% in March. After four months of stagnation, **household** expectations also fell in March – by 2.0 pp to 8.0%. **Trade union** expectations picked up in January by 0.8 pp to 10.0% and stayed unchanged until end-Q1. All sectors further revised down their expectations in April. **Financial sector** expectations fell to 4.2%, those of the **corporate sector** to 4.5%, and expectations of the **household** and **trade union** sectors to 5.0%.

Inflation outlook for Q2

Y-o-y inflation is expected to trough and stay around the lower bound of the target tolerance band in early Q2. Until the quarter-end, inflation will move within the target tolerance band.

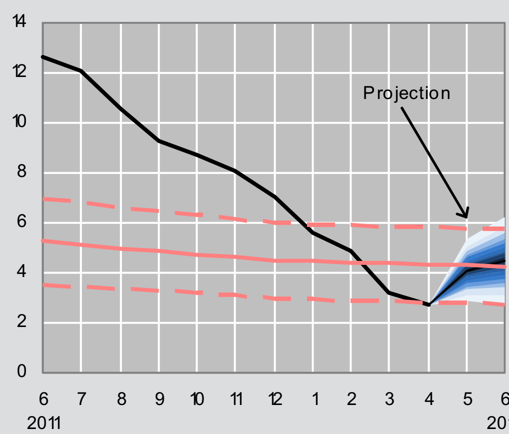
Y-o-y inflation will continue down and trough in April close to the lower bound of the target tolerance band. The further decline in y-o-y inflation will to a great measure be prompted by the continuing effect of the high last year

Chart III.0.6 **One-year ahead expected and targeted inflation**
(y-o-y rates, in %)



Financial sector inflation expectations stayed within the target tolerance band at end-Q1.

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



Inflation will trough in April, around the lower bound of the target tolerance band. It will move within the target tolerance band until end-Q2.

base. In May and June, it will rise under the impact of the supply of seasonal fruits and vegetables as currently low prices of some products from this group can be attributed to the application of the imputation method.[5]

In quarterly terms, Q2 inflation is likely to slightly outpace the rate recorded in Q1. The main boost will come from rising prices of **unprocessed food**, primarily fruit and vegetables with the coming of the new agricultural season.

Q2 is likely to record a higher contribution of **processed food** prices as their pace of growth may accelerate on the back of heightened cost-push pressures triggered by higher prices of primary agricultural commodities.

Prices of industrial products, excluding food and energy, and prices of services will grow by more or less as much as in Q1. At the same time, inflationary pressures prompted by rising import prices are likely to neutralise the disinflationary pressures stemming from low aggregate demand.

In terms of energy, the expected growth in prices will be lower than in Q1 since prices of petroleum products, following their April rise, will decline in May and June owing to plummeting global oil prices and the government's decision to temporary cut excises.

No major adjustments in **administered prices** are likely in Q2. The strongest growth is expected for prices of medicaments reflecting the adjustment for the nominal exchange rate of the dinar.

Risks to the short-term projection are balanced and relate to the effects of the new season on fruit and vegetable prices and developments in the international environment.

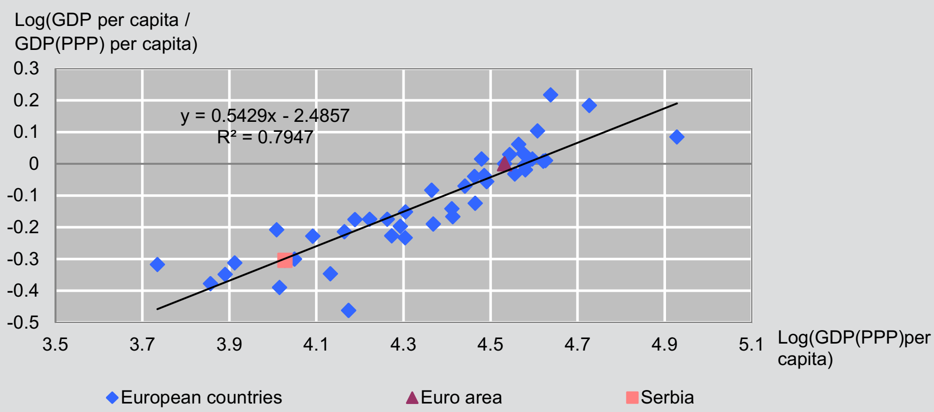
[5] See Text box 1 of the February 2012 *Inflation Report*.

Text box 1: Income and price conversion of Serbia and euro area countries

Since the introduction of the inflation targeting regime, inflation targets have been set to reflect a gradual disinflation process aimed at achieving low and stable inflation without triggering macroeconomic instability. In setting the inflation targets for 2013 and 2014[1], account was taken, among other things, of the degree of economic and price convergence of Serbia and euro area countries. The fact that the process of economic, and consequently, price convergence (along with price deregulation) will not be completed over the next two years, also reflected on the level of the set targets. As a result, Serbia's inflation targets will continue to be higher in the period ahead than those set by developed economies (2.0% or 2.5%).

The analysis of economic convergence tested the linear relationship between income and prices in Serbia and in European countries.[2] The results revealed a strong positive correlation between the level of income (x) and the level of prices (y), i.e. that more developed economies are characterized by a higher level of prices. Based on data on European countries for 2011, the level of prices in Serbia can be said to have matched the income level. The estimated linear relationship ($y = -2.4857 + 0.5429x$) shows that income convergence to the euro area of 1% leads to price convergence (real appreciation) of 0.54% over the long run. To the extent that this is the result of the convergence process, faster price growth in Serbia relative to the euro area is inevitable over the long run. Consequently, a target inflation of 4.0% at a GDP growth rate of 4.0% would not create additional pressures in the foreign exchange market over the medium run.

Chart O.1.1 **Ratio of income and price levels in European countries, euro area and Serbia in 2011**



Source: IMF WEO (September 2011).

However, the convergence of Serbian prices to EU27 was lower in the first months of 2012 than in 2011. According to the most recent analysis, in March 2012 headline prices in Serbia amounted to 52% of the average in EU27 countries, the same as at end-2010. In the selected group of countries[3], Serbia is second only to Bulgaria as the country with the

[1] See Appendix 1, p. 47.

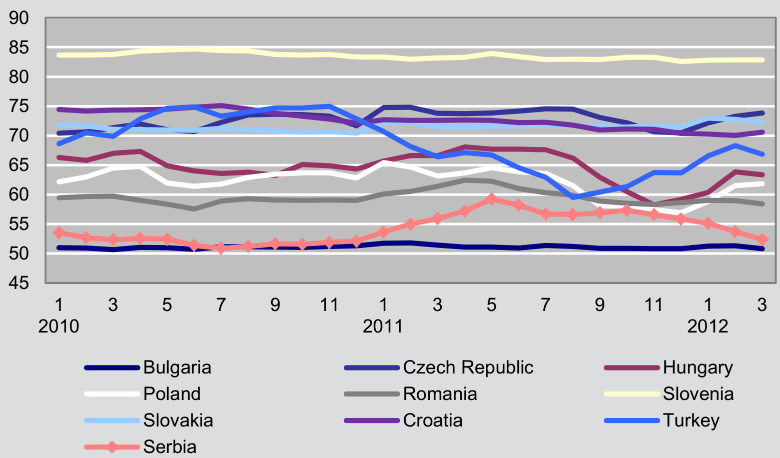
[2] Income was measured by GDP per capita based on purchasing power parity (log (GDP(PPP) per capita)). Price level was measured as the relationship between GDP per capita and GDP per capita based on purchasing power parity (log (GDP per capita /GDP(PPP) per capita). Data were transformed so that the euro area should represent the base.

[3] Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovenia, Slovakia, Croatia, Turkey and Serbia.

lowest headline prices compared to the European average. Thus, Serbia recorded the lowest prices of energy (electricity, gas, liquid and solid fuels), food, furniture and carpeting, postal and telecommunications services and equipment, and alcohol and cigarettes, and the highest prices of clothing and footwear, compared to other reviewed countries.

Increased convergence of Serbian prices to EU27 in 2011 resulted primarily from the agricultural shock that affected food prices in Serbia more than in other countries. This induced a rise in the convergence of prices of this group of products. As the effects of the shock waned, however, the degree of convergence subsided. Indeed, the latest statistics show that food prices in Serbia are the lowest among the reviewed countries. Increased convergence of prices of major home appliances, small home appliances, audio, DVD and TV sets during 2011 resulted primarily from a cheapening of these products in the European Union.

Chart O.1.2 **Headline prices by country**
(EU27 = 100)



Sources: NBS and Eurostat.

Chart O.1.3 **Prices of specific groups of products by country**
(EU27 = 100)

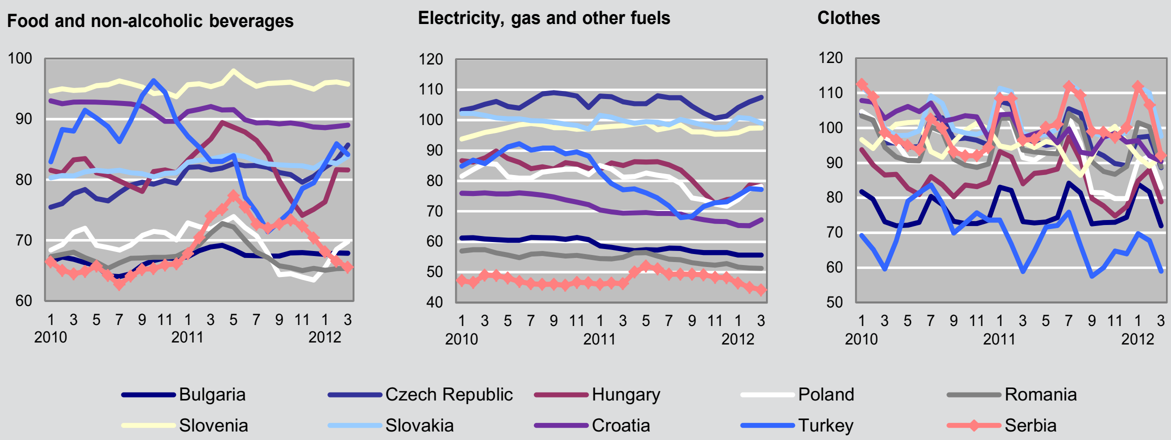
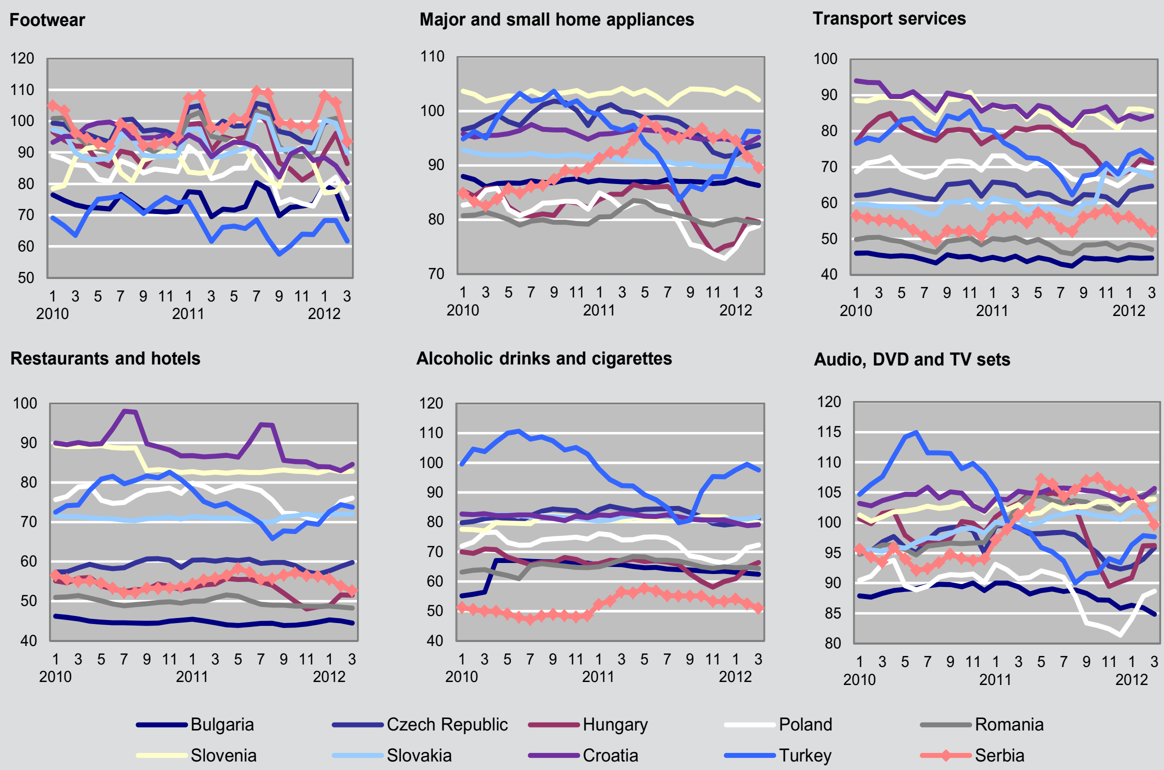


Chart O.1.3 **Prices of specific groups of products by country**
(EU27 = 100)



Sources: NBS and Eurostat.

IV. Inflation determinants

1. Money and capital market trends and bank lending

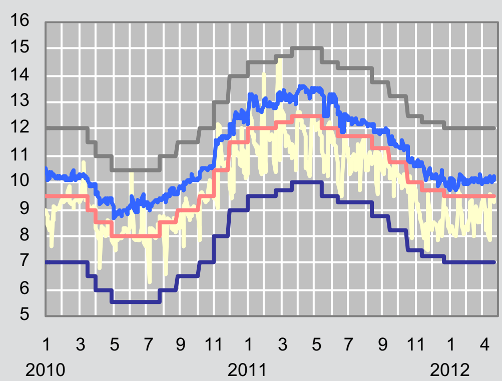
Interest rates

Nearly all dinar interest rates declined from a quarter earlier. Shorter-maturity rates in the government securities market experienced sharper cuts. Falling until March, rates on dinar loans trended up thereafter.

Throughout Q1, BEONIA was recording a mild rise from its low December 2011 values as dinar liquidity was dampened by NBS interventions in the IFEM. Still, the banking sector continued to operate at a satisfactory level of dinar liquidity, as confirmed by BEONIA trending below the key policy rate. Consistent with a moderate decline in banking sector dinar liquidity, an increase was recorded in trading volumes in the overnight interbank money market.

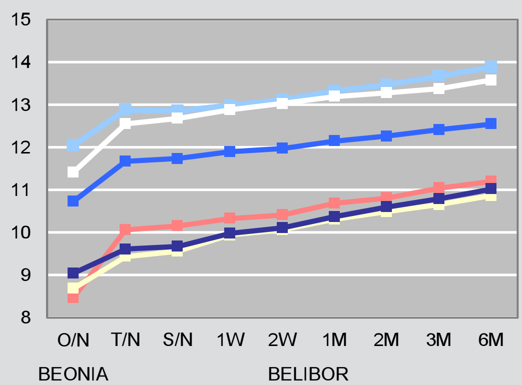
In contrast to BEONIA, BELIBOR rates shifted down in Q1, particularly for shorter maturities. BELIBOR TN touched 9.4% on average in March, which is below the key policy rate. The average monthly values for other maturities ranged from 9.6% to 10.9% in March, down by between 0.3 and 0.4 pp on end-2011. Owing to a faster drop in the shortest-maturity rates, the spread went up by between 0.3 pp and 1.4 pp.

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



Despite its mild rise, BEONIA continued to trend below the key policy rate.

Chart IV.1.2 **Yield curve in the interbank money market**
(average values, p.a, in %)



In contrast to BEONIA, BELIBOR rates declined in Q1.

In April, all interbank money market rates edged up in response to somewhat lower banking sector liquidity. The average rate for BEONIA rose by 0.4 pp to 9.1%, while BELIBOR rates increased by up to 0.2 pp depending on maturity.

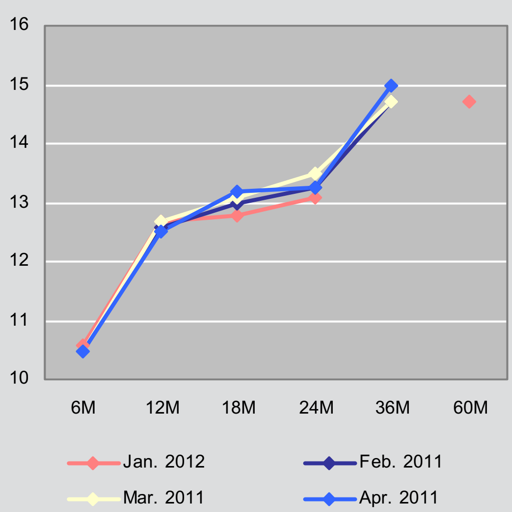
A hefty fall was also recorded for shorter-maturity accepted rates in the primary market of dinar government securities. Relative to the closing auctions of 2011, 6-month and 1-year rates dropped by 0.4 pp and 0.3 pp respectively, while 18-month and 3-year rates lost 0.2 pp each. Only the 2-year rate rose 0.2 pp compared to the previous November 2011 auction. A 5-year auction of government securities was held for the first time in January, which led to further lengthening of the dinar yield curve. The accepted rate came at 14.7%, equalling the rate recorded at 3-year securities auctions held in February and March.

Shorter-maturity accepted rates fell reflecting the key policy rate cuts, as well as the government's intention to reduce the supply of shorter-maturity securities. The last auction of 3-month securities was held in October 2011. Auctions of 6-month securities are held once a month with volumes limited to RSD 6.0 bln. In Q1, the government offered securities in the nominal value of RSD 127.4 bln (of which RSD 109.4 bln was open for trading by non-residents as well), while in Q4 2011 it offered RSD 79.3 bln. Bolstered performance, at higher issue volumes, also contributed to falling longer-maturity accepted rates. Market performance increased as foreign investor participation stepped up from Q4. Better risk perception and amended regulations envisaging equal tax treatment of non-residents led to their return to the government securities market.

Movements in April accepted rates on government securities were rather similar to those displayed in Q1. The 6-month rate stayed the same, while 1- and 2-year rates lost 0.2 pp each. Rates for 18-month and 3-year maturity rose slightly (by 0.1 pp and 0.3 pp respectively).

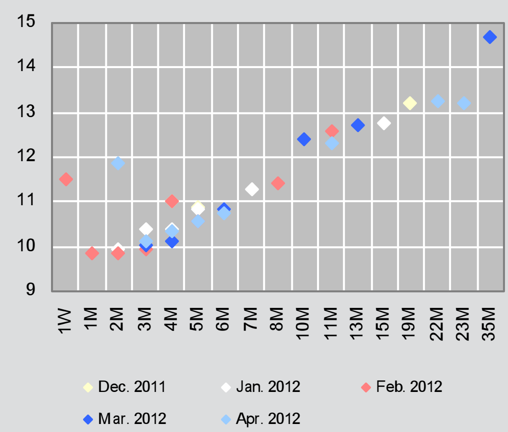
The first issue of euro-denominated 1-year government securities in the amount of EUR 200.0 mln matured in Q1. The government then offered a new series of the same maturity, worth EUR 120.0 mln nominally – EUR 55.2 mln were sold at 5.95%. The March auction of 2-year securities in the nominal value of EUR 50.0 mln closed at 6.1% with maximum performance.

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



Most interest rates recorded a mild drop in Q1.

Chart IV.1.4 **Yield curve in the secondary market of government securities***
(weighted average values, p.a., in %)



* All trading above RSD 5 mln in the secondary market of government securities.

Trading volumes in the secondary market picked up, while the yield to maturity rates declined.

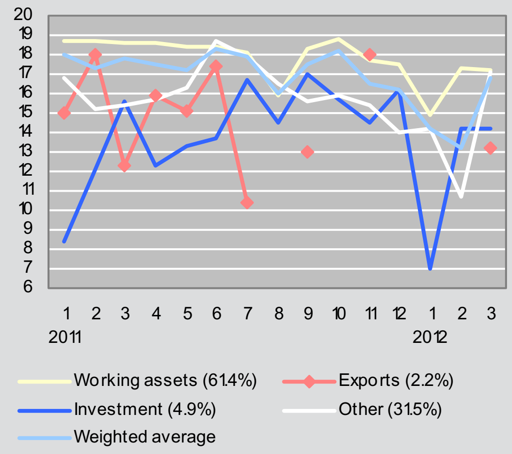
Positive developments were also observed in the secondary market – trading volumes went up and the yield to maturity rates declined. Total secondary trading in government dinar securities amounted to RSD 40.2 bln in Q1 and was generally prompted by movements in the primary market. Excluding trading 2 business days after the primary trading settlement date, trading volumes came at RSD 22.7 bln. April volumes amounted to RSD 5.0 bln, while up to 6-month yield to maturity rates picked up.

The weighted average rate on new dinar corporate and household loans was up 0.9 pp to 18.0% in Q1 mainly on account of rising rates on 'other loans'. However, a decline was noted for rates on special-purpose dinar corporate and household loans in Q1 – rates on dinar investment and current assets loans were down 2.0 pp and 0.2 pp respectively. In the household sector, rates on consumer loans dropped by 2.0 pp although only a negligible amount of such new loans was approved.

FX and FX-indexed[6] loans were extended at lower rates in January and February, which can be associated with a mild decline in EURIBOR and ECB's refinancing operations (3-year loans to banks at a 1% rate). However, as these rates rose in March, the weighted average rate reached 8.0%, up by 0.3 pp on December 2011. A small increase was observed for rates on most corporate loans, while a drop was recorded only for import loans and 'other loans' categories. The price of investment and current assets loans grew by 0.2 pp and 0.1 pp respectively. The interest rates on FX and FX-indexed household loans went up reflecting a rise in rates on housing loans. In contrast, rates on consumer and other loans declined.

Interest rates on new dinar term deposits of households stayed unchanged from end-Q4 2011 (9.7%), while rates on corporate deposits fell by 0.6 pp to 9.1%. The rate on new euro deposits declined in Q1 – to 4.3% for households, and 3.7% for the corporate sector in March.

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

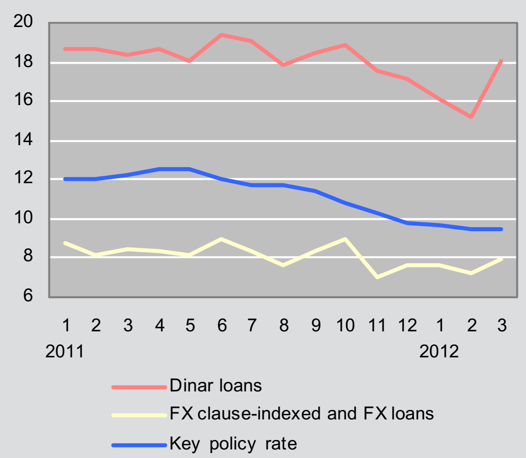


* Excluding revolving loans, current account and credit card overdrafts.

Note: The brackets contain the share of a type of loans in total new loans over the past year.

The downward tendency in rates on dinar loans continued in Q1, apart from the 'other loans' category.

Chart IV.1.5 **Interest rates on new corporate and household loans***
(weighted average values, p.a, in %)



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

Rates on dinar loans were declining until March when they recorded a rise.

[6] The average share of newly approved corporate and household loans at variable rates equalled 93.1% in Q1.

Stock exchange trends

Despite a long-awaited recovery on the Belgrade and most other regional stock exchanges in Q1, the trends deteriorated again in April.

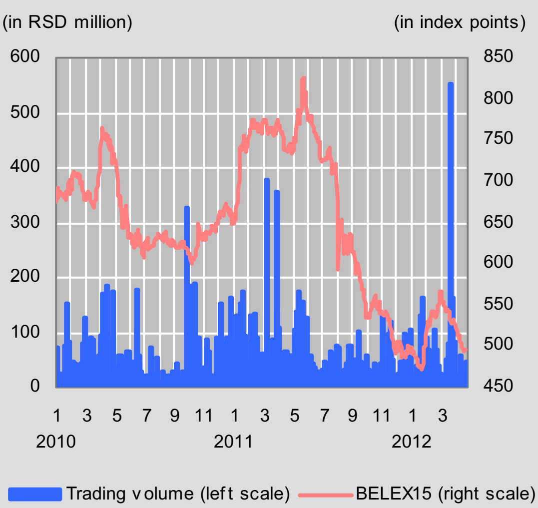
A downward trend in shares of companies listed on the Belgrade Stock Exchange (BSE), set in train by mid-2011, came to a halt in Q1. After rising in February, BSE indices moderated down in March. By end-Q1, BELEX15 and BELEXline rose by 6.6% and 5.3% to 531.9 and 1029.0 points respectively.

Such movements were generally shaped by global factors. Varying central bank measures directed at further monetary policy easing brought about a faster than expected rise on the world main stock exchanges.

Total BSE trading reached RSD 5.4 bln, down by 14.5% from Q4 2011. Trading in shares remained broadly unchanged on the previous quarter, while trading in bonds receded. More active on the purchase- than sale-side, foreign investors bought 8.6% net of total trading in shares.

Trading in frozen FX savings bonds amounted to RSD 1.3 bln, down by 41.9% on Q4 2011. A2015 (30.8%) and A2012 series (25.3%) bonds were most traded. At end-Q1, the yield to maturity ranged from 5.4% for A2013-series to 8.1% for the series maturing in May 2012.

Chart IV.1.7 **BELEX 15**

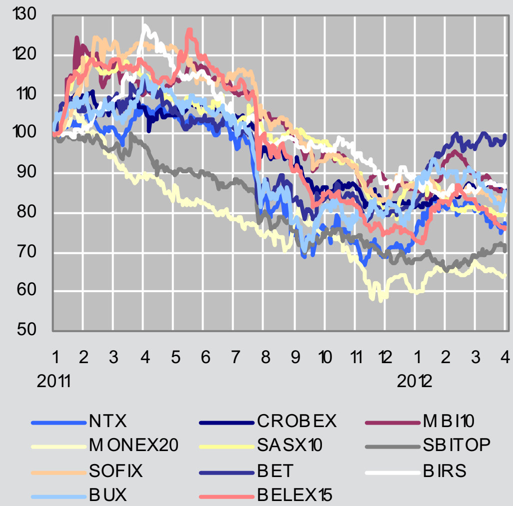


Source: BSE.

Despite rising BELEX15 in Q1, trends in April indicate that we still cannot talk with certainty about market recovery.

Chart IV.1.8 **Stock exchange indices across the region**

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



Indices recovered on most regional stock exchanges.

Driven by rising prices of shares, market capitalisation was up RSD 34.1 bln from end-2011 to RSD 851.5 bln by end-March (its share in GDP rose by 1.0 pp to 26.7%). Dinar's depreciation buoyed the capitalisation of frozen FX savings bonds.

On a rise across the region, indices on the Bucharest (BET 23.9%) and Budapest (BUX 9.8%) stock exchanges recorded the sharpest growth in Q1. In contrast, shares plummeted in Bosnia and Herzegovina (SASX10 3.6% and BIRS 4.7%) and Sofia (SOFIX 4.1%).

In April, all indices observed tumbled down. The steepest drops were noted for BSE indices – BELEX15: 7.7% and BELEXline: 5.3%. Despite this, BELEXsentiment (118.1 points in April) indicates optimism of market participants regarding future trends. Other regional indices lost 1.6% on average, with Sofia indices recording the deepest fall (2.3%) and those in Ljubljana the smallest (0.7%).

Monetary aggregates

After recording stronger than seasonal growth in Q4 2011, money supply contracted in Q1. Y-o-y, accelerated growth in money supply was discontinued in March.

By end-Q1, overall reserve money contracted q-o-q – 7.5% nominally or 11.0% in real terms. Dinar reserve money lost 13.1% and 14.8% in nominal and real terms, respectively.

Dinar reserve money declined (RSD 29.6 bln) on the back of both NBS's net foreign and net domestic assets. In January, reserve money was withdrawn mainly through open market operations. In February and particularly in March (when the bulk was withdrawn), NBS's interventions in the interbank FX market were the main vehicle of withdrawal. The government contributed to the issue of reserve money in Q1 as well, though to a smaller extent than in the quarter before. In March, it continued spending from its accounts with the NBS (mainly FX), while banks made further investments into repo securities – their stock peaked in early February at RSD 138.9 bln. These investments did not subside earlier than by mid-March, resulting in a RSD 116.2 bln repo stock in late Q1, down by RSD 4.3 bln q-o-q.

Within the structure of dinar reserve money, currency in circulation declined by RSD 7.3 bln, though remaining above the November 2011 levels (when the government stepped up spending its FX deposits). Bank reserves fell by RSD 25.9 bln due to dented excess reserves held with the NBS, while dinar required reserves rose by RSD 3.7 bln.

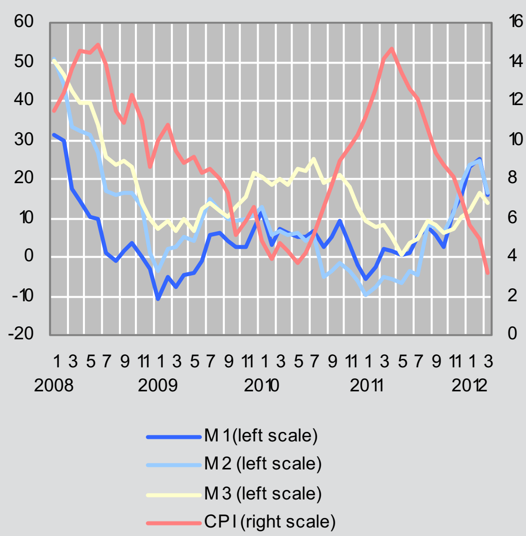
Money supply saw a sharper than seasonal drop in Q1. Dinar monetary aggregates M1 and M2 lost 11.1% and 10.6% in real terms respectively, while the broadest aggregate M3 declined by real 4.2%. Y-o-y, accelerated growth in money supply was discontinued in March – relative to end-Q1 2011, M1, M2 and M3 rose by 12,2%, 12,7% and 8.5% in real terms respectively.

M3 withdrawal in Q1 reflected a drop in net foreign assets of the NBS to a greater and of banks to a lesser extent. NBS's net foreign assets declined mainly as a result of the central bank's interventions in the interbank FX market. Bank lending, chiefly to the corporate and household sectors, prompted the creation of M3. The government also made its contribution to M3 creation by spending

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

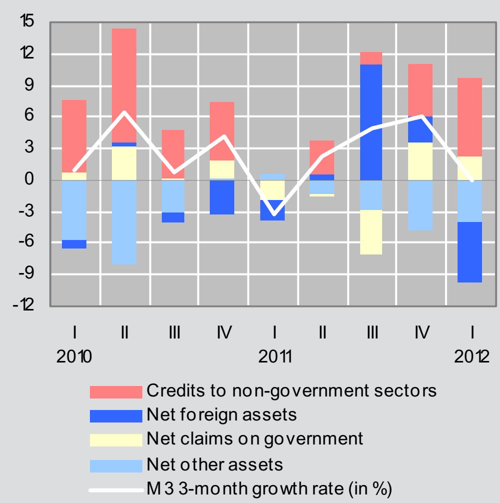
	2011			2012	Share in M3 March 2012
	June	Sep.	Dec.	March	(in %)
M3	5.2	11.8	11.0	8.5	100.0
FX deposits	9.2	13.5	7.4	5.1	70.3
M2	-14.7	-1.5	11.1	12.7	29.7
Time and savings dinar deposits	-20.4	1.4	15.5	13.4	11.9
M1	-10.2	-3.4	8.4	12.2	17.8
Demand deposit	-7.5	-3.1	3.9	4.0	10.6
Currency in circulation	-14.7	-4.0	16.3	27.3	7.1

Chart IV.1.9 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Growth in money supply stopped in March.

Chart IV.1.10 **Contribution to M3 growth**
(in percentage points)



Lending activity gave the strongest contribution to the creation and net foreign assets to the withdrawal of M3.

deposits in NBS accounts and enhanced borrowing via securities issues.

All money supply components declined in Q1. A smallest drop was recorded for currency in circulation, which is attributable to households' preference to keep assets in their most liquid form. Dinar transactions and savings deposits generally declined (RSD 20.0 bln and RSD 15.6 bln) in response to the withdrawal of funds from corporate accounts. The economic slack, typical for early year, and additionally fuelled by unfavourable weather conditions, triggered a decline in corporate account balances. FX corporate deposits fell for the same reason.

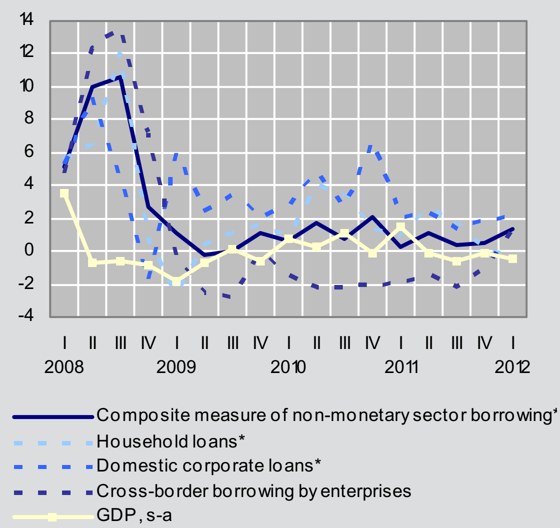
Household dinar and FX saving continued up in Q1 – RSD 1.3 bln and EUR 78.8 mln respectively, with households opting rather for up to 1-year savings.

Monetary multiplier rose slightly q-o-q, reflecting a faster decline in bank excess reserves than dinar deposits.

The velocity of circulation lessened in Q1 as well, though to a smaller extent than in the past period. Unlike H2 2011 when it decelerated due to rising money supply, the velocity of circulation slowed in Q1 owing to a weaker rise in domestic prices and the economic downturn.

The growth in dinar and FX deposits in April drove up the broader monetary aggregates.

Chart IV.1.11 **Loans and GDP**
(quarterly rates, %)



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

Domestic loans rose at a slower pace than in Q4 2011. After quite a while, enterprise external borrowing stepped up.

Bank lending

Bank lending rose at a slower pace in Q1 compared to a quarter earlier. Household borrowing declined, while enterprise external borrowing stepped up after quite a while.

Under the composite measure[7], total lending rose faster in Q1 than in the quarter before. After quite a while, owing to increased external borrowing by enterprises, foreign borrowing, in addition to borrowing at home, had a positive impact on overall borrowing.

Down by 0.2 pp q-o-q, real domestic lending[8] grew 1.3% in Q1. Corporate lending rose by 2.1%, while household lending dropped by 0.2%. Nominally, total bank lending was up RSD 104.7 bln. Excluding the exchange rate effect, lending rose by RSD 22.1 bln.

Y-o-y lending continued up at a slower pace. Real y-o-y growth rate for domestic loans came at 7.4% in March, down by 0.4 pp from December 2011.

The share of domestic loans in GDP increased by 3.1 pp to 57.4% at end-March.

Bank lending was for its major part financed from domestic sources, mainly by the withdrawal of required reserve FX balances held by banks with the NBS. A positive contribution to lending also came from contracted net external claims. In contrast to earlier periods, the contribution of deposits to bank lending was negative given a decline in dinar and FX corporate deposits (the loan-to-deposit ratio was up 7.4 pp to 133.0% in Q1). At the same time, banks continued to invest a part of their disposable liquidity into safer assets, such as repo and government securities.

[7] As an indicator of total borrowing, it covers domestic lending to the private sector and public enterprises and enterprise cross-border borrowing.

[8] As of this *Inflation Report*, real growth in lending to companies, public enterprises, households, non-profit organisations, other financial organisations and local authorities will be monitored.

Bank claims on corporate loans rose by RSD 75.2 bln, or RSD 22.4 bln excluding the exchange rate effect. The rise was due to increased lending in January when more loans were extended to companies. February and March developments were less favourable. Though current assets loans remained dominant, the share of corporate investment loans was rising. The amount of newly approved investment loans in Q1 outstripped the levels recorded in H2 2011. The disbursement of import and export loans was somewhat higher than in Q4 2011. Most loans were extended to the transportation sector. Trade and industrial companies received less loans compared to a quarter earlier. Weather conditions and negative trends in construction affected lending in this sector.

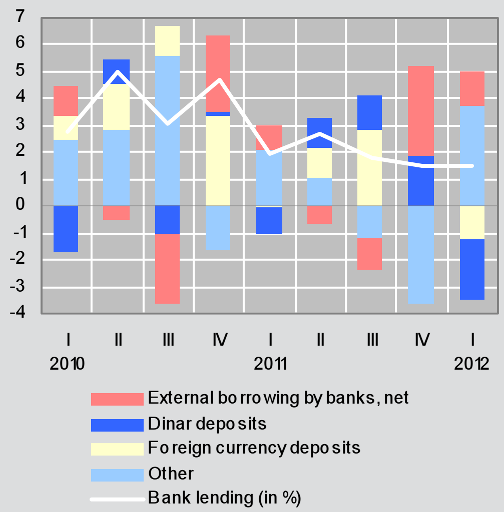
After quite a while, enterprise cross-border borrowing went up by EUR 126.0 mln (mainly "Telekom Srbija"). Further, enterprises continued to tap external trade loans[9] (EUR 107.6 mln).

Household lending declined in Q1. Nominally, claims under household loans rose RSD 26.2 bln, but were down RSD 1.1 bln excluding the exchange rate effect. The extension of housing loans continued at satisfactory dynamics, while the disbursement of other types of loans declined. Borrowing under consumer and cash loans and credit cards contracted. The use of current account overdrafts was somewhat higher than in the prior quarter.

Activity abated in the subsidised segment of the lending market as well. Subsidised lending approved in Q1 (RSD 0.9 bln) was almost entirely channelled into housing loans. Extension of agricultural loans started in March, while the extension of loans for military members is likely to begin in Q2 under the terms agreed for this year.

The share of dinar in total loans fell by 1.3 pp to 27.9% in March. The share of dinar loans declined in both the corporate and household sectors, though more sharply in the corporate sector. Excluding the exchange rate effect, the degree of dinarisation in the household sector continued up. We expect the implementation of the *Memorandum on the Strategy of Dinarisation of the Serbian Financial System*[10], signed by the NBS and the RS Government, to bolster dinar lending.

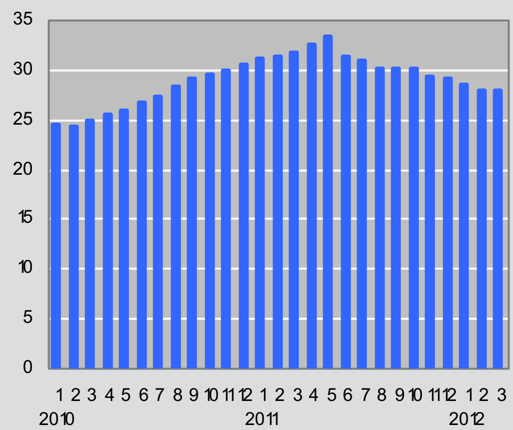
Chart IV.1.12 **Contributions to quarterly rate of lending growth***
(in percentage points)



* Excluding the effect of exchange rate changes.

The contribution of private sector saving to financing of lending activity was negative in Q1.

Chart IV.1.13 **Share of dinar in total bank receivables on corporate and household sectors**
(%)



The share of dinar receivables contracted further.

[9] Given the specifics of trade loans, they are not covered by the composite measure of lending.

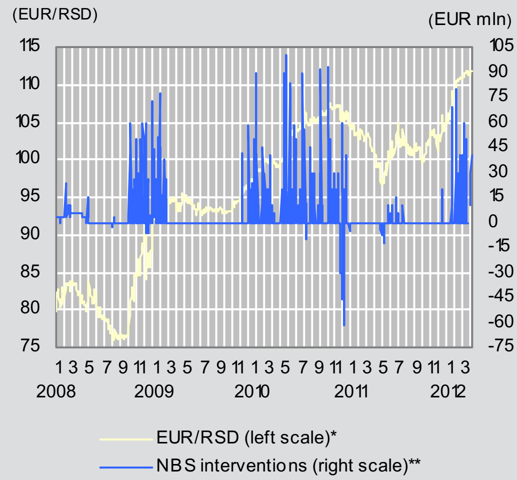
[10] http://www.nbs.rs/internet/english/30/MemorandumVladaDinarizacija_20120406_eng.pdf.

Table IV.1.2 **Subsidised loans**
(in RSD bln)

	2011				2012
	Q1	Q2	Q3	Q4	Q1
Government Programme of Measures to Ease the Effects of the Global Financial Crisis					
	27.0	**59.0**	**7.9**	**-**	**-**
Subsidised housing loans					
	0.9	**1.3**	**2.0**	**2.0**	**0.9**
Subsidised military loans					
	n.a.	**0.2**	**0.5**	**0.5**	**-**
Subsidised farmers' loans					
	n.a.	**n.a.**	**2.7**	**3.7**	**0.0**

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

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



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

In Q1, the National Bank of Serbia intervened by selling foreign exchange in the IFEM.

The loan repayment capacity, measured by the NPL share in total loans, deteriorated mildly on end-2011. According to preliminary data, the total NPL share, under the gross principle, totalled 20.1% in March (11.3% under the net principle). Broken down by sector, the NPL shares changed somewhat from end-2011. The NPL share in the corporate sector fell by 0.3 pp to 22.1%.[11] Household loan arrears were up by 0.3 pp to 8.3% in March 2012.[12] Despite a high NPL share, other relevant indicators point to the stability of the banking sector – the capital adequacy ratio came at 17.3% in March, while the loan loss reserves to NPL ratio equalled 127.1%.

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

Movements in the foreign exchange market were marked by depreciation pressures and interventions of the National Bank of Serbia. The exchange rate of the dinar stabilized towards end-Q1.

Depreciation pressures in place since late 2011 continued in Q1. The dinar lost 5.5% on average against the euro. The exchange rate ranged from 103.7 in mid-January to 111.4 dinars per euro on the last day of March. The dinar slid more sharply against the dollar, by 8.0% on average. The nominal effective exchange rate of the dinar[13] depreciated on average by 6.0% and the real effective exchange rate by 5.5% (4.9% against the euro and 8.0% against the dollar).

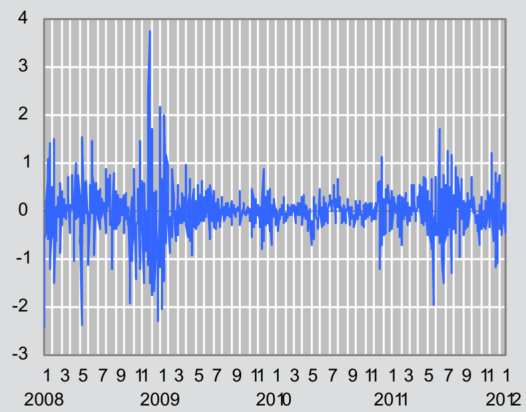
Q1 depreciation pressures resulted from increased demand from enterprises for foreign exchange against the background of lower export receipts. The increase in demand was primarily caused by the need to provide foreign exchange funding for energy imports which swelled on account of extremely cold weather. Weaker economic activity and transport related problems caused by adverse weather led to a poorer export performance. Postponed completion of the review under the arrangement with the IMF, US Steel's departure from Serbia and a downward revision of the economic growth forecast for 2011 all played a role in the weakening of the dinar. Foreign capital inflows were also low. The

[11] One of the reasons for a high NPL share is the unfavourable tax treatment of their direct write-off, which is why banks perform direct write-off only after all prior legal actions are concluded (cashing the collateral, conclusion of bankruptcy proceedings etc). Court proceedings often span several years, have an uncertain outcome and involve the accompanying costs.

[12] Including entrepreneurs, loan arrears rose by 0.5 pp to 9.9%.

[13] Weights used: 0.8 for the euro and 0.2 for the dollar.

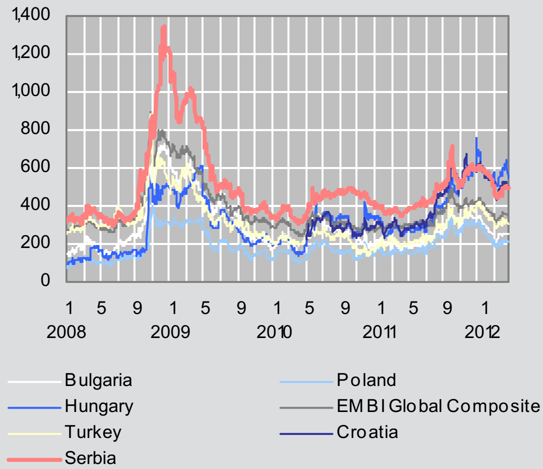
Chart IV.2.2 **Daily changes in EUR/RSD exchange rate***
(in %)



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

Daily oscillations of the dinar exchange rate were stronger in Q1 relative to Q4 2011, but moderated from one month to another.

Chart IV.2.3 **Risk premium indicator – EMBI by country**
(daily data, in basis points)



Source: JP Morgan.

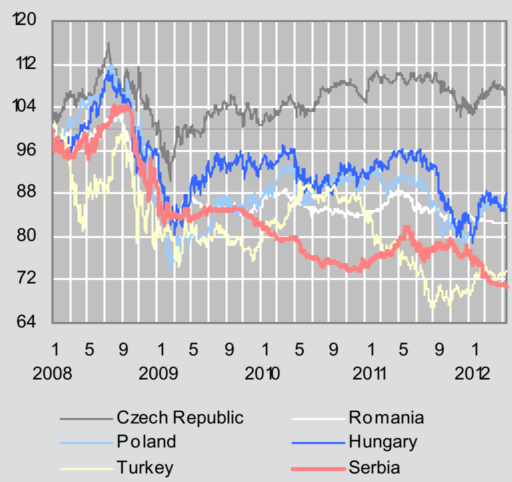
In Q1, EMBI decreased for all countries of the region, with Serbia recording the sharpest fall of this index.

government continued to tap on its accounts with the National Bank of Serbia, maintaining high dinar liquidity and spurring foreign exchange demand. Foreign cash purchases were lower by one third than in Q4 2011, mostly as a reflection of decreased inflow of remittances.

Although IFEM trading volumes were higher on average in Q1 than in Q4 2011, average daily trading fell from one month to another down to EUR 46.2 million in March. Similarly, average daily oscillations of the exchange rate also moderated in Q1. To ensure smooth functioning of the foreign exchange market, the National Bank of Serbia sold EUR 188.5 mln in the IFEM in February, compared to EUR 310.0 mln in March. In order to provide impetus to the development of the interbank swap market, the National Bank of Serbia continued organizing three-month foreign exchange swap auctions, buying EUR 87.0 mln and selling EUR 100.0 mln in Q1.

Risk premium movements were broadly similar across the region. Following an increase until mid-January, risk premium was on a decline until mid-March when it rebounded slightly. A general decline in risk premium can

Chart IV.2.4 **Movements in exchange rates of national currencies against the euro**
(daily data, December 31, 2007 = 100)



*Growth indicates appreciation.

The dinar depreciated in Q1, while currencies of most other countries of the region appreciated.

be attributed to an easing of tensions in the euro area and liquidity creation through ECB's three year long-term refinancing operations. At the end of March, EMBI for Serbia was 467 bp. It fell by 134 bp in Q1, decreasing more than EMBI Global (84 bp), but also more than EMBI for other reviewed economies. The award of official EU candidate status to Serbia and Standard&Poor's affirmation of Serbia's credit rating determined a more positive perception of the country risk compared to regional peers in Q1.

A mild increase in the value of EMBI Global and EMBI for most countries of the region, apparent since mid-March, continued in April. Although Serbia saw the highest increase (31 bp), its risk premium (498 bp) is still lower than the risk premiums for Hungary and Croatia.

The currencies of most countries of the region appreciated against the euro in Q1. Apart from the dinar, the only other currency to depreciate against the euro was the Romanian lei (by 1.4%).

The dinar depreciated against the euro by 0.6% on average in April, with the National Bank of Serbia intervening in the IFEM. Depending on the speed and intensity of fiscal consolidation and structural reforms that ought to even out external imbalances, the dinar exchange rate is expected to level off in the period ahead.

Foreign capital inflow

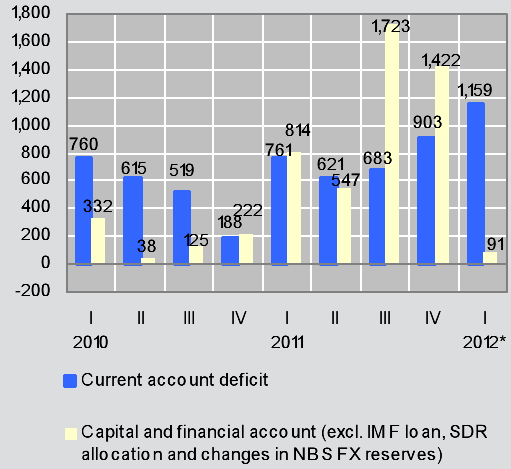
External imbalances worsened in Q1, triggering depreciation pressures. By contrast to earlier quarters, capital inflows were not sufficient to meet the current account deficit financing needs.

Meagre capital inflows in Q1 were not sufficient to cover a widening current account deficit. Q1 saw an inflow of portfolio and other investments, and an outflow of FDI.

Net outflow of FDI (EUR 371.6 mln) refers to the telecommunications sector – the repurchase of shares of the Telekom Srbija enterprise from a foreign investor (EUR 380.0 mln) and the withdrawal of a portion of invested capital by another mobile telephony operator (EUR 122.7 mln). On the inflows side, Q1 saw smaller-scale investments in processing industry, trade, construction, communications, real estate business, financial activity and insurance.

After auctions of government securities were resumed, an improved risk perception and Standard&Poor's affirmation of Serbia's credit rating encouraged a rise in foreign investment relative to Q4 2011. As a result, even with a significant volume of euro-denominated government securities falling due, Q1 saw a net inflow of portfolio investment of EUR 75.8 mln. Still, this is lower than in the corresponding period a year earlier (EUR 519.9 mln).

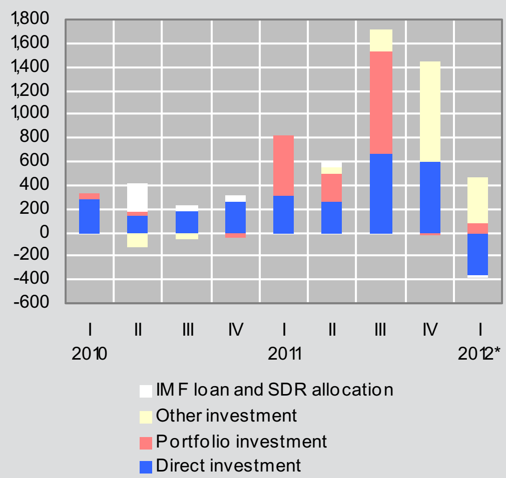
Chart IV.2.5 **Current account deficit and net capital inflow**
(in EUR mln)



*Preliminary data.

Capital inflows were not sufficient to cover a widening current account deficit.

Chart IV.2.6 **Structure of the financial account**
(in EUR mln)



*Preliminary data.

Capital flows in Q1 were marked by net outflow of FDI.

Net debt in respect of financial loans declined during Q1. By contrast to Q4 2011, banks repaid more loans than they took out, which resulted in a net outflow of EUR 149.7 mln. Net foreign borrowing by enterprises increased by EUR 126.0 million, primarily on account of loan disbursement by Telekom Srbija. Net government borrowing rose by EUR 5.2 mln – most of the inflow of EUR 97.2 mln came from the disbursement of EIB loans, while payments falling due on foreign obligations resulted in an outflow of EUR 92.0 mln.

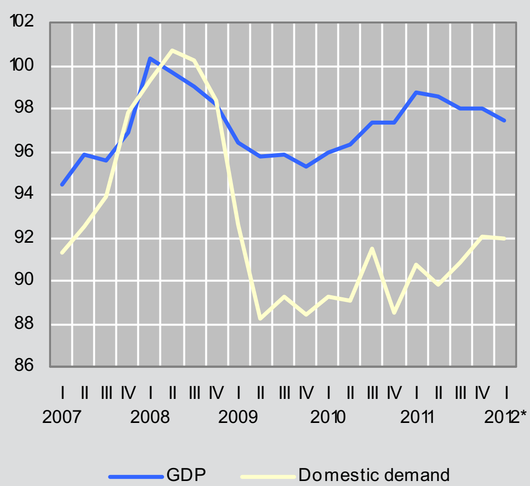
Despite a drop in net borrowing, Q1 saw an inflow of other investments due to a temporary withdrawal of banks' funds from accounts abroad in order to comply with the requirement regarding maximum exposure to a connected person (5% of capital).

3. Aggregate demand

Aggregate demand is estimated to have dropped in Q1, mostly on account of falling net exports.

GDP growth of 1.6% in 2011 was driven by rising investment in export-oriented sectors, while final consumption and net exports contributed negatively. The negative contribution of net exports resulted from increased imports of equipment for investment in export-oriented sectors.

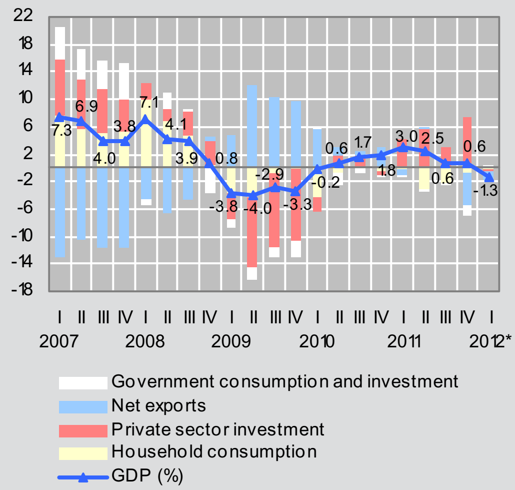
Chart IV.3.1 **GDP and domestic demand**
(s-a, H1 2008 = 100)



* NBS estimate.

Dwindling domestic demand contributed to lower GDP in Q1.

Chart IV.3.2 **Contribution to y-o-y GDP growth rate – expenditure side**
(in percentage points)



* NBS estimate.

Y-o-y decline in GDP in Q1 resulted primarily from a fall in net exports.

Aggregate demand continued to subside in Q1 as a result of shrinking in both domestic and net external demand. On the domestic demand side, household and government consumption were on the up, while private investments recorded a decline.

Observed year-on-year, aggregate demand fell in Q1 for the first time after seven successive quarters. This is estimated to have resulted from a continuing y-o-y decline in net external demand and household consumption, as well as lower private investments. Government consumption and investments made a positive contribution.

According to the projection of the National Bank of Serbia, GDP will grow by around 0.5% in 2012. GDP growth will be driven by a rise in exports which is expected to gain momentum in H2.

Domestic demand

Household consumption

Household consumption edged up in Q1.

Household consumption is estimated to have risen by 0.1% s-a in Q1, giving a positive contribution to GDP (0.1 pp). Higher consumption is signalled primarily by an

Table IV.3.1 **Investment indicators**

	2005-2008 (average)	2011				2012
		Q1	Q2	Q3	Q4	Q1
Real indicators *(seasonally-adjusted, quarterly, growth, in %)*						
Construction	2.2	3.1	3.0	0.4	0.8	-2.3 *
Industrial production of capital goods (physical volume)	-6.5	18.0	-18.8	-9.1	6.2	12.6
Exports of capital goods**	29.3	-0.4	-1.8	9.5	-0.8	3.1
Imports of capital goods**	11.2	23.4	-11.8	6.5	3.4	-8.1
Stocks of capital goods	-1.6	49.2	0.9	-3.2	-13.8	-3.3
Industrial production of intermediate goods (physical volume)	3.9	6.6	-1.1	-2.9	-3.0	-4.7
Exports of intermediate goods**	17.6	15.6	-7.4	-2.5	0.4	-7.0
Imports of intermediate goods**	15.4	8.3	0.0	-5.7	-0.1	8.6
Stocks of intermediate goods	0.5	2.7	-3.4	-2.6	-4.4	-1.3
Government investment***	16.2	-2.5	-7.9	-3.9	-5.2	0.0
Financial indicators						
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	528.8	-213.2	-169.0	-58.5	11.8	126.2
Domestic long-term credits to enterprises (in RSD bln)	43.3	8.9	43.6	35.3	47.1	48.3
of which: investment loans	n.a.	-6.4	7.0	11.0	21.5	37.1
Domestic long-term credits to households (in RSD bln)	78.9	-9.1	19.9	5.2	16.0	21.7

* NBS estimate.

** Exports and imports are denominated in euros.

*** Government investment spending is deflated by the industrial producer price index.

upturn in retail trade turnover, as the key indicator of household consumption, which is estimated to have upped by 3.0% s-a in Q1.

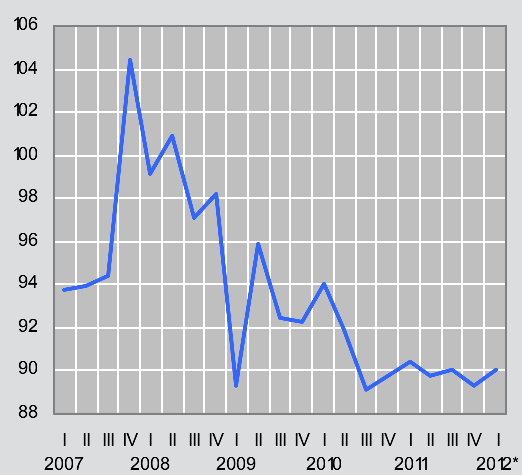
Household real income from wages, pensions and social benefits, as their main source of consumption financing, increased in Q1 (by 1.1% s-a), mostly as a result of wage hikes. Remittances also rose in real terms s-a in Q1, while fewer consumer loans were disbursed during the period under review.

Private sector investments

Private sector investments subsided in Q1.

Private sector investments are estimated to have dropped by 1.4% s-a in Q1, contributing negatively to GDP movements by 0.3 pp. The decline was due to a fall in fixed investments (0.3 pp). Investments in current assets (stock building) fell marginally.

Chart IV.3.3 **Government spending**
(s-a, H1 2008 = 100)



* NBS estimate.

Government consumption increased in real terms in Q1.

The decline in fixed investments is signalled by lower construction activity on account of extremely cold month of February and by a drop in imports of capital goods.

Government consumption

Government consumption went up in Q1, while its investments remained stagnant.

Government consumption gave a positive contribution to economic activity in Q1 (0.1 pp). Government investments, on the other hand, remained stagnant.

Government consumption is estimated to have risen by 0.8% s-a in Q1, as indicated by increased outlays for purchase of goods and services and a hike in public sector wages.

Government investments are expected to level off in Q1, as signalled by s-a movements in budget capital expenditures.

Net external demand

Reflecting a rise in imports and a fall in exports, net external demand recorded a decrease in Q1.

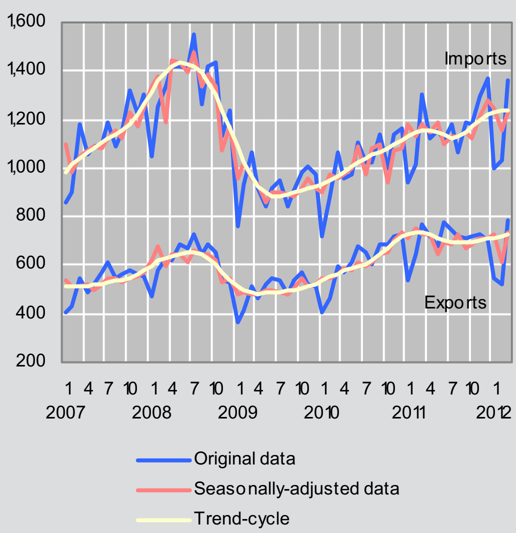
With real s-a exports of goods and services falling (0.3%) and imports rising (0.5%), foreign trade made a negative contribution to GDP movements in Q1 (0.4 pp).

Y-o-y, foreign trade also contributed negatively to GDP (1.1 pp) as imports of goods and services increased by 1.5% and exports declined by 0.6%.

In euro terms, s-a exports of goods slumped by 1.4% in Q1 as a result of bad weather in February and extraordinary domestic circumstances.[14] The steepest fall was registered for exports of base metals, chemicals and chemical products, while exports of agricultural products and electrical equipment increased.

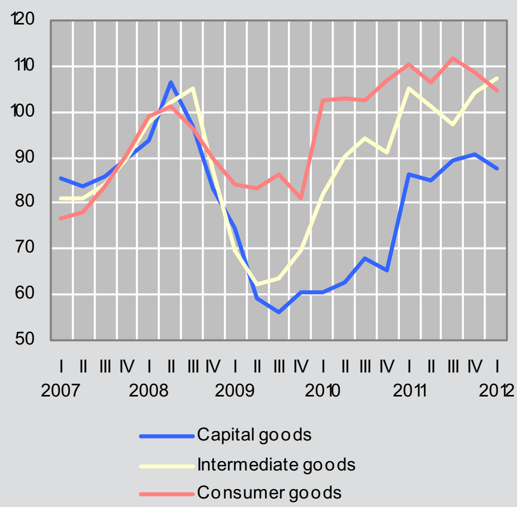
At the same time, the euro value of imports of goods rose by 3.2% s-a. The structure of imports reflected unfavourable weather conditions. Increased energy imports contributed to the rise in imports of intermediate

Chart IV.3.4 **Exports and imports of goods**
(in EUR mln)



Net exports had a negative impact on GDP movements in Q1 as imports rose and exports fell.

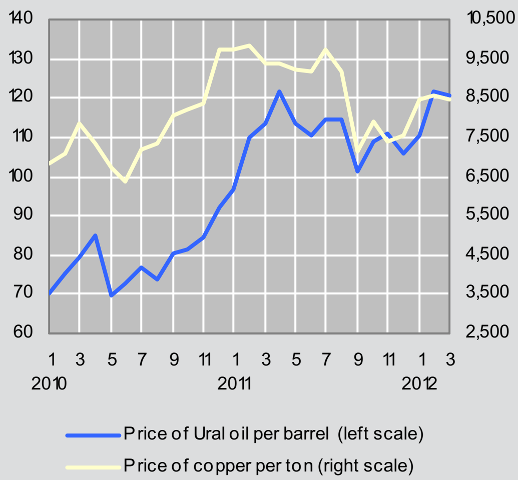
Chart IV.3.5 **Imports by key components**
(s-a, H1 2008 = 100)



Imports of intermediate goods increased in Q1, while imports of capital and consumer goods subsided.

[14] See Text box 2, p. 33.

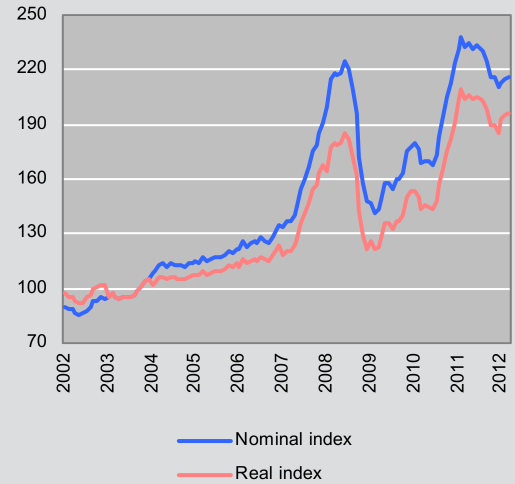
Chart IV.3.6 **Oil and copper price movements**
(in USD)



Source: *Bloomberg.*

Prices of oil and copper increased in Q1.

Chart IV.3.7 **World food price index**
(2002 - 2004 = 100)



Source: FAO, UN.

Food prices in the world maked upped slightly in Q1.

goods, while imports of equipment and consumer goods entered a decline.

Despite unfavourable movements in Q1, by the end of the quarter, exports were 17.0% higher and imports 9.6% lower than pre-crisis[15].

Climbing 8.2% on the previous quarter, oil prices reached their historical high in euros in Q1. The rise began in January and gathered momentum in February on the back of mounting geopolitical tensions in the Middle East, cold weather and positive signs in the US labour market. However, oil prices retreated by the end of the quarter as a result of the weakening in demand, prompted by China's lower imports, and increased oil supply following the opening of new oil fields in Saudi Arabia. Average oil prices are expected to be lower in 2012 than last year because of the possible recession in the euro area and the slowing of China's economic growth.

Copper prices rose by around 12% in Q1 relative to the previous quarter. The rise unfolded entirely in January and was triggered by demand-side factors: positive signs in the US labour market, the expected waning of the euro area crisis and the anticipated easing of China's monetary policy. The rise in copper prices was halted in February by the release of data on China's moderating growth in Q4 2011 and the renewed concerns over euro area debt crisis. They flatlined until the end of the quarter.

The FAO Food Price Index edged up by 2.4% in Q1 relative to the quarter before. The strongest growth was observed for prices of sugar, oils and cereals due to the delayed sowing season (cold weather) and the weakening of the dollar.

4. Economic activity

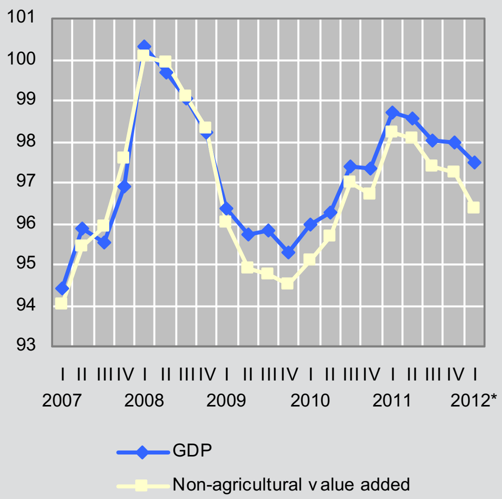
Economic activity is estimated to have contracted further in Q1. The negative output gap is widening.

Official statistics put real GDP growth in 2011 at 1.6%. Following a relatively strong upswing in H1, economic activity decelerated notably in H2, reflecting a slowdown in the euro area and South East Europe, which are Serbia's main foreign trade partners.

In 2012, GDP is expected to grow by a modest 0.5%. The Q1 fall in economic activity is likely to be offset by a

[15] H1 2008.

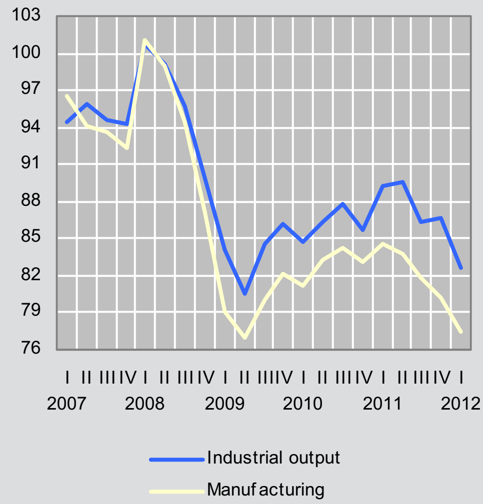
Chart IV.4.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



* NBS estimate.

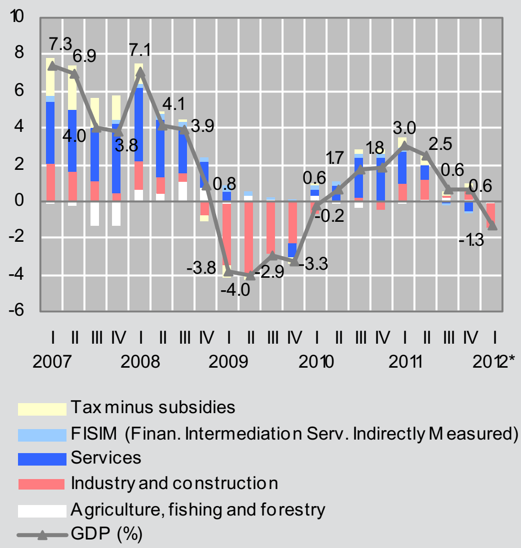
Both GDP and NAVA declined in Q1.

Chart IV.4.3 **Industrial output**
(s-a, H1 2008 = 100)



Total industrial production and manufacturing contracted in Q1.

Chart IV.4.2 **Contribution to y-o-y GDP growth rate – production side**
(in pp)



*NBS estimate.

Industry and construction made a negative contribution to y-o-y GDP movements in Q1.

rebound in industrial production starting from Q2, when the launch of production in black metallurgy and automotive industry are expected to produce positive effects.

GDP and NAVA are estimated to have declined by 0.5% and 0.9% s-a, respectively, in Q1. Economic activity was below its pre-crisis level (GDP –2.5%, NAVA –3.6%) from H1 2008.

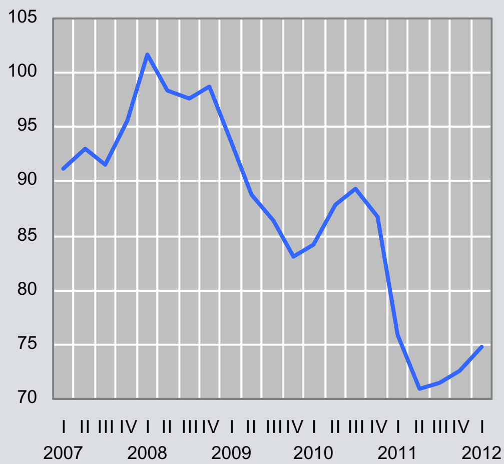
The GDP performance was weighed down by a sharp fall in industrial production caused by an extremely cold month of February and the one-month suspension of operations in the Smederevo Steel Plant.[16]

The physical volume of industrial production shrank by 4.6% s-a. All sectors of industry recorded a fall: manufacturing by 3.4% s-a (contribution 3.2 pp), mining by 5.2% s-a (contribution 0.5 pp) and electricity, gas and steam supply by 5.4% s-a (contribution 1.0 pp).

Within manufacturing, the greatest s-a drop of activity was recorded for production of base metals (contribution of 1.7 pp), coke and petroleum products (1.3 pp), basic pharmaceutical products and preparations (0.7 pp) and chemicals and chemical products (0.6 pp). The largest s-a

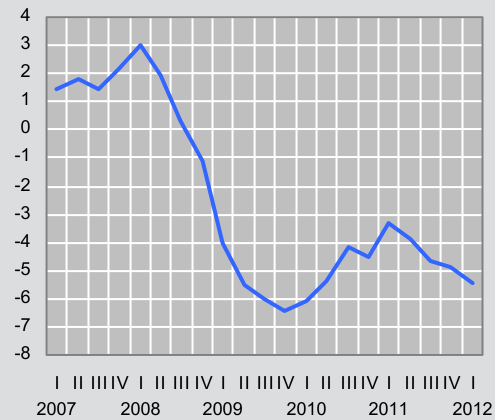
[16] See Text box 2, p. 33.

Chart IV.4.4 **Retail trade**
(s-a, H1 2008 = 100)



Retail trade increased marginally in Q1.

Chart IV.4.5 **Output gap***
(percentual deviation from the trend)



* NBS estimate based on Kalman filter.

The negative output gap widened further in Q1.

rise in output was recorded for rubber and plastic products (contribution 0.6 pp) and food products (0.3 pp).

Gross value added in construction is estimated to have contracted, as signalled by a fall in the production of non-metal minerals. A cold wave in February caused work on most construction projects to be suspended. Estimates are that both transport and warehousing recorded a fall in activity in Q1 for this very same reason.

Estimated gross value added in trade rose by 2.1% s-a in Q1, but remained 10.3% below the pre-crisis level. Retail trade turnover gained 3.0% in Q1.

According to preliminary estimates of the Statistical Office, GDP contracted by 1.3% y-o-y in Q1 after growing for seven successive quarters. According to NBS estimate, NAVA fell by 2.0% y-o-y. The greatest negative contribution was made by industrial production (1.2 pp), followed by trade (0.2 pp) and transport and warehousing (0.2 pp). The greatest positive contribution came from the information and communications sector (0.5 pp).

The fall in economic activity in Q1 induced a widening of the negative output gap, which could signal strengthening of disinflationary pressures stemming from aggregate demand. However, as potential GDP may be overestimated in periods of crisis (due to the erosion of production capacities and work skills of the long-term unemployed), the actual output gap may be lower than estimated. In that case, disinflationary pressures stemming from aggregate demand may actually turn out to be weaker than anticipated.

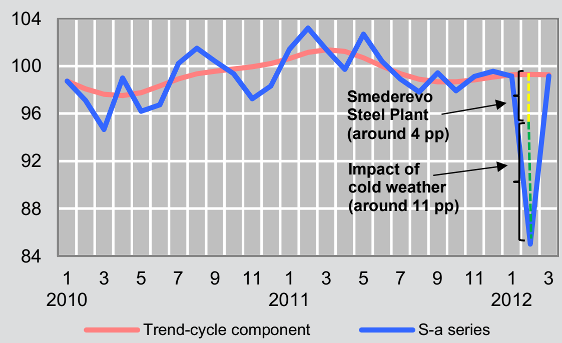
Text box 2: Impact of cold weather in February on economic and foreign trade activity

In early February 2012, Serbia was hit by a wave of extremely cold weather. The state of emergency was in effect from 5 to 26 February. As electricity consumption for heating purposes swelled, decision was made to restrict the supply of electricity to parts of industry in order to preserve the stability of the electric power system. This decision affected around 2,000 businesses.

Restricted electricity supply had major ramifications for economic activity in February. Industrial production was hardest hit (down by 13.6% s-a), with all of its sectors recording an s-a decrease. Manufacturing plunged by 15.2% s-a, while output in mining and electricity production sectors dwindled by 14.5% and 3.3% s-a, respectively.

Movements in industrial production in February were largely conditioned by extraordinary circumstances – adverse weather and the one-month suspension of operations of the Smederevo Steel Plant. To estimate the impact of the shock, we used the irregular component of the industrial production index. Chart O.2.1. shows the trend-cycle component of the industrial production series and its seasonally adjusted values. The difference between the two is the irregular component which represents the effects of unanticipated shocks. The chart shows that the irregular component accounts for roughly 15 pp of the February contraction in industrial production. It is estimated that around 4 pp of the component refers to the suspension of production in the Smederevo Steel Plant, as signalled by the s-a February drop of 56.1% in base metals production, while the remainder (of around 11 pp) could be put down to adverse weather.

Chart O.2.1 **Movements in the industrial production index**
(base index, 2011 = 100)



Sources: NBS and Serbian Statistical Office.

In addition to pulling industrial production down, bad weather also affected activity in construction, and transport and warehousing sectors. Namely, iced rivers and snow-blocked roads triggered problems in river and road transport. Construction activity shrank, as signalled by a drop in the production of non-metal minerals.

Difficulties relating to river transportation of goods and the suspension of operations of the Smederevo Steel Plant were the key factors behind poorer performance in foreign trade activity. Exports of goods in euros were down 18.4% s-a in February relative to January, with about half of the fall in total exports due to a drop in exports of agricultural products (4.6 pp) and base metals (4.0 pp) which use river routes as key channels of exports of products and imports of raw materials.

Imports of goods in euros also declined s-a, but not as much as exports. The decline in imports slowed down mostly on account of swelling imports of energy (by 29.3% s-a in February), in particular of oil, natural gas and electricity. Other import components recorded an s-a decline, with imports of consumer goods (19.7%) declining more than imports of capital goods (17.0%).

Adverse weather which hit Serbia in February is not expected to have long-term effects on movements in macroeconomic aggregates (GDP, exports, imports). Therefore, data on economic growth and foreign trade performance in February should be considered in view of this one-off shock. This is confirmed by data on industrial production growth in March (by 12.2% s-a).

5. Labour market developments

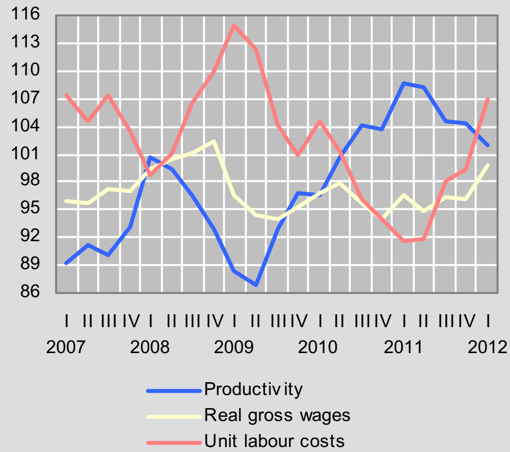
Wages

Q1 wages increased on a quarter earlier in nominal and real terms in both private and public sectors. Industrial unit labour costs went up.

According to seasonally-adjusted data, net wages in Q1increased by 5.4% in nominal and 4.4% in real terms. Real net wages rose by 2.4% s-a in the private and by 2.3% s-a in the public sector. The fact that the second wave of the crisis did not topple real wages signals that the adjustment of the formal economy labour market occurred primarily through a reduction in the total number of employees.

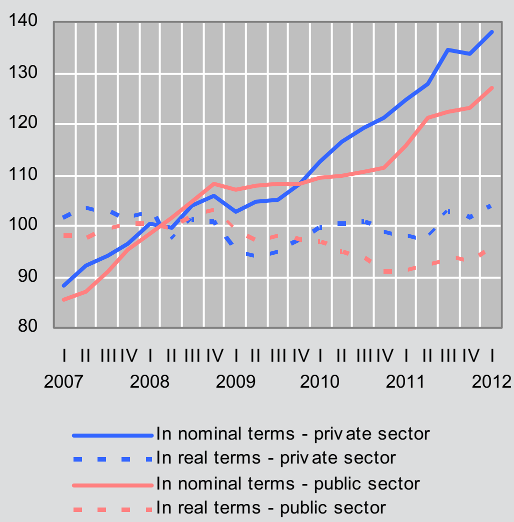
Across the industries, real net wages increased most in expert, scientific, innovation and technological activities, as well as in mining, finance and insurance. Real wages declined in education and information and communications sectors.

Chart IV.5.2 **Movements in productivity, real gross wages and unit labour costs in the industry**
(s-a, H1 2008 = 100)



Industrial unit labour costs increased in Q1 on the back of a hike in real gross wages and a dip in productivity.

Chart IV.5.1 **Average net wages**
(s-a, H1 2008 = 100)



In Q1, both private and public sectors saw real wage growth.

Observed y-o-y, real wages accelerated to 6.3% in Q1 (from 3.0% in Q4 2011). Real wages increased in both public and private sectors (by 6.0% and 4.9%, respectively).

The average net wage paid out in Serbia in Q1 equalled RSD 39,068.

Continuing their rise, industrial unit labour costs increased by 7.5% s-a from a quarter earlier, as a result of a hike in real gross wages (3.8% s-a) coupled with a fall in industrial labour productivity (2.1% s-a). Industrial unit labour costs rose across all sectors including, in particular, mining (18.8% s-a), electricity supply (13.5%) and manufacturing (5.3% s-a), on account of a fall in labour productivity and a hike in real gross wages.

Employment

Employment subsided in Q1 relative to Q4 2011 as a result of lower economic activity, but also of labour market failings.

[17] Vulnerable employment refers to employment in insecure jobs, most often in the informal sector, with poor workplace safety practices.

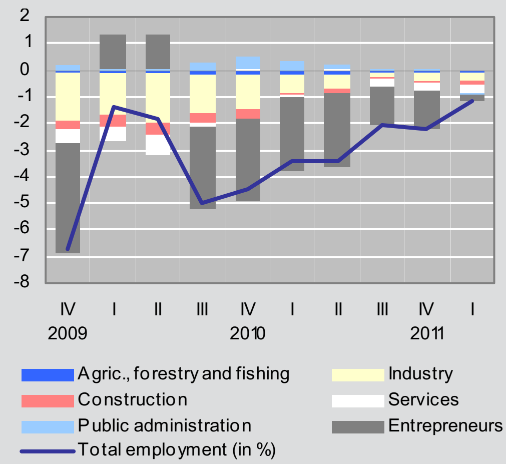
[18] Employees that have entered into contracts of employment with the employer (legal entities and private entrepreneurs). Employed persons are not persons working under a Special Services Contract or a Contract of Temporary and Periodic Work.

Chart IV.5.3 **Employment figure and unemployment rate**

Source: Serbian Statistical Office.

Employment continued to slide in Q1.

Chart IV.5.4 **Contributions to y-o-y employment growth rate**
(in pp)



Source: Serbian Statistical Office.

Y-o-y decline in employment slowed down in Q1 as the fall in employment in the entrepreneurial sector decelerated.

Negative trends in the labour market continued. Although it is the vulnerable workers[17] who bore the brunt of the crisis, the situation in the formal market is not looking up either. According to the RAD Survey of the Statistical Office, formal employment[18] continues to slide. In Q1, formal employment was down by 0.1% or 2,164 persons less than in Q4 2011. Such fall in employment was expected due to a contraction of economic activity and labour market failings (inadequate skills and age structure, high long-term unemployment rate, low labour mobility, high unemployment rate among the young, etc.). According to the November Labour Force Survey, the unemployment rate reached 23.7%. There is no reason to expect April Survey results to be more encouraging.

Employment plunged in manufacturing (1,401 persons), which continues to pull overall employment figures down. Conversely, it hiked in the information and communications sector and state administration.

Observed y-o-y, the decline in employment slowed down in Q1 to 1.2% (from 2.2% in Q4 2011), as a result of deceleration of the fall in employment in the entrepreneurial sector.

A rising number of unemployment beneficiaries[19] is another signal of adverse developments in the labour market. Following a steady rise since September last year, this number increased by 7.9% or 4,898 persons in Q1 from a quarter earlier.

According to a World Bank analysis[20], employment in Serbia is lower than in most countries of the region (Bulgaria, Croatia, Hungary, Romania) and all new European Union member states. The World Bank estimates that closing the gap in employment between Serbia and EU27 countries by 2020 would require creation of 57,000 jobs annually, and reaching the EU2020 target (of 75%) employment would require about 87,000 new jobs a year. In addition to adopting a new export-oriented growth model, Serbia must resolve the problem of a mismatch between the supply and demand of skills/qualifications in the labour market as a precondition to enhanced productivity and competitiveness.

[19] Persons eligible for unemployment benefit are unemployed persons who were the recepients of a mandatory unemployment insurance for 12 continuous months within the past 18 months. The entitlement to unemployment benefit lasts from 3 months to 12 months, depending on the length of insurance.

[20] Republic of Serbia, Country Economic Memorandum: The Road to Prosperity: Productivity and Exports, Volume 2 of 2, The World Bank, Report No. 65845-YF, December 2011,
http://siteresources.worldbank.org/SERBIAEXTN/Resources/300903-1106760681824/625341-1323878646102/CEM_VOL_2Dec13.pdf.

6. International environment

The first quarter saw some easing of tensions stemming from the euro area sovereign debt crisis. The IMF's forecast for the euro area growth has been revised modestly upwards.

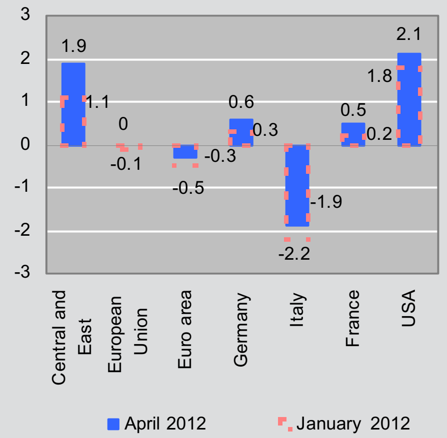
The euro area sovereign debt crisis is showing some signs of abatement following successful implementation of the debt swap agreement between Greece and private investors. In Q4 2011, the euro area economy contracted from the previous quarter by 0.3%, and slowed y-o-y from 1.3% in Q3 to 0.7%.

The PMI[21] and Eurocoin[22] readings point to a contraction in Q1 as well, indicating that the euro area economy is in technical recession. Still, the situation is somewhat better than at end-2011 thanks to the agreement between private investors and Greece and larger ECB interventions which helped reduce the yields on peripheral bonds. At the same time, persistent slump in production activity and rising unemployment give no reason for optimism, and the euro area is expected to record negative growth in 2012. Nonetheless, the IMF has recently revised slightly upwards its 2012 and 2013 growth forecasts for the euro area.

As indicated by the April Consensus Forecast, the sharpest downturn in advanced euro area countries in 2012 is expected for Spain and Italy (1.6% and 1.5%, respectively). Propped up by strong domestic demand, German economy is set to expand by 0.7%. Debate is heating up over austerity measures which have failed thus far to produce the expected results in peripheral euro area members. Spain, for instance, is likely to see its public debt soar to around 80% of GDP by end-2012 despite implemented austerity measures, wherefore Standard&Poor's downgraded its credit rating by two notches, from A to BBB+.

Growth forecasts for Central and Eastern Europe are slightly more favourable than those released by the end of last year, though the impact of the euro area crisis is to be felt with waning intensity over the next several quarters. Growth prospects vary from one country to another. The Czech Republic, for instance, entered technical recession in Q4 2011 and is expected to stagnate in 2012. Recession is predicted for Croatia and Hungary (-0.8% and -0.4%,

Chart IV.6.1 **Revisions of real GDP growth forecasts for 2012 by the IMF***
(%)

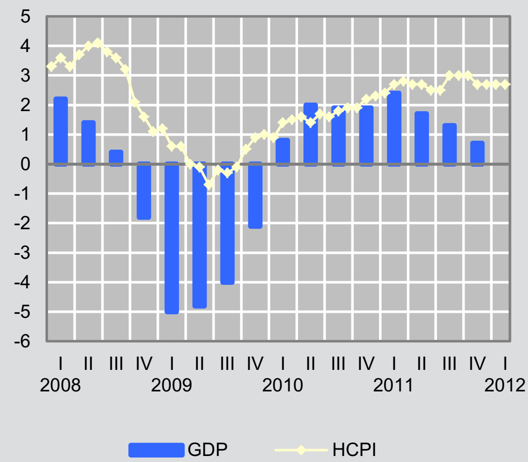


* Revision relative to the January World Economic Outlook Update.

Source: IMF WEO, April 2012 and January 2012 Updates.

Growth prospects for European countries and the United States have slightly improved.

Chart IV.6.2 **Euro area GDP and inflation**
(y-o-y rates, in %)



Source: Eurostat.

Y-o-y inflation has been unchanged since December 2011. Y-o-y GDP growth continued to slow in Q4 2011.

[21] Purchasing Managers Index.

[22] Estimate of the monthly growth of euro area GDP, construed by the experts of the Bank of Italy.

respectively). The latest Consensus Forecast, on the other hand, envisages relatively strong growth in 2012 for Poland and Russia (2.8% and 3.8%, respectively). In the case of Poland, the forecast is underpinned by robust domestic demand, and in the case of Russia, by higher public spending and oil price hikes.

The US economy is showing signs of recovery and its growth prospects for 2012 are much better than those of the euro area. And yet, these positive trends are still not strong enough to support the recovery in the euro area. The US GDP grew 0.7% s-a in Q4 2011 and 1.7% in the year as a whole. This growth should help reduce the average unemployment rate from 9% in 2011 to 8.2% in 2012, though the latest data flow from the US labour market indicates that the number of jobs in non-agricultural sectors increased less than expected. Nonetheless, data from the US labour market are more encouraging than the corresponding data for the euro area that paint a rather bleak picture – average unemployment rate is expected to rise from 10.2% in 2011 to 10.8% in 2012. Ranging between 2.1% and 2.5%, the 2012 growth forecasts for the US economy are also much better than those for the euro area.

Inflationary pressures in the euro area are receding, but the inflation rate remains above the targeted level of below, but close to, 2%. March inflation stood at 2.7% y-o-y, unchanged from the previous three months. There have been no changes in the ECB reference rate since the beginning of the year (1.0%) and none are expected in the foreseeable future. To help banks repair their balance sheets, the ECB proceeded with monetary easing by offering the second round of full allotment three-year refinancing operations at reference interest rate (LTROs). The ECB expects inflation to stay above the targeted level in 2012, due primarily to higher energy prices, and to return close to the target in Q1 2013.

In the United States, inflation stabilised under 3%, giving rise to expectations that the Fed would launch another round of quantitative easing measures to boost the liquidity of the economy. These expectations proved false as the Fed stepped back from another round of quantitative easing at its March meeting. The minutes from this meeting confirmed the Fed's decision to keep interest rates low through 2014.

Some Central and East European countries, like the Czech Republic and Hungary, witnessed stronger inflationary pressures in Q1 due to the one-off increase in the VAT rate. Romania recorded negative economic growth in Q4 2011 (0.2% s-a), resulting in lower inflationary pressures and a drop in y-o-y inflation to 2.7% in February. The National Bank of Romania therefore revised its policy rate down in three steps during Q1, each by 25 bp, to 5.25%. Other central banks in the region kept their policy rates on hold.

Since late January, the exchange rate of the dollar against the euro has ranged from 1.30 to 1.35, without exhibiting any distinct trend. The news of a recovery in US economic activity were accompanied with a decrease in investor risk aversion following successful restructuring of Greek debt and the second round of LTROs. According to the April Consensus Forecast, the exchange rate of the dollar against the euro will revolve around 1.30 over the coming two years. The Swiss franc has been holding up slightly below 1.20 for one euro ever since the Swiss National Bank announced this level as its ceiling.

For the major part of Q1, the price of gold was relatively high due to the still present risk aversion. As expectations of further quantitative easing by the ECB and the Fed dissipated in late Q1 and early Q2, the price of gold declined. This, together with increased likelihood of a recession in the euro area, caused a drop in the prices of other commodities, oil and copper, and induced a decline in stock exchange indices in early Q2.

V. Inflation projection

After reaching minimum level in April 2012, y-o-y inflation is expected to rise at a moderate pace towards its peak in H1 2013 and then to gradually fall back within the target tolerance band in H2 of the same year. The rise in inflation from May 2012 onwards will be driven by the onset of the new agricultural season, rising import prices and the expected faster growth in administered prices following the formation of the future Government of the Republic of Serbia. Low aggregate demand will work in the opposite direction as the key disinflationary factor. The greatest risks to the projected inflation path continue to be associated with the domestic fiscal policy stance, food prices, administered prices and the international environment. After modest growth in 2012 (0.5%), GDP is expected to step up to 3.0% in 2013, driven mainly by net exports.

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 assumes 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

Inflation returned within the target tolerance band in January 2012 and continued to fall. The drop in y-o-y inflation rates in Q1 was rather steep – from 7.0% in December 2011 to 3.2% in March 2012 – mainly because of the exclusion of high price increases recorded in early 2011 from CPI. The drop was consistent with the inflation projection published in the February Report.

Quarterly inflation reached 2.0% in Q1, reflecting robust growth in prices of some unprocessed food items and an appreciable increase in petroleum product prices. Significant contributions to consumer prices growth came also from cigarettes, because of higher excise duties, and from products and services whose prices are linked directly to the RSD/EUR exchange rate (automobiles and flat rentals).

Notwithstanding the fall in the country risk premium, the dinar lost 6.0% in Q1. Depreciation pressures built up amid stronger demand for foreign exchange, increased government spending of dinar funds begun late last year, growing foreign trade deficit, dampened capital inflow, and psychological factors induced by unfavourable news (postponed review of the arrangement with the IMF and the US Steel's departure from Serbia). In consequence, trading volumes in the IFEM shrank, and the mismatch between foreign exchange supply and demand widened. Depreciation pressures were moderated to a degree by the positive news of the EU granting a candidate status to Serbia and Standard&Poor's affirming the country's credit rating.

GDP is estimated to have declined in Q1 (1.3% y-o-y and 0.5% s-a) primarily due to unfavourable trends in industrial production and retail trade in February, which were prompted by bad weather[23], and last year's high base. On the expenditure side, negative contributions to GDP came from investment activity and net exports, while positive contribution came from total final consumption. The output gap deepened in Q1, heralding further disinflationary pressures from aggregate demand in the coming period.

[23] See Text box 2, p. 33.

Heavy snowfall, strained energy supply and a greater number of non-working (otherwise working) days in February led to a deterioration of foreign trade in Q1. At quarterly level, imports of goods rose by 2.8% and exports fell by 1.4% s-a. Imports rose thanks to intermediate goods, notably energy, while exports fell driven by base metals, and chemicals and chemical products.

Following successful implementation of the debt swap agreement between Greece and private investors, movements in the international environment have slightly improved relative to the end of last year. On the other hand, PMI and Eurocoin readings point to a contraction in the euro area's GDP in Q1 2012 as well, indicating that the euro area economy is practically in technical recession.

As the tensions in the euro area eased, owing to the ECB's accommodative stance, the risk premiums for Serbia and other countries in the region headed down. In fact, the sharpest fall in risk premium was registered for Serbia, whose EMBI came at 467 bp at end-Q1, down by 134 bp from end-2011.

Global oil prices rose in the first two months of the year in response to mounting geopolitical tensions in the Middle East and cold weather. However, they retreated in April as a result of China's reduced imports and the opening of new oil fields in Saudi Arabia.

In the year to April, domestic prices of corn and wheat, the main primary agricultural commodities, rose by 28.8% and 15.2%, respectively, largely under the impact of their international counterparts (due to cold weather) and the weakening of the dinar. Still, the April announcement of a brighter outlook for global production has soothed the nerves in global commodity markets, which should alleviate the pressure on domestic prices until the new sowing season.

After trending up early in the year, global food prices *(FAO Food Price Index)* have resumed the decline.

In the first two months of 2012, the financial sector reported the same inflation expectations as in December 2011 (6.0%), but then revised them down by 0.2 pp in March. Following a rise in April, inflation expectations edged down to 5.5% in May and thus settled within the target tolerance band. On the other hand, based on the Ipsos survey, inflation expectations of the financial sector fell from 7.6% in December 2011 to 5.0% in March, entering the target tolerance band for the first time since September 2010.

With inflationary pressures subsiding, the key policy rate was trimmed by 0.25 pp in the course of Q1 (in January). It currently stands at 9.5%. In April, the NBS amended the reserve requirement regulations, lowering the FX reserve requirement ratio and raising the percentage share of FX required reserves to be allocated in dinars. These changes should contribute to the stabilisation of inflation movements and to the release of FX liquidity. They should also support moderate lowering of borrowing costs and facilitate refinancing, and additionally stimulate banks to use longer-term sources of funding.

As indicated by the MCI, monetary policy turned expansionary in Q1. This is signalled by both MCI components. The weakening of the dinar early in the year and the falling inflation have led to the opening of the depreciation gap of the real exchange rate. At the same time, the real interest rate was running below its trend. Looking forward, an increase in net importers' marginal costs seems likely on this account.

Projection assumptions

The current medium-term inflation projection is based on the assumption of a slower administered price growth in 2012 than in 2011, most of the growth unfolding in the second half of the year following the formation of the future Government of the Republic of Serbia.

The projection also operates on the assumption that the current pressures in the foreign exchange market will be short-lived, i.e. that they will dissipate with the start of fiscal consolidation on the expenditure side. Fiscal consolidation on the revenue side by changing the VAT rate has not been used as an assumption.[24]

Still rather low due to the steep fall last year and running below their long-term trend[25], fruit and vegetable prices are likely to step up in the course of 2012.

[24] If any, fiscal consolidation on the revenue side would have a one-off effect on inflation and, as such, would not call for an adjustment of the key policy rate. In case such consolidation induced a rise in inflation expectations, the NBS would rely primarily on communication with the markets.

[25] Long-term trend has been approximated by the movement in prices of non-food products and services.

Table V.0.1 **Projection assumptions**

	2012	2013
External assumptions		
EU inflation (Q4 to Q4)	1.9%	1.7%
ECB policy rate (year-end)	1.00%	1.00%
Euro area GDP growth	-0.5%	0.9%
Ural oil price per barrel (year-end, USD)	110	110
Internal assumptions		
Administered prices (Dec to Dec)	7.8%	7.2%
Fruit and vegetable prices (Dec to Dec)	7.8%	8.6%
Trends		
Appreciation trend of the real exchange rate (average)	2.0%	2.2%
Real interest rate trend (average)	4.3%	3.1%

Average oil prices are expected to be lower in 2012 than last year because of the likely recession in the euro area and the slowing of China's economic growth. The projection assumes that having grown early in the year, oil prices will not rise further as they are currently rather high. Besides, oil futures signal a likely drop in oil prices in the coming period.

The outlook for the euro area GDP is unchanged from the February mid-term projection, i.e. the projection assumes a 0.5% drop in 2012, followed by a moderate recovery to 0.9% in 2013. With inflation in the euro area running above 2.0% for the greater part of 2012, no lowering of the ECB rate is expected in the coming period.

Inflation projection

Y-o-y inflation is projected to revolve around the lower bound of the target tolerance band in early Q2 2012 and to rise steadily thereafter before peaking in H1 2013. During this time, inflation is likely to temporarily overshoot the upper bound of the target tolerance band and return within it in H2 2013.

Since current fruit and vegetable prices are estimated to be relatively low, their adjustment in the new agricultural season is bound to fuel inflation in Q3 2012 even in case of average agricultural performance. Besides, disinflationary cost-push pressures on processed food prices have been waning under the impact of increases in the prices of primary agricultural commodities over the past several months.

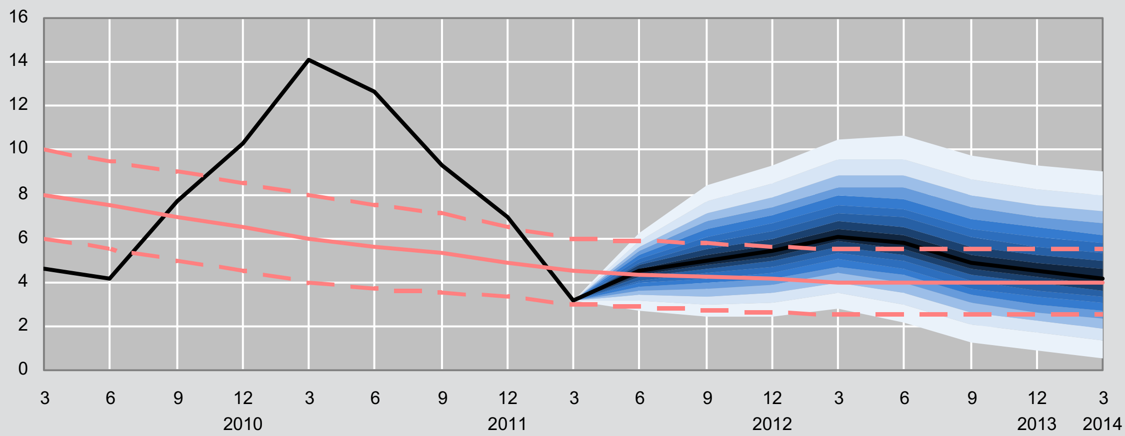
Import prices could also rise because of pressures in the foreign exchange market since late last year, feeding through into higher net importers' real marginal costs. The intensity of the resulting inflationary pressures will depend on the net importers' capacity to adjust their prices against the backdrop of low demand.

Greater inflationary effect of administered prices, typical for H1, will probably be delayed until H2 2012, i.e. it will unfold after the formation of the future Government.

Petroleum product prices are expected to be broadly stable over the forecast period, though this will largely depend on movements in the international oil market.

While administered, import, and fruit and vegetable prices are expected to exert upward pressures on inflation, low aggregate demand will work in the opposite direction and dampen inflation growth over the forecast period. It should be noted that both domestic and net external demand are running low. Though the risks surrounding the euro area economic outlook are decreasing, the demand for our exports will probably remain low for some time yet, which will slow the recovery of demand in Serbia.

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

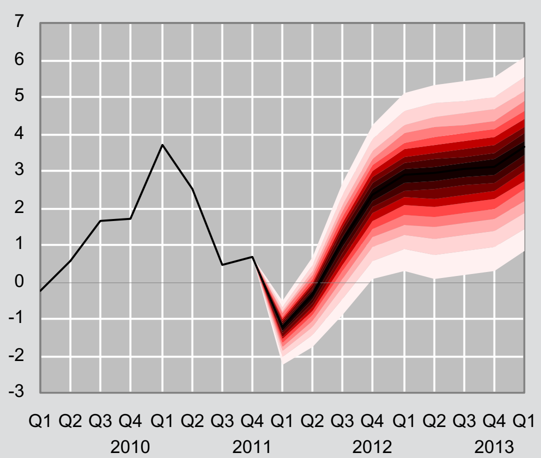


Inflation is expected to rise from Q2 2012 onwards and peak in H1 2013. After overshooting the target tolerance band temporarily, inflation is expected to return within it in H2 2013. The projection is tilted slightly to the upside due to the uncertain outlook for fiscal movements, food prices, administered prices and the international environment.

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%.

As economic growth softens and the negative output gap widens, inflation expectations will continue to fall, aiding the process of disinflation.

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



After slowing down in 2012, economic activity is expected to recover in 2013.

As in the previous Inflation Report, GDP growth in 2012 is projected at a modest 0.5%. The projection is based on slower economic recovery of Serbia's main trading partners, which is bound to weigh down on export demand and domestic investment. Nonetheless, the key contribution to GDP growth in 2012 is expected from net exports, as a result of the dinar's weakening over the past several months and the automotive industry investments completed in the prior period. Fixed investment and final consumption will probably record a decline in 2012 and contribute negatively to GDP movements.

On the production side, positive contributions to GDP growth in 2012 could also come from increased agricultural production. High prices of primary agricultural commodities and implementation of the new system of agrarian subsidies may act as an encouragement to producers to invest more in production this year.

The fiscal stimulus in H1 will have a positive impact on short-term GDP movements. On the other hand, fiscal consolidation, which we assume will be implemented after the formation of the future Government, could slow the expected economic growth in the short run, but, at the same time, provide significant support to long-term macroeconomic stability.

After slowing in 2012, GDP will accelerate to 3.0% in 2013, driven mainly by net exports. The projection band for GDP growth is tilted to the downside due to the possibly higher than expected effect of fiscal consolidation on economic growth in the short run.

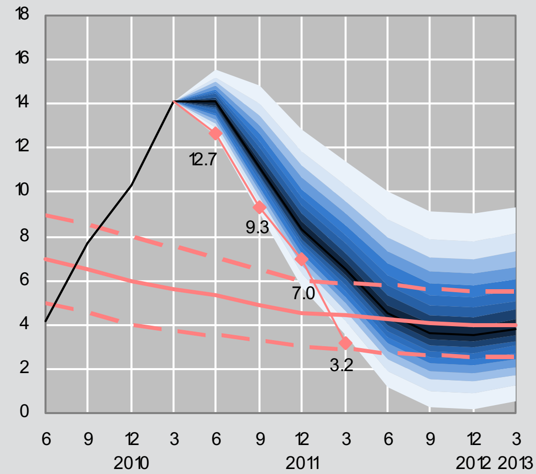
Based on the above, over the forecast period, disinflationary pressures will be coming from low aggregate demand and falling inflation expectations, while inflationary pressures will stem from faster growth in fruit and vegetable prices in the new agricultural season, accelerated growth in administered prices in H2 2012 and higher import prices.

Risks to the projection

Uncertainties surrounding the projected outlook for inflation are associated with the post-election discipline of fiscal policy makers, food prices, administered prices and developments in the international environment.

At a time when the global financial market is extremely sensitive to indicators of public debt sustainability, the importance of public finance cannot be overestimated. Given the current level of Serbia's public debt, fiscal sustainability cannot be guaranteed even if the fiscal framework agreed earlier with the IMF is complied with. Any deviation of the 2012 budget from the framework planned could therefore produce significant inflationary consequences through the rise in risk premium and depreciation pressures.

Chart V.0.4 **Inflation outturn vs. May 2011 inflation projection**
(y-o-y rates, in %)

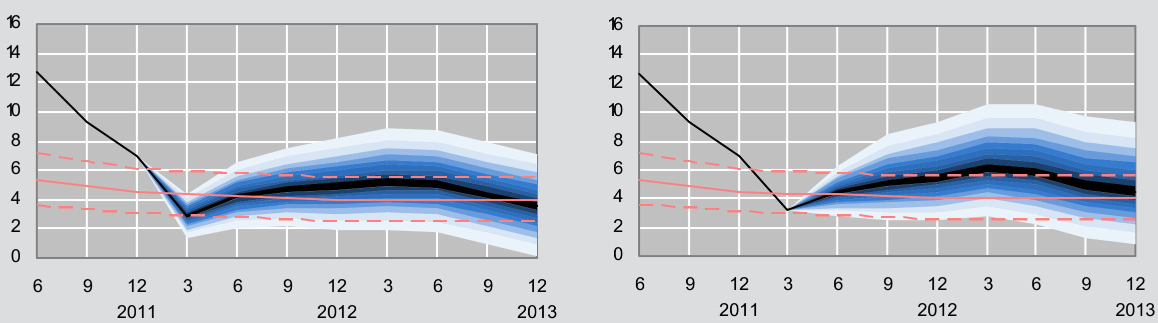


Durign the last year, y-o-y inflation moved around the lower bound of the band projected in May 2011.

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

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

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



Over the entire projection horizon, the spread of inflation outcomes is higher than in the previous projection.

Besides, lacking fiscal consolidation on the expenditure side after the formation of the future Government that we assume will take place, pressures in the foreign exchange market could become entrenched and lead to stronger than projected inflationary pressures. Fiscal consolidation on the revenue side, by raising the VAT rate, would have a similar, though one-off, effect on inflation.

Failure to restore investor confidence in public finance sustainability of some euro area members could push the area into still deeper crisis, affecting Serbia's exports and the risk premium. Crisis in the euro area would weigh down on investment inflows and clog the wheels of the domestic economy. Although this would in itself generate disinflationary effects, the potential rise in risk premium and the resulting depreciation pressures would only fuel inflation growth.

High volatility of agricultural commodity prices in Serbia puts them among the risk factors over the forecast period, and especially so once the new agricultural season sets in. It is expected that the increase in prices of primary agricultural commodities and fruit and vegetables will be noticeable, but if it turns out stronger than anticipated, we could see a rise in the processed food production costs and, by extension, a build-up in inflationary pressure.

On balance, the risks to inflation projection are judged to be skewed slightly to the upside.

Comparison with the previous projection

The projected spread of inflation outcomes is higher than in the February Report, due mainly to the rise in import prices, but also to the faster than expected growth in prices of oil and primary agricultural commodities.

Analysis of inflation movements during the last year shows that inflation revolved around the lower bound of the band projected in May 2011. The main reason for the departure from the projected trajectory was the faster than expected fall in food prices.

Outlook for the key policy rate

The future path of the key policy rate will depend primarily on the pace and intensity of fiscal consolidation and the continuation of the arrangement with the IMF. The risks are also associated with food and administered prices and developments in the international environment.

Table A

Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Q1 2012
EXTERNAL LIQUIDITY INDICATORS (in %)											
Forex reserves/imports of goods and services (in months)	4.1	4.7	3.9	6.1	9.0	7.2	5.2	9.4	8.1	8.6	7.8
Forex reserves/short-term debt	360.7	535.6	702.2	519.2	941.7	917.5	380.8	528.8	546.4	1,860.8	1,914.1
Forex reserves /GDP	13.6	16.4	16.3	24.2	38.7	33.8	25.0	36.6	35.7	38.7	35.7
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.1	10.6	11.5	12.3	13.1	12.4
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	35.5	33.5
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.7	84.9	77.5	77.6
Short-term debt/GDP	3.8	3.1	2.3	4.7	4.1	3.7	6.6	6.9	6.5	2.1	1.9
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	210.3	210.9
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
Forex reserves/M1	143.3	195.1	220.1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	462.9
Forex reserves/reserve money	131.9	167.8	165.5	169.8	179.5	173.8	140.7	190.5	196.4	207.6	219.4
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	59.3	63.9	73.7	73.6	81.2	85.8	86.8	73.6	90.3	90.9	95.6
MEMORANDUM: (in EUR million)											
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,957	28,006	31,140	6,860[1)]
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	23,786	24,125	24,068
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,314	3,403	4,072	848
Central bank foreign exchange reserves	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	12,058	11,073
Short-term debt	606	529	442	948	958	1,050	2,143	2,005	1,830	648	579
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-2,968	-1,159

		2004	2005	2006			2007	2008	2009	2010	2011
		Nov	May	July	Feb	Apr	Jun	Dec	Dec	Nov	March
CREDIT RATING	*S&P*	B+		BB-	BB-/positive		BB-/stable	BB-/negative	BB-/stable		BB /stable
	Fitch		BB-			BB-/stable		BB-/negative		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.

1) NBS estimate.

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: short-term debt repayment and advanced debt repayment.
5. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
6. 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.
7. 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).

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Q1 2012
Real GDP growth (in %)[1]	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.3[9]
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	7.0	3.2
NBS foreign exchange reserves (in EUR million)	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	12,058	11,073
Exports of goods and services (in EUR million)[3)8]	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	10,070	11,470	2,528
- 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	13.9	-2.2
Imports of goods and services (in EUR million)[3)8]	-6,387	-7,206	-9,543	-9,613	-11,971	-16,016	-18,843	-13,577	-14,838	-16,823	-4,033
- 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	13.4	4.1
Current account balance[4)8]											
(in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-2,968	-1,159
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-7.2	-7.4	-9.5	-16.9
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	23	/
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	372.5	357.6
RS budget deficit/surplus (in % of GDP)[6]	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-2.1	-3.7	-3.7	-4.2	/
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	1.0	-1.6	-2.0	-2.6	-4.5	-4.7	-5.0	/
RS public debt (external + internal, in % of GDP)[6)7]	72.9	66.9	55.3	52.2	37.6	30.9	29.2	34.5	44.0	47.7	/
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	73.34	82.38
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	80.87	83.31
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	101.95	108.11
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	104.64	111.36
Memorandum											
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,957	28,006	31,140	6,860[9]

1) At constant prices of previous year.
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: MoF for public debt and NBS for estimated GDP.
7) Public debt statistics records government securities at market value since November 2011. In line with such methodological change, the National Bank of Serbia made a backward estimate of the stock of public debt.
8) 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.
9) NBS estimate.

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

Appendix 1: National Bank of Serbia's Memorandum on Inflation Targets until 2014

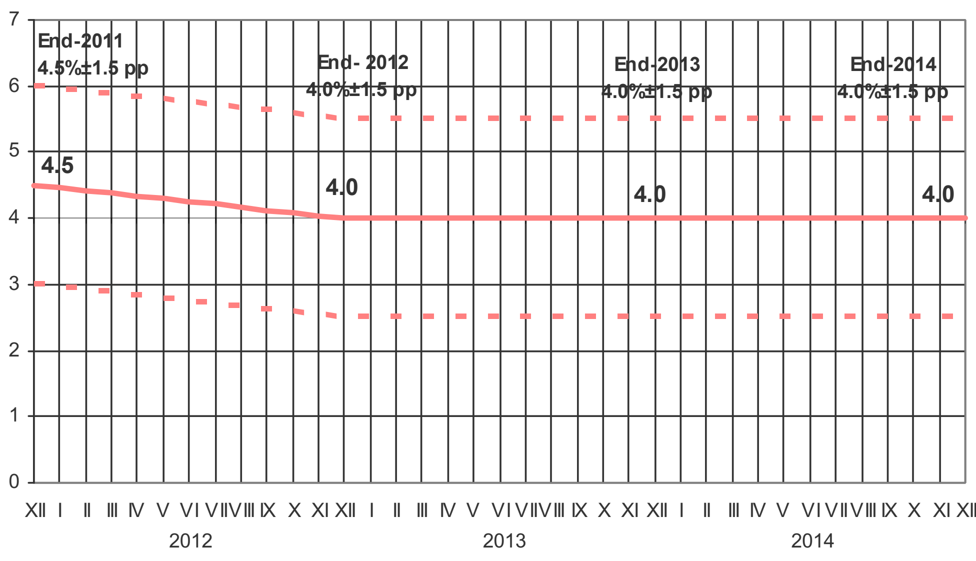
National Bank of Serbia's Memorandum
on Inflation Targets until 2014[26]

To define the framework for medium-term monetary policy decision-making and to anchor and stabilise inflation expectations, the Executive Board of the National Bank of Serbia hereby sets the inflation targets for the years 2013 and 2014.

In line with the Agreement between the National Bank of Serbia and the Government of the *Republic of Serbia on Inflation Targeting*[27] and *the Memorandum of the National Bank of Serbia on Monetary Strategy*[28], pursuant to which the National Bank of Serbia has committed to set inflation targets in cooperation with the Government, the Executive Board of the National Bank of Serbia hereby sets the **headline inflation targets (with a tolerance band), measured as an annual percentage change in the consumer price index**, for the period 2012–2014, with the inflation outturn at the end of the previous year as its starting point:

- December 2011: 4.5% with a tolerance band of ±1.5 percentage points
- December 2012: 4% with a tolerance band of ±1.5 percentage points
- December 2013: 4% with a tolerance band of ±1.5 percentage points
- December 2014: 4% with a tolerance band of ±1.5 percentage points

Inflation targets with a tolerance band for the period 2011-2014



The inflation targets are set as point targets (with a tolerance band) for each month of the year (see the chart). The inflation targets for 2012 have not been changed from the levels determined earlier[29].

Based on macroeconomic projections, the National Bank of Serbia has set the inflation targets for each month in 2013 and 2014 at the level of 4% with a tolerance band of ±1.5 percentage points.

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[26] Adopted at the NBS Executive Board meeting of 10 May 2012.
[27] Adopted in Government session of 19 December 2008.
[28] Adopted at the NBS Monetary Policy Committee meeting of 22 December 2008.
[29] See the *National Bank of Serbia's Memorandum on Setting Inflation Targets for the Period 2010–2012.*

The trajectory of inflation targets reflects the intention to achieve price stability without causing any disruptions to macroeconomic processes. The inflation targets for 2013 and 2014 are set above the price stability level based on the quantitative definition and the inflation targets of advanced economies (2.0% or 2.5%) due to the assessment that the process of structural reforms and the liberalisation of prices, i.e. nominal, real and structural convergence to the European Union, will not be completed by 2014.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation may temporarily deviate from the target due to exogenous shocks. As so far, monetary policy will not respond to first-round, but rather to second-round shock effects.

In consultation with the Government, the National Bank of Serbia may decide to change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

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Sources of data: the National Bank of Serbia and Serbian Statistical Office, unless stated otherwise.

Executive Board meetings and changes in the key policy rate

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	12.50	0
9 June	12.00	-50
7 July	11.75	-25
11 August	11.75	0
8 September	11.25	-50
6 October	10.75	-50
10 November	10.00	-75
8 December	9.75	-25

2012

Date	Key policy rate (p.a., in %)	Change (in basis points)
19 January	9.50	-25
9 February	9.50	0
8 March	9.50	0
12 April	9.50	0
10 May	9.50	0
7 June		
12 July		
9 August		
6 September		
18 October		
8 November		
6 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 8 March 2012

The NBS Executive Board decided to keep the key policy rate at 9.5 percent.

In line with earlier NBS projections, y-o-y inflation returned in January within the target tolerance band and settled at 5.6 percent. Inflation continues down, reflecting primarily low aggregate demand and high monthly inflation rates recorded in the same period last year. In April or March, y-o-y inflation is expected to revolve around the lower bound of the target tolerance band.

Given the inflation factors with a medium-term effect, such as low aggregate demand, rising import prices, risks stemming from the international environment and fiscal policy at home, the NBS Executive Board voted to keep the key policy rate on hold. The Executive Board continues to stress that keeping the budget deficit in line with statutory fiscal responsibility rules remains one of the key prerequisites for maintaining the country's macroeconomic stability.

The next rate-setting meeting will be held on 12 April 2012.

Press release from Executive Board meeting held on 12 April 2012

The NBS Executive Board voted to keep the key policy rate at 9.5%.

A decline in y-o-y inflation continues. Inflation is expected to reach its minimum level in April, when it is likely to move around the lower bound of the target tolerance band. Low aggregate demand will remain the key disinflationary factor. However, in light of uncertainties regarding the movements in import prices, the new agricultural season and probably a faster rise in administered prices in the second half of the year, the Executive Board decided to keep the key policy rate unchanged.

At its meeting today, the Executive Board adopted the new Decision on Banks' Required Reserves with the National Bank of Serbia. The ratio of FX required reserves on banks' sources of funding of up to two-year maturity is lowered from 30% to 29%, or from 25% to 22% for sources of over two years. The share of FX required reserves allocated in dinars is raised by 5 percentage points – to 20% for funding sources of up to two years, and 15% for sources of over two years. This measure aims to:

- contribute to the stabilisation of inflation over the projected period,
- support moderate lowering of borrowing costs and facilitate refinancing,
- contribute to the stabilisation in the foreign exchange market, and
- stimulate banks to obtain longer-term sources of funding.

Governor Dejan Šoškić will explain the reasoning behind these decisions at today's press conference.

The next rate-setting meeting of the NBS Executive Board will be held on 10 May 2012.

Press release from Executive Board meeting held on 10 May 2012

The NBS Executive Board voted to maintain the key policy rate at 9.5 percent.

Year-on-year inflation continues down. In line with earlier announcements, it is expected to trough in April at around the lower bound of the target tolerance band. However, the Executive Board has decided to keep the key policy rate unchanged in light of the expected moderate rise in year-on-year inflation from May onwards on the back of the new agricultural season, past growth in import costs, and the anticipated rise in administered prices in the second half of the year.

The Executive Board underlines that the future path of the key policy rate will largely depend on the speed and intensity of fiscal consolidation to be undertaken by the future Government, as well as on the continuation of the arrangement with the IMF. Price and financial stability can be delivered at a lower level of monetary restrictiveness provided fiscal consolidation and structural reforms are more efficient.

At its today's meeting, the Executive Board adopted the May Inflation Report which will be presented to the public on Wednesday, 16 May 2012.

The next rate-setting meeting will be held on 7 June 2012.

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