National Bank of Serbia

May 2014

INFLATION REPORT

2014

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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.

The May *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 8 May 2014.

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

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

Đorđe Jevtić, Director of the Administration for Supervision of Financial Institutions

ABBREVIATIONS

bln – billion
bp – basis point
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FAO – UN Food and Agriculture Organization
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
NBS – National Bank of Serbia
NPLs – non-performing loans
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Right
SORS – Statistical Office of the Republic of Serbia
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Year-on-year inflation moved around the lower bound of the target tolerance band in the first quarter and drifted slightly below it in March (2.3%).

Inflationary pressures remained very low in the first quarter and the consumer price growth of 1.2% was largely due to the upward revision of the special VAT rate and excise tax. Low inflationary pressures reflected well-coordinated and calibrated monetary policy measures, reduced cost-push pressure, low aggregate demand, falling inflation expectations and relative stability of the exchange rate. Core inflation (CPI excluding energy, food, alcohol and cigarettes) as the inflation component most responsive to monetary policy measures, has been moving within the target tolerance band since October 2013 and ended the first quarter of this year at 3.4%.

The cost-push pressures on inflation remain rather low..

The cost of raw materials in food production stayed low despite the rise in prices of primary agricultural commodities in the first quarter, which neutralised to a large extent the effects of the increase in the special VAT rate on food prices. In the period observed, there were no major cost-push pressures from import prices, while the drop in wages caused a fall in unit labour costs.

...and so do the pressures generated by domestic demand.

Domestic demand weakened further during the first quarter, in response to decreasing credit activity, falling wages and the rise in the unemployment rate which reached 20.8% according to the April Labour Force Survey. While the details of fiscal adjustment measures will be unveiled by mid-year, announcements of the new Government suggest that fiscal consolidation will be stronger than expected earlier. This means that the fall in final consumption will also be steeper than anticipated and that the disinflationary pressures on that account will be strong.

Prospects for the economic recovery of the euro area seem brighter now than three months ago, though there are some downside risks associated with deflation and the deepening of geopolitical tensions.

Prospects for the economic recovery of the euro area, our most significant foreign trade partner, have improved relative to the previous quarter and the gap between member states has narrowed down. And yet, there are downside risks to the bloc's economic growth, especially those concerning further escalation of the crisis in Ukraine. Despite increased deflation risks, the European Central Bank judges that inflation will gradually return to the target over the next year and that there is no need for additional accommodative monetary policy measures for the time being. Still, the European Central Bank hinted at the possibility of using non-conventional measures if deflation risks build up in the months ahead. Assured of the self-sustaining recovery of the US economy, the Fed began tapering its asset purchase programme in January by USD 10 bln a month.

The risk premia of all countries in the region declined in the first quarter, and that of Serbia the most despite the January downgrade in credit rating.

Though Fitch lowered Serbia's credit rating in January, this did not have a negative impact on the country risk premium. The credit rating downgrade was in part counterbalanced by the prospective arrangement with the IMF and the start of Serbia's EU accession negotiations. The fall in Serbia's risk premium was further perpetuated by expectations of decisive implementation of the announced structural reforms and fiscal consolidation in the wake of parliamentary elections. On the other hand, despite the rise in fiscal deficit and public debt, Standard & Poor's affirmed Serbia's credit rating in April, assessing that a more favourable environment has been created to undergo fiscal consolidation and structural reforms.

As in other countries of the region, depreciation pressures were at their strongest in January, only to dissipate by the end of the quarter.

Depreciation pressures on the dinar, generated by both global and local factors, persisted until mid-March when the trend reversed and the dinar regained some strength. Increased demand for foreign exchange on the part of domestic enterprises was of seasonal character and related mainly to energy imports. Though hardly a surprise, the Fed's decision to start tapering its asset purchases as of January also gave rise to depreciation pressures across the region. These pressures were at their strongest in January. In the second half of March, however, appreciation pressures developed as a result of continued narrowing of the external imbalance and expectations of faster implementation of fiscal consolidation and structural reforms.

The National Bank of Serbia is treading cautiously in easing its monetary policy stance, mindful primarily of the risks stemming from the international environment.

Due to increased volatility in the international financial markets and the strengthening of geopolitical tensions, the Executive Board of the National Bank of Serbia kept the key policy rate on hold in the first four months of the year. Judging that the pressures on the exchange rate were only temporary, the National Bank intervened in the interbank foreign exchange market as the net seller until mid-March and as the net buyer of foreign exchange from end-March and in April. At its meeting in May, the Executive Board lowered the key policy rate to 9.0%, citing that the current geopolitical tensions and the Fed's QE tapering have had no negative effects thus far on the country risk premium and foreign trade flows and that the financial market has been responding well to measures announced by the new Government, notably those relating to fiscal consolidation.

External imbalance will continue to narrow down in 2014.

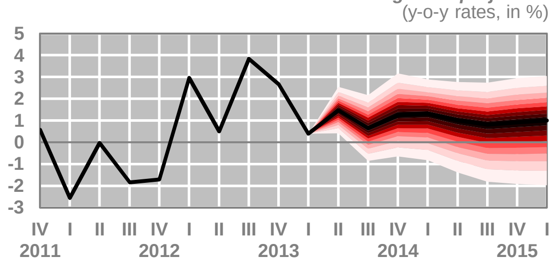
Low aggregate demand brought about a further decrease in external imbalance in early 2014, which, despite the rise in the cost of external debt servicing, resulted in a halved current account deficit relative to the same period a year earlier. Export growth was registered in a considerable number of manufacturing branches. According to our estimates, external imbalance will continue to narrow down in 2014 and the current account deficit will fall to below 4% of GDP. Exports will continue to grow, supported by the pickup in external demand of our key foreign trade partners, while imports will rise modestly against the backdrop of falling domestic consumption.

Economic activity continues to slow down.

Year-on-year growth in economic activity slowed down further in the first quarter. On the production side, this slowdown was chiefly due to the anticipated reduction in agricultural production and the slackening of industrial production this year. Net exports continued to provide a positive contribution to the growth in aggregate demand, though smaller than in the quarters before. Domestic demand, on the other hand, stepped up its year-on-year decline as a consequence of a sharp downturn in private investment. At quarterly level, dented activity in industry and agriculture was compensated for by the moderate recovery registered in the construction industry and services, leading to a negligible GDP growth of 0.1% s-a.

The Serbian economy will grow less in 2014 than in 2013, due to the wearing off of the effects of last year's exceptionally high agricultural yields and new production capacities in the automobile and oil industries.

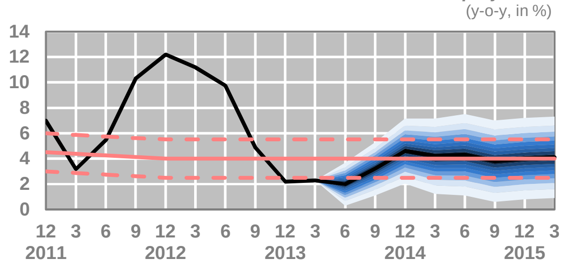
GDP growth projection
(y-o-y rates, in %)



Despite the expected recovery of the euro area, the Serbian economy is likely to record lower growth (around 1%) in 2014 due to the wearing off of the effects of supply-side factors which led the growth in 2013. This relates primarily to agricultural production and oil and automobile industries. Besides, fiscal consolidation is bound to exert negative effects on economic activity in the near term. On the expenditure side, GDP growth will be led by net exports, while final consumption will provide a significant drag because of the restructuring of state-owned enterprises, lowering of wages and a real cut in pensions. Based on our estimates, this will also lead to slower GDP growth in 2015 relative to the projection stated in the February *Report*.

Year-on-year inflation is expected to rise moderately in the second half of 2014, staying within the target tolerance band until the end of the projection horizon.

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



According to our estimates, year-on-year inflation should move around the lower bound of the target tolerance band in the second quarter of 2014. In the second half of the year, it is expected to rise moderately, though staying within the target tolerance band until the end of the projection horizon. Low aggregate demand will continue to act as the key disinflationary factor, its effect probably being reinforced by additional fiscal consolidation measures. On the other hand, moderate inflationary effects will be generated by food inflation, which is expected to move from the negative into the positive zone in the second half of the year as a result of low last year's base.

The character of monetary policy in the coming period will depend on developments in the international environment, pace and intensity of fiscal consolidation at home and the outcome of this year's agricultural season.

Further monetary policy easing in the coming period will depend primarily on the strength of potential negative effects of external shocks on the country risk premium and primary commodity prices, as well as on the pace and intensity of fiscal consolidation and the outcome of this year's agricultural season.

II. Monetary policy since the February *Report*

Following a cut in December, the key policy rate was kept on hold in the first four months of 2014.

Though inflationary pressures were very low and inflation expectations stable, the NBS Executive Board decided at its March and April meetings to keep the key policy rate unchanged on account of heightened instability in the international financial markets.

At its May meeting, the Executive Board lowered the key policy rate to 9.0%, guided by the fact that the risks from the international environment have not affected the country risk premium and capital flows thus far, as well as by the announcement of decisive economic policy action by the new Government.

The projection published in the February *Report* indicated that y-o-y inflation was most likely to move within the target tolerance band over the entire projection horizon (Q2 2014–end-2015). It was estimated that low aggregate demand would remain the main disinflationary factor, while upward pressures would be generated by the VAT increase and administered price growth. The risks to the projected inflation path were associated primarily with the outcome of this year's agricultural season and developments in the international environment, and to a degree, with fiscal movements at home. Assuming fiscal consolidation would be implemented as planned, the Executive Board hinted at further monetary policy easing which would depend primarily on the strength of potential negative effects of the Fed's QE tapering.

Inflation returned within the target tolerance band in January and moved in line with NBS expectations until the next Executive Board meeting in March. Monthly inflation rate in January was much higher (1.4%) than the average rate over the prior twelve months as a consequence of the upward revision of the special VAT rate and excise tax. At the same time, market developments in February indicated likely stagnation of prices in that month, i.e. continuation of low inflationary pressures.

At its meeting in March, the Executive Board voted to keep the key policy rate on hold, having in mind the international financial market instability, triggered by the Fed's QE tapering decision and fuelled by the geopolitical tensions in Ukraine. For its potential to dampen investor mood and affect capital inflows to Serbia, this instability warranted further caution in the conduct of monetary policy.

In its press release, the Executive Board said it expected consistent implementation of fiscal consolidation measures to reduce the exposure of the domestic economy to the above exogenous risks. Working in the same direction would also be an arrangement with the IMF, which should underpin the credibility of measures aimed at maintaining macroeconomic stability and delivering sustainable growth.

The Executive Board stated that growth had been recorded since the beginning of the year in a considerable number of manufacturing branches, boding well for the economic growth rate in 2014 as a whole. Positive economic growth rate should also be sustained by the expected euro area recovery and the start of negotiations on Serbia's EU accession.

At its meeting in April, the Executive Board stated that y-o-y inflation rate was moving around the lower bound of the target tolerance band, that inflationary pressures had abated significantly and that inflation expectations were stable. It also stated that risks emanating from the international environment did not abate in the meantime. The Board warned that the instability in international financial markets and heightened uncertainties stemming from the current geopolitical tensions could reflect on Serbia through contracted capital inflows and higher prices of primary commodities.

In view of all of this, t**he Executive Board decided to keep the key policy rate unchanged in April**. Explaining the decision, the Board said that the expected stepping up of fiscal consolidation and structural reforms would contribute to stabilising inflation at low levels and preserving price and financial stability over the medium run, while at the same time reducing the exposure of the domestic economy to the above exogenous risks. The Board also voiced expectation that the announced fiscal policy measures would open up the scope for monetary policy easing in the period ahead, which should have a positive effect on the sustainability of economic growth.

Standard & Poor's affirmed Serbia's long-term local and foreign currency sovereign credit rating at BB- in April, highlighting that the ratings could stabilise at current levels if the reforms consolidate public finances, leading to more favourable economic growth prospects and a sustainable external position of the country over the medium term.

At its meeting in May, the Executive Board lowered the key policy rate to 9%, citing that the current geopolitical tensions and the Fed's QE tapering have had no negative effects on the country risk premium and foreign trade flows thus far and that the financial market has been responding well to measures announced by the new Government, notably those relating to fiscal consolidation.

Since the last *Inflation Report*, the NBS also made use of an additional monetary policy instrument – interventions in the foreign exchange market, in order to ease excessive short-term volatility of the exchange rate of the dinar. From early February through late April, the NBS sold EUR 490.0 mln and bought EUR 130.0 mln in the foreign exchange market.

III. Inflation developments

After falling for two consecutive quarters, consumer prices went up in Q1, mainly reflecting the increase in the special VAT rate and excise rate adjustment. Inflationary pressures however stayed rather low, as signalled by core inflation moving around zero in Q1. Following the January rise, y-o-y inflation declined in February and March, and stood below the lower bound of the target tolerance band in late Q1.

Inflationary pressures subsided also on the back of reduced expectations across the board. Over the past half a year, financial sector expectations stabilised within the target band, and corporate expectations slid to the target in April.

Y-o-y inflation will move around the lower bound of the target tolerance band in Q2, with risks heavily weighted to the downside. CPI growth in Q2 will be under the strongest sway of the seasonal rise in fruit and vegetable prices, whilst low demand will generate further disinflationary pressures.

Inflation developments in Q1

Trending around the lower bound of the target tolerance band in Q1 (2.5%), **y-o-y inflation** slid negligibly below the bound in March (2.3%), which is lower than projected in the February *Inflation Report*. The weaker price growth compared to our central projection is due to the lesser than expected rise in prices of non-food products and services.

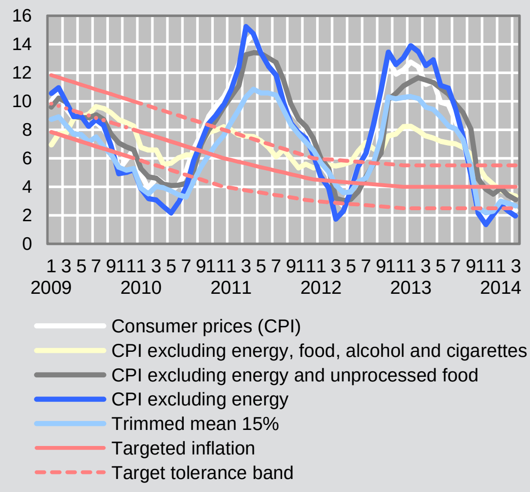
After declining for two straight quarters, **consumer prices** gained 1.2% in Q1. The rise was driven primarily by a special VAT rate hike and the regular annual excise rate adjustment in January, as shown by the monthly dynamics of inflation. Following a robust rise in January (1.4%), consumer prices stagnated in February (0.1%), only to fall by 0.3% in March.

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

	2013				2014
	I	II	III	IV	I
Consumer prices (CPI)	1.1	1.8	-0.5	-0.2	1.2
Unprocessed food	2.2	10.9	-13.4	-4.3	3.9
Processed food	1.1	-0.4	-0.3	-0.7	0.6
Industrial products excluding food and energy	1.7	0.9	2.0	1.0	1.6
Energy	-0.2	-0.9	5.1	-0.4	0.9
Services	0.6	1.8	0.7	1.2	0.0
Core inflation indicators					
CPI excluding energy	1.4	2.3	-1.4	-0.2	1.3
CPI excluding energy and unprocessed food	1.2	0.7	1.0	0.5	0.8
CPI excluding energy, food, alcohol and cigarettes	0.7	1.7	0.7	1.0	-0.1
Administered prices	2.9	0.7	5.6	0.9	1.8

Sources: SORS and NBS calculation.

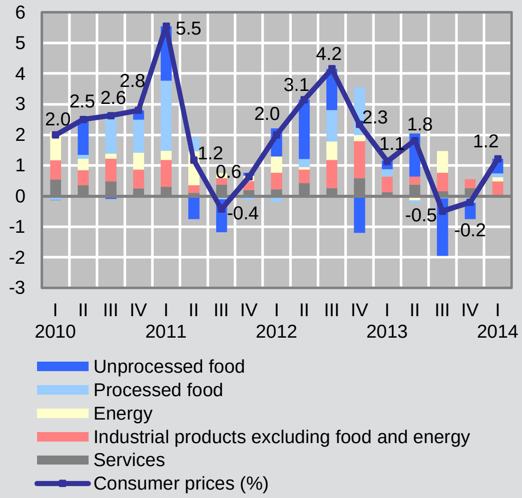
Chart III.0.1 **Price movements**
(y-o-y rates, in %)



Sources: SORS and NBS calculation.

On a continuous decline throughout Q1, core inflation moved within the bounds of the target tolerance band.

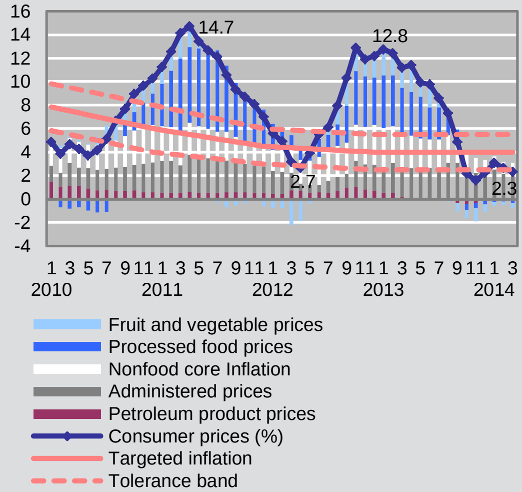
Chart III.0.2 **Contribution to quarterly consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

VAT and excise rate adjustments lifted up consumer prices in Q1.

Chart III.0.3 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Food prices produced further disinflationary pressures on y-o-y inflation in Q1.

In the category of **unprocessed food**, the sharpest rise was noted for fresh fruits (13.2%) and vegetables (7.8%), whilst prices of fresh meat lost 2.8%. Following three consecutive quarters of decline, **processed food prices** edged up by 0.6% in Q1. Bread and cereal prices increased the most (2.0%), followed by milk and dairy products and processed meat (1.2% each). The effects of the special VAT rate hike on food prices were neutralised somewhat by disinflationary pressures arising from low food production costs.

Industrial product prices excluding food and energy expanded by 1.6% in Q1. The bulk of the price increase in this group was caused by rising cigarette prices, resulting from the January excise rate adjustment (9.6%), and higher prices of medicaments (2.3%) led by the special VAT rate adjustment. By contrast, prices of clothes (3.3%) and footwear (3.7%) declined more than seasonally expected.

Energy prices were up 0.9% in Q1, chiefly on the back of an increase in petroleum product prices (1.6%) following the excise rate adjustment. Besides, the special VAT rate hike lifted up the prices of central heating, gas and solid fuels (wood and coal).

In Q1, **prices of services** stayed unchanged from the quarter earlier. An upturn was registered for prices of hotel and restaurant services, utilities and urban passenger transport because of the VAT adjustment. The rise was, however, neutralised by lower prices of travel arrangements (17.3%).

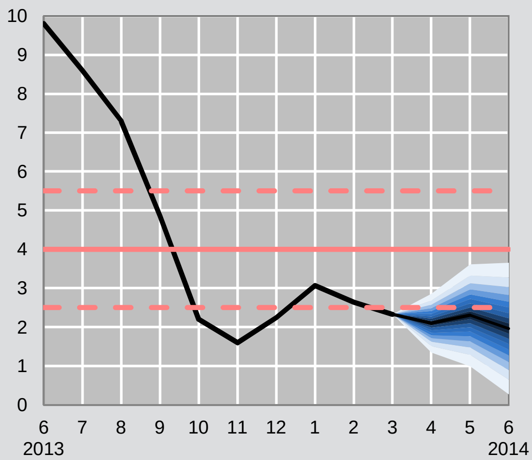
Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) was down 0.1%, on account of cheaper clothes, footwear and travel arrangements. Y-o-y, core inflation was on a continuous decline in the review period and reached 3.4% in March.

Administered prices recorded a heftier rise (3.0%) than in the previous quarter, also because of the VAT and excise rate adjustments. Within this group, the main contribution to overall growth was provided by rising prices of cigarettes, medicaments and utilities.

Projection for Q2

Under the NBS estimate, y-o-y inflation will move around the lower bound of the target tolerance band in

Chart III.0.4 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

In Q2, y-o-y inflation is likely to move around the lower bound of the target tolerance band.

Q2, with risks heavily weighted to the downside. Y-o-y core inflation is also likely to trend around the lower bound.

Q2 consumer price growth will slightly exceed somewhat the Q1-figure, mainly on account of the seasonal rise in fruit and vegetable prices once the new growing season starts.

Prices of **food and non-alcoholic beverages** are expected to outstrip those in Q1. **Unprocessed food** prices will rise significantly, whilst processed food prices will go down. Within unprocessed food, the steepest rise is expected from fruit and vegetable prices as new seasonal products come to the market. On the other hand, low costs in the production of **processed food** will probably fuel disinflationary pressures further in Q2, though not as much as in the previous three quarters.

Prompted by an increase in medicament prices, the rise in **industrial product prices excluding food and energy** will be smaller than in Q1.

Energy prices are likely to rise moderately because of the anticipated surge in heating prices. Contrary to the February projection, the electricity price adjustment is anticipated in Q3.

Prices of services will outperform the Q1 figure, mainly owing to an increase in travel arrangement prices with the onset of new summer season and the adjustment of prices for postal services.

The main risks to the projection are associated with agricultural product prices with the onset of the new season and the current geopolitical tensions in the world, which may affect Serbia through lower foreign capital inflows and rising prices of energy products and primary agricultural commodities.[1]

Import and producer prices

Industrial producer prices for the domestic market gained 0.4% in Q1, reflecting higher prices in the production of chemical products, beverages and the exploitation of metal ores. In contrast, producer prices in the food industry and the production of clothes drifted down relative to the quarter before. Despite a Q1 increase, producer prices continued down to 0.2% y-o-y in March.

Unlike the previous quarter when they recorded vigorous growth, **agricultural producer prices**[2] fell by 2.6% in Q1. Prices of live stock declined the most (8.0%), spilling over into sale prices of fresh meat. Cereal prices stagnated, while prices of industrial plants went up

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

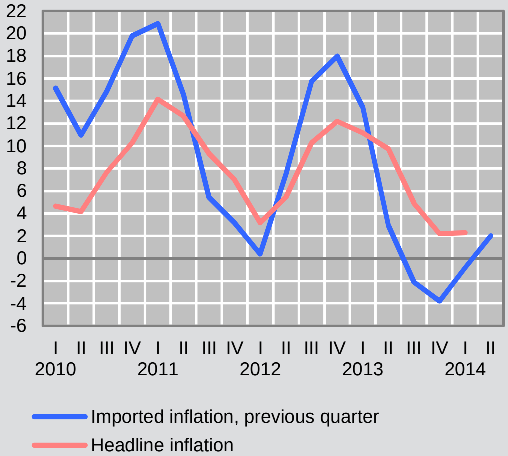
	VI 2013 / VI 2012	IX 2013 / IX 2012	XII 2013 / XII 2012	III 2014 / III 2013
Consumer prices	9.8	4.9	2.2	2.3
Domestic industrial producer prices	4.3	1.6	0.8	0.2
Agricultural producer prices	5.2	-26.1	-11.6	-6.1
Prices of elements and materials incorporated in construction	3.1	2.5	2.1	3.5

Sources: SORS and NBS calculation.

[1] See Text Box 3 on page 41.

[2] Producer prices in agricultural and fishing sectors.

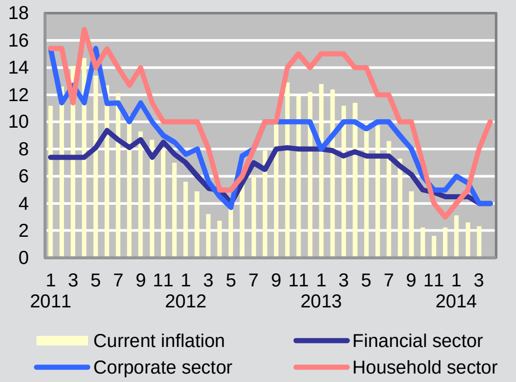
Chart III.0.5 **Domestic and imported inflation**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

Import prices recorded a mild y-o-y rise in Q1. The following quarter is not expected to witness any major inflationary pressures either.

Chart III.0.6 **Current inflation and one-year ahead inflation expectations – by sector***
(y-o-y rates, in %)



Sources: Gallup, Ipsos and NBS.
* Ipsos from November 2011 and Gallup in the earlier period.

Inflation expectations of financial and corporate sectors stand within the target tolerance band, while household expectations have overshot the upper bound of the target most probably because of the methodological change in the survey.

(8.6%). However, both categories remained around 20% below the last-year level. At the same time, a y-o-y decline in agricultural producer prices slowed further to 6.1% in March.

Prices of elements and materials incorporated in construction went up by 2.2% in Q1. After six quarters, these prices sped up to 3.5% y-o-y in March.

Having declined in Q4, **import prices expressed in dinars**[3] added 1.1%[4] in Q1. The rise was triggered mainly by higher world food prices precipitated by extreme weather in the US and the political crisis in Ukraine, as well as an increase in prices of imported intermediate goods. A dampening effect was produced by global oil prices and import prices of consumer goods, which declined in Q1. The Q1 depreciation of the exchange rate also contributed to a rise in dinar import prices. After three quarters in a row, import prices rose in y-o-y terms as well, reaching 2.0% in March.

Inflation expectations

Over the last six months, one-year ahead inflation expectations of the financial sector stabilised within the target tolerance band. Stabilisation of inflation expectations within the band will lower the cost of price stability in the period ahead.

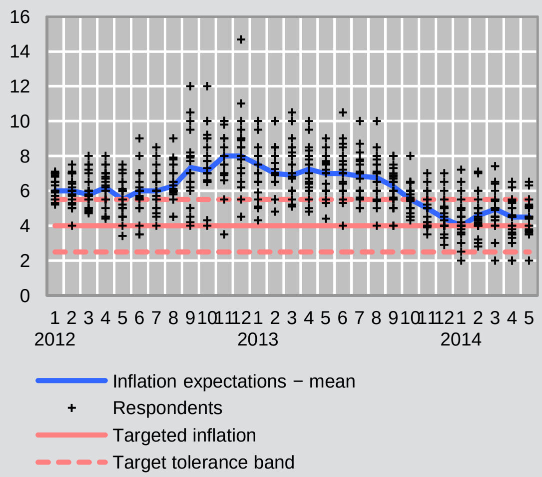
According to the **Bloomberg** survey, following the January decline to the target level (4.0%), one-year ahead inflation expectations of the financial sector rose over the next two months (to 5.0% in March), only to slide to 4.5% in April, where they stayed in May. Financial sector expectations were pared back reflecting a drop in current inflation and expectations of rather low inflationary pressures. Under the **Ipsos** survey, financial sector expectations declined from 4.5% in January and February to the target level in March. Corporate expectations also dropped to the target in March. As suggested by the April survey, both financial and corporate sector expectations remained unchanged.

One-year ahead inflation expectations went up only within the household sector. The reason probably lies with the methodological change. Up to the March survey, respondents expressed their expectations only after being presented with data on current inflation. For that reason household expectations are estimated to have been largely determined by current inflation, which diminished the validity of responses obtained. As of March, households

[3] As an indicator of import prices, we used the weighted average indices of global oil and food prices, export and consumer prices of Germany as our most important foreign trade partner.

[4] The ratio of averages for two consecutive quarters.

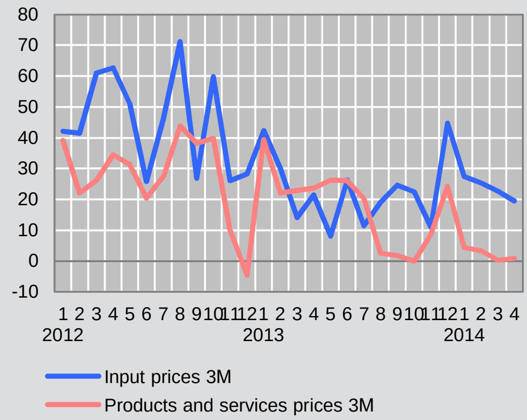
Chart III.0.7 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

Since October, financial sector expectations have moved within the target tolerance band.

Chart III.0.8 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos and NBS.

Over the next three months, enterprises do not expect a rise in their product and services prices. The share of enterprises expecting a rise in their input prices declined significantly since early 2014.

are no longer presented with information on current inflation. This is the principal reason why their expectations equalled 8.0% and 10.0% in March and April respectively, versus 5.0% in February.

Another novelty in the Ipsos March survey concerns **medium-term inflation expectations** – for two years ahead. Namely, all sectors now expect relatively stable medium-term inflation. Financial and corporate sectors see inflation within the target tolerance band in two years' time (4.5% and 4.0% respectively), while households expect the figure of 8.0%.

Following a robust January increase across the board, the dispersion of responses of financial sector respondents declined. It however continued up in corporate and household sectors. The dispersion of corporate responses displayed a moderate upward trend from December last year. Though usually high, the dispersion of household responses touched a record high level in March and April because of the above methodological change.

Since the beginning of the year, the net percentage[5] of enterprises expecting a rise in prices of their inputs, products and services over the next three months was on a decline. Moreover, the net percentage of enterprises expecting a rise in their product and services prices was brought to a zero.

[5] The difference between the percentage of enterprises expecting an increase and those expecting a reduction in the prices of their inputs, products and services. To increase representation, data are weighted by operating revenue.

Text box 1: Private sector inflation expectations

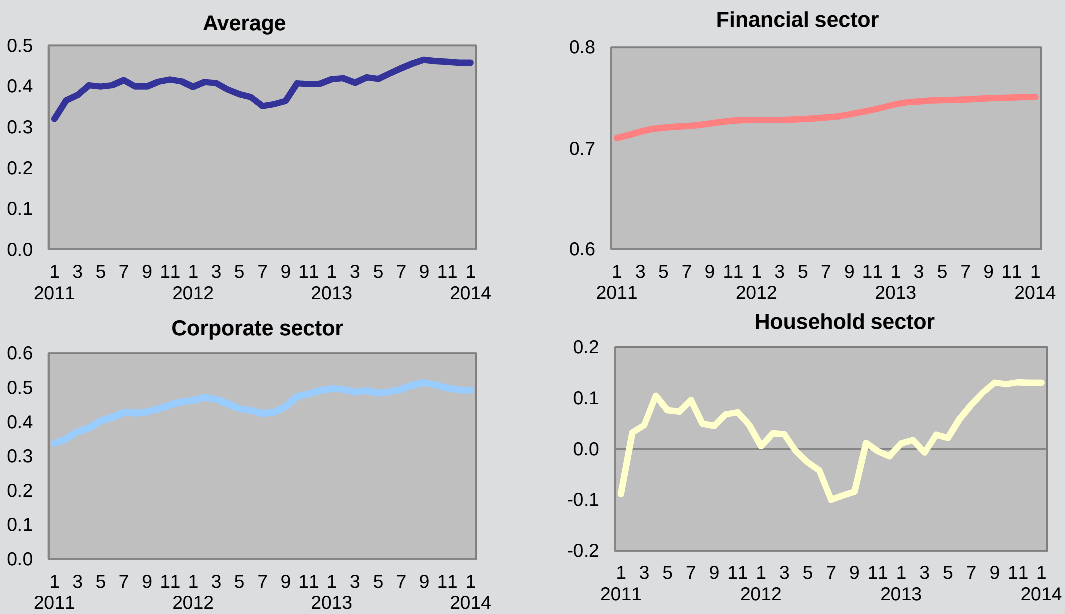
Inflation expectations of market participants have a direct impact on their business decisions and, consequently on the price level in the short run. Anchoring of inflation expectations is therefore the key precondition for stabilising inflation and increasing the efficiency of monetary policy measures. Higher credibility, i.e. a higher extent to which expectations are anchored, enables a central bank to achieve the same degree of monetary policy restrictiveness by smaller increases in the key policy rate, and thus with a smaller negative effect on economic activity.

The extent to which inflation expectations are anchored in Serbia has been examined by using the vector autoregressive model with time variable parameters (TVP VAR)[1]. As a measure of inflation expectations, monthly data from Bloomberg and Ipsos surveys were used – from January 2009 to January 2014 for the financial sector, and from October 2010 to January 2014 for the corporate and household sectors. Consistent with the behaviour of market participants and the theoretical model developed by Bomfim and Rudebusch (2000)[2], it was assumed that inflation expectations (π_t^e) are formed based on the observed previous level of inflation (π_{t-1}) and a long-term (stable) level of inflation expected by the private sector (π_t^*):

$$\pi_t^e = \lambda\pi_t^* + (1-\lambda)\pi_{t-1}$$

The main hypothesis is the following: the higher the extent to which inflation expectations are anchored, the smaller the impact of changes in current inflation on changes in inflation expectations (λ is higher).

Chart O.1.1 **Extent to which inflation expectations of the private sector are anchored**



Source: NBS.

[1] See: *Demertzis Maria, Marcellino Massimiliano and Nicola Viegi (2010): Anchors for Inflation Expectations EUI Working Paper 2010/10 u Primiceri, Giorgio E. (2005), Time varying structural vector autoregressions and monetary policy, Review of Economic Studies 72, 821–852.*

[2] *Bomfim, Antulio N., and Glenn D. Rudebusch, (2000), Opportunistic and Deliberate Disinflation under Imperfect Credibility, Journal of Money, Credit & Banking 32(4), 707–21.*

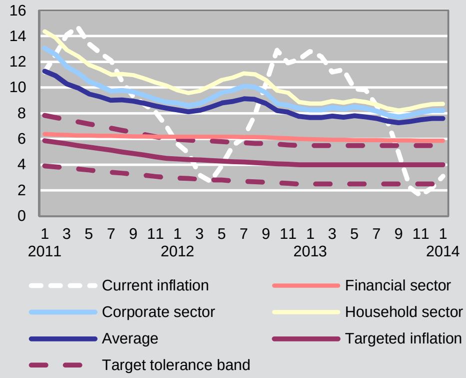
Results of the analysis show that the extent to which inflation expectations are anchored (λ), following a drop in H1 2012, recorded a continuous increase (Chart O.1.1). In the period June 2012–January 2014, it increased by 9.0 pp – from 37% to 46%. The increase was recorded also in the period of growth in current inflation, in H2 2012 and early 2013, and intensified in Q2 and Q3 2013. The extent to which inflation expectations are anchored went up in all sectors, most notably in the household sector. It is, however, the highest in the financial sector, where it recorded a gradual, but continuous rise, arriving at around 75% in January 2014.

Survey results also show that, although above the upper bound of the target tolerance band, the long-term (stable) level of inflation expected by the private sector (π_t^*) has displayed a downward tendency from H2 2012 (Chart O.1.2). Similarly to the above, the decline in this period was the most pronounced in the household sector, while long-term expectations of the financial sector were very stable and slightly above the upper bound of the target.

The effects of a higher extent to which inflation expectations are anchored may be alternatively viewed also by examining the effect of an unexpected rise in inflation on private sector expectations (Chart O.1.3). The examination was conducted for three periods: January 2010 (one year after inflation targeting was adopted as the official monetary policy regime), June 2012 (soon after inflation fell below the lower bound of the target) and January 2014. Results show that the inflation shock of 1.0 pp in January 2010 led to a rise in one-year ahead inflation expectations of somewhat above 0.5 pp, while the rising effect of the shock on inflation expectations with a time lapse shows that they were not anchored. In June 2012, the maximum effect of the shock on inflation expectations equalled 0.38 pp. Then, over the last two years it declined and arrived at below 0.2 pp in January 2014. Therefore, the impact of the sudden increase in inflation on inflation expectations was almost twice less in January 2014 than in June 2012, and is much more rapidly waning.

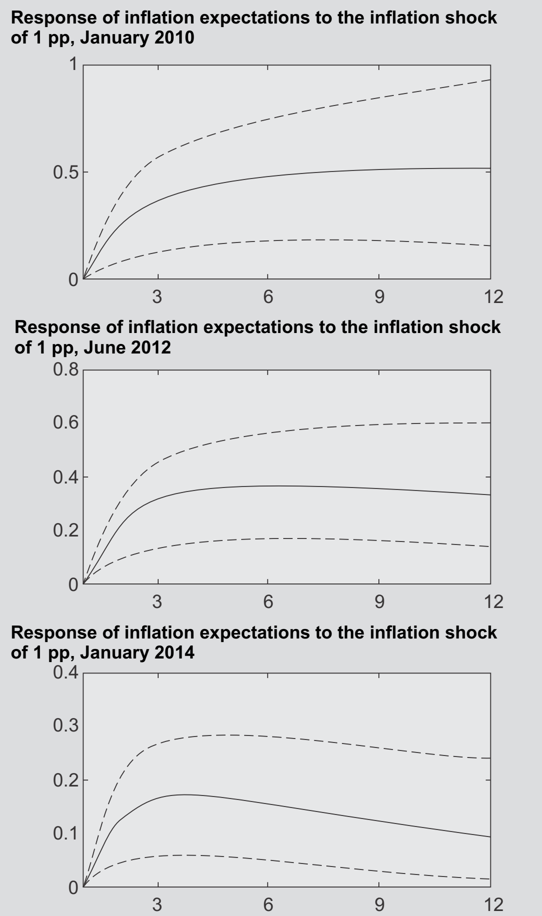
The above results point to an increase in the extent to which inflation expectations are anchored, over the past year and a half. However, despite positive tendencies, the extent is lower than in developed countries running inflation targeting regimes, where it moves at around 90%. Given the importance of inflation expectations and their anchoring to the target level, the NBS will continue to actively inform the public about the manner of functioning of monetary policy. Better assessment of monetary policy credibility will be underpinned also by publishing medium-term inflation expectations – for two years ahead, as the Ipsos agency has recently started (in March 2014), in cooperation with the NBS.

Chart O.1.2 **NBS inflation target and implicit long-term level of inflation expected by the private sector**



Source: NBS.

Chart O.1.3 **Impact of the inflation shock of 1.0 pp on one-year ahead inflation expectations***



* The full line shows the quantitative effect; interrupted lines show confidence intervals of 95%.

IV. Inflation determinants

1. Financial market trends

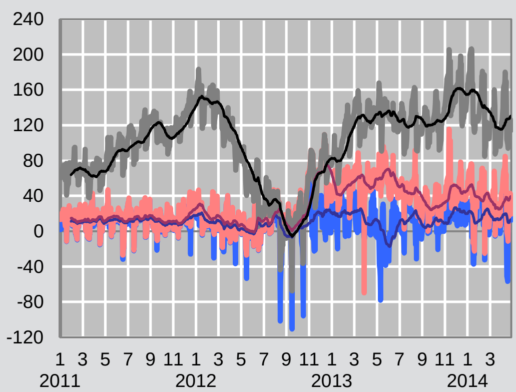
In the course of Q1, trends in the domestic financial market were largely affected by developments in international financial markets, notably the Fed's decision to embark on QE tapering. As a result, rates on government securities increased under the impact of the temporary decline in non-residents' propensity to invest, notwithstanding the decline in interbank money market rates. As was the case in other countries of the region, depreciation pressures were the strongest in January, when the risk premium recorded a one-off rise. The pressures waned by the quarter-end, which was followed by a sharp drop in the risk premium.

Interest rates

The average repo rate[6] displayed minimum volatility in Q1. It touched its lowest value of 7.3% by mid-January, only to rise to 7.6% by March on account of diminished liquidity, thus approaching the end-2013 level. As banking sector liquidity contracted, the NBS reduced its sales volumes at repo auctions, while at the same time the degree of meeting the demand was raised.

Reduced banking sector liquidity induced a moderate increase in activity in the interbank overnight money market. Average daily trading volumes came at RSD 1.6 bln in Q1, up by RSD 0.3 bln and RSD 0.4 bln from Q4 and Q1 2013 respectively, but still remaining significantly below the average quarterly values of 2012. The average

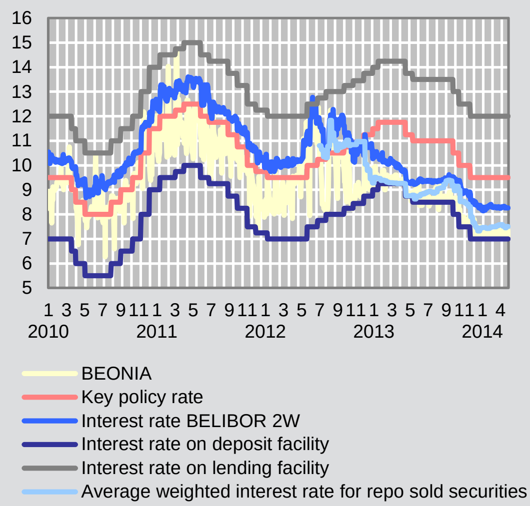
Chart IV.1.1 **Dinar liquidity**
(daily stock and moving averages, in RSD bln)



Source: NBS.

Banking sector liquidity declined relative to Q4 2013, but remained high.

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



Sources: Thomson Reuters and NBS.

The weighted average benchmark rate displayed minimum volatility in Q1.

[6] Rate achieved at repo auctions, weighted by the amount of sold securities.

monthly BEONIA fell by 0.4 pp in Q1. Following the January drop (0.3 pp), it stayed flat in February, only to slide by 0.1 pp to 7.2% in March.

BELIBOR rates showed a similar trend – a fall in January and stagnation in February and March. They declined by 0.3–0.4 pp at the quarterly level, and their average March figure ranged from 7.9% for the shortest to 9.1% for the longest maturity.

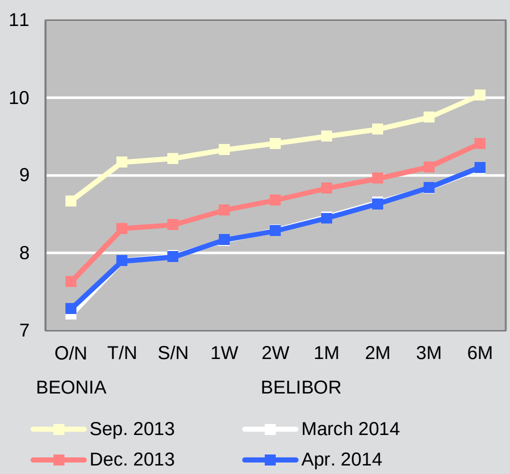
In the course of April, trading volumes in the overnight interbank money market went up, while interest rates stayed unchanged from March.

Rates in the primary securities market recorded divergent movements. The shortest-maturity rates – of three and six months, lost 1.6 pp and 1.2 pp respectively, and arrived in February at 7.5% and 7.8% respectively partly because only a small amount of securities was offered for sale. On the other hand, longer-maturity rates mirrored the behaviour of non-residents. External factors, notably the Fed's QE tapering and mounting geopolitical tensions, weighed down on non-resident participation in February. As a result, following a January drop, the rates increased in February. The decline in interest was only temporary as non-residents stepped up their investment in the second half of March, even though a significant amount of securities in their possession fell due for redemption in this period. By end-March, rates in the primary market moved from 8.9% for one-year to 13.0% for seven-year maturity. The weighted average rate on dinar securities equalled 10.4% in March, up by 0.8 pp on end-2013.

Rates were on a downward slope at four auctions of euro-denominated securities held in Q1. Rates on one-, two- and three-year maturities fell by 0.2 pp each, while five-year rates lost 0.1 pp, which implies a range from 3.3% for the shortest to 5.1% for the longest maturity. In contrast to Q4 2013, when almost the entire amount of securities was sold to domestic investors, the share of non-residents in primary trade picked up in Q1.

Total trading volumes in the secondary market reached RSD 34.7 bln, which is almost three times down on the quarter before. Most traded were one- and three-year securities. Excluding trading up to two business days from the primary settlement date, trading volumes totalled RSD 18.5 bln. Mirroring the trends in primary trading, the rates of return in the secondary market

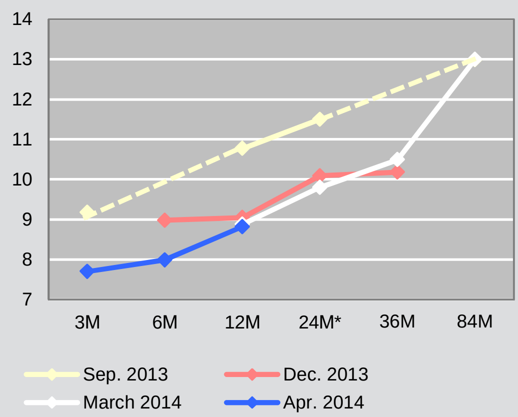
Chart IV.1.3 **Yield curve in the interbank money market**
(average values, p.a., in %)



Sources: Thomson Reuters and NBS.

Following a January drop, money market rates stayed broadly unchanged by end-April.

Chart IV.1.4 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities whose interest rate is linked to the NBS key policy rate.

The slope of the dinar yield curve increased in Q1.

declined in January and rose slightly in February and March. However, they were lower in late Q1 than at end-2013, and ranged from 7.8% for the remaining one-month maturity to 10.4% for 32-month maturity.[7]

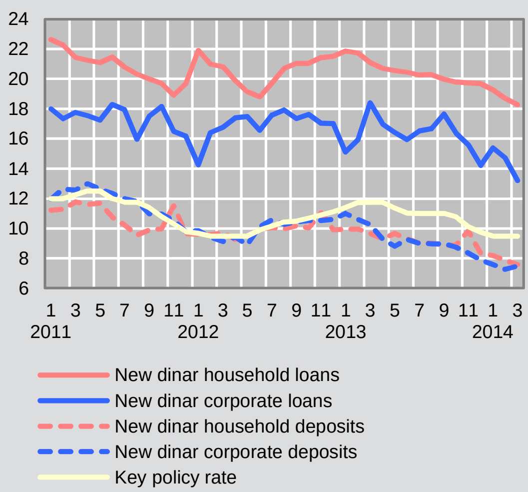
April saw an insignificant rise in rates on short-term dinar securities, while longer-maturity rates remained unchanged compared to March. A ten-year euro-denominated government security was issued for the first time in the domestic market, and there are also plans to issue ten-year dinar securities in the course of the current year.

The weighted average rate on new dinar loans fell by 0.5 pp down to 16.6% in March. Rates on corporate loans were down by 1.0 pp to 13.2%, and rates on household loans fell by 1.4 pp to 18.3%. The decline in the weighted average rate on total dinar loans was smaller than that on corporate and household loans alone because of the modified structure of fresh dinar loans, i.e. a higher share of household loans which are costlier than the corporate ones.

Reflecting a reduction in rates on current assets loans and other loans of 13.1% and 13.3% respectively, rates on dinar corporate loans declined. Interest on investment loans went up to 14.7%. Interest declined on dinar household loans mainly because of a 1.4 pp drop in rates on cash loans to 18.2% in March. Also, interest on consumer loans, which are much less in demand, went down to 21.2%. In March, rates on current account overdrafts also declined. As part of the initiative aimed at a general reduction in prices of banking products, the NBS began to publish in February the costs of authorised current account overdrafts by individual banks, so as to facilitate access to publicly available data on terms offered by banks. Responding to this initiative, already in February some banks reduced their rates on authorised current account overdrafts.

Rates on new euro and dinar euro-indexed loans stayed unchanged from end-2013 and equalled 6.5% in March. Rates on corporate loans fell by 0.2 pp to 6.1%, while rates on household loans upped by 0.4 pp to 8.3%. Similarly to rates on dinar loans, the rates on euro-indexed current assets and other loans fell to 6.1% and 6.3% respectively, while rates on investment loans edged up to 6.4% in March. Unlike rates on dinar loans, interest rates on other euro-indexed household loans increased. Rates on FX-indexed consumer loans declined.

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

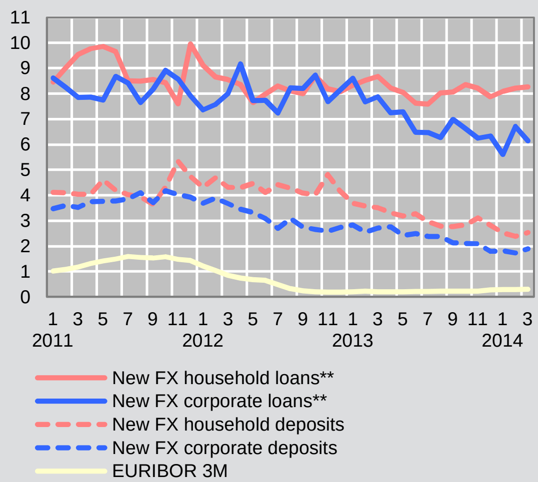


Source: NBS.

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

The interest margin on dinar sources decreased...

Chart IV.1.6 **Lending rates on FX loans and corporate and household deposits***
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.

* Excluding revolving loans, current account overdrafts and credit card debt.
** Euro and euro-indexed.

... while the margin on FX sources went up in Q1.

[7] Excluding the rate on seven-year securities (13.0%), which equalled the rate in primary trade in these securities.

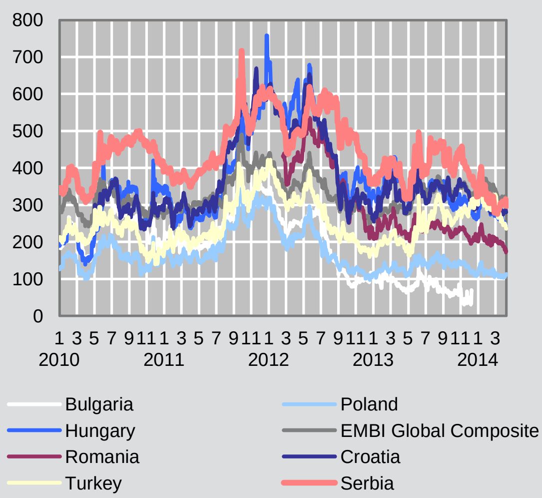
Deposit interest rates continued down in Q1. In March, weighted average rates on new dinar corporate and household deposits amounted to 7.5% and 7.6% respectively. Interest rates on household euro deposits fell to 2.5%, while those on corporate deposits increased slightly, to 1.9% by end-Q1.

Deposit rates reached their lowest value from September 2010 when the current methodology of interest rate statistics was introduced. The NBS supports the banks' commitment to continue lowering their deposit rates as this will reduce the price of funding, which is one of the prerequisites for the reduction in lending rates and the recovery of credit activity.

Risk premium

Measured by EMBI, risk premia of all countries in the region declined in Q1, most notably for Serbia. Over the entire period under review, EMBI precipitated down across the region, apart from end-January when it temporarily rebounded in response to the Fed's decision to continue with QE tapering. The decline resumed in early February and continued until the quarter-end reflecting higher yields on US sovereign bonds and falling yields on eurobonds of the countries observed.

Chart IV.1.7 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Risk premia of all countries observed experienced a drop since early 2014, most notably for Serbia.

In the course of Q1, EMBI for Serbia lost 92 bp and reached 282 bp by end-March, thus trending close to the values recorded in Croatia (273 bp) and Hungary (267 bp). In terms of the period-average, risk premia shrank in all countries, apart from Turkey. The steepest fall was seen in Serbia (79 bp), where the premium touched its recorded low (in March) since November 2007.

Though the Fitch rating agency downgraded Serbia's credit rating to B+ in January, this had no repercussions on the risk premium. The downgrade was counterbalanced to a degree by the announcement of an arrangement with the IMF and the start of Serbia's EU accession negotiations. Serbia's risk premium contracted further also on the back of expectations of vigorous implementation of announced structural reforms and fiscal consolidation following the parliamentary elections.

In April, Standard & Poor's affirmed Serbia's credit rating at BB-. As appraised by the agency, the rating is constrained by risks stemming from high fiscal and external deficits, and limited monetary policy flexibility owing to the high euroisation of the economy. Still, the rating is supported by Serbia's long-term economic growth potential, which is contingent on reforms in the labour market, business environment and public administration. Furthermore, more favourable conditions were created in which to embark on fiscal consolidation and structural reforms. Besides, in the agency's view, policy making must focus on containing any further deterioration of public finances, designated as the main reason for keeping the negative outlook.

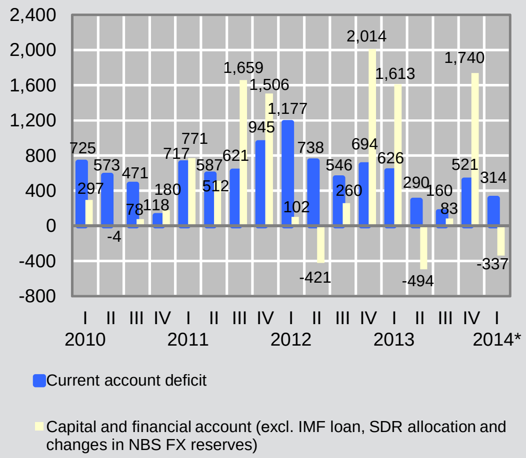
In the course of April, Serbia's risk premium increased slightly from end-March – to 297 bp.

Foreign capital inflow

The external trade imbalance narrowed further at the beginning of 2014 as Q1 witnessed a 49.8% reduction in the current account deficit y-o-y. The main impetus came from much faster growth in goods and services exports relative to imports. At the same time, the deficit on the income account widened as rates on portfolio investments went up.

Developments in the financial account were less favourable as capital flowed out, notably for the purpose of reducing the foreign debt burden. Inflow was recorded only for FDIs.

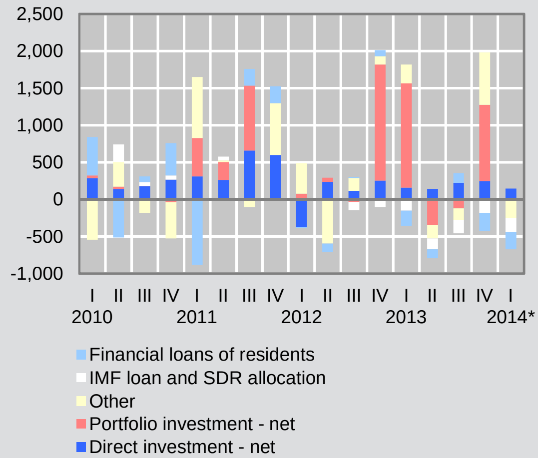
Chart IV.1.8 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Q1 saw a low current account deficit and a net foreign capital outflow.

Chart IV.1.9 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

The FDI inflow did not suffice to cover the outflow arising mainly from the settlement of obligations towards foreign creditors.

The FDI inflow was somewhat lower than in the quarter before – it totalled EUR 143.6 mln in Q1. Most of it went to manufacturing (21.1%), trade (18.7%), construction (18.5%) and financial activities (15.7%). We expect that the pace of FDIs will speed up after the formation of the government, acceleration of structural reforms and fiscal consolidation.

The outflow of portfolio investments came at EUR 4.1 mln net in Q1. Broken down by month[8], non-residents were net buyers of government securities in January and March, and net sellers in February. Such trends were driven mainly by Fed's QE tapering, which began in January and continued through February.

In Q1, residents repaid external debt worth EUR 233.2 mln net. Bank external liabilities contracted by additional EUR 248.1 mln, mainly in respect of long-term loans. The government repaid EUR 71.0 mln net. Of this, foreign debt servicing costs were EUR 123.2 mln, and loan withdrawals EUR 52.2 mln, including EIB loans for public sector research and development and for the Corridor X. By contrast to banks and the government, net cross-border borrowing by enterprises increased by EUR 85.9 mln.

Enterprises repaid trade loans worth EUR 116.9 mln net.

[8] According to data from primary trade.

To service its external liabilities, the NBS paid EUR 188.9 mln (almost entirely in respect of the regular settlement of liabilities to the IMF).

Trends in the FX market and exchange rate

Following its weakening recorded in January, the dinar stabilised against the euro by end-Q1 at a somewhat higher level compared to end-2013, only to appreciate slightly thereafter. In the course of Q1, one euro was worth between 114.8 and 116.1 dinars. In nominal terms, the dinar lost 0.6% against the euro end-of-period and 1.2% q-o-q on average.

Moderate depreciation of the dinar against the euro and dollar's strengthening against the euro triggered a 0.9% depreciation of the dinar vis-à-vis the dollar relative to end-2013. Observed by the period-average, the dollar weakened against the euro. As the dinar also depreciated against the euro, it lost 0.6% against the dollar in the period under review.

Consistent with such trends, the nominal effective exchange rate of the dinar[9] weakened by 1.1% on average in Q1.

[9] Calculated as the geometric mean of nominal exchange rates of EUR/RSD and USD/RSD, with respective weights of 0.8 and 0.2, i.e. according to the formula: (EUR/RSD^0.8)*(USD/RSD^0.2).

By contrast to the quarter before, the major part of Q1 featured depreciation pressures, fuelled by both global and domestic factors. Despite the low current account deficit and against the background of a modest FDI inflow and reduced inflow from exchange operations, the depreciation pressures were generated primarily by heightened demand for foreign currency by enterprises and non-residents.

Higher demand for foreign currency by domestic enterprises was of seasonal nature and was noted mainly for importers of energy. Besides, though the Fed's decision to embark on QE tapering in January was expected, it spurred a temporary rise in the risk premium and depreciation pressures across the region, which were particularly pronounced in January. The dinar edged down by 1.1% in January, while other currencies recorded even sharper depreciation despite central bank interventions in some countries. Throughout Q1, non-residents were net buyers of foreign currency, particularly in February and the first half of March.

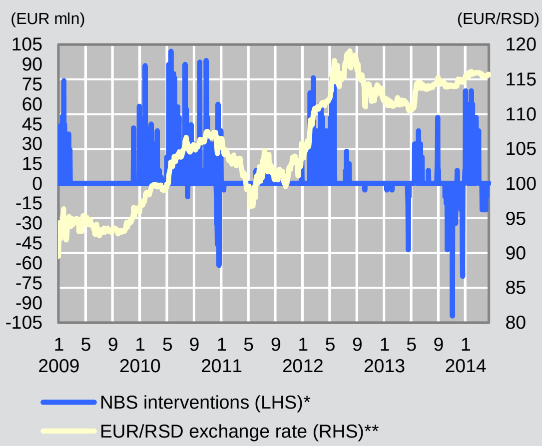
The current account deficit narrowed q-o-q, thus lessening pressures on the FX market. However, the supply of foreign currency in the domestic market did not increase to any significant extent either, because of the modest inflows from FDIs and exchange operations.

IFEM trading slackened further in 2014. Average daily trading volumes (excluding the NBS) amounted to EUR 23.7 mln in Q1. The highest value of trading was recorded in January (EUR 28.4 mln). In February and March, trading volumes came at EUR 21.6 mln and EUR 21.1 mln respectively. Exchange rate volatility, measured by EWMA[10] and EGARCH[11], was consistent with low trading volumes in the IFEM, which were close to the end-2013 levels.

Judging that depreciation pressures did not reflect a long-term tendency, but were of temporary nature, the NBS intervened in Q1 by selling EUR 820.0 mln in order to ease excessive short-term volatility of the exchange rate. It intervened to the same effect by end-March, purchasing EUR 20.0 mln.

In Q1, the NBS continued to organise three-month and two-week FX swap auctions. At three-month auctions, it sold EUR 4.0 mln and bought the same amount. At two-

Chart IV.1.10 **Movements in EUR/RSD exchange rate and NBS FX interventions**

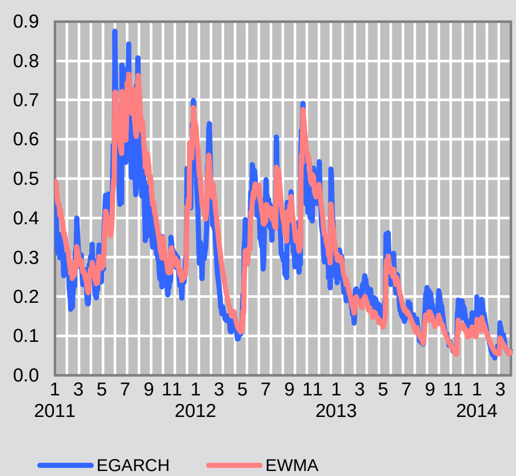


Source: NBS.

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

In contrast to Q4 2013 when it acted as a net buyer, the NBS intervened in Q1 mainly by selling foreign currency.

Chart IV.1.11 **Short-term volatility of the RSD/EUR exchange rate**
(in %)

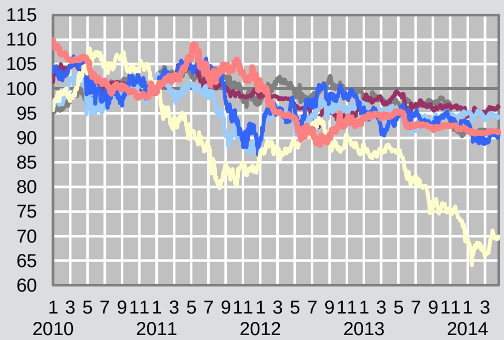


Source: NBS.

Oscillations of the dinar exchange rate were at a low level throughout Q1 as well.

[10] EWMA – Exponentially Weighted Moving Average.
[11] EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

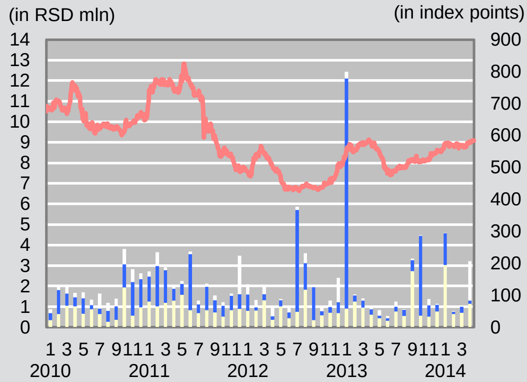
Chart IV.1.12 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)



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

In terms of the period-end and period-average, the dinar was among the currencies which depreciated the least in Q1.

Chart IV.1.13 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

BSE indices recorded minimum growth in Q1.

week auctions, it sold EUR 14.0 mln and bought the same amount.

The increased net sale of foreign currency by non-residents and a higher level of net purchases from exchange dealers sparked appreciation pressures in the course of April, and the NBS bought EUR 110.0 mln in the IFEM.

Among currencies of countries in the region running similar exchange rate regimes, the Hungarian forint (3.3%) and Turkish lira (2.4%) weakened the most in Q1, while the Polish zloty depreciated to much the same extent as the dinar (0.6%). The Czech korona remained practically unchanged q-o-q, while it was only the Romanian lei that picked up (0.7%).

Stock exchange trends

Indices of the Belgrade Stock Exchange (BSE) were stable in Q1. By late March, BELEX15, the index of the most liquid shares, totalled 564.2 points, up by 1.1% from end-2013. BELEXline, the general index of shares, experienced a similar rise – of 1.6% to 1,122.6 by end-Q1.

Total trading in BSE shares amounted to RSD 6.3 bln, down by RSD 0.3 bln q-o-q. The highest value was recorded in January (RSD 4.6 bln), mainly owing to trading in open market[12] shares. Trading in BELEX15 shares amounted to RSD 4.4 bln, up by RSD 2.5 bln from the previous quarter.

Foreign investors were net sellers of shares in early 2014, in the total amount of RSD 1.6 bln, as a result of the January net sale. Over the three months that ensued, non-residents were more active on the purchase than sale side, which may suggest heightened investment in the Serbian capital market.

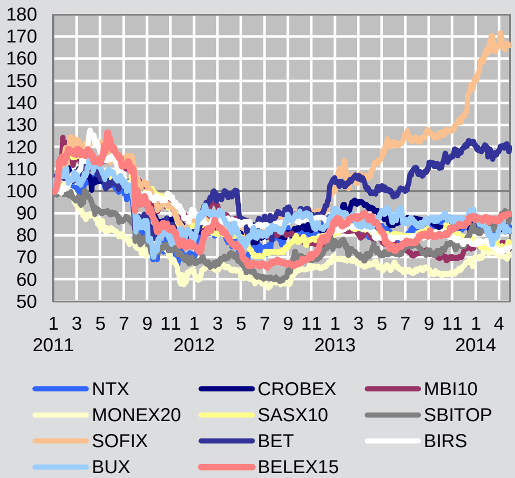
Trading in frozen FX savings bonds receded to RSD 66.4 mln in Q1, almost six times below the Q4-level. All of the three bond series were traded in almost equal amounts and yields on all of them declined. By late March, yield rates ranged from 3.2% for A2015-series to 5.2% for A2014-series.

Corporate bonds were not traded in Q1 either.

BSE capitalisation expanded by RSD 1.5 bln to RSD 774.2 bln by end-March. The share of market

[12] A regulated market segment, consisting of shares not eligible for BSE listing.

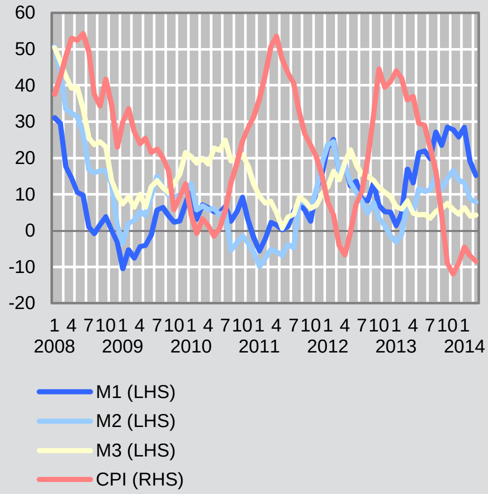
Chart IV.1.14 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

Indices on other stock exchanges in the region recorded larger changes than on the BSE.

Chart IV.2.1 **Monetary aggregates and CPI**
(y-o-y rates, in %)



Sources: SORS and NBS.

Y-o-y growth in money supply, particularly its most liquid component, slowed in Q1.

capitalisation in estimated GDP[13] stayed unchanged from end-2013, equalling 21.3% in late Q1. Broken down by segment, regulated market capitalisation was up by RSD 3.3 bln to RSD 437.9 bln, while the MTP[14] capitalisation contracted by RSD 1.8 bln to RSD 336.3 bln.

Indices on regional stock exchanges displayed greater volatility than BSE indices. The sharpest increase was recorded for indices on Sofia (22.1%) and Ljubljana (9.3%) stock markets, while Banjaluka (6.3%) and Budapest (5.6%) indices tumbled the most.

In April, BELEX15 and BELEXline rose further – by 3.6% and 3.0% respectively. Total trading volumes also increased, partly due to foreign investor activity. Indices on regional stock exchanges recorded less significant changes in both directions.

2. Money and loans

Money supply contracted in Q1, notably its dinar component. The sharpest seasonal decline was observed for corporate deposits, while household dinar savings continued up. Negative tendencies in credit activity prevailed into 2014.

Monetary aggregates

In Q1, dinar reserve money lost 10.5% in nominal and 11.5% in real terms respectively. As a result, total reserve money declined by 2.7% in nominal and 3.9% in real terms respectively. In real y-o-y terms, dinar reserve money was down 0.9% and total reserve money 1.7%.

NBS net FX sales in the IFEM had the decisive impact on the withdrawal of dinar reserve money – RSD 86.9 bln in Q1. On the other hand, a moderate reduction in bank investment in repo securities (by RSD 20.0 bln) and FX payment transactions with Kosovo and Metohija (RSD 8.7 bln) induced a rise in liquidity. By drawing from its dinar and FX accounts, the government prompted a RSD 17.1 bln rise in liquidity.

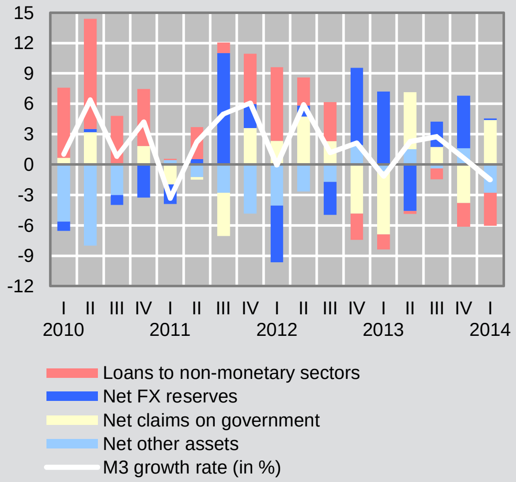
In terms of the composition of dinar reserve money, bank excess reserves[15] declined the most (RSD 26.4 bln). Funds in bank gyro-accounts and overnight facility with the NBS fell by RSD 17.9 bln and RSD 10.5 bln respectively. As usual for the year-start, cash in circulation also declined – by RSD 11.4 bln. The level of required reserves allocated in dinars declined by RSD 3.9 bln relative to end-2013.

[13] Estimated GDP over the last four quarters.

[14] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

[15] Including balances in bank gyro accounts, vault cash and overnight deposits with the NBS.

Chart IV.2.2 **Contribution to M3 3-month growth rate**
(in percentage points)



Source: NBS.

The credit downturn exerted the strongest impact on a decline in M3 during Q1.

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

	2013			2014	Share in M3 March 2014 (%)
	June	Sep.	Dec.	March	
M3	-4.8	1.2	2.3	1.9	100.0
FX deposits	-7.1	-0.8	-1.5	0.4	69.5
M2	0.9	5.9	11.5	5.4	30.5
Time and savings dinar deposits	-14.7	-13.4	-9.4	-7.9	9.3
M1	11.0	17.8	23.1	12.6	21.2
Demand deposit	21.9	30.8	31.3	15.7	14.7
Currency in circulation	-5.8	-3.2	8.4	6.3	6.6

Source: NBS.

Broader monetary aggregates were also on a decline. The sharpest drop in real terms was observed for M1 (8.7%), reflecting the seasonal reduction in corporate transaction deposits and a drop in accounts of other financial institutions. Movements in M1 brought about a real 6.8% fall in M2, while the broadest aggregate M3 experienced the smallest reduction (2.7%). Against the background of low y- o-y inflation, such trends in money supply weighed down on real y-o-y growth in money supply in Q1. Growth in the narrowest monetary aggregate M1 decelerated the most – to 12.6%, while M2 and M3 added 5.4% and 1.9% in real y-o-y terms respectively by end-Q1. The credit downturn, which continued into early 2014, exerted the strongest negative impact on M3. In contrast, by borrowing in the domestic market, mainly by selling of securities, but also by drawing-down deposits, the government gave the major boost to M3 growth.

Among M3 components, demand deposits decreased the most (RSD 18.0 bln), primarily in accounts of other financial institutions and enterprises from the sectors of manufacturing, mining, construction and trade. Savings and term dinar deposits declined by RSD 1.8 bln, mostly on account of the drawdowns by the said enterprises. Dinar household savings continued up – by RSD 2.7 bln from the start of 2014. The sharpest increase was noted for deposits up to three months and between six months and one year. Though remaining low, the degree of dinarisation of savings was on a continuous rise since the beginning of 2013 and reached 3.7% in March of the current year. Unlike dinar savings, FX household savings declined somewhat compared to end-2013.

Bank lending

Adverse developments in Serbia's lending market extended into 2014. Excluding the exchange rate effect[16], the lending activity experienced a 7.9% y-o-y downturn in March. A downturn, though smaller, is also observed when receivables of banks delicensed over the past year are excluded. The loan to estimated GDP ratio[17] fell by 1.8 pp from end-2103 to 48.3% in March.

At the quarterly level, excluding the exchange rate effect, domestic lending was down 3.4% in Q1, mainly because of a reduction in corporate lending. Though usual for the first quarter, the contraction in lending was further amplified by the delicensing of Univerzal banka Beograd in January.

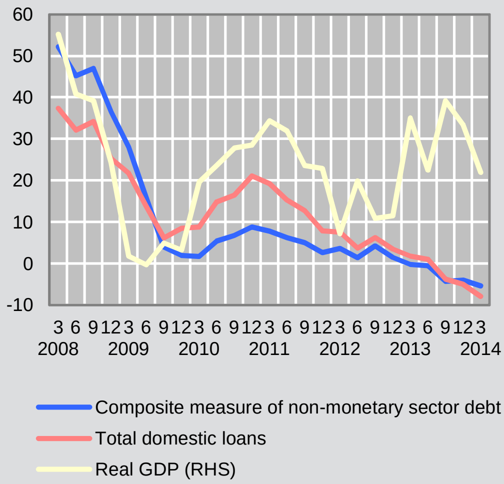
In terms of sources of finance, banks invested less in repo securities in Q1 and allocated less into their dinar required reserves with the NBS, which sufficed to compensate for the reduction in dinar deposits of the corporate sector and other financial institutions[18]. On the other hand, banks continued repaying their external debts in Q1, mainly in respect of long-term loans, while at the same time

[16] Calculated at the RSD/EUR exchange rate on 31 August 2008, assuming that all FX and FX-indexed loans were extended in euros.

[17] Estimated GDP for the last four quarters.

[18] However, as loan receivables declined more than deposits, the LTD ratio fell by 2.2 pp in Q1 to 113.7% in March.

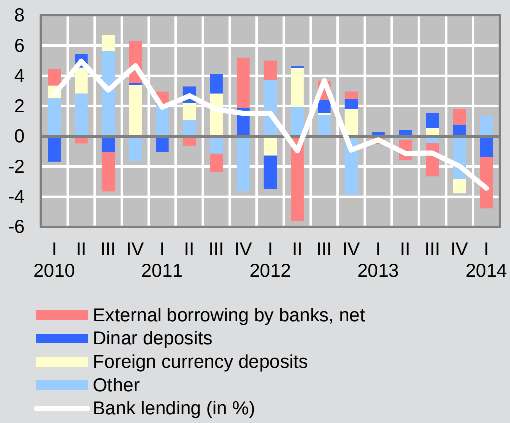
Chart IV.2.3 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

Led by a decline in corporate loans, domestic lending activity continued down.

Chart IV.2.4 **Contributions to quarterly rate of lending growth***
(in pp)



Source: NBS.

* Loans to non-monetary sectors excluding the exchange rate effect.

Bank external debt repayment, rising external receivables and a drop in deposits, exerted a negative impact on lending activity.

increasing their receivables from abroad. In addition, banks kept on channelling a part of available funding into government securities.

Excluding the exchange rate effect, corporate lending fell by RSD 59.2 bln or 5.8% in the review period. Loan receivables declined partly because subsidised loans fell due, and partly because bank due receivables were assigned to non-financial entities (RSD 3.6 bln in Q1). After a longer period, enterprises stepped up external borrowing at the quarterly level, which may be one of the reasons behind the contraction in demand for loans of domestic banks.

As suggested by the April bank lending survey[19], banks continued to tighten their terms of lending to the corporate sector. The tightening was prompted by increased risk perception (somewhat lower than in Q4) regarding the collection of receivables, collectability of collateral, and expectations about the overall economic activity. At the same time, the demand for loans receded further, though at a slower pace compared to Q4, chiefly because of the absence of any major capital investments. In an environment of general illiquidity and aggravated collection of receivables, corporate debt restructuring loans were in the highest demand, while the demand for current assets loans also picked up somewhat. This is corroborated also by the fact that current assets and other loans accounted for over 80% of fresh loans in Q1.

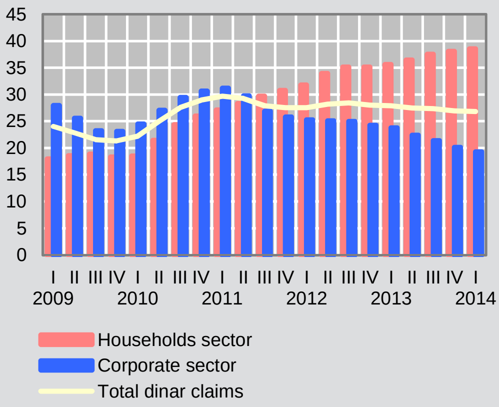
The announced government programme of corporate subsidised lending, aimed primarily at resolving the problem of illiquidity, is expected to buoy up lending activity and investments.

Following the Q4 downswing, household lending stagnated in Q1. Under the impact of lower demand, less housing loans were approved than in the prior period. Of this amount, loans worth RSD 1.5 bln related to subsidised loans which were extended in 2013 and disbursed this year. Of costlier loan categories, citizens were somewhat more reluctant to resort to current account overdrafts and credit cards, whereas the amount of revolving loans was similar to the Q4 figure.

Under the survey results, banks relaxed their household lending standards compared to Q4, primarily regarding refinancing loans. The standards for housing loans did not change after being tightening in Q4. According to banks' estimate, lending standards were eased on the back of

[19] For more detail see the text box in the February 2014 Inflation Report.

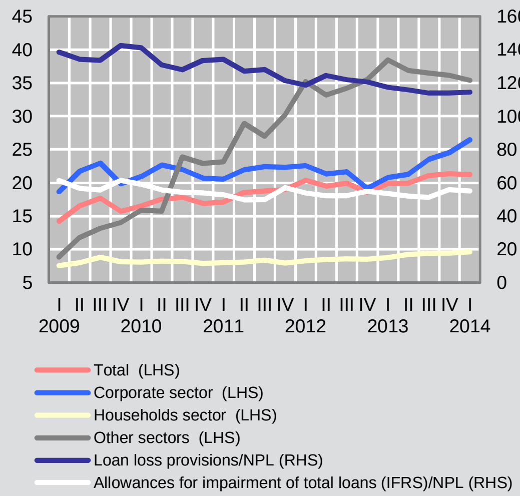
Chart IV.2.5 **Share of dinar in total bank receivables on corporate and household sectors**
(in %)



Source: NBS.
* Excluding the exchange rate effect.

An increase in dinarisation of household loans and a decline in dinarisation of corporate loans continued into 2014.

Chart IV.2.6 **NPLs share in total loans, gross principle**
(%)



Source: NBS.

The share of NPLs in total loans increased in Q1.

reduced costs of sources of finance and competition among banks, although the impact of these two factors was lesser than before. As indicated by banks, in Q1 they reduced margins on dinar household loans and offered more favourable repayment deadlines and lower appertaining costs. The lending survey suggests the highest demand for dinar refinancing and cash loans in Q1, which were approved to the highest extent in the period under review.

The share of dinar loans in total household and corporate lending contracted by 0.2 pp from December to 26.6% in March. The share of dinar corporate loans fell by 0.9 pp to 19.1%. Unlike the corporate sector, households continued to increasingly borrow in dinars. In Q1, around two thirds of new household loans were extended in dinars, prompting a 0.3 pp rise in the share of dinar loans in total household lending – to 38.3% in March.

The NPL to loan ratio (gross principle) went up by 0.9 pp from end-2013 to 22.2% in March. The NPL ratio in the corporate sector was up by 1.9 pp to 26.5%, and in the household sector by 0.2 pp to 9.6%. The continued rise in corporate NPLs indicates the need to step up the efforts in finding solutions to corporate debt restructuring, to employ to a greater extent the out-of-court settlement mechanism, and ensure a more efficient collateral collection.

Despite a high NPL share in total loans, the capital adequacy ratio of around 21% indicates unimpaired stability of the domestic banking sector. Allowances for impairment equalled 55.2% of NPLs in March. At 114.4% in March, loan loss provisions fully covered the level of gross NPLs.

3. Real estate market

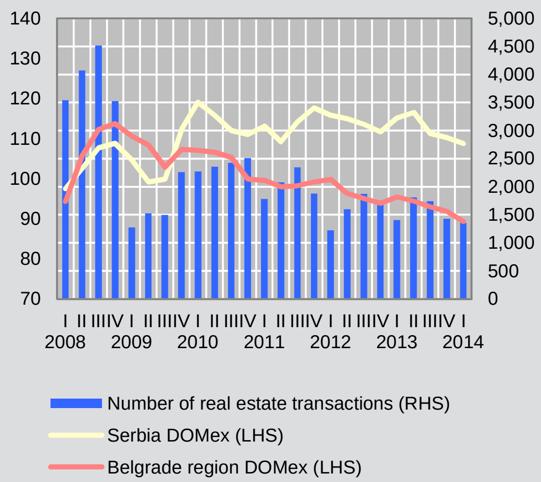
The real estate index and the number of new construction permits and real estate transactions signal further deterioration in the real estate market compared to 2013.

In Q1, DOMex[20] lost 1.4% q-o-q or 5.6% y-o-y. The number of transactions[21] declined to 1,351, down by 5.1% and 3.7% from Q4 and Q1 2013 respectively, or as much as threefold from the peak recorded in Q4 2007. Though it does not monitor purchase/sale transactions financed by cash or uninsured loans, DOMex is judged

[20] DOMex is published by the National Corporation for Insurance of Housing Loans and relates only to real estate purchased by insured loans. It shows the ratio of the average value of all achieved prices per square meter in a particular period to the average value of all achieved prices per square meter in a base period.

[21] The number of real estate transactions and apartment prices per square meter also concern only the real estate purchased by insured loans.

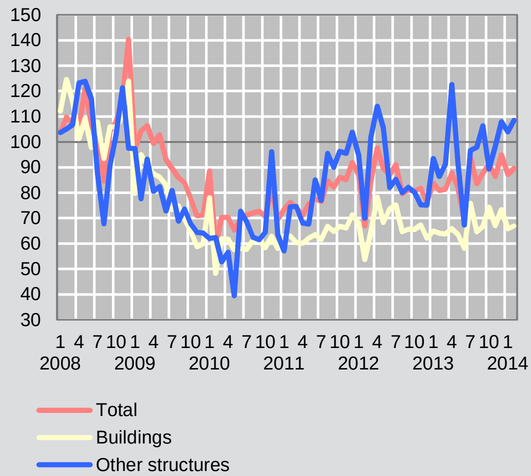
Chart IV.3.1 **DOMex and real estate transactions**



Source: National Corporation for Insurance of Housing Loans.

Real estate transactions and prices declined in Q1.

Chart IV.3.2 **Indices of the number of issued construction permits**
(s-a data, H1 2008 = 100)



Source: SORS.

The number of issued permits for the construction of apartments also declined relative to end-2013.

to mirror the trends in the real estate market, in light of high unemployment, plummeting wages and muted credit activity.

In Q1, prices of apartments fell to EUR 900.3 per square meter on average. Considering the tightened housing loan standards, introduced in Q4 2013 and expected for Q2[22], and the announced cut in public sector wages, real estate demand is not likely to rise this year. Increased number of real estate securing housing loans in default, advertised for auctioning by banks in the process of the collection of receivables may, coupled with less favourable terms of household lending, trigger a further drop in real estate prices.

Given the inopportune situation in the construction sector, no substantial increase is likely in the number of new apartments becoming available this year. In Q1, the number of permits for the construction of buildings fell by 7.4% s-a[23] from the quarter before or by one third relative to the pre-crisis period[24]. Furthermore, construction enterprises struggle to stay current on their obligations, whilst more than a half of their loans are classified as NPLs. Nonetheless, considering the government's new measures to overcome the crisis in the construction sector, we may expect new government-backed projects for housing construction.

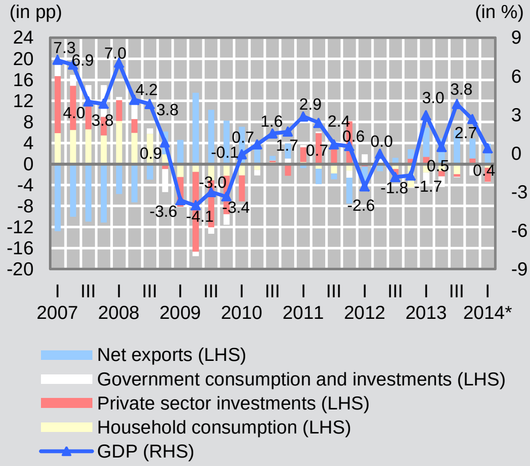
4. Aggregate demand

Led by a continuing positive contribution of net exports, aggregate demand picked up by 0.4% y-o-y in Q1. It slackened somewhat relative to Q4 because of contraction in private sector investment. A q-o-q rise in aggregate demand was even weaker, with an impetus provided by net exports and government investment, and a negative contribution coming from private consumption and investments. GDP growth in 2014 is expected to be driven by net exports, sustained by economic growth in the euro area, and to a smaller extent by investments. On the other hand, fiscal consolidation measures will constrain final household and government consumption. Q1 experienced no major price pressures spilling over from global primary commodity markets, though global food prices started up in February.

Aggregate demand is estimated to have picked up somewhat in Q1, with a positive contribution coming

[22] According to results of the April survey of bank lending activity.
[23] January and February.
[24] H1 2008.

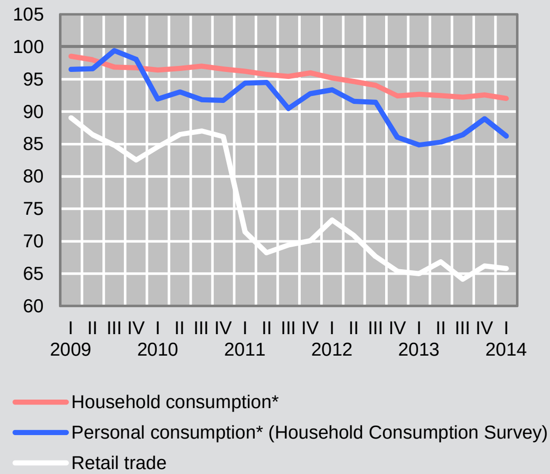
Chart IV.4.1 **Contribution to y-o-y GDP growth rate – expenditure side**



Sources: SORS and NBS calculation.
* NBS estimate for Q1 2014.

Aggregate demand growth slowed down further as a consequence of lower investment activity and private consumption.

Chart IV.4.2 **Household consumption**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.
* NBS estimates for Q1 2014.

Household consumption indicators suggest a decrease in Q1.

from net external (2.1 pp) and negative from domestic demand (2.0 pp). Private consumption and investments went down. Net exports pushed up aggregate demand thanks to a s-a rise in real exports and a drop in imports.

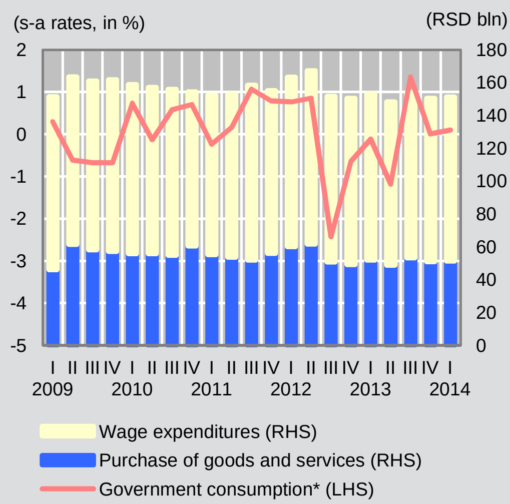
In y-o-y terms, growth in demand slowed further, to 0.4% in Q1. Net exports continued to boost aggregate demand (3.9 pp), though to a lesser degree than in the earlier quarters. In contrast, the y-o-y decline in domestic demand accelerated to 2.9%, in response to the sharp reduction in private investment.

The year 2014 is likely to witness a 1.0% rise in demand, assuming a positive impulse from net exports and investments, and a dampening effect from final consumption as a result of continued implementation of fiscal consolidation measures.

Domestic demand

Private consumption is estimated to have declined in Q1 both in y-o-y (0.9%) and q-o-q terms (0.6% s-a), as suggested by the leading indicators – plummeting retail trade volumes and estimated further contraction in green

Chart IV.4.3 **Government consumption**
(in real terms)



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q1 2014.

Final government consumption continued to stagnate in Q1.

market turnover. At the same time, inventories of consumer goods went up, notably in the production of food, beverages and tobacco. The reduced number of tourist overnight stays is also indicative of dampened private consumption. In contrast, Q1 saw a further rise in imports of durable consumer goods. The volume of services in passenger transport also increased.

Sources of consumption data also point to depressed household consumption. The real wage bill continued down in Q1 on the back of shrinking public sector wages. The volume of new household consumption loans receded as well. Mild growth was registered for social transfers, while remittances stayed flat from Q1 last year.

Private investments shrank by 1.2% s-a in Q1. Investment in equipment also declined, as signalled by diminished equipment imports and the volume of fresh investment loans. Conversely, construction indicators reveal a positive trend, in place since early 2014. Namely, the production of construction material and the number of hours worked bounced back, which may signal the recovery of investment. Inventories of agricultural and industrial products in export-oriented branches decreased.

A y-o-y decline in private investment reached 19.6% in Q1, yielding a negative contribution of 2.7 pp to aggregate demand. A drop in inventories, notably of capital (16.0% y-o-y) and durable consumer goods (8.6% y-o-y) was again the main cause for the reduction in investment.

Government consumption is estimated to have stagnated further in Q1. Though remaining below the previous-year figure, both components of final government consumption – labour costs in the public sector and outlays for the purchase of goods and services increased a tad. Significant savings are expected in the public sector, which will weigh down on final government consumption.

Following a robust decline in the previous year, early 2014 saw a 10.2% revival in **government investment** s-a. After four consecutive quarters, growth was recorded in y-o-y terms as well (3.1%).

Net external demand

Exports of goods and services grew 4.3% s-a in real terms in Q1, while imports were down by 0.4% q-o-q. As a result, net exports had a buoyant effect on demand.

In y-o-y terms, exports continued up (19.1% in real terms). Consequently, despite the increase in imports (6.2%), the current account deficit narrowed further.

The export-to-import ratio[25] scaled further up, to 75.9% in March. Rising steadily over the last two years, exports of goods and services exceeded the pre-crisis[26] level by 57.3% in March. Imports, on the other hand, were 11.2% below that level.

The external imbalance is expected to diminish further in 2014 and the current account deficit to fall below 4% of GDP. The main boost will be provided by a continued rise in exports, led by external demand and the recovery of our main foreign trade partners. Contrary to this, a drop in domestic demand against the backdrop of fiscal

Table IV.4.1 **Investment indicators**

	2013				2014
	Q1	Q2	Q3	Q4	Q1
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Hours worked in construction	-8.8	-9.1	-0.6	-12	6.4*
Industrial inventories	0.6	0.8	-16	3.3	16
Industrial production of capital goods (physical volume)	-3.2	21.4	3.8	-14.8	-0.2
Exports of equipment**	-9.4	-7.7	14.6	-6.7	21.3
Imports of equipment**	12	-3.5	-2.7	0.8	-6.3
Inventories of capital goods	5.1	-0.7	-3.2	-2.0	-11.1
Industrial production of intermediate goods (physical volume)	-14	2.3	3.3	0.6	-2.6
Exports of intermediate goods**	6.1	3.9	5.5	11	2.1
Imports of intermediate goods**	10	-16	-0.2	-0.1	0.8
Inventories of intermediate goods	4.0	2.8	4.2	12	2.7
Industrial production of construction materials (physical volume)	-12.7	0.4	-0.7	-3.1	12.7
Inventories of construction materials	-11.1	7.5	-3.2	-6.6	4.7
Government investment***	-29.7	7.8	2.2	-29.5	29.8

* SORS estimate.
** Exports and imports are denominated in euros.
*** Government investment spending is deflated by the industrial producer price index.

[25] Twelve-month moving average.
[26] H1 2008.

consolidation will probably prompt a timid increase in imports.

The leading indicator of external demand for Serbian exports[27] continued to rise. Being on a constant increase throughout Q1, the indicator trended above its long-term average figure.

Euro-denominated commodity exports gained 1.4% s-a in Q1. The major part of growth originated from exports of inventories of agricultural and industrial products, which increased in Q4. This is substantiated by a downturn in inventories in agriculture, the automobile industry, and the production of electrical equipment, pharmaceutical and chemical products in Q1, i.e. branches accounting for a fair portion of exports.

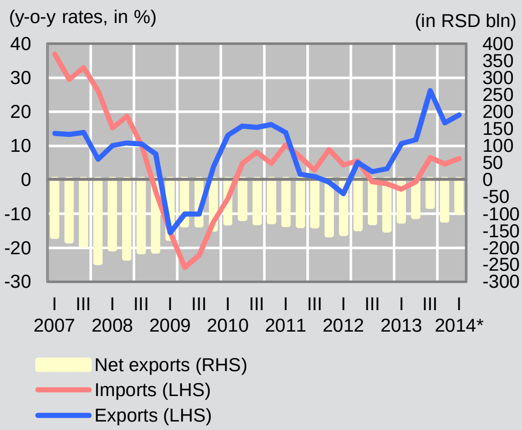
In large part, exports went up reflecting a 7.3% s-a upturn in motor vehicle exports. "Fijat automobili Srbija" was the main exporter in Q1, accounting for EUR 375 mln. Other major exporters also included companies producing automobile components.

Q1 witnessed continued growth in exports of electrical equipment and tobacco products, whereas exports of rubber and plastic products, machines, chemical products and non-ferrous metals recovered after a Q4 squeeze. In contrast, exports of articles of apparel continued down. In addition, following three quarters of growth, exports of base metals drifted down.

A good agricultural performance continued to reflect on exports of agricultural products which, though somewhat below the average of H2 2013, rose by as much as 75.0% y-o-y in Q1. From July 2013 to March 2014, over one million tonne of wheat was exported, or around 90% of estimated market surpluses from the previous agricultural season[28]. Moreover, the dynamics of corn exports so far (around one million tonne from October to March) suggests that the surpluses will be exported to foreign markets.

Euro-denominated commodity imports fell by 6.6% s-a in Q1 on the back of declining imports of equipment (6.3% s-a) and intermediate goods (3.6% s-a). The downturn is associated with a slowdown in manufacturing as it imports the major part of equipment and raw materials. Contrariwise, despite the stagnation in private consumption, imports of consumer goods rose by 1.3% s-a in Q1.

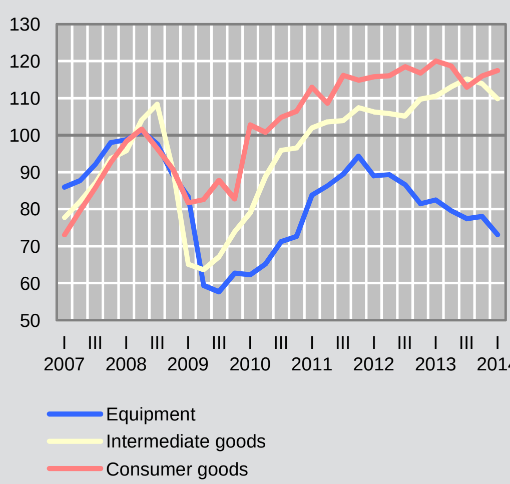
Chart IV.4.4 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
* NBS estimate for Q1 2014.

Y-o-y growth in exports continued to outpace that in imports, contributing positively to the growth in aggregate demand in Q1.

Chart IV.4.5 **Imports by key components**
(s-a, H1 2008 = 100)



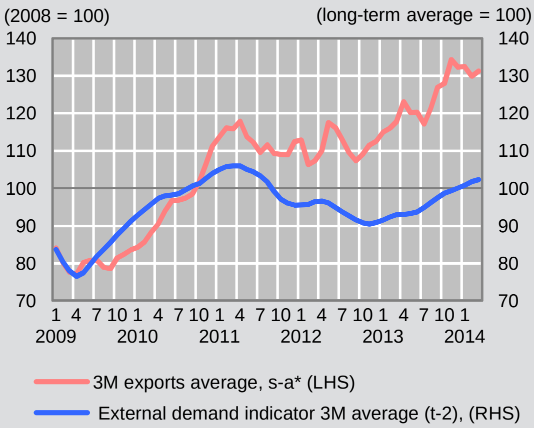
Sources: SORS and NBS calculation.

Q1 saw a further decline in the imports of equipment and a rise in the imports of consumer goods.

[27] The leading indicator of external demand for Serbian exports was construed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners – their shares in Serbian exports being used as weights.

[28] According to stock estimate of the Ministry of Agriculture, Forestry and Water Management.

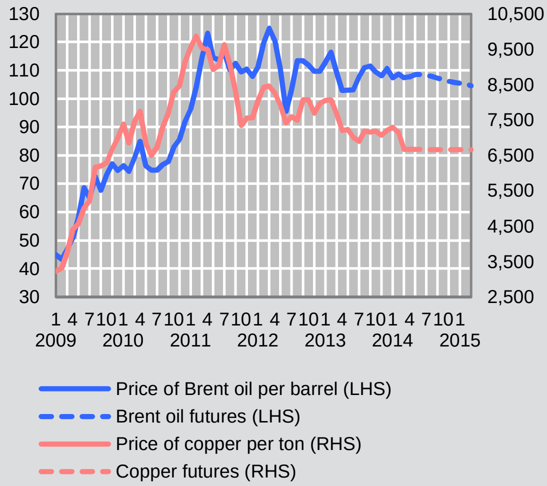
Chart IV.4.6 **External demand and Serbian exports**



Sources: European Commission, SORS and NBS.
* Excluding automobile industry.

Further recovery of our key foreign trade partners will continue to serve as a fillip to domestic exports in the coming period.

Chart IV.4.7 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

International price of oil was relatively stable in Q1, while that of copper was on the decline.

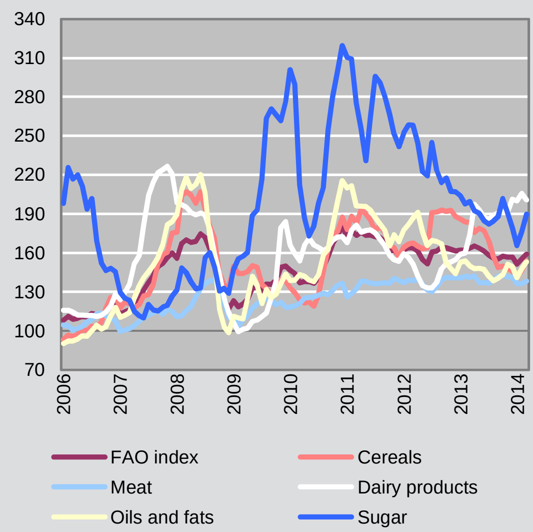
The real effective exchange rate of the dinar appreciated by 0.4% in Q1, indicating a moderate decrease in Serbia's external price competitiveness. The nominal depreciation of the effective exchange rate[29] of 1.1% did not suffice to compensate for the difference between domestic and foreign inflation, generated by a rise in domestic and fall in foreign prices.

The price of Brent oil was volatile throughout the quarter observed and shed 3.5% end-of-period. Elevated US consumption fuelled by cold weather in early 2014 and geopolitical tensions in the world pushed up the price of oil, while increased production in OPEC member countries worked in the opposite direction.

The global price of copper was on a prolonged decline since early 2014, down by around 10% in March relative to end-December. The main reason behind the price cut are ever more frequent signals about softened economic growth in China which is the main importer and consumer of copper (accounting for 40% of total global consumption).

World food prices in Q1 were on average 1.1% lower than in Q4, notably because of the January drop following the report on high inventories of agricultural commodities.

Chart IV.4.8 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

Though lower in Q1 than in Q4, world food prices have been rising since February.

[29] Calculated as the geometric average of nominal EUR/RSD and USD/RSD exchange rates, with 0.8 and 0.2 weights respectively, i.e. by the formula (EUR/RSD^0.8)*(USD/RSD^0.2).

Still, February and March underwent a rise in the index of global food prices, in response to extreme weather in the US and geopolitical tensions in Ukraine which is an important producer and exporter of cereals. Broken down by component, the sharpest Q1 rise was noted for prices of sugar (6.0%) and cereals (5.4%), while meat prices went down (2.2%).

Reflecting a rise in cereal and soy prices on global commodity exchanges, the composite index[30] gained 3.6% in Q1. Following a drop in January, prices of primary agricultural commodities picked up in February and March, most notably the price of corn (13.2%). At the same time, prices of wheat and soy were up 9.1% and 7.0% respectively. Still, an upswing in global inventories of main agricultural commodities, following a good agricultural season, should slow down further price hikes precipitated by global demand.

5. Economic activity

Growth in the construction and service sectors in Q1 outstripped the contraction in the industry and agriculture. Quarterly GDP grew 0.1% s-a. A slowdown however continued in y-o-y terms to 0.4%, mainly on account of the slower rise in manufacturing. Sluggish GDP growth is expected to continue in 2014 (1.0%) because of the short-term negative effects of fiscal consolidation.

After declining by 0.6% s-a in Q4, GDP is estimated to rise by 0.1% s-a in Q1, coming at 0.7% below the pre-crisis level[31]. The growth will be largely prompted by the gradual recovery in the construction sector (contribution of 0.3 pp). A positive impetus will also come from information and communications and transport sectors. On the other hand, contraction in agricultural and industry sectors will provide a negative contribution to GDP growth (0.4 pp and 0.3 pp respectively). According to our estimate, measured by NAVA, economic activity should rise by 0.4% s-a in Q1, thus arriving at mere 0.9% below its pre-crisis level.

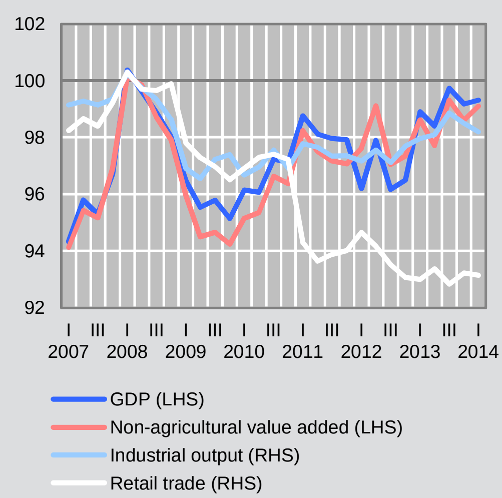
In terms of the physical volume, industrial production fell by 1.8% s-a in Q1, and the slackening was observed in all sectors. The steepest fall was recorded for the physical volume of production in the sector of electricity, gas and steam supply (4.3% s-a), whereas manufacturing and mining dropped by 0.8% and 2.5% s-a respectively.

A drop in the physical volume of production in manufacturing was primarily due to dampened production of petroleum products, electrical equipment, tobacco and metal products. A reduction was also registered in the production of machines and equipment, paper and computers. In contrast, positive results were recorded in the production of motor vehicles, construction material, food and beverages, chemical and pharmaceutical products and rubber and plastics.

Following a vigorous fall in 2013, the beginning of the current year saw positive tendencies in the construction sector. We estimate that the sector rose by 10.5% s-a in Q1. The construction activity increased as indicated by elevated production of construction material[32] in Q1 (12.7% s-a) and an increase in the number of hours worked on construction sites (6.4% s-a).

Services sectors also gave a positive contribution to the moderate recovery of economic activity in Q1. Stable growth continued in the information and communications. For the third quarter in a row, positive trends were also observed in the transport sector. On the

Chart IV.5.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Despite the downturn in industrial production and retail trade, economic activity recorded growth in Q1.

[30] The composite index of primary agricultural commodities, used to approximate cost pressures in the production of food, comprises the prices of corn, wheat and soybean from the relevant international commodity markets.

[31] Level of H1 2008.

[32] The production of construction material is estimated based on the physical volume of products of non-metal minerals.

other hand, the activity in the trade sector declined somewhat in Q1, as indicated by retail trade volumes.

In y-o-y terms, according to the flash estimate of the Serbian Statistical Office, GDP growth continued to slow to 0.4% in Q1. A positive contribution was provided by the information and communications sector (0.3 pp) and manufacturing (0.3 pp), while agriculture gave a negative contribution (0.3 pp) due to the high last year's base.

The physical volume of industrial production expanded by 2.2% y-o-y in Q1, which implies a slowdown relative to the previous two quarters. Manufacturing stepped up to 3.7% y-o-y, adding 2.5 pp to the y-o-y growth in the physical volume of total industry. On the other hand, a drop in the physical volume of production was recorded in the sector of electricity, gas and steam supply – 0.7% y-o-y (contribution of -0.1 pp), as well as in the sector of mining – 0.3% (contribution of -0.1 pp).

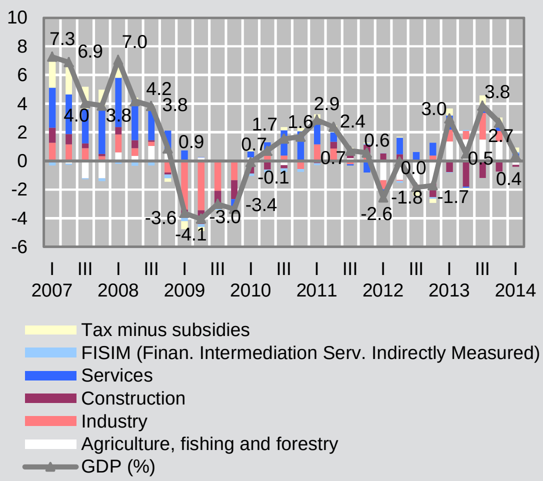
Y-o-y growth in the physical volume of manufacturing accelerated further on account of the production of automobiles, petroleum products and food, while the production of construction material recovered after an extended period of time. A y-o-y decline in the physical volume was recorded in the production of metal products, machines, tobacco products and computers.

At 1.0%, the GDP growth projection for 2014 remained unchanged from the previous *Inflation Report*. The projection is also based on assumptions of an average agricultural season, gradual wearing off of the effects of growth of automobile and oil industries by the year-end and the partial recovery of the construction sector.

The expected slowing of growth in industrial production to 2.0% in 2014 is due to the significantly smaller contribution of automobile and oil industries which are gradually approaching production levels which meet current demand. However, the euro area recovery should serve as an incentive to further growth in other export-oriented areas of manufacturing (production of chemical products, electrical equipment, metal products).

Though slowing its pace, the automobile industry is expected to prop up economic growth this year. The contribution of the company "Fijat automobili Srbija" to GDP growth in 2014 should equal 0.3 pp. Besides, upon the recovery of automobile markets in the EU and US,

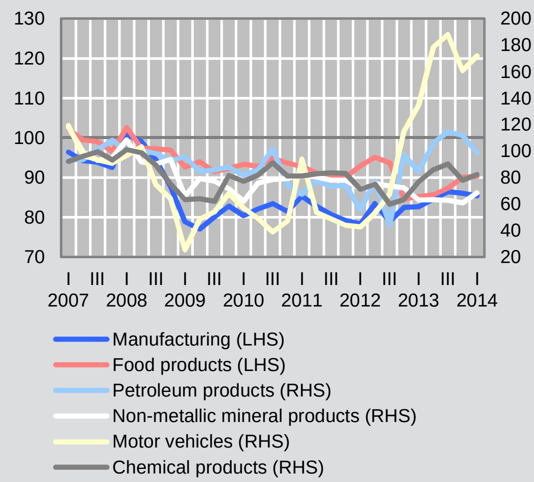
Chart IV.5.2 **Contribution to y-o-y GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

Y-o-y GDP growth slowed down further in Q1 amid slower growth in industrial production and the fall in agricultural production.

Chart IV.5.3 **Physical volume of production by branches of manufacturing industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

The most significant branches of manufacturing industry recorded growth in Q1 in s-a terms.

[32] The production of construction material is estimated based on the physical volume of products of non-metal minerals.

growth may also be expected in other export-oriented auto companies.

An impetus to GPD growth (0.2 pp) is also likely from the oil industry based on the rising volume of crude oil processing and an increase in the production of higher quality petroleum products after the modernisation of the Pančevo refinery.

Following a robust decline in the construction sector last year, the year 2014 is likely to experience a partial recovery (around 15%) and provide a 0.5 pp contribution to GDP growth. Furthermore, growth should continue in the sectors of information and communications and the transport sector. On the other hand, fiscal consolidation measures will weigh down on the trade sector and budget-financed activities, thus providing a negative contribution to GDP growth.

Weather conditions in the year to date have been conductive to winter crops (wheat and barley), while April rains raised the degree of soil humidity and created favourable conditions for the spring sowing. Barring any major adverse weather conditions, agricultural performance this year is estimated to reach its multi-annual average. However, given the above-average performance in the last season and the consequentially high base, the year 2014 is likely to see a mild drop in agricultural output.

6. Labour market developments

Real wages fell in Q1 due to a decrease recorded in both public and private sectors. Lower wages reflected on the lowering of unit labour costs. According to the Labour Force Survey, labour market indicators worsened slightly in Q1, which is confirmed by data on formal employment and unemployment trends.

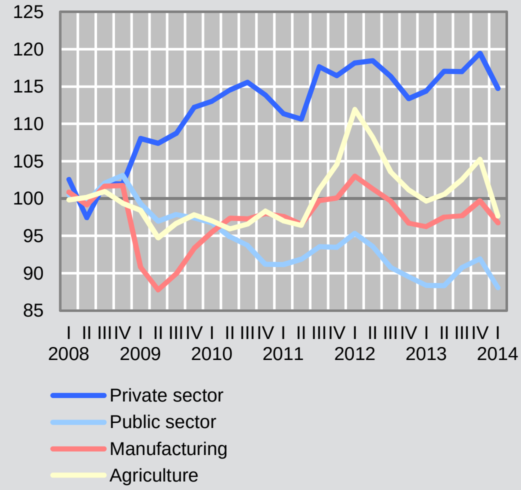
Wages and labour productivity

Real net wages fell in Q1, with a greater decrease recorded in the public relative to private sector (4.2% vs. 4.0% s-a). However, real net wages in the private sector are still 14.7% above their pre-crisis level[33], whereas public sector wages are 11.9% below that level.

During Q1, a real drop in net wages was recorded in the majority of sectors, most prominently in mining (7.4%).

[33] H1 2008.

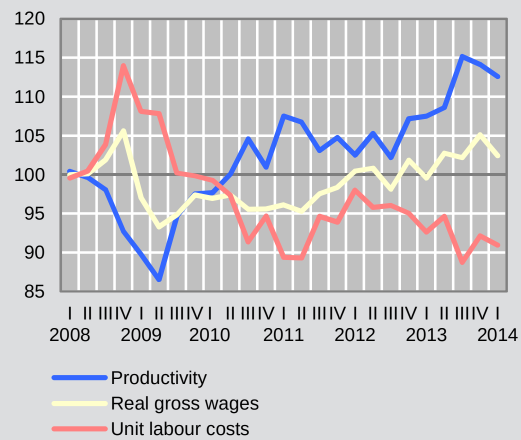
Chart IV.6.1 **Average real net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Real net wages decreased in Q1 in both public and private sectors.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Unit labour costs declined in Q1 as real gross wages fell more than productivity.

The wage lowering was also recorded in other industrial branches, agriculture, construction, trade, transport and all sectors relating to state activities. On the other hand, growth in real net wages was recorded in food and accommodation, and information and communications services.

Y-o-y real net wages increased in private sector (0.3%), whereas in the public sector they were 0.2% lower relative to the same period last year.

Real growth in the net wage bill in the private sector continued for the third successive quarter, while the real net wage bill in the public sector was lower relative to the previous quarter. The lowering in the wage bill is likely in H2 also based on the announced 10% wage cut in the public sector. The average nominal net wage in the Republic of Serbia equalled RSD 41,841 in Q1 and was 9.4% lower relative to Q4 2013.

Contrary to growth recorded in Q4, **unit labour costs** of the total industry were reduced 1.7% s-a in Q1, declining 9.1% below the pre-crisis level. A similar trend was recorded in manufacturing unit labour costs, which dropped 1.4% s-a. In both cases, the drop derived from a sharper decrease in real gross wages relative to labour productivity.

Employment

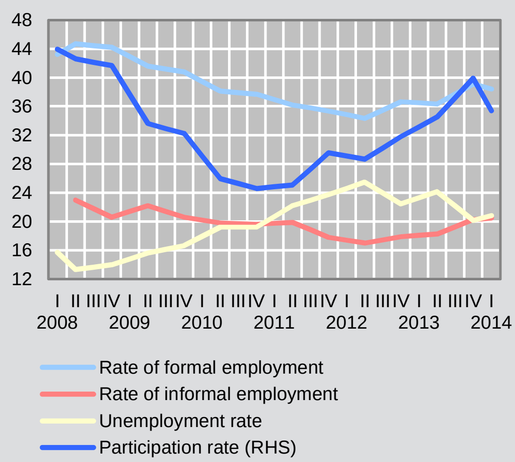
According to the **Labour Force Survey**, the situation in the labour market slightly worsened in Q1 as the unemployment rate rose to 20.8% and the employment rate fell to 38.4% i.e. by 0.7 pp each, relative to October 2013. However, these rates are still significantly better than the rates from April 2013. The participation rate[34] in the same period fell by 1.0 pp to 61.2%, which indicates that a number of recently jobless persons shifted to the inactive status. The rate of informal employment[35] continued to increase in Q1 and amounted to 20.5%.

Survey data confirm our presumption that the recovery of labour market indicators in October 2013 was the result of seasonal factors. The largest decrease in employment relative to October was recorded in agriculture (52,888 persons) and in construction (29,876), activities which are seasonally influenced and which also recorded the highest increase in employment in October. In addition, the number of the employed in manufacturing, electricity, gas and steam supply, and in the education sector also decreased. On the other hand, the greatest growth in employment was recorded in services – trade (11,414 persons), transport (10,435 persons) and information and communications (6,656 persons).

The entire decrease related to full-time employees, whereas the number of part-time employees even slightly increased in Q1. The youth (15–24 years) unemployment rate also recorded growth to 51.8%, while – contrary to the previous period – the share of long-term unemployed persons in the total number of the unemployed fell by as much as 8.8 pp – to 66.9%. Viewed by categories, the largest drop in employment was recorded in the self-employed category (31,986 persons), while the number of those employed with legal entities and unpaid family workers slightly decreased.

The Labour Force Survey results are also confirmed by formal data sources. According to the **RAD research**[36], formal employment decreased by 6,596 persons in Q1, rather due to a drop in the private (5,923 persons) than in the public sector (673 persons). The greatest decrease in employment numbers in Q1 was observed in manufacturing (2,531 persons), as well as in the public administration and health and social care. In addition, the

Chart IV.6.3 **Labour market indicators under the Labour Force Survey**
(in %)



Sources: SORS.

Q1 saw a slight rise in unemployment and a fall in employment.

[34] Calculated as the share of active population (both the employed and unemployed) in the total population of working age (15–64 years).

[35] More detailed information on the dynamics and structure of informal employment is given in Text box 2, page 36.

[36] RAD research is conducted twice a year, in March and September, while the data for other months are estimation-based.

number of formally employed persons in agriculture, construction and trade continued to decrease, which is in conformity with the seasonal nature of these activities. The only larger growth in formal employment was recorded in the information and communications sector, which reflects the growth of economic activity in this sector of the economy.

A part of the decrease in the formally employed persons moved to the jobless category, whose number – according to the **National Employment Service** – increased by 20,955 in Q1. The bulk of the increase in unemployment relates to persons who were already employed (16,976), whereas the number of first-time job seekers rose by 3,979 in Q1. Viewed by professions, the largest increase in the unemployment figure was recorded in groups relating to manufacturing (mechanical engineering, metal processing and electrical engineering), which is in conformity with the lower number of formally employed in that sector. The number of beneficiaries of unemployment benefits continued to grow during Q1 (by 1,996) and amounted to 65,578 persons in March.

It is likely that employment will decline further in the subsequent period, due to the final stage of restructuring of state-owned companies. However, according to recent announcements, the economic environment is expected to get improved and incentives are to be provided to the private sector, which altogether should enable the re-employment of the jobless.

In addition, the new Labour Law is about to be adopted, which should ease the process of employment and reduce informal employment. The most important changes relate to the calculation of severance payment, precise stipulation of terms for employment termination, prolongation of the term for contract-based employment and redefining the wage calculation method.

Text box 2: Methodological differences in monitoring labour market indicators and the structure of informal employment

Due to the methodological differences in the coverage and manner of calculation of labour market indicators (employment and unemployment in particular) from various sources, these indicators are often interpreted differently by different people in Serbia. There are two main sources of data for the calculation of labour market indicators – the Labour Force Survey and administrative registers of employed and unemployed persons. The Labour Force Survey is an internationally accepted source of information regarding developments in the labour market. It is based on a precisely defined methodology, which ensures spatial and historical comparability of data. The Serbian Statistical Office has been conducting this survey since 1994. Until 2008 the survey was conducted once a year and since then twice a year (in April and October), but beginning with 2014 it will be conducted quarterly. The second source of data are administrative registers where data on employment are obtained from the surveys of business units (RAD research), also conducted by the Statistical Office, and data on unemployment from the registers of National Employment Service.

There are both advantages and disadvantages of using either of the two sources. In the Labour Force Survey, the household address is the main sampling unit, which ensures homogeneity of data and prevents double entry of the same person if he has two or three jobs and loss of data if a person is looking for a job on his own. Also, the advantage of the Labour Force Survey is that employment and unemployment data are derived from the same source, which is not so in the case of administrative registries. The main advantage of this survey is that it also captures the informal labour market, which is exceptionally significant in countries where informal employment figures are particularly high. The main disadvantages of the Labour Force Survey are the use of sampling units which implies methodological and statistical problems, questionable reliability of data provided by those surveyed and the delay in availability of data compared to the access to data from administrative registers. But since the advantages of using the Labour Force Survey prevail in spite of the above mentioned problems, this survey is internationally recognised as the main source of official data on labour force movements.

Informal employment represents the share of persons working in the "grey market"[1] in the total employment. It has been monitored in Serbia since April 2008 when it was measured at 23.0%. A decrease was recorded over the following four years to 17.0% in April 2012. Then followed a continuous increase until February 2014 (20.5%). The reason for the increase lies in the deteriorating economy of the country in the course of 2012 which, combined with the insufficiently flexible legal framework and a high share of tax costs in total labour cost, encouraged employers to fill new job posts by informally employed persons.

Broken down by sector of the economy (Table O.2.1), the highest number of informally employed persons was recorded in sectors with high seasonality of employment (agriculture, construction, services) and activities of households as employers where a large number of members of the household provide unpaid work. The share of informal employment in all of the above sectors increased in 2013 from a year earlier but for the activities of households as employers where it fell by over 10 pp. An increase in informal employment was also recorded in 2013 in most other sectors of the economy where the share of informal employment is notable relative to the total employment. On the other hand, note that informal employment figures are very low in activities where the state is the majority employer (education, health and social protection, electricity, gas and steam supply).

The share of informal employment increased in 2013 across all regions but was significantly lower in the Belgrade region compared to all other regions. Broken down by region, data on informal employment in agriculture are rather interesting because they indicate that the share of informal employment in Vojvodina, which is predominantly oriented towards agricultural production, was lower compared to other regions of Serbia. Broken down by gender, the share of informal employment of women (20.9%) was higher than of men (18.1%), while the analysis by type of settlement shows that informal employment was almost five times higher in rural (34.5%) than in urban areas (7.3%). In addition, the level of education also has an important impact on the volume of informal employment. The higher the level of education, the lower the share of informally employed persons – from 64.5% for persons without any education to 2.3% for persons with university degree.

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[1] Grey work includes employees in a non-registered firm, employees in a registered firm without a formal employment agreement and social and pension insurance, and unpaid family workers.

Table O.2.1 **Dynamics and structure of informal employment**
(in %)

	2008		2009		2010		2011		2012		2013		2014
	Apr.	Oct.	Apr.	Oct.	Apr.	Oct.	Apr.	Nov.	Apr.	Oct.	Apr.	Oct.	Feb.
Informal employment rate	23.0	20.6	22.2	20.6	19.8	19.6	19.9	17.8	17.0	17.9	18.2	20.3	20.5

	Total		Belgrade region		Vojvodina		Šumadija and Western Serbia		Southern and Eastern Serbia	
	2012	2013	2012	2013	2012	2013	2012	2013	2012	2013
Agriculture, forestry and fishing	60.9	62.5	60.3	58.6	44.4	46.6	63.7	68.0	71.9	66.4
Mining	-	1.0	-	-	-	-	-	3.8	-	-
Manufacturing	3.6	5.1	1.9	5.6	4.1	6.1	4.7	3.9	2.7	4.7
Electricity, gas and steam supply	0.3	0.5	-	-	-	-	1.0	2.0	-	-
Water supply	2.1	3.4	-	-	7.4	1.4	-	6.1	1.5	5.9
Construction	25.2	25.1	9.9	14.2	29.7	30.0	34.1	29.8	22.4	25.7
Wholesale and retail trade	7.2	7.8	4.9	2.9	7.6	12.5	10.4	8.5	6.7	8.6
Transport and storage	3.2	4.8	0.5	5.0	1.9	5.1	9.0	4.3	3.3	4.5
Accommodation and food services	8.5	15.0	4.2	7.8	12.5	19.2	8.8	14.7	9.4	18.8
Information and communications	1.6	4.1	-	1.7	5.5	7.6	-	2.7	-	9.5
Financial and insurance services	0.7	0.5	0.6	1.2	-	-	1.6	-	-	-
Real estate business	-	10.9	-	21.5	-	-	-	-	-	-
Professional, scientific and technical activities	1.9	4.0	-	3.5	2.4	6.7	5.1	2.4	1.8	3.9
Administrative and support service activities	5.2	7.3	4.8	4.3	2.0	13.0	15.7	6.8	0.9	7.2
Education	0.1	1.3	0.0	1.3	0.0	2.3	0.3	1.7	0.0	-
Health and social care	1.4	0.6	2.0	1.2	3.1	1.0	0.0	-	0.0	-
Arts, entertainment and recreation	4.0	17.0	2.1	17.5	4.1	13.4	9.6	16.4	0.0	21.6
Other service activities	18.6	19.7	18.2	11.5	19.0	23.6	22.2	26.7	13.4	17.1
Activities of households as employers	88.0	79.4	79.0	86.9	100.0	76.7	83.8	82.2	94.2	76.9

Source: SORS.

High share of informal employment in the overall employment figure is most often recorded in economies in which the share of tax costs in the total labour cost is very high, which is the case in Serbia in comparison to countries at a similar level of economic development. Informal employment can display countercyclical movement, i.e. it can increase in times of crisis when flexibility of work processes is required in order to amortise negative developments in the labour market. Still, high share of informal employment in an economy represents a major problem from the point of view of sustainability of its pension system since fewer workers pay in taxes and contributions and a higher share of the pension bill has to be covered from the budget. Hence, it is important that the share of informal in the total employment is decreased in future years, which can be achieved through creation of a more favourable business environment, lowering of the share of tax costs in the total labour cost, as well as by implementing stricter controls of tax and inspection services. Finding a solution to this problem is high on the agenda of the new Government and we expect that the share of informal in total employment will gradually decrease over the coming years.

7. International environment

The euro area recovery proceeded in Q4 and the differences in the pace of growth across member states eased. Unemployment, however, remained high. Assured of the self-sustaining economic recovery, the Fed began tapering its asset purchase programme in Q1. Inflationary pressures in the euro area, United States and the region abated further. The yields on peripheral sovereign bonds decreased, while Greece made a return to the international capital market.

Economic activity

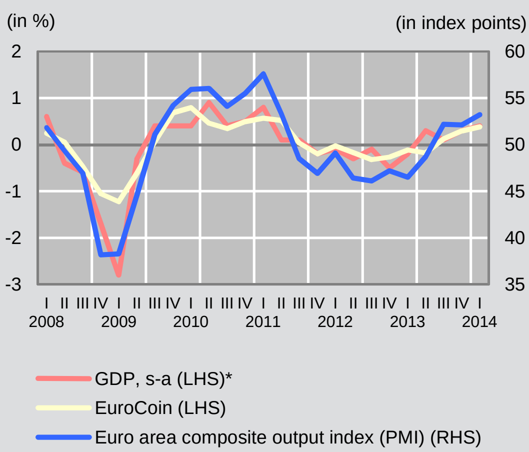
Growth of the **euro area** economy continued in Q4 (0.2% s-a) and the differences in the pace of recovery among some member states eased. Peripheral countries (Spain and Portugal) continued to record positive growth rates, while France, after a temporary blip in Q3 (0.1% s-a), experienced growth of 0.3% s-a in Q4. The euro area growth in Q4 was led by the German economy, which expanded 0.4% s-a. Growth was based on domestic demand, thanks to the gradual weakening of the fiscal drag on private consumption and stepped up private investment on the back of the business sector's optimism.

According to leading indicators for the euro area, growth picked up to 0.4% s-a in Q1 2014. The Composite PMI indicated expansion for the tenth month in a row, measuring 54.0[37] in April, the highest since June 2011. Economic upturn is also indicated by the Eurocoin, which continued to rise in Q1. According to the April Consensus Forecast, the euro area is set to grow 1.2% in 2014. The same figure has been forecast by the IMF and the ECB. Growth should be led by the further recovery of domestic demand, while anticipated depreciation of the euro vis-à-vis the dollar caused by the Fed's monetary tightening should serve as a fillip to net exports as well. Growth is expected to gather pace in Germany and France, while Italy and Spain are likely to see growth after two years of contraction.

The yields on newly-issued sovereign bonds of peripheral euro area states decreased further in Q1, pointing to restored investor trust in the recovery of these economies. In early April, Greece made a return to the international capital market after four years of exclusion – it issued five-year Eurobonds, achieving an interest rate of 4.95%.

Downside risks to economic growth, however, persist. Stagnant credit activity and negative output gap create deflationary pressures, which may lead to delayed

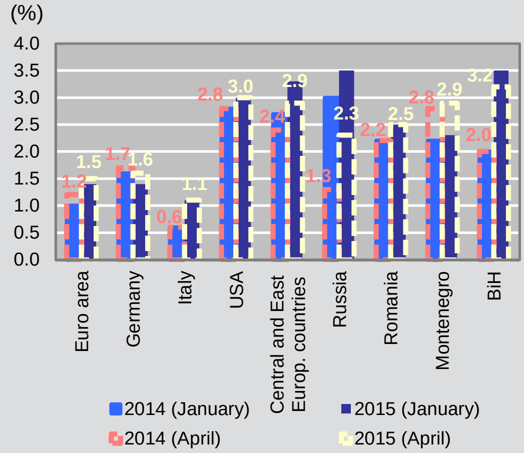
Chart IV.7.1 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



Sources: Eurostat, Markit Group and Banca d'Italia.
* Consensus Forecast estimate for Q1 2014.

Economic activity indicators point to a modest pickup in the euro area growth in the period ahead.

Chart IV.7.2 **Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF***
(%)



Sources: IMF WEO Update (January 2014) and IMF WEO (April 2014).
* Revision compared to January WEO Update.

The projection of economic growth for the euro area has been revised upwards and that for Russia downwards relative to January.

[37] Above 50 indicates expansion and below 50 indicates recession.

spending in anticipation of lower prices and slow down the nascent recovery. Despite small signs of improvement in the labour market, unemployment stayed high in March, measuring 11.8% for the fourth consecutive month.

According to the IMF's forecasts, the economic growth of **Central and Eastern Europe** will soften from 2.8% in 2013 to 2.4% in 2014 and will be driven by external demand as a result of gradual recovery of the euro area. The slackening of the region's growth as a whole is attributable to lower growth forecasts for Turkey, which reflect a slowdown in domestic demand and monetary policy tightening. Poland and Hungary, by contrast, are likely to see a pick-up in growth, powered by the rebound of domestic demand following monetary policy easing and improvements in the labour market.

There are appreciable downside risks to economic growth in Europe stemming from the current crisis in Ukraine. The Ukrainian economy will probably contract this year due to the spill-over of the negative effects of political crisis on consumption and investment. Furthermore, Russia is faced with capital outflows and depreciation pressures, and a potential tightening of economic sanctions, announced by the EU and United States, could put additional pressure on its already sluggish growth. This would trigger a negative feedback loop to the euro area through reduced volume of trade and difficulties in energy supply.[38]

The **US economy** grew at a slightly slower pace in Q4 2013 (0.6% s-a). Growth was supported by household spending, private investment and exports, while government consumption worked in the opposite direction. In early 2014, the United States were hit by a wave of extremely cold weather, which, according to preliminary estimates, caused GDP to stagnate in Q1. This is also indicated by the leading economic activity indicator ISM Manufacturing, which lost 5.2 index points in January. However, it bounced back in February and March and is again, for the tenth month in a row, in the expansion zone, heralding economic rebound as early as in Q2. Consumer confidence seems to have been rebuilt to a significant degree given that the March Consumer Confidence Index touched its highest value in the last six years.

Despite the slowing of economic growth in the last two quarters, the situation in the labour market continued to improve. The unemployment rate was cut to 6.3% in April and total non-farm payroll employment rose by 288,000. According to Consensus Forecast, GDP will grow 2.7% in 2014, the balance of risks surrounding that forecast being significantly diminished now that the US Congress has agreed to raise the debt ceiling until March 2015. The IMF issued a similar growth forecast for the States (2.8%), citing private sector demand as the main driver of growth.

Economic activity in China showed signs of deceleration in Q1. Industrial production and retail trade recorded a decline and the value of PMI Manufacturing has been below 50 for several months already. The IMF's growth projection for 2014 has stayed unchanged from January (7.5%).

Inflation movements

Inflation in the **euro area** slowed down further in Q1, increasing the risk of deflation. Inflation measured 0.5% in March, down by 0.3 pp from end-2013, driven mainly by food and energy prices. According to preliminary estimates, inflation edged up in April (to 0.7% y-o-y), but remained well below the ECB's target of close to but just below 2%. Low inflation increases the real cost of public debt servicing, which could again raise the question of its sustainability in highly-indebted member states. Persistently low inflation could pull down long-term inflation expectations, which would make the inflation's return to the target more difficult. Still, long-term inflation expectations are currently stable and close to the ECB's target.

Low demand and sluggish credit activity are the main reasons behind the inflation slowdown in the majority of **Central and Eastern European** countries. Low prices in the euro area also play a role. Besides Bulgaria, which has been registering deflation for eight months already, the y-o-y fall in prices in March was also registered for Croatia. Turkey, on the other hand, is contending with a relatively high inflation rate (7.0–8.0%) that reflects the weakening of the local currency and the food price growth in H2 2013.

After falling in February, **US** inflation returned in March back to the end-2013 level (1.5%). As in the euro area, the mains disinflationary factor were the prices of energy. According to Consensus Forecast, inflation in the United States will amount to 1.7% in 2014, long-term inflation expectations remaining firmly anchored.

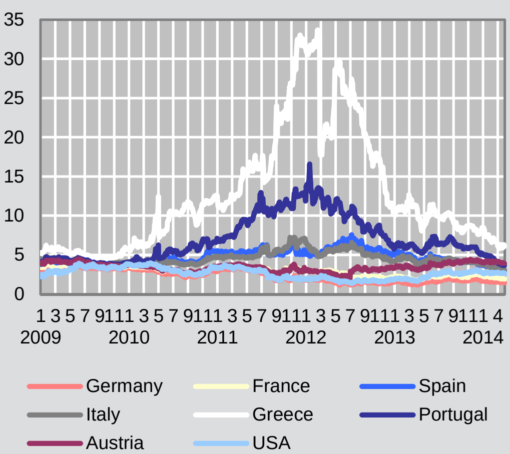
[38] See text box 3, on page 41.

Monetary policy

Despite increased deflation risks, the **ECB** kept the main refinancing rate on hold in Q1 (0.25%). The monetary authorities have judged that inflation will gradually return to the target during the next year and that there is no need for additional accommodative monetary policy measures for the time being. This is also confirmed by the long-term inflation expectations which remain anchored. Still, the authorities hinted at the possibility of further monetary policy easing through non-conventional measures if deflation risks build up in the months ahead.

The weakening of inflationary pressures in **Central and Eastern Europe** has enabled some central banks to proceed with monetary policy easing with a view to boosting the economy. Since the beginning of the year, the central banks of Romania and Hungary have lowered their policy rates by 50 bp and that of Albania by 25 bp. The Russian central bank, on the other hand, raised its benchmark rate by 150 bp in March and further up by 50 bp in April, in a bid to counter depreciation pressures triggered by capital outflows and the worsening of the situation in Ukraine. At an extraordinary meeting of its Monetary Council in April, the central bank of Hungary adopted new monetary policy measures in order to reduce the country's exposure to external risks due to the high level of external debt and to strengthen the domestic sources of financing its public debt.

Chart IV.7.3 **Yield on 10-year bonds of euro area members**
(daily data, in %)



Source: Bloomberg.

The fall in yields on sovereign bonds of highly-indebted euro area members continued in Q1.

Sustainable economic growth and favourable labour market indicators prompted the **Fed** to start tapering its asset purchase programme in January. In Q1 tapering totalled USD 30 bln. Also, the expectation of the majority of Fed officials that the federal funds rate would reach 1.0% at end-2015 (up from 0.75%) has encouraged marked belief that the rate would be raised earlier than expected. At its meeting in April, the Fed decided to further reduce the monthly purchase of Treasury securities and mortgage-backed bonds to USD 25 bln and USD 20 bln, respectively.

Financial and commodity markets

The dollar edged up mildly against the euro in Q1 (0.3% end-of-period). It strengthened in January on the back of launched QE tapering and favourable macroeconomic indicators in the United States. However, as the expected lowering of the ECB's main refinancing rate failed to come about in Q1, the euro trended up in February and March. Looking ahead, the dollar is likely to appreciate against the euro on account of further reduction in the degree of accommodation of the US monetary policy.

Croatia's credit rating deteriorated in Q1. Standard & Poor's lowered it from BB+ to BB, changing the grade outlook from negative to stable, while Fitch and Moody's kept the rating at the same level, but changed the outlook from stable to negative. The agencies cited the country's unfavourable fiscal position and the sluggish pace of budget deficit reduction as the main reasons for the change. At the same time, Standard & Poor's affirmed Hungary's rating at BB, changing the outlook from negative to stable as a result of accelerated economic growth. Russia's credit rating, by contrast, was cut to BBB-, just one notch above junk, and the grade outlook was kept negative due to slowing economic growth, capital outflows and a possible tightening of economic sanctions.

The price of gold rose 7.1% in Q1 (end-of-period). It trended up by mid-March, fuelled by increased uncertainties over the speed of recovery of the US economy following the cold wave and the deepening of geopolitical tensions in Ukraine. Still, indicators attesting to the sustainability of the euro area and US growth and estimates of a possibly earlier increase in the Fed's benchmark rate brought about a fall in the price of gold in the second half of March.

Text box 3: Potential effect of the Ukrainian crisis on Serbia

The current Ukrainian crisis increasingly opens the issue of its potential negative effect on countries with which it has established relations in the area of trade, finance and energy or where Ukraine is a transient country for the exercise of such arrangements, or on geostrategic relations and their impact on global economic flows.

Serbia's direct exposure to the Ukrainian crisis is not large since bilateral economic relations between the two countries are not extensive. To illustrate, last year, only 1.2% of our exports went to Ukraine while the share of imports from Ukraine in total Serbian imports was even smaller (0.7%). Far more important for us are the potential knock-off effects of the crisis on countries with which we have established strong economic relations, as well as on global commodity and financial markets and capital flows. The intensity of the impact on Serbia would depend primarily on the intensity of the crisis. In case the transport of natural gas is temporarily disrupted through the Ukrainian pipeline system, Serbia's energy supply may be very adversely affected. However, compared to the energy supply crisis of 2009, Serbia's exposure is now smaller as in the meantime the gas storage "Banatski dvor" was put in operation.

Considering that EU member countries and Russia are important economic partners of Serbia, the crisis in Ukraine could have a knock-off effect on Serbia, primarily due to unfavourable developments in these economies. In the year so far Russia has recorded a significant outflow of capital, currency depreciation and the fall in share prices. A substantial weakening of the Russian rubble despite interventions in the foreign exchange market and increases in the policy rate by its central bank may necessitate further increases in the policy rate to soften inflationary pressures, which could lead to further slowdown in growth of the Russian economy. Last month the IMF decreased its projection of 2014 GDP growth for Russia to mere 0.2%, pointing to a high probability of negative growth. On the other hand, the economic outlook in the euro area for this and the next year has been revised upward.

Trade flows may be the first direction of the potential knock-off effect of the Ukrainian crisis on Serbia. Russia is among Serbia's major partners in foreign trade. In 2013, exports to Russia accounted for 7.3% of our total exports and imports for 9.2% of our total imports. Like most countries in Europe, Serbia is also dependant on energy imports from Russia, primarily on imports of oil and natural gas.[1] Still, though Russia remains our most important import partner in this area, the share of imports of oil and gas from Russia in total imports of oil and gas has decreased over the last four years (from 55% to 36% in case of oil and oil derivatives and from 75% to 60% in case of gas), while Kazakhstan became our second major import partner.[2] Also, thanks to investment into the oil industry which modernised domestic capacities for processing of oil and increased production, imports of oil derivatives were reduced in 2013 by around 35%. The privilege of duty-free export of goods to Russia[3] has contributed to the accelerated increase in our exports to the Russian market. This tendency has been particularly pronounced since 2010 – from 2010 to 2013 Serbian exports to Russia were increasing at the annual rate of 35% and in 2013 reached double the amount recorded in 2010. Contracted imports and rising exports resulted in a rise in the import-to-export ratio from 18% in 2009 to 56% in 2013.

Deceleration of Russia's growth may weigh down on Serbia's exports to Russia. Furthermore, given that some of Serbia's major foreign trade partners in the EU are at the same time important exporters to Russia, there is risk that our exports to the EU may be smaller in the event of major disturbances in trade relations between the EU and Russia. Moreover, possible disruptions in the gas supply to EU countries may adversely affect the European economy (though it should be borne in mind that not all EU member countries are equally dependent on imports of Russian gas), and thus Serbia's exports and GDP.

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[1] Imports meet Serbia's 55% of needs for crude oil and semi-finished products for processing in oil rafineries, and around 80% of needs for gas (according to the energy balance of the Republic of Serbia for 2014).

[2] In 2013, imports of crude oil and oils obtained from bituminous minerals from Kazakhstan almost equalled as much as imports from Russia. Imports of gas from Kazakhstan were 2.4 times lower compared to imports from Russia and satisfied a fourth of Serbia's total gas imports.

[3] In 2000, an agreement was signed on free trade between Serbia and Russia (i.e. between the Government of the Federal Republic of Yugoslavia and the Government of the Russian Federation) for the purpose of deepening and improving trade and economic cooperation.

Another direction of a potential knock-off effect of the Ukrainian crisis relates to **capital flows**. From the point of view of global financial markets, the very inability of Ukraine to settle its obligations could lead to an increase in investors' risk aversion and a reduction in their exposure to emerging countries. For these countries, Serbia included, that may lead to an increase in the country's risk premium and generate depreciation pressures on their currencies. Still, it should be borne in mind that there are indications of increased differences in the attitude of investors to different emerging countries.[4] Also, some banks from EU countries are financially exposed to Russia and Ukraine (loans and securities) and in case of intensification of tensions a question could arise as to the quality of such assets, which may further reduce their credit exposure to Serbia.

Finally, the crisis in Ukraine could lead to an increase in prices of **primary products in the world market** and, consequently, the increase in these prices in the domestic market. In addition to prices of oil and gas, escalation of the crisis could also lead to higher prices of cereals since Ukraine is one of the world's major exporters of wheat and corn.

[4] See: *International Monetary Fund, Global Financial Stability Report (March 2014), Box 2.4. „Are Investors Differentiating among Emerging Markets during Stress Episodes?“.*

V. Inflation projection

After undershooting it currently, y-o-y inflation is expected to return within the target tolerance band in H2 2014 and stay therein throughout 2015. Low aggregate demand will continue to act as the key disinflationary factor, its effect probably being reinforced by additional fiscal consolidation measures. On the other hand, moderate inflationary effects will be generated by food inflation, which is expected to move in H2 from the negative into the positive zone as a result of low last year's base. The risks to the projected inflation path are associated primarily with the outcome of this year's agricultural season and developments in the international environment, and to a degree, with fiscal movements at home.

GDP growth projection for 2014 has remained unchanged, while growth in 2015 is likely to be lower than projected in the February Report because of the announced stronger-than-expected fiscal consolidation measures.

The medium-term inflation projection aims to show the 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

Though within the bounds of the short-term projection published in the February *Report*, y-o-y inflation was lower than the central projection and moved around the lower edge of the target tolerance band in Q1. In March, it even slipped slightly below that edge, measuring 2.3%. Inflation fell short of the central projection as the anticipated stronger growth in prices of non-food products and services failed to come about.

Broken down by month, the 1.2% consumer price growth in Q1 was driven mainly by the January price growth (1.4%) that stemmed from the upward revision of the special VAT rate and regular annual adjustment of excise tax. In February, prices flatlined, whereas in March they inched down (0.3%).

The cost of raw materials in food production has remained low despite the rise in prices of primary agricultural commodities in Q1. Average domestic price of corn rose somewhat more and that of wheat somewhat less than at the Budapest Commodity Exchange.[39] Still, domestic wheat and corn prices in late Q1 were below the levels recorded in the same period a year earlier (by 17.0% and 11.8% respectively). The effects of the special VAT rate increase on food prices were largely offset by the low cost of raw materials in food production.

One year-ahead inflation expectations of the financial sector were relatively stable and within the target tolerance band in Q1. In March, inflation expectations of businesses fell to the target as well. Encouraging news is that all sectors expect inflation to stay stable in the two years ahead, i.e. in the medium term.

In early 2014, the dinar came under depreciation pressures generated by both global and local factors. The pressures persisted until mid-March, when the dinar regained some strength. Against the background of modest FDI inflow and smaller inflow from exchange operations, depreciation pressures reflected chiefly

[39] Price of corn in the Novi Sad Commodity Market rose 7.4% (5.9% in the Budapest Commodity Exchange) and that of wheat 4.5% (8.2% in the Budapest Commodity Exchange).

increased demand for foreign exchange on the part of corporates (energy importers) and non-residents. Though hardly a surprise, the Fed's decision to start QE tapering triggered a temporary rise in the risk premia and ushered in depreciation pressures in all countries of the region, especially in the course of January. The pressures on the Serbian foreign exchange market were moderated by the low current account deficit and the resumption of sale of foreign exchange by non-residents as of mid-March. As a result, appreciation pressures emerged in late Q1 and continued into April. Judging that the pressures on the exchange rate were short-term, the NBS intervened in the IFEM by selling EUR 820.0 mln net until mid-March and by buying EUR 130.0 mln net from late March and in April.

As a result of real depreciation of the dinar, the depreciation gap of the real exchange rate widened slightly in Q1[40], indicating a rise in net importers' marginal costs.

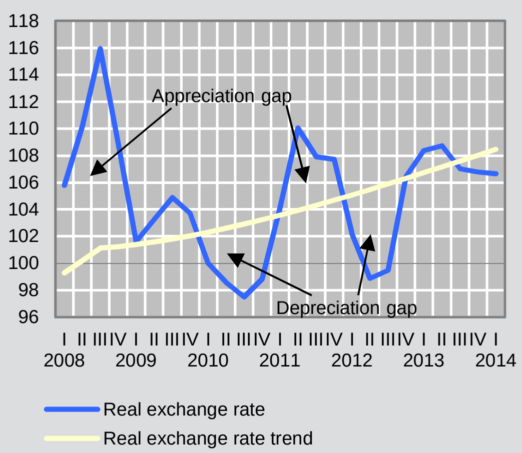
Consolidated budget deficit in Q1 amounted to 7.7% of GDP, more than half of it (4.2 pp) relating to interest payments. At the end of April, the Government announced the adoption of new fiscal consolidation measures, the most important being a 10% cut in public sector wages.

According to NBS estimates, GDP grew 0.1% s-a in Q1, i.e. its growth slowed down to 0.4% y-o-y. On the expenditure side, positive contributions to GDP growth came from net exports and government investment, while negative contributions originated from private investment and private consumption. On the production side, the negative contributions of agricultural and industrial production were compensated for by the better performance of the construction industry and services.

Negative output gap[41] stayed the same as in the previous quarter, indicating persistently strong demand-side disinflationary pressures in the medium run.

Leading indicators for the euro area point to continuing moderate economic recovery in Q1 2014 (0.4% s-a). Inflationary pressures remained subdued and the ECB reiterated a pledge to keep rates low for an extended period of time. At the same time, the wave of extremely cold weather that hit the United States early in the year took some steam out of the US economy. Encouraged by the progress made on the path to maximum employment and by the improved labour market prospects, the Fed started winding down its asset purchase programme in January.

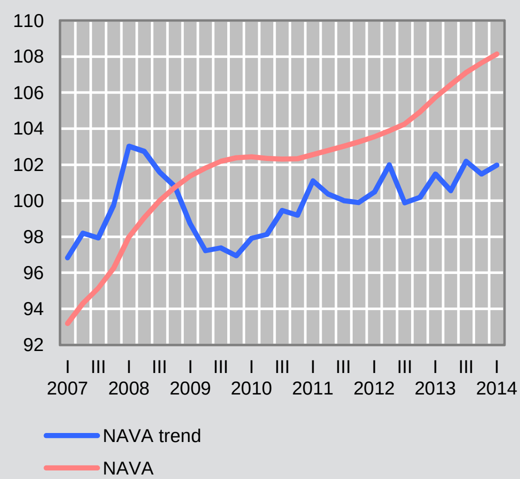
Chart V.0.1 **Real exchange rate and its trend***
(base index, Q1 2010 = 100)



Source: NBS.
* The estimate is based on the assessment of the impact of the real exchange rate on inflation.

The depreciation gap of the real exchange rate widened mildly in Q1.

Chart V.0.2 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Negative output gap stayed the same as in Q4 2013.

[40] By applying the Kalman filter, the real exchange rate trend has been assessed as that of moderate appreciation.

[41] Output gap is calculated based on NAVA (GDP less agricultural production and net taxes). NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

Projection assumptions

The assumption for the euro area's GDP growth in 2014 and 2015 has been slightly revised up from the February projection to 1.2% and 1.5%[42], respectively. Further recovery of the economy should be based on stronger domestic demand, supported by monetary policy, improvement in financing conditions and progress made in fiscal consolidation and structural reforms. Economic activity should also receive impetus from a gradual increase in export demand.

Though euro area inflation measured 0.5% y-o-y in March, medium-term inflation expectations remain firmly anchored below, but close to, 2.0%. According to Consensus Forecast, the markets expect no change in the ECB's main refinancing rate this year and the projection assumes the same for 2015 as well.

The movements of primary agricultural commodity prices internationally have a decisive impact on the movements of these prices locally. The current commodity futures herald a considerable fall in international soybean prices and a mild rise in wheat and corn prices in 2014. However, given that the international agricultural commodity prices are currently rather low thanks to the high yields last year, the projection assumes that the composite index of international primary agricultural commodity prices will go up this year by 15.0%[43].

Table V.0.1 **Projection assumptions**
(changes relative to the prior projection are given in brackets)

	2014		2015	
External assumptions				
EU inflation (Q4 to Q4)	12%	(-0.2)	15%	(-)
ECB policy rate (year-end)	0.25%	(-)	0.25%	(-)
Euro area GDP growth	12%	(+0.2)	15%	(+0.1)
International prices of primary agricult. commodities (Q4 to Q4)*	15.0%	(+2.0)	4.0%	(-)
Brent oil price per barrel (year-end, USD)	107.0	(-)	107.0	(-)
Internal assumptions				
Administered prices (Dec to Dec)	9.9%	(-0.6)	8.8%	(-0.2)
Trends				
Appreciation trend of the real exchange rate (average)	18%	(-)	2.0%	(-)
Real interest rate trend (average)	2.7%	(-0.7)	3.0%	(-0.6)

* Composite index of soybean, wheat and corn prices.
Source: NBS.

Even though oil futures suggest a decline in both 2014 and 2015, the projection is more conservative in assuming oil prices[44] will stay close to the level recorded at end-2013.

The projection envisages that administered prices will grow faster than headline CPI in 2014 and 2015 due to the gradual removal of price disparities.

The current medium-term inflation projection is based on the assumption that administered prices will go up by 9.9% in 2014 and that they will contribute, as in 2013, around 2.0 pp to headline inflation. The strongest contribution to this year's inflation is expected from the upward revision of excise tax on cigarettes and the increase in electricity prices (0.8 pp and 0.5 pp, respectively). Still, it should be noted that while the increase in electricity prices (10.0%) is foreseen in August, there have been no official confirmations as yet that it would take place this year at all.

The projection operates on the assumption that fiscal consolidation measures will be implemented (notably on the expenditure side of the budget), leading to a slump in final consumption, but also to the stabilisation of the share of public debt in GDP over the next three years. At the same time, these measures should contribute to the further narrowing of the current account deficit and should help stabilise the country risk premium at a relatively low level.

Inflation projection

Y-o-y inflation is projected to remain low and revolve around the lower bound of the target tolerance band in Q2. Though low last year's base for food prices will contribute to the gradual rise in the inflation rate as of Q3, according to the central projection, inflation will stay within the bounds of the target tolerance band (4±1.5%) in H2 2014 and 2015. At end-2014, inflation is expected to settle slightly north of the 4.0% target.

Low domestic demand continues to be the main disinflationary factor in both short and medium term. The

[42] The assumption for the euro area's GDP growth in 2014 and 2015 is consistent with the latest Consensus Forecast.

[43] This index comprises the prices of wheat, corn and soybean as the most important inputs to the domestic food production.

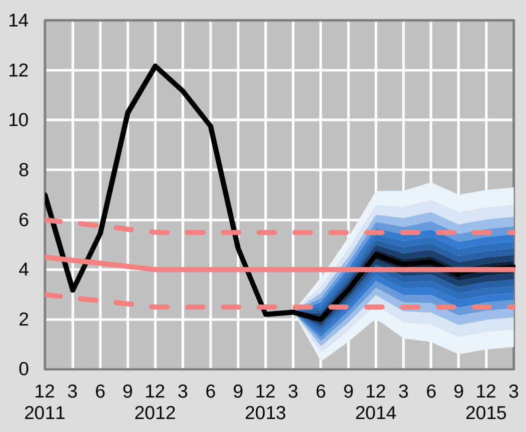
[44] Brent.

disinflationary effect of this factor could be reinforced, depending on the intensity of fiscal consolidation that will weigh down on government and household consumption.

On the other hand, the gradual rise of inflation towards the target beginning from Q3 will be aided by its food components, which should move from the negative into the positive zone in H2 2014 on account of the low last year's base. After a very good agricultural season last year, fruit and vegetable prices should rise more than other CPI components even in the event of an average agricultural performance this year. A potential further increase in the primary agricultural commodity prices would work towards ending their disinflationary effect. If our assumption on the movement of these prices in the new agricultural season proves correct, food production costs will revert to their neutral level and food prices will be following a pattern similar to that of other CPI components.

The widening of the depreciation gap of the real exchange rate of the dinar in Q1 could send some upward pressure on inflation through the rise in import prices, but the intensity of this pressure will depend on the net importers' ability to command higher prices against the backdrop of depressed domestic demand.

Chart V.0.3 **Inflation projection**
(y-o-y, in %)



Source: NBS.

Y-o-y inflation is expected to rise towards the target in H2 2014 and continue to revolve around it in 2015.

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%.

Table V.0.2. **Projections of key macroeconomic indicators for Serbia**

	2014		2015	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	5.0	4.0	-	4.0
European Commission	4.9	4.3	5.3	5.0
Consensus Forecast	4.7	3.8	5.1	4.9
GDP (%)				
IMF	2.0	10	-	15
European Commission	15	13	2.0	2.2
Consensus Forecast	16	12	2.7	2.5
Current account deficit (% of GDP)				
IMF	6.5	4.8	-	4.6
European Commission	4.7	4.7	5.2	4.8
*Consensus Forecast**	5.8	5.7	6.2	6.1

Sources: IMF WEO (October 2013 and April 2014), *Consensus Forcast* (January 2014 and April 2014), *European Commission* (*Winter forecast* 2014 and *Spring forecast* 2014).

* Calculated based on the NBS projection of nominal GDP in dollars from February and May 2014.

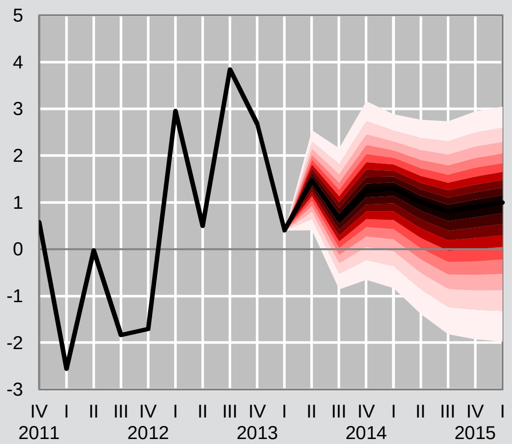
The movement of inflation expectations shows that unlike the years before, they no longer have an inflationary, but rather a neutral effect.

This year again the contribution of administered prices to headline inflation is expected to amount to around 2.0 pp. However, if electricity prices do not go up, this contribution would be smaller by around 0.5 pp, implying downside risks to the projected inflation path.

GDP growth projection for 2014 has remained unchanged, while growth in 2015 is likely to be lower than projected in the February Report because of the announced stronger-than-expected fiscal consolidation measures.

Despite the expected recovery of the euro area, we project lower GDP growth in 2014 (around 1.0%). This projection operates on the assumption of an average agricultural season, resulting in some fall in agricultural production relative to the previous year, and on the assumption of a slower industrial production growth (due to the gradual waning of the effects of the automobile and oil industries). Besides, economic activity is bound to suffer some negative short-term effects of fiscal consolidation. On the expenditure side, growth should be led by net exports, given the continuing recovery of the euro area – our main foreign trade partner. At the same

Chart V.0.4 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

GDP growth in 2014 and 2015 is expected to be lower than in 2013.

time, it will receive headwinds from household and government consumption weighed down by fiscal consolidation and the fall in credit activity.

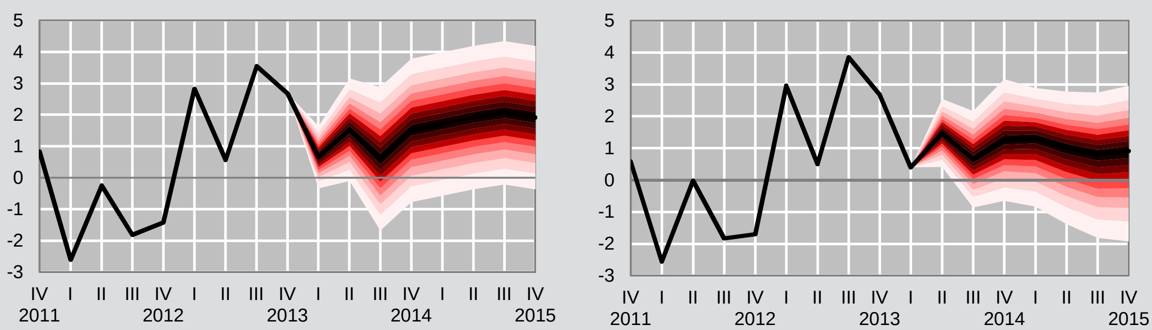
Uncertainties surrounding the GDP projection relate mainly to the speed of the economic recovery of the euro area, notably Serbia's main foreign trade partners, especially in case heightened geopolitical tensions cause disruptions to global trade, energy and financial flows, and to the extent to which tighter access to external financing (due to QE tapering) will reflect on movements in the real sector. While the details of fiscal adjustment measures will be unveiled by mid-year, the Government's announcements suggest that fiscal consolidation will be stronger than expected earlier. This means that the negative short-term effects on GDP will be stronger as well. On the other hand, recent upward revisions of the euro area growth prospects for 2014 and 2015 herald a potentially stronger recovery of external demand, which should reflect on our GDP growth. A positive effect on GDP growth could also come from the resumption of subsidised lending to the corporate sector, which has been announced by the Government and which would feed through primarily into higher investment. Still, everything taken into account, the announced intensity of fiscal consolidation in particular, the risks to the GDP growth projection are judged to be tilted to the downside.

Risks to the projection

The risks to the projected inflation path are associated primarily with primary agricultural commodity prices and developments in the international environment, and to a certain degree, with fiscal movements at home.

Chart V.0.5 **Current vs. previous GDP growth projection**

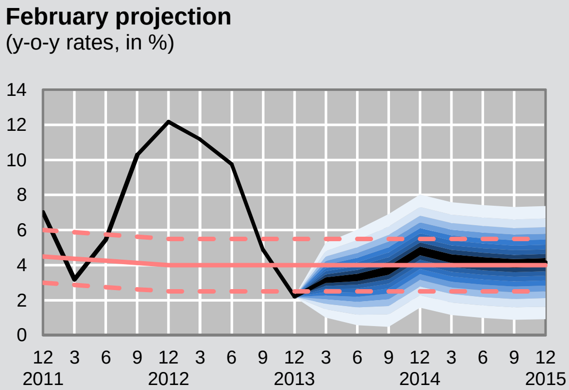
February projection (y-o-y rates, in %) | **May projection** (y-o-y rates, in %)

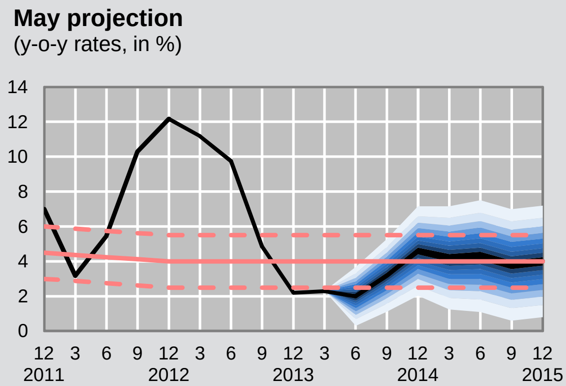


Source: NBS.

GDP growth projection for 2014 has remained unchanged, while growth in 2015 is most likely to be slower than forecast in February. The risks to the projection are tilted to the downside.

Chart V.0.6 **Current vs. previous inflation projection**





Source: NBS.

As indicated by the new inflation projection, y-o-y inflation will move around the lower bound of the target tolerance band in Q2 as well.

Though the expected rise in primary agricultural commodity prices is not likely to trigger any major growth in food prices this year, a below average agricultural season could turn food prices once again into an inflationary factor, especially so in the event of an upsurge in global food prices and an increase in export demand. The growth in primary agricultural commodity prices in the international market could be fuelled by a potential strengthening of current geopolitical tensions, considering that Ukraine is one of the world's largest exporters of corn and wheat.

International environment continues to be plagued by uncertainties over the strength of the effects of the Fed's QE tapering on the financial markets of emerging economies. These uncertainties have amplified with the outbreak of crisis in Ukraine, which could increase risk aversion in the global financial markets and induce investors to further reduce their exposure to emerging economies.

Hence, the threat of growing investor risk aversion towards Serbia cannot be excluded. A potential rise in the country risk premium and the strengthening of depreciation pressures could lead to a higher-than-projected inflation outturn. For this reason, it is critical that the authorities continue their efforts towards reducing the fiscal imbalance and step up the implementation of structural reforms, notably in the public sector, labour market and business environment, all with a view to strengthening economic fundamentals. There are signs that investors have started differentiating between developing countries by the level of risk associated, and a credible fiscal adjustment in this context is what might just tip the scales and ease the impact of potential external shocks.

On balance, the risks to inflation projection are judged to be symmetrical.

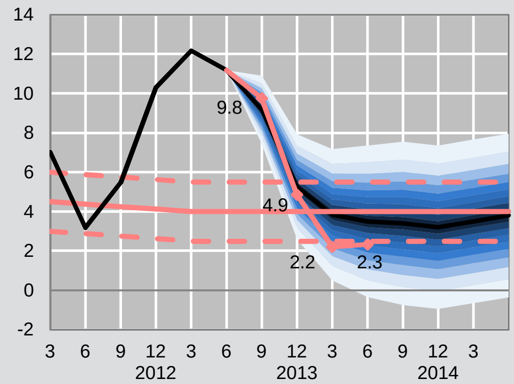
Looking ahead, further monetary policy easing will depend primarily on the strength of potential negative effects of external shocks on the country risk premium and primary commodity prices, as well as on the pace and intensity of fiscal consolidation and the outcome of this year's agricultural season.

Comparison and outcome of projections

Since disinflationary pressures in Q1 proved to be stronger than anticipated earlier and are most likely to continue into Q2, the new projection envisages inflation to return to the target in H2 faster than the February projection. Inflation projection for 2015 has remained almost unchanged, and so has the medium-term projection band.

During the last twelve months, y-o-y inflation was moving within the band projected in May 2013. Inflation hovered around the central projection rate in Q2 and Q3 2013 and slid below it in Q4 2013 and Q1 2014. Inflation fell short of the central projection as the disinflationary effect of food, notably fruit and vegetable prices, and aggregate demand proved stronger than envisaged before.

Chart V.0.7 **Achievement of May 2013 inflation projection**
(y-o-y rates, in %)



Source: NBS.

In the last six months, y-o-y inflation was lower than the May 2013 central projection.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014
EXTERNAL LIQUIDITY INDICATORS (in %)										
FX reserves/imports of goods and services (in months)	6.1	9.0	7.2	5.2	9.5	8.2	8.7	7.6	7.4	6.9[1)]
FX reserves/short-term debt	177.2	267.2	253.9	154.5	214.9	189.4	298.6	242.8	272.1	252.6
FX reserves /GDP	24.3	38.5	33.8	24.9	36.6	35.8	38.3	36.9	35.0	32.7
Debt repayment/GDP	5.2	10.8	10.7	10.9	13.5	12.7	13.3	14.0	14.0	12.8
Debt repayment/exports of goods and services	19.8	36.2	34.9	35.1	46.0	35.3	36.5	35.0	31.2	27.2
EXTERNAL SOLVENCY INDICATORS (in %)										
External debt/GDP	60.1	60.9	60.2	64.6	77.7	85.0	76.7	86.9	80.8	80.0
Short-term debt/GDP	13.7	14.5	13.3	16.2	17.0	18.9	12.8	15.2	12.9	12.9
External debt/exports of goods and services	228.9	204.1	197.3	207.6	265.3	236.2	210.3	217.4	179.7	171.6
FINANCIAL RISK EXPOSURE INDICATORS (in %)										
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	335.3
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	192.8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	73.6	81.2	86.8	88.8	75.6	88.2	89.3	97.9	101.3	104.1[1)]
MEMORANDUM: (in EUR million)										
GDP	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	31,994	7,251[1)]
External debt	12,196	14,182	17,139	21,088	22,487	23,786	24,125	25,721	25,842	25,504
External debt servicing	1,054	2,513	3,034	3,563	3,897	3,556	4,182	4,143	4,479	928
Central bank foreign exchange reserves	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,189	10,428
Short-term debt[2)]	948	958	1,050	2,143	2,005	1,830	648	493	212	152
Current account balance	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,176	-1,585	-313.8[1)]

		2006	2007	2008	2009	2010	2011	2012	2013	2014	2014
		Feb. /Apr.	June	Dec.	Dec.	Nov.	Mar.	Aug.	July	Jan.	Apr.
CREDIT RATING	S&P	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative			BB- /negative
	Fitch	BB- /stable		BB- /negative		BB- /stable		BB- /negative	BB- /negative	B+ /stable	
	Moody's								B1 /stable		

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of end-of-period foreign exchange reserves to average monthly imports of goods and services during period under review.
Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to stock of short-term debt at remaining maturity at end-of-period.
Foreign exchange reserves/GDP (in %) - ratio of end-of-period foreign exchange reserves to GDP.
Debt repayment/GDP (in %) - ratio of debt repayment (excluding early debt repayment to the London Club creditors) to GDP during period under review.
Debt repayment/exports (in %) - ratio of debt repayment (excluding early debt repayment to the London Club creditors) to exports of goods and services during period under review.
Debt/GDP (in %) - ratio of end-of-period outstanding debt to GDP.
Short-term debt/GDP − ratio of end-of-period short-term debt at remaining maturity to GDP.
Debt/exports (in %) - ratio of end-of-period outstanding debt to annual value of exports of goods and services.
Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-of-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.
2) At original maturity.

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 early 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 1 January 2010 the Serbian Statistical Office, according to UN recommendations, applies general trade system which is a 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 433.7 mln) used in December 2009, as well as the capitalised interest to the Paris Club creditors (EUR 12.2 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 836.3 mln, of which EUR 383.2 mln relates to domestic banks and EUR 453.1mln to domestic enterprises).

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014
Real GDP growth (in %)[1)]	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	0.4
Consumer prices (in %, relative to the same month a year earlier)[2)]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	2.3
NBS foreign exchange reserves (in EUR million)	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,189	10,428
Exports (in EUR million)[3)8)]	5,329	6,948	8,687	10,157	8,478	10,070	11,472	11,829	14,378	3,416[9)]
- growth rate in % compared to a year earlier	19.1	30.4	25.0	16.9	-16.5	18.8	13.9	3.1	21.5	16.5[9)]
Imports (in EUR million)[3)8)]	-9,612	-11,970	-16,016	-18,843	-13,404	-14,643	-16,627	-17,153	-18,023	-4,131[9)]
- growth rate in % compared to a year earlier	0.7	24.5	33.8	17.6	-28.9	9.2	13.6	3.2	5.1	2,0[9)]
Current account balance[4)8)]										
(in EUR million)	-1,778	-2,356	-5,053	-7,054	-1,910	-1,887	-2,870	-3,176	-1585	-314[9)]
as % of GDP	-8.8	-10.1	-17.7	-21.6	-6.6	-6.7	-9.1	-10.7	-5.0	-4.3[9)]
Unemployment according to the Survey (in %)[5)]	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	20.8
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	361.4
RS budget deficit/surplus (in % of GDP)[6)]	0.7	-1.7	-1.1	-1.9	-3.3	-3.5	-4.1	-5.7	-4.8	-8.6
Consolidated fiscal result (in % of GDP)	1.1	-1.5	-1.9	-2.6	-4.5	-4.8	-5.0	-6.6	-5.0	-7.7
RS public debt, (external + internal, in % of GDP)[6)7)]	52.2	37.7	31.5	29.2	34.7	44.5	48.2	60.0	63.7	65.1
RSD/USD exchange rate (average, in the period)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	84.47
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	83.89
RSD/EUR exchange rate (average, in the period)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	115.75
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	115.38
MEMORANDUM: GDP (in EUR million)	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	31,994	7,251[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) Government securities at nominal value.

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.

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Tables in boxes

Executive Board meetings and changes in the key policy rate

2013

Date	Key policy rate (p.a, in %)	Change (in basis points)
17 January	11.50	+25
5 February	11.75	+25
12 March	11.75	0
11 April	11.75	0
14 May	11.25	-50
6 June	11.00	-25
11 July	11.00	0
8 August	11.00	0
10 September	11.00	0
18 October	10.50	-50
7 November	10.00	-50
17 December	9.50	-50

2014

Date	Key policy rate (p.a, in %)	Change (in basis points)
16 January	9.50	0
13 February	9.50	0
6 March	9.50	0
17 April	9.50	0
8 May	9.00	-50
12 June		
10 July		
7 August		
11 September		
16 October		
13 November		
11 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 6 March 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 9.5%.

The Executive Board stated that the y-o-y inflation rate has returned within the target tolerance band in January, in line with NBS expectations. However, caution in monetary policy is warranted by heightened volatility in the international financial markets, stirred by geopolitical turmoil and the Fed's QE tapering, which dampens investor sentiment and may negatively influence capital inflows. By keeping the key policy rate on hold, the NBS aims to support price and financial stability in the medium term.

The Executive Board expects that consistent implementation of fiscal consolidation measures will diminish the exposure of the domestic economy to external risks triggered by the above developments and strained liquidity in the international financial markets. Working in the same direction would be the expected conclusion of an arrangement with the IMF as it would strengthen the credibility of measures aimed at maintaining macroeconomic stability and sustainable growth.

Growth has been recorded since the beginning of the year in a larger number of manufacturing branches, which is anticipatory of positive growth rates in 2014 as well. This will be aided by the expected euro area recovery and the start of negotiations on EU accession, concluded the Executive Board.

The next rate-setting meeting of the Executive Board will take place on 17 April.

Press release from Executive Board meeting held on 17 April 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 9.5%.

The Executive Board stated that y-o-y inflation rate moves around the lower bound of the target tolerance band and that inflationary pressures have significantly abated, while inflation expectations are stable.

In deciding to keep the key policy rate on hold, the Executive Board was guided by instability in international financial markets and heightened uncertainties surrounding the current geopolitical tensions. This may reflect on Serbia through contracted capital inflows and higher prices in global commodities markets, notably prices of energy and primary agricultural commodities. Besides, EU countries may experience lower economic growth, which would dampen the demand for our export products, warned the Executive Board.

The expected stepping up of fiscal consolidation and structural reforms will contribute to stabilising inflation at low levels and preserving price and financial stability over the medium run, and will also reduce the exposure of the domestic economy to the above exogenous risks. The Executive Board expects that the announced fiscal consolidation measures will open up the scope for monetary easing, which should have a positive effect on the sustainability of economic growth

The next rate-setting meeting will be held on 8 May.

Press release from Executive Board meeting held on 8 May 2014

At its meeting today, the NBS Executive Board decided to cut the key policy rate by 0.5 percentage points to 9%.

In making its decision the Executive Board was guided by the fact that year-on-year inflation has been moving around the lower bound of the target tolerance band and that inflationary pressures have subsided significantly. Also, medium-term inflation expectations of financial and real sectors are stable and within the band.

Strong disinflationary pressures in the coming period will be generated by low aggregate demand, arising from, among other things, the credit downturn and adverse developments in the labour market. The continuing low food production costs will also have a disinflationary effect. Trends in the foreign exchange market are stable, due not only to monetary policy measures, but the low current account deficit as well.

No negative impact on the country’s risk premium and external trade has so far resulted from the Fed’s QE tapering and geopolitical tensions arising from the Ukrainian crisis.

The Executive Board's view is that the financial market has so far responded positively to the announced economic measures of the new Government, which imply a commitment to vigorous and full implementation of fiscal policy measures. This would stabilise inflation at a low level and create the room for further monetary policy easing.

At its meeting today, the Executive Board adopted the May Inflation Report, which will be presented to the public on Wednesday, 14 May 2014.

The next rate-setting meeting will be held on 12 June 2014.

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