National Bank of Serbia

May 2015

INFLATION REPORT

2015

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www.nbs.rs
Number of copies: 60
ISSN 1820-9394

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 11 May 2015.

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
TLTROs – targeted long-term refinancing operations
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NBS – National Bank of Serbia
NPLs – non-performing loans
OFI – other financial organisation
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
RHS – right hand scale
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 is rising, but continues to move below the lower bound of the target tolerance band.

Consistent with expectations stated in the February *Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band in the first quarter of the year. This was mostly due to a sharper fall in oil prices and the absence of expected changes in administered prices. Core inflation, being the part of the consumer price index which is most strongly influenced by monetary policy measures, continued to move below the lower bound of the target tolerance band, and at 1.9% year-on-year in March, equalled headline inflation.

Inflation expectations which have been stable within the target tolerance band for over a year also indicate that no major inflationary pressures are expected in the period ahead.

From the start of the year, consumer price growth was higher than the central projection published in the February *Inflation Repor*t. According to our estimate, however, this was caused by one-off factors bringing about higher-than-expected unprocessed food prices. That no major inflationary pressures are expected in the period ahead is also indicated by inflation expectations which have been stable within the target tolerance band for over a year and have declined still further over the past months to their lowest level on record, with financial sector expectations below the 4.0% target midpoint.

Euro area economic recovery is gaining momentum and gradually spilling over into the region of Central and East Europe.

Due to low oil prices, accommodative monetary policy stance of the European Central Bank and the euro's depreciation against other leading global currencies, euro area economic recovery is gradually gaining momentum and slowly spilling over into the region of Central and East Europe. The pace of euro area growth, however, remains weaker relative to the US – growth estimates for this year are 1.5% for the euro area and 3.0% for the United States of America.

The initial results of the new monetary policy measures of the European Central Bank are encouraging.

The quantitative easing programme of the European Central Bank is working according to plan, and the initial results of the European Central Bank's monetary policy measures are encouraging. In all likelihood, euro area deflation will not persist, real interest rates are falling and the euro is weakening, all of which should have a stimulating effect on the economy. The quantitative easing of the European Central Bank, together with low oil prices, has created additional room for central banks of Central and East European countries to relax their monetary policies. At the same time, the quantitative easing programme has resulted in higher liquidity in the international financial market, despite expectations that the Federal Reserve System will start raising its policy rate this year.

Appreciation pressures on the dinar have prevailed from February onwards, fuelled by increased investor interest in Serbia following conclusion of a stand-by arrangement with the International Monetary Fund and a more accommodative monetary policy stance of the European Central Bank.

Increased liquidity in the international financial market has resulted in larger capital flows to emerging markets, including Serbia. Another important impulse to improved risk perception of Serbia came with the conclusion of a three-year precautionary stand-by arrangement with the International Monetary Fund. As a result, non-residents' investment in government securities was very high in February and March, fuelling an increase in their demand for dinars. Together with other capital inflows from abroad and lower foreign exchange demand of energy importers, this gave the highest contribution to appreciation pressures in the reviewed quarter. Since the start of the year, the National Bank of Serbia intervened in the interbank foreign exchange market by buying EUR 280.0 mln net.

Monetary easing continued, with the key policy rate slashed to its lowest level since the introduction of the inflation targeting regime.

In March, April and May, the key policy rate was cut each time by 50 basis points, down to 6.5% – its lowest level since the introduction of the inflation targeting regime. The Executive Board of the National Bank of Serbia decided to further ease the monetary policy stance given that no major inflationary pressures are expected in the coming period. The Board also took account of the fact that, against a background of European Central Bank's quantitative easing, the fiscal adjustment at home and the arrangement with the International Monetary Fund serve as a fillip to investors' interest in Serbia and contribute to a reduction in external imbalances. Progress in the implementation of policies under the arrangement with the International Monetary Fund is monitored on a quarterly basis and all quantitative programme criteria have so far been met. Among other things, foreign exchange reserves, at the programme exchange rate, were much higher at end-March than the floor defined by the programme. Year-on-year inflation in March moved within the bounds of the agreed inner inflation consultation band.

First-quarter fiscal deficit was lower than either expected or envisaged under the arrangement with the International Monetary Fund.

First-quarter fiscal deficit was lower than expected and was brought about by the initial positive results of fiscal consolidation and improved fiscal discipline, but also by higher one-off inflows and lower-than-planned capital expenditure. Consolidated fiscal deficit came at 2.4% of GDP in the first quarter, with interest payment costs at 4.6% of the estimated GDP, partly as a result of a stronger US dollar. According to our estimate, and assuming further consistent implementation of fiscal consolidation, consolidated fiscal deficit will be lower this year than the 5.9% of GDP mark set by the Fiscal Strategy.

In addition to the lowering of internal imbalances, reduction of external imbalances also continued.

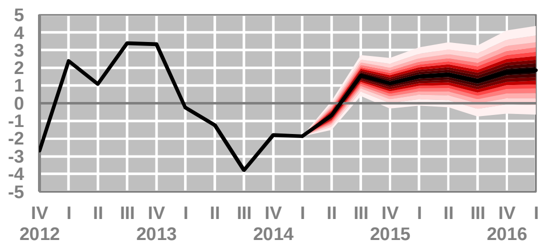
Exports of goods and services continued rising. By contrast to end-2014 when exports of agricultural commodities prevailed, exports of a large number of manufacturing industry branches are now trending up. Imports are also rising at a faster pace than in the quarter earlier, but their composition has improved – imports of consumer goods have shrunk, while imports of equipment went up. Current account deficit is expected to come to 4.2% of GDP in 2015, driven primarily by the recovery of the euro area and our other major foreign trade partners, as well as by falling oil prices and rallying of the mining and energy sectors.

Industrial production recovery begun in late 2014 gained additional momentum in the first quarter of the year, hence offsetting negative trends in the service sectors.

The external demand-driven recovery of manufacturing and revitalisation of the mining-energy complex managed to counterbalance negative trends in the service sectors in the first quarter. As a result, GDP remained unchanged from the previous quarter. Encouragingly, a large number of export-oriented branches have recovered, constituting solid ground for growth in the quarters ahead.

GDP will most probably stagnate this year (an upward revision by 0.5 percentage points from the February projection), while next year's economic activity growth is expected at 1.5%.

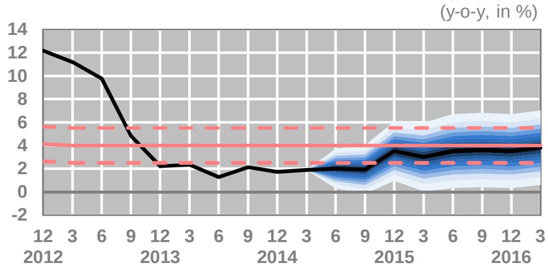
GDP growth projection
(y-o-y rates, in %)



GDP will most probably stagnate this year, by contrast to the February projection when a slight fall was expected. Projection of economic growth for the next year remains unchanged at 1.5%. On the expenditure side, consistent fiscal adjustment, coupled with structural reforms, ought to result in higher investment and net exports, while a negative contribution to GDP during the year is expected from both final household and government consumption. Net exports will rise on the back of an anticipated stronger recovery of external demand in the period ahead, primarily within the euro area, which is one of the reasons behind the upward revision of GDP projection for this year. Such upward revision was also motivated by available household consumption indicators, which signal that household consumption declined less than expected from the start of the year due in part to lower oil prices.

Inflation is expected to return within the bounds of the target tolerance band in the second half of the year, levelling off within the band thereafter.

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



Year-on-year inflation will return within the target tolerance band in the second half of the year and stay within the band until the end of the projection horizon. According to our estimate, inflation growth over the coming period will not be a result of dispersed price increases, but rather a consequence of a rise in a small number of CPI items (prices of electricity, cigarettes and petroleum products), which contributed considerably to the undershooting of the inflation target band in the past year. The risks to the projected inflation path are associated primarily with developments in the international environment, including prices of primary commodities, departure from the assumed administered price hike at home, and to a certain extent the outcome of this year's agricultural season.

Monetary policy stance in the period ahead will depend primarily on international developments and commodity price movements.

Looking ahead, monetary policy easing will depend primarily on the assessment of the potential impact of developments in the international environment on capital flows and Serbia's risk premium, as well as on movements in oil and agricultural commodity prices. Further, consistent implementation of fiscal consolidation measures should be continued, as this opens up additional room for monetary policy easing.

II. Monetary policy since the February *Report*

After holding it steady in February, the Executive Board lowered the key policy rate by 50 bp in each of the following three months, down to 6.5% – its lowest level since inflation targeting was first introduced.

The Executive Board decided to ease the monetary policy stance further given that no major inflationary pressures are expected in the coming period. Inflation expectations have fallen again, the disinflationary effect of aggregate demand is still present, and inflation abroad is extremely low. Against the background of the ECB's quantitative easing, additional fiscal adjustment at home and the arrangement with the IMF serve as a fillip to investors' interest in Serbia, and together with the expected reduction in external imbalances, contribute to the stabilisation of the foreign exchange market.

Inflation projection released in February was the same as the one released in November – y-o-y inflation was expected to return within the target tolerance band (4±1.5%) around mid-2015 and stay within the band thereafter. Consumer prices were expected to rise steadily on the back of the anticipated adjustment in administered prices, the effects of the dinar's depreciation in H2 2014 and the gradually waning disinflationary pressures generated by the prices of primary agricultural commodities. The projection indicated that consumer price growth would be slowed by low aggregate demand, whose disinflationary effect would be amplified by additional fiscal consolidation measures. The risks to the projected inflation path were associated primarily with developments in the international environment, including prices of primary commodities, and administered prices at home. Due to additional fiscal consolidation measures, it was expected that GDP would contract by around 0.5% in 2015 and recover in 2016.

Starting from the February projection and estimates based on incoming information on economic developments, the NBS Executive Board concluded in both its March and April meetings that there was room for further monetary easing and monetary policy contribution to long-term sustainable recovery of the domestic economy. In the May meeting too, the Executive Board proceeded with monetary easing, encouraged by the May inflation and GDP projections. Thus, in the period March–May the key policy rate was cut by a total of 150 bp, down to 6.5%, which is its lowest level since inflation targeting was first adopted as the new monetary policy framework of the country.

The Executive Board's decision to cut the key policy rate was taken in view of the exceptionally low inflation and no expectation of major inflationary pressures in the coming period. Consumer price growth since the beginning of the year is attributable to one-off factors, notably the increase in fruit and vegetable prices, and does not indicate a rise in inflationary pressures. This is also confirmed by the low core inflation. Inflation expectations, which have been moving within the target tolerance band for over a year, fell still further, touching their lowest level on record (inflation expectations of the financial sector are below the 4.0% target midpoint). Besides, aggregate demand continues to generate disinflationary pressures, while inflation in the international environment is extremely low and even negative in some countries.

The Executive Board also stated that the ECB's quantitative easing has already reflected on the rebalancing of investment portfolios and global capital flows, given that the yields on shorter-term sovereign securities of many of the bloc's members were low to negative even before the start of quantitative easing. As they are seeking higher yields, investors' interest in Serbia has increased. This interest is underpinned by consistent implementation of fiscal consolidation and structural reforms and the conclusion of a precautionary stand-by arrangement with the IMF, which serves as an assurance of the commitment of Serbian policy makers to ensuring long-term sustainable recovery of the domestic economy. This is evidenced by the fall in the country risk premium and a rise in non-residents' demand for government securities.

At its meeting in May, the Executive Board also adopted amendments to the Decision on Interest Rates of the National Bank of Serbia. The amendments narrowed the interest rate corridor relative to the key policy rate from ±2.5% to ±2.0%, with a view to supporting further steadying of interest rates in the interbank money market.

III. Inflation movements

Consistent with expectations presented in the February Inflation Report, y-o-y inflation continued to move below the lower bound of the target tolerance band in Q1. After reaching a low in January, it began to rise in February towards the target. Subdued inflationary pressures were due to the interplay of several factors – low prices of primary commodities, the absence of pressures on import prices and low aggregate demand, which is also indicated by core inflation that stayed below the lower bound of the target tolerance band in Q1.

Moving within the target tolerance band for more than a year already, inflation expectations of the financial and corporate sectors declined further over the past months to their lowest levels on record (even below the midpoint of the target band as assessed by the financial sector). This was due primarily to an extended period of low inflation and expectations of subdued inflationary pressures.

Inflation movements in Q1

Due to high last year's base caused by the VAT hike, y-o-y inflation touched a low in January (0.1%). It began to rise in February towards the lower bound of the target tolerance band, which is consistent with expectations presented in the previous *Inflation Report*. Y-o-y inflation continued up until March when it reached 1.9%.

In quarterly terms, consumer price growth equalled 1.4% in Q1, reflecting primarily higher unprocessed food prices. Though smaller, the contribution of processed food and energy prices was also positive, while industrial product prices (excluding food and energy) and prices of services were on a decline.

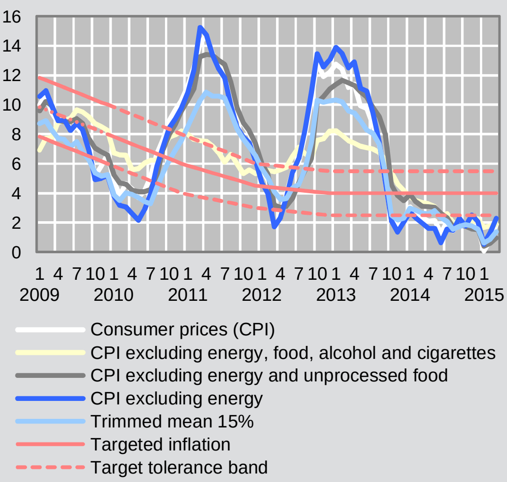
Consumer price growth in Q1 was higher relative to the central projection from the February *Inflation Report*.

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

	2014				2015
	I	II	III	IV	I
Consumer prices (CPI)	12	0.8	0.3	-0.6	14
Unprocessed food	3.9	4.9	0.8	-4.0	8.6
Processed food	0.6	-0.5	0.2	0.2	17
Industrial products excluding food and energy	16	-0.1	-0.3	-0.6	-0.1
Energy	0.9	-0.4	10	-18	0.7
Services	0.0	16	0.7	16	-0.5
Core inflation indicators					
CPI excluding energy	13	0.9	0.2	-0.4	15
CPI excluding energy and unprocessed food	0.8	0.3	0.1	0.3	0.3
CPI excluding energy, food, alcohol and cigarettes	-0.1	0.8	0.2	13	-0.5
Administered prices	3.0	0.2	-0.6	-14	-0.1

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

This was due to developments recorded in March, i.e. a higher than seasonal rise in fruit and vegetable prices, and higher prices of fresh meat.

Unprocessed food prices rose by 8.6% (contribution to inflation: 1.1 pp), led by the higher than seasonal growth in fruit and vegetable prices (16.9%, contribution: 1.3 pp), while prices of fresh meat, despite the March increase, declined at the quarterly level (5.6%, contribution: -0.23 pp). **Processed food prices** picked up by 1.7% (contribution to inflation: 0.35 pp), but the strongest positive contribution came from prices of non-alcoholic beverages (4.0%, contribution: 0.14 pp).

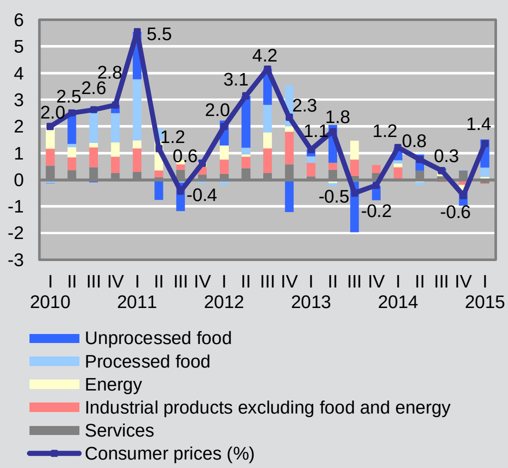
Higher household gas prices (11.2%) and heating tariffs (3.5%) pushed up prices within the group of **energy** by 0.7% in Q1 (contribution to inflation: 0.11 pp). A slight positive contribution was also provided by petroleum product prices (growth of 0.2%), while the growth was moderated by declining prices of firewood.

Prices of services fell by 0.5% (contribution: -0.13 pp) due to lower prices of travel arrangements and kindergarten services. A significant rise was noted for prices of mobile telephony and public transportation.

Industrial product prices excluding food and energy were on a decline for the fourth consecutive quarter. They fell by 0.1% in Q1 (contribution: -0.03 pp). The largest drop was recorded for prices of pharmaceutical products, clothes and footwear and passenger cars. In contrast, a rise was noted for prices of alcoholic beverages due to the excise adjustment, as well as prices of recreation and culture products, arising mainly from imports and under the effect of dinar's depreciation from H2 2014.

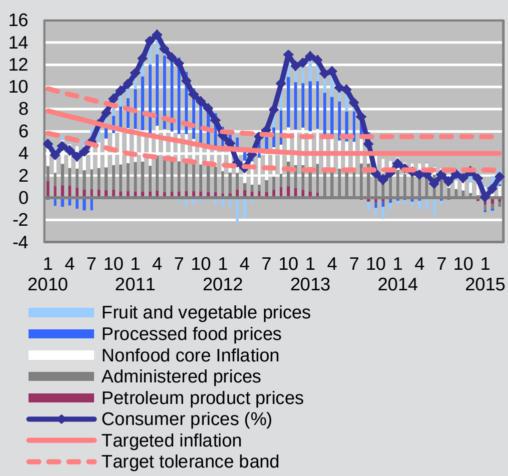
Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) fell by 0.5% in Q1 (contribution: -0.21 pp), mainly on the back of the seasonal decrease in prices of travel arrangements and clothes and footwear, and the government's decision to lower the prices of medicaments and kindergarten services. On the other hand, the strongest positive contribution to core inflation came from mobile telephony prices. In y-o-y terms, core inflation continued to move below the lower bound of the target tolerance band. Such movement was set in train in August last year, whereas in March core inflation reached the rate of headline inflation.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

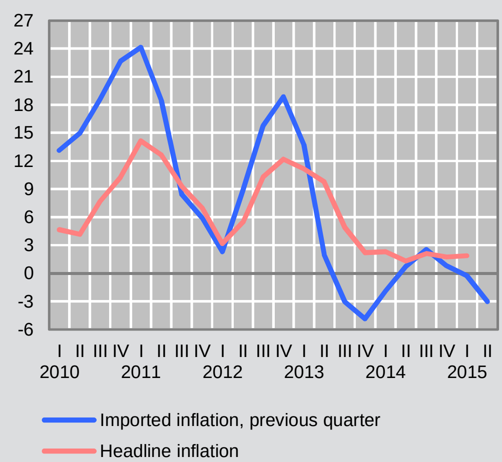
For the third quarter in a row, **administered prices declined** in Q1 (-0.1%, contribution to CPI: -0.02 pp), mainly reflecting lower prices of medicaments and kindergarten services. For the first time on record, in Q1 administered prices fell in y-o-y terms as well (2.0% at end-March). Such price movements were due mainly to falling prices of cigarettes and medicaments over the past year and the absence of electricity price adjustment last year.

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

	VI 2014 / VI 2013	IX 2014 / IX 2013	XII 2014 / XII 2013	III 2015 / III 2014
Consumer prices	13	2.1	17	19
Domestic industrial producer prices	10	10	0.2	0.7
Agricultural producer prices	-4.2	-0.1	-7,9	-3.0
Prices of elements and materials incorporated in construction	3.9	3.8	4.6	0.7

Sources: SORS and NBS calculation.

Chart III.0.4 **Domestic and imported inflation**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

Broken down by group of products, in Q1 prices of food and non-alcoholic beverages increased the most (4.2%), while prices of communications and hotel and restaurant services declined somewhat less (1.7% and 1.2% respectively). Prices declined in quarterly terms in the groups of recreation and culture (3.3%), healthcare (1.8%) and clothes and footwear (16%).

Producer and import prices

Industrial producer prices in the domestic market rose by 1.2% in Q1. The strongest contribution (0.6 pp) came from an increase in prices of electricity, gas and steam supply (2.9%), which may be partly explained by higher costs of natural gas transport following harmonisation with EU directives. In February and March, prices were on a rise also in the production of petroleum products (7.1% at the quarterly level). The only significant fall was registered in the production of pharmaceutical products (7.8%). As y-o-y growth in producer prices stepped up on account of a quarterly rise, these prices were by 0.7% higher in March relative to the same period last year.

Agricultural producer prices[1] continued down in Q1 2015 (0.6%), fully on account of reduced livestock prices. The strongest cuts were made for prices of pigs (14.6%) because of elevated supply in the domestic market.[2] In addition, prices of animal products were lowered – milk (2.4%) and eggs (6.6%). The strongest rise in producer prices was noted for fruit and wine growing (21.2%), while prices in the production of cereals increased less. In y-o-y terms, agricultural producer prices were on a decline for the seventh consecutive quarter (3.0% in March), largely due to the relatively favourable agricultural performance over the past two years.

Prices of elements and materials incorporated in construction fell in line with seasonal dynamics in Q1 (5.0%). Their y-o-y growth decelerated as well – from 4.6% in December 2014 to 0.7% in March 2015.

Following a relatively vigorous fall in Q4, caused by plummeting global oil prices, **dinar-denominated import prices**[3] went up by 1.2% in Q1. The rise was

[1] Producer prices in agricultural and fishing sectors.

[2] Several factors led to higher supply in the domestic market: increased domestic production due to low animal feed prices, higher supply from the EU and limited export possibilities in the Russian market in late 2014 because of significant depreciation of the rouble.

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

driven by higher export prices of Germany (used to assess movements of the largest portion of import prices), which is partly explained by increased labour costs in Germany following the introduction of the minimum wage in January 2015. On the other hand, global oil prices continued down in Q1, though the decline was smaller than in H2 2014, but together with a further decline in food prices, they moderated the growth in import prices. Pressures arising from import prices were alleviated also by the mild nominal appreciation of the dinar against the euro in Q1. In y-o-y terms, dinar-denominated import prices accelerated down to 3.0%, mainly due to the base effect, i.e. high global oil and food prices of Q1 2014.

Inflation expectations

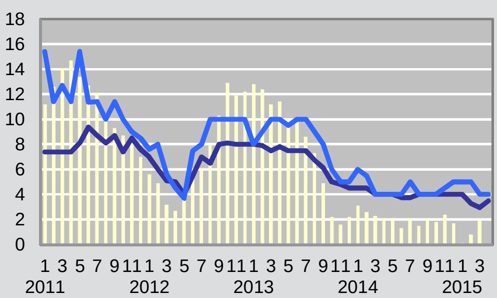
Over the past months, inflation expectations continued down to their lowest levels on record. This was due to an extended period of low inflation and expectations of subdued inflationary pressures.

According to the **Bloomberg** survey, following the February fall by 0.5 pp to 4.0%, **one-year ahead** inflation expectations of the financial sector remained unchanged over the next three months. They have moved within the target tolerance band for more than a year and a half. Judging by the **Ninamedia**[4] survey, financial sector expectations are even lower – they are below the midpoint of the target band after being pared back by 0.7 pp to 3.3% in February and to 2.95% in March – this being the lowest level ever. In April they edged up slightly, to 3.5%. After trending at 5.0% for three months, inflation expectations of the corporate sector stood at the midpoint in March and April. They have moved within the target tolerance band since February 2014.

Medium-term, i.e. **two-year ahead** inflation expectations of the financial sector moved around the midpoint – 3.9% in February, 3.7% in March and 4.0% in April. Medium-term expectations of the corporate sector also stood at the midpoint in April, sliding down from the level of 5.0% recorded in the previous several months.

As of February, one-year ahead inflation expectations of the household sector measure 5.0%, which is the lowest level since March 2014 when information on current inflation was no longer provided in the survey process. Two-year ahead inflation expectations of the household sector are also 5.0%. Qualitatively expressed inflation expectations of households have not changed a lot

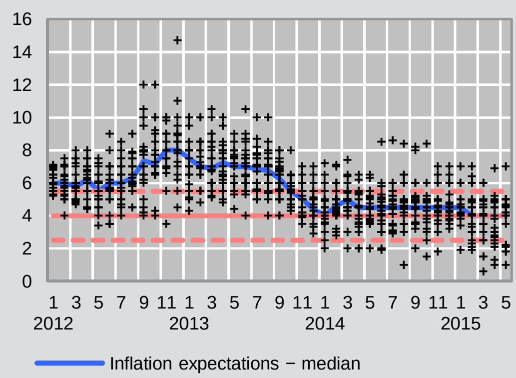
Chart III.0.5 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

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



Sources: Bloomberg and NBS.

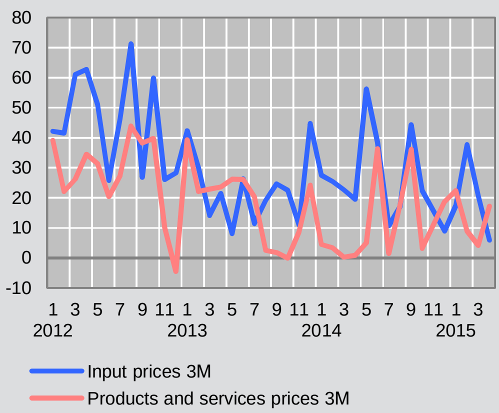
[4] Ninamedia clipping d.o.o. Novi Sad has been conducting a survey on expectations of economic entities since December 2014, in accordance with the methodology currently in use.

relative to the previous quarter. The only change concerns a further rise in the share of respondents who do not expect a price adjustment from 11.6% in December to 14.9% in April, which is a relatively high percentage for households. At the same time, the share of respondents expecting a decline in prices fell marginally, from 4.5% to 4.1%.

The dispersion of responses in the financial sector, which is the lowest among all sectors, remained largely unchanged from Q4. Also, the dispersion of responses of the corporate and household sectors continued to narrow owing to the absence of major inflationary pressures.

The net percentage[5] of enterprises expecting a rise in their input prices over the next three months is higher than the net percentage of enterprises expecting a rise in prices of their products. Thus, in March the net percentage of enterprises expecting a rise in their input prices was 20.7%, while the net percentage of enterprises expecting a rise in their product prices was only 4.1%. According to our estimate, corporate expectations regarding prices of inputs and finished products were under the impact of the expected electricity price increase and low domestic demand, which limits the pass-on of larger production costs to consumers.

Chart III.0.7 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos, Ninamedia and NBS.

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

IV. Inflation determinants

1. Financial market trends

Interest rates

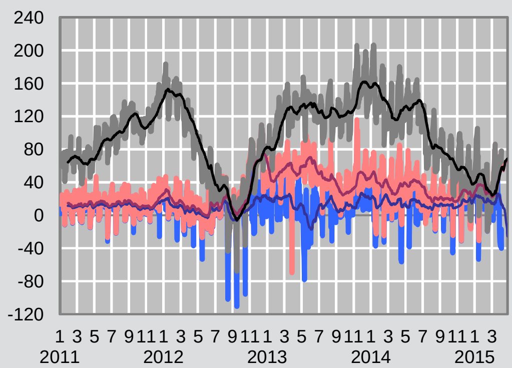
Changes in dinar liquidity prompted stronger volatility in interest rates in the Serbian interbank money market. Part of the increase in rates spilled over to the cost of private sector borrowing. After the arrangement with the IMF was concluded and concurrently with the start of ECB's quantitative easing, foreign investors stepped up investment in government securities, pushing down the rates in this market. The latter also reflected on appreciation pressures in the second half of Q1 in an environment of subdued FX demand of energy importers.

In early 2015, the average repo rate[6] went through marginal changes in both directions. The auction of 18 February closed at 6.0%, down by 0.2 pp from end-2014. Since then, because of the reduced excess dinar liquidity of banks, auctions were not held until the start of April when the drop in the average repo rate (0.9 pp) outstripped the cut in the key policy rate in March (0.5 pp).

Reduced excess dinar liquidity of banks drove up the trading volumes in the interbank overnight money market in Q1. The average daily trading volumes were RSD 9.6 bln, which is almost two and a half times more than in Q4 2014. The largest trading volumes were recorded in February, but began to decline in March reflecting higher liquidity of banks. Mirroring changes in bank liquidity, after the February rise BEONIA headed down until end-Q1. It touched 6.8% on average in March, down by 0.7 pp compared to December.

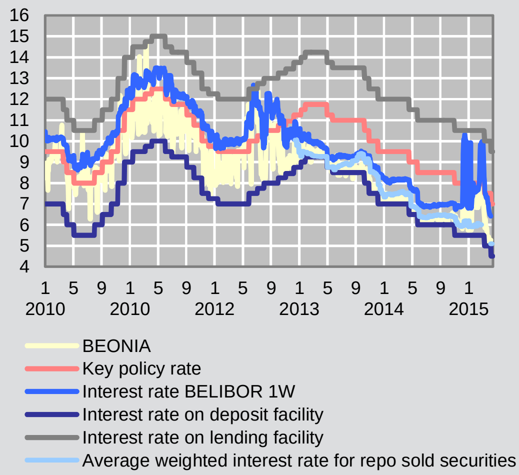
BELIBOR rates showed similar dynamics – they declined in January, picked up in February and declined anew in March, trending between 7.6% on average for the shortest and 9.2% for six-month maturity. The curve slope increased relative to December as the two shortest-maturity rates went down (by 0.4 pp and 0.3

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



Source: NBS.

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



Sources: Thomson Reuters and NBS.

[6] The rate achieved at repo auctions weighted by the amount of sold securities.

pp), while longer-maturity rates went up (between 0.3 pp and 0.5 pp).

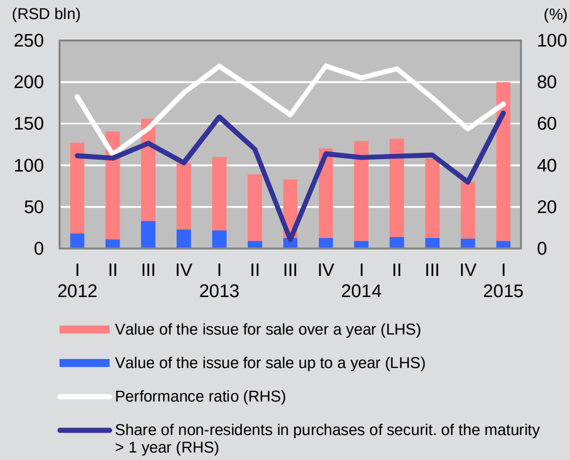
Interest rates in the interbank money market continued down in April and trading volumes receded.

Rates edged up somewhat at auctions of dinar government securities in early 2015. The decline began in March as non-residents stepped up investment in these securities after Serbia concluded the stand-by arrangement with the IMF. The new ECB's measures and the resulting increase in liquidity in the international market also gave a boost to investment. As in the quarter earlier, foreign investors opted for longer-maturity securities, prompting the rates on seven-year securities to record the sharpest decline in Q1 (by 1.2 pp). In March, interest rates on shorter-maturities also declined, but the reduction did not suffice to compensate for the rise in rates of early 2015. Hence, March rates on the dinar yield curve moved between 7.0% for six-month and 10.8% for seven- year securities.

The rates on one- and two-year euro-denominated securities stayed largely unchanged from end-2014 and equalled 2.5% and 3.5% respectively, while the rates on three- and five-year securities fell by 0.2 pp to 4.3% and 4.8% respectively.

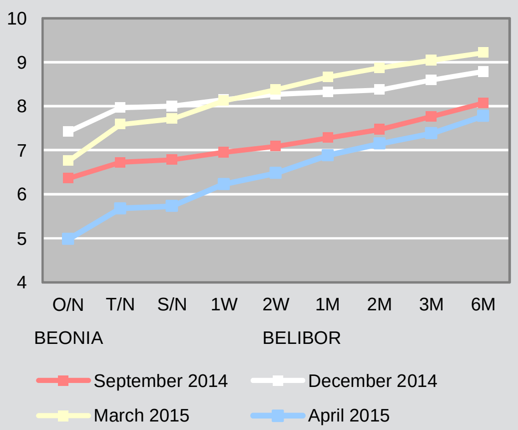
Increased foreign investor interest lent an impetus to secondary trading in government securities as well. Total trading volumes in this market amounted to RSD 116.6 bln, up by RSD 38.4 bln from Q4 2014. Most traded were seven- and three-year bonds. The rates of return generally mirrored the primary market trends – by end-Q1 they ranged between 7.0% for the remaining one-month maturity and 12.2% for the maturity of six and a half years.

Chart IV.1.4 **Primary market of government dinar securities – performance ratio and foreign investor participation**



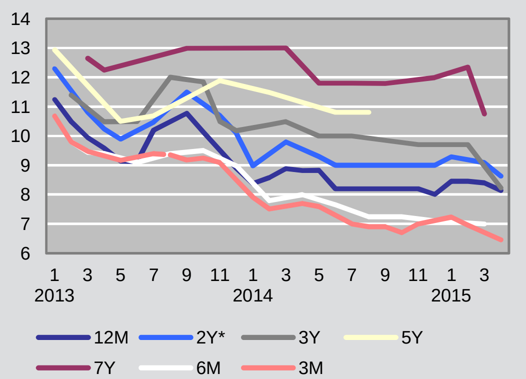
Source: Ministry of Finance.

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



Sources: Thomson Reuters and NBS.

Chart IV.1.5. **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities with the rate linked to the NBS key policy rate.

The cost of dinar lending to corporate and household sectors went up as of early 2015 and totalled 16.5% on average in March. This was due to the winding down of the subsidised lending programme where the relatively low interest rates affected the average loan cost in H2 2014, inducing an increase in rates in the interbank money market. The rise was more pronounced for rates on corporate loans (by 2.9 pp to 13.8%) relative to rates on household loans which moved up by 1.0 pp to 17.9%. At the same time, within the structure of new dinar loans, the share of household loans increased – their cost being higher than for corporate loans, the rise in the weighted average rate (3.9 pp) exceeded that on corporate and household loans separately.

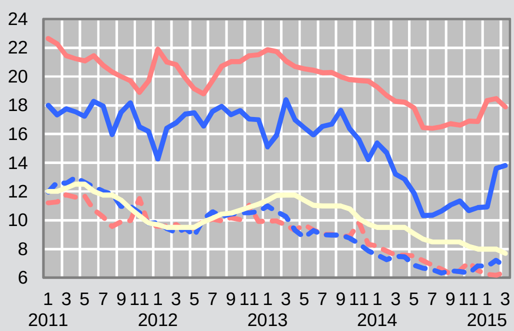
After winding down of the subsidised lending programme, the rates on current assets loans increased the most – by 3.7 pp to 14.3% in March. The average dinar rate went up also on account of higher rates on investment and other dinar loans. In regard to household loans, the rates on cash loans, the most popular dinar loans, stayed flat in Q1, ending March at 18.3%. At the same time, the rates on consumer and housing loans drifted down, while rates on other loans edged higher.

The cost of FX and FX-indexed lending also grew, though at a lesser pace compared to dinar lending. The weighted average rate on new euro and euro-indexed loans added 1.0 pp in Q1 and reached 6.1% in March. The average price of corporate loans climbed to 6.0%, mainly due to rising rates on investment and current assets loans. The cost of other FX-indexed and little used, import loans, also increased. In the course of Q1, citizens borrowed at practically unchanged rates of 7.0% on average. At the same time, rates on housing and other loans went down, while rates on consumer and cash loans went up. In March, rates ranged between 3.9% on housing and 8.0% on other loans.

Higher lending rates drove up the interest margin in Q1, just as banks expected according to the results of the January bank lending survey. Deposit rates shrank further – the weighted average rate on new euro deposits fell by 0.3 pp to 1.2%, and the rate on dinar deposits by 0.1 pp to 6.7%.

In Q1, the rates on household deposits came to their new lowest levels since September 2010 when the current interest rate statistics came into effect. The drop in rates was sharper for euro savings (by 0.4 pp to 1.3%), whereas the average rate on dinar savings fell by 0.1 pp to 6.4%. Rates on dinar and euro corporate deposits also decreased a tad (by 0.1 pp for each category), equalling in March 6.7% and 1.1% on average respectively.

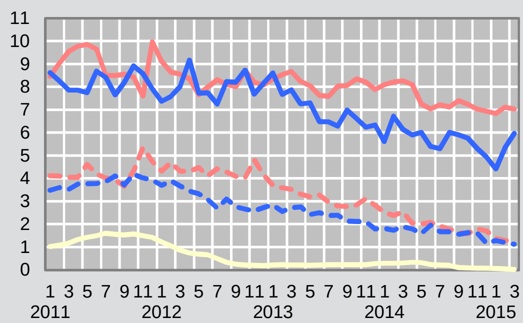
Chart IV.1.6 **Interest rates on new dinar loans and new corporate and household deposits***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **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.

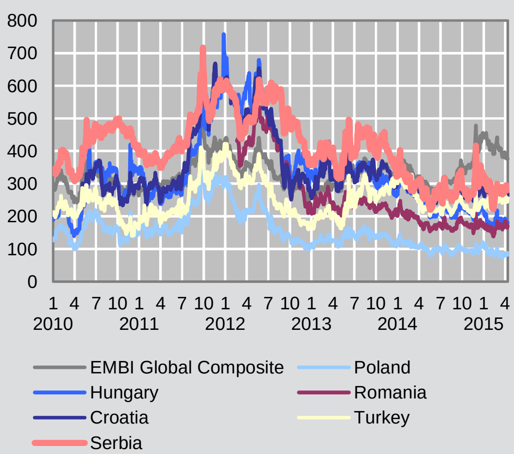
Risk premium

Serbia's risk premium measured by EMBI lost 33 bp in Q1, this being the largest decline in the region. In addition to Serbia, EMBI fell for Hungary (-20 bp), Poland (-12 bp) and Romania (-1 bp). It went up for Turkey (29 bp) and stayed the same for Croatia. At end-April, EMBI for Serbia stood at 285 bp, up by 6 bp on end-Q1.

The movements in Serbia's risk premium, i.e. the difference in yields between Serbia's eurobonds and the benchmark ten-year US Treasury note, have been under the impact of both domestic and global factors since early 2015. Of domestic factors, the strongest positive influence came from the conclusion of the arrangement with the IMF and affirmation of the country's credit rating (in January, Fitch affirmed Serbia's credit rating at B+ with stable outlook, and Standard & Poor's affirmed the rating at BB- with negative outlook). Serbia maintained its credit rating owing to the adoption of fiscal consolidation measures and further implementation of structural reforms, and the expected conclusion of the arrangement with the IMF.

In addition to Serbia-specific factors, changes in EMBI were largely driven by uncertainties as to the start of the Fed's rate hike, which prompted the variation in yields on the ten-year Treasury note from 1.64% in January (widening the yield spreads for Serbia and other emerging economies) to 2.24% in March (narrowing the yield spreads for Serbia and other emerging economies). Generally, the yields on US Treasury notes have been on a downward path, reflecting the start of the ECB's quantitative easing and the fact that low or negative inflation has helped many central banks ease their monetary policies. The trend may continue in the coming period, which may negatively affect emerging economies via the financial channel – more so the countries with large external liabilities and uncompetitive exchange rates. The ECB's quantitative easing could act towards dampening of this effect.

Chart IV.1.8 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Foreign capital inflow

The current account deficit narrowed relative to Q4 2014 owing to the seasonally lower trade deficit and weaker FDI expenditure. The net capital inflow in Q1 was more than sufficient to cover the current account deficit, generating appreciation pressures across the domestic FX market.

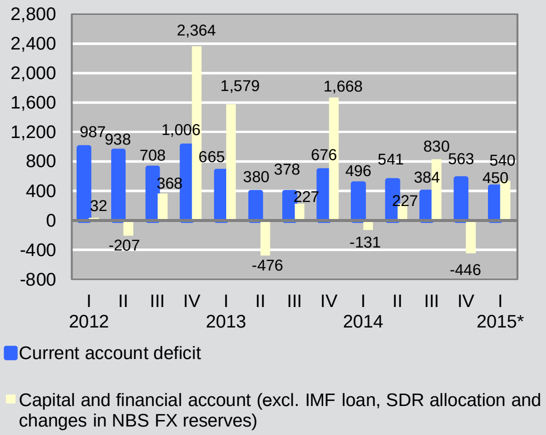
The net capital inflow on the financial account was due to portfolio investment, notably in government securities, and direct non-resident investment. At the same time, resident credit foreign liabilities contracted further.

According to preliminary data, the net **FDI** inflow amounted to EUR 235.2 mln in Q1. In terms of structure, the major portion of FDIs went into in equity (EUR 205.3 mln), while reinvested earnings and debt instruments accounted for EUR 15.0 mln and EUR 14.9 mln respectively.[7] At the same time, the net outflow from paid and collected dividends arrived at EUR 12.7 mln and interest payments at EUR 11.7 mln.

The FDI inflow is expected at around EUR 1.3 bln in 2015, notably through investment in manufacturing, trade and the financial sector. Consistent implementation of structural reforms and fiscal consolidation, Serbia's progress in the EU integration process, recovery of the euro area and implementation of the announced bilateral cooperation projects should give the key impetus to

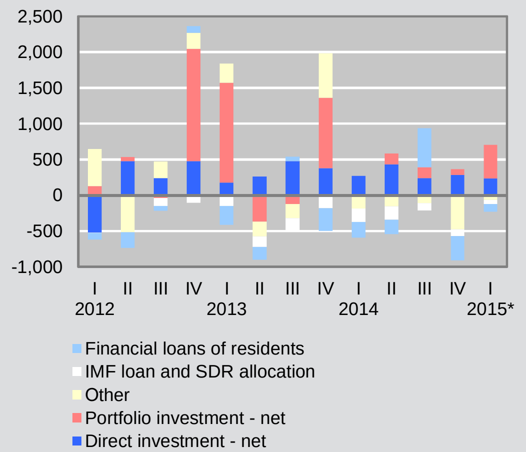
[7] According to the IMF's BPM6, reinvested earnings and intercompany debt are included within FDIs. This change is explained in more detail in Text box 1 of the August 2014 *Inflation Report*.

Chart IV.1.9 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Chart IV.1.10 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

further FDI growth. Thus, the conclusion of the arrangement with the IMF, as an assurance of credibility of the economic policy pursued by the Government and the National Bank of Serbia, sends a positive signal to potential investors.

Unlike in the previous quarter when investment in government securities abated because of the turmoil in international markets, foreign investment in these securities stepped up in Q1. This was due not only to the conclusion of the arrangement with the IMF, but also to stronger monetary policy accommodation of the ECB. Hence, net **portfolio investment** expanded by EUR 473.7 mln, while EUR 157.7 mln were paid out in interest to these investors in Q1. Given the large share of dollar-denominated government securities held by foreign investors, the increase in interest payments was also partly caused by dollar's appreciation.

Net external debt repayment by residents continued in Q1, though at a weaker pace than in Q4 2014. Thus, resident liabilities arising from **financial loans** fell by EUR 109.6 mln. Of this, banks repaid EUR 24.3 mln and the government repaid EUR 89.6 mln net. The servicing of government's credit liabilities accounted for EUR 157.6 mln and loan disbursements for EUR 68.0 mln. These loans include the EBRD loan for the Belgrade transport and traffic infrastructure and EIB loans for the construction of the Belgrade bypass and the development of regional and municipal infrastructure. Enterprises borrowed EUR 4.3 mln net in respect of cross-border financial loans, while their foreign liabilities under trade loans went up by EUR 0.3 mln net.

To service liabilities due to foreign creditors, the NBS paid out EUR 57.5 mln, of which EUR 53.4 mln to the IMF. In late February 2015, the IMF Executive Board approved a new stand-by arrangement to the Republic of Serbia, in support of the agreed economic programme. The arrangement is precautionary, meaning that Serbia does not intend to draw the funds committed by the IMF, but may do so in case of balance of payments needs.

Text box 1: Precautionary stand-by arrangement with the IMF

In February 2015, the Executive Board of the International Monetary Fund (IMF) decided to approve a three-year, SDR 935.4 million (around EUR 1.2 bln or 200% of Serbia's quota) new stand-by arrangement for Serbia. The Serbian Government has indicated its intention to treat the programme as precautionary. Precautionary arrangements are used when countries do not intend to draw on approved amounts, but retain the option to do so should they need it. At this point, Serbia does not need to draw on the approved amounts as its foreign exchange reserves (EUR 10.5 bln at end-March) are high enough by all observed criteria.

The programme is based on three main "pillars":

1. restoring public finances' health, i.e. implementing fiscal consolidation,
2. increasing the stability and resilience of the financial sector, and
3. implementing comprehensive structural reforms.

In its Memorandum of Economic and Financial Policies (hereinafter: Memorandum), attached to the Letter of Intent, the Government set out in detail the policies it intends to pursue during the arrangement in order to to meet programme targets, as well as the timelines for the implementation of individual measures.

Fiscal adjustment will largely be based on curbing mandatory government spending and reducing state aid to state-owned enterprises (SOEs). One of the major measures, related to reduction of pensions and public sector wages, was already introduced last year. The Memorandum further states that the indexation of public sector wages and pensions will be suspended (i.e. they will be "frozen" in the nominal amount) until their share of GDP declines to 7% and 11%, respectively. General government employment will be reduced by 5% annually, and pay grades introduced. The fiscal programme needs to be supported by an improved public financial management framework, which means creating an institutional framework for monitoring SOEs, enhancing the payment discipline among public sector entities, strictly limiting the issuance of state guarantees from January 2015, etc.

The second target of the programme is to support financial sector stability and resilience to shocks and to improve financial intermediation. According to the Memorandum, financial sector policy priorities include further strengthening of the supervisory and regulatory framework for banks, improving the bank resolution framework and addressing the issue of high NPLs. Also, efforts to implement the dinarisation strategy will be continued.

Structural reforms are essential to enhance Serbia's growth potential. Within this "pillar", there are three broad priorities to be implemented over the medium term: job creation, improvement of the business environment and competitiveness, and resolution and reform of SOEs. The last of these priorities is vital for reducing state aid to SOEs, i.e. limiting their reliance on the budget. The Memorandum sets out that authorities aim to privatise or find strategic partners for a large number of SOEs, while ensuring the resolution of 502 enterprises in the portfolio of the Privatisation Agency through either privatisation or bankruptcy. The Memorandum also gives an overview of specific measures planned for several largest SOEs ("Elektroprivreda Srbije", "Srbijagas", "Železnice Srbije" and "Putevi Srbije".)

According to the IMF, the implementation of the above programme will enable Serbia to restore public debt sustainability, rebalance macroeconomic policies, enhance financial sector resilience to shocks and improve competitiveness and medium-term growth potential. The IMF assessed as appropriate the authorities' fiscal package, which aims to place the debt-to-GDP ratio, which is currently over 70%, on a downward path by 2017.

In view of the above, the arrangement with the IMF is likely to improve investors' perception of safety of investing in Serbia. In addition, *ceteris paribus*, a consistent implementation of fiscal consolidation creates room for further monetary easing in order to support credit growth and domestic demand, which has been contained due to the short-term negative effect of reduced fiscal expansion.

Progress in the implementation of the policies under the programme will be reviewed by the IMF quarterly, through prior actions, quantitative performance criteria, indicative targets, structural benchmarks and inflation consultation clause. The first such review took place in May. At end-March, all quantitative criteria were met (see Table O.1.1). Due to higher revenues, in Q1 the fiscal deficit was much lower than agreed under the arrangement. Also, net international reserves, at the programme exchange rate (as at 30 September 2014), were much higher (by EUR 895.0 mln) than the floor set under the programme. Y-o-y inflation in March moved within the bounds of the inner band (1.7 ± 1.5%).[1]

Table O.1.1 **Selected quantitative programme targets**

	2015				
	March		June	Sep	Dec
	Programme	Actual	Programme		
Floor on net international reserves of the NBS (in mln EUR)	6,290	7,185	6,063	5,718	5,835
Ceiling on the consolidated general government deficit (in bln RSD)	56	21	96	153	232
Ceiling on current primary expenditure of the Serbian Republican Budget excluding capital expenditure and interest payments (in bln RSD)	207	195	429	657	906
Ceiling on gross issuance of new guarantees by the Serbian Republican Budget for project and corporate restructuring loans (in mln EUR)	0	0	121	401	481
End of period inflation (centre point, %)	1.7	1.9	3.0	2.6	4.2

Sources: IMF, Ministry of Finance, NBS and SORS.

1

[1] According to the Technical Memorandum of Understanding, breaching the inflation consultation inner band limits (centre point ± 1.5 pp) at the end of a quarter would trigger discussions with IMF staff on the reasons for the deviation and the proposed policy response. Breaching the outer band limits (centre point ± 2.5 pp) would trigger a consultation with the IMF's Executive Board on the reasons for the deviation and the proposed policy response before further purchases could be requested under the arrangement.

Trends in the FX market and exchange rate

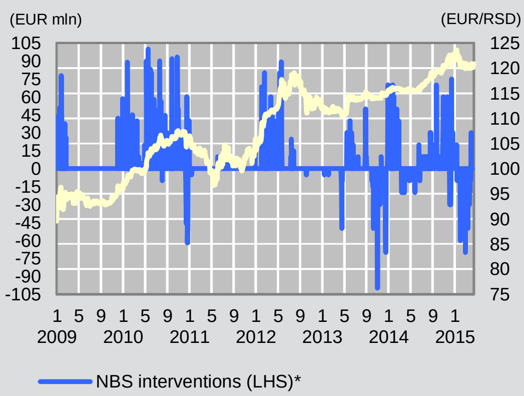
The depreciation pressures experienced in Q4 2014 continued into January only to be followed by the strengthening of the dinar since February. Observed at end-period, the dinar strengthened by 0.6% vis-à-vis the euro in Q1, while weakening 1.0% in period-average terms.

The weakening of the dinar against the euro was caused by both domestic and global factors. Demand for foreign currency of domestic enterprises, primarily of large energy importers, was heightened in the period under review. As trading in the domestic foreign exchange market stayed low, depreciation pressures intensified. January saw reduced net investment of non-residents into government securities, which may be attributed to global factors and probably to some caution pending the conclusion of the arrangement with the IMF.

Faced with the impact of global factors, domestic currency weakened further against the US dollar in Q1. Namely, the growing divergence between monetary policies of the euro area on the one hand, and the USA on the other, resulted in further strengthening of the dollar against the euro in Q1 (12.7%), thus bearing down on the dinar which fell by 10.7% vis-à-vis the dollar from end-2014 to end-March.

In late January, the ECB decided to expand its private sector asset purchase programme from March onward to include bonds issued by euro area central governments. Combined monthly purchases will amount to EUR 60.0 bln. Higher liquidity in the international financial market sparked by the ECB measures and low yield rates on securities of advanced economies steered the flow of capital increasingly towards emerging markets, including our own.A strong additional boost, contributing also to improved perception of the risk of investment in Serbia, came from the conclusion of a three-year stand-by arrangement with the IMF in the latter half of February. As a result, non-resident investment in the Serbian government dinar securities was very high in February and March, which reflected on greater non-resident demand for dinars. The slowdown in the demand of domestic enterprises for foreign currency, relatively small deficit in the balance on goods and services and the resumed level of high net purchases of foreign cash from exchange offices in March were additional factors generating appreciation pressures on the dinar in the quarter reviewed.

Chart IV.1.11 **Movements in EUR/RSD exchange rate and NBS FX interventions**

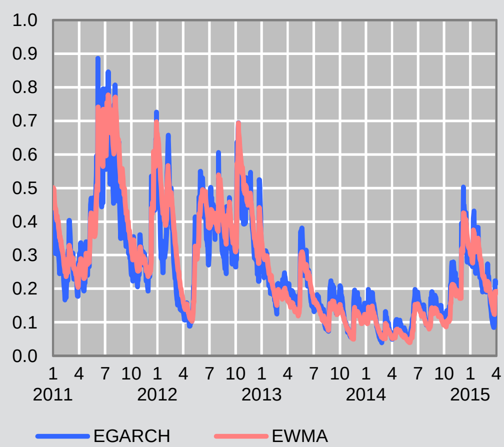


Source: NBS.

* + sale; - purchase.

** 1 EUR in RSD.

Chart IV.1.12 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

Volatility of the exchange rate (measured by EWMA[8] and EGARCH[9]), which was somewhat sharper at end-Q4 2014, subsided in the course of the first quarter.

IFEM trading volumes recuperated further and averaged EUR 41.9 mln daily in Q1, up by EUR 3.1 mln from Q4 2014.[10] The highest average daily turnover was observed in February (EUR 54.9 mln).

To ease excessive short-term volatility of the exchange rate and without any intention to influence its trend, the NBS intervened in the IFEM in Q1 by purchasing EUR 170.0 mln net. Unlike in January, when it intervened on the sale side (EUR 90.0 mln), in February and March it intervened on the purchase side (EUR 260.0 mln). In the course of April, the NBS purchased EUR 140.0 mln and sold EUR 30 mln in the IFEM.

In Q1, the NBS sold and bought EUR 15.0 mln at three-month swap auctions, EUR 9 mln less than in Q4 2014, while at two-week auctions it bought and sold EUR 131.5 mln, substantially more than in Q4 2014 (EUR 42.0 mln). Besides, the period under review saw a significantly higher volume of swap transactions between banks, more than twice the amount recorded in the entire year of 2014 (EUR 55.9 mln vs EUR 25.8 mln).

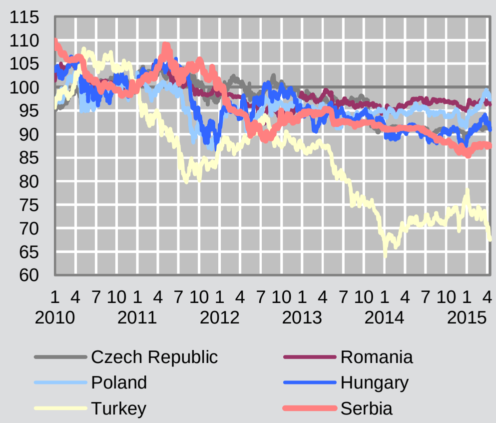
Other countries in the region running similar exchange rate regimes, except for Turkey, also faced depreciation pressures at the beginning of the first quarter, after which their currencies picked up against the euro. Relative to end-Q4, the Hungarian forint and Polish zloty appreciated the most (5.3% and 4.2% respectively), while the appreciation of the Romanian leu and Czech koruna was moderate (1.6% and 0.7% respectively). Unlike them, the Turkish lira first notched up in January, then weakened against the euro, and as a result, at end-March it was 0.4% weaker than at end-Q4.

Stock exchange trends

Over the course of the first quarter of 2015, the index of most liquid shares did not record any notable fluctuations. BELEX15 stood at 666.7 points, while the general index BELEXline climbed by 2.3% to 1,376.0 points.

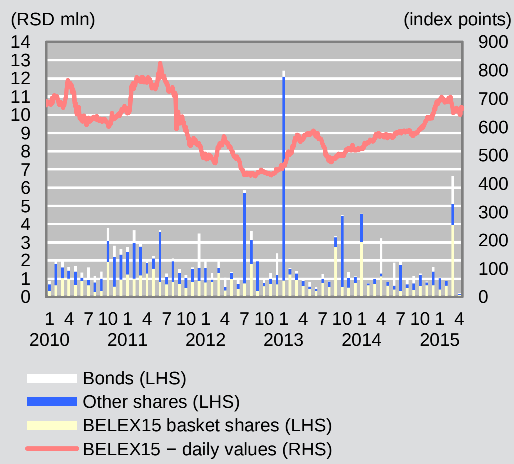
Total trading in shares at the Belgrade Stock Exchange amounted to RSD 7.0 bln in Q1. The highest trading volume was registered in March (RSD 5.1 bln), primarily as a result of trading in the open market, mostly in bank shares.

Chart IV.1.13 **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.

Chart IV.1.14 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

[8] EWMA (Exponentially Weighted Moving Average).

[9] EGARCH (Exponential General Autoregressive Conditional Heteroskedastic).

[10] Excluding the NBS.

Foreign investors accounted for over 50% of total trading in shares in Q1, but unlike a quarter earlier, they were net sellers of domestic shares worth RSD 3.8 bln owing to net sale in March.

Total trading in frozen FX savings bonds measured RSD 1.6 bln in Q1, with A2016-series bonds accounting for as much as 96% of the total. The rates of return for this series rose to 3.1% at end-Q1. However, the rates of return for the series maturing this year slumped to 1.8% at the end of March.

BSE market capitalisation shrank by RSD 16.2 bln in Q1, coming to RSD 780.4 bln at end-March. More specifically, market capitalisation of the regulated market decreased by RSD 29.8 bln to RSD 420.4 bln, as shares of certain issuers were excluded from trading. On the other hand, MTP[11] capitalisation expanded by RSD 13.5 bln to RSD 360.0 bln. The share of market capitalisation in estimated GDP dropped by 0.4 pp to 20.1% at the end of Q1.

The majority of stock exchanges in the region experienced diverging index movements, more pronounced than those observed at the Belgrade Stock Exchange. Skopje and Banja Luka stock exchanges witnessed the sharpest fall in indices (4.8% and 2.6% respectively), whilst indices in Budapest and Podgorica went up most vigorously, by 18.4% and 7.8% respectively.

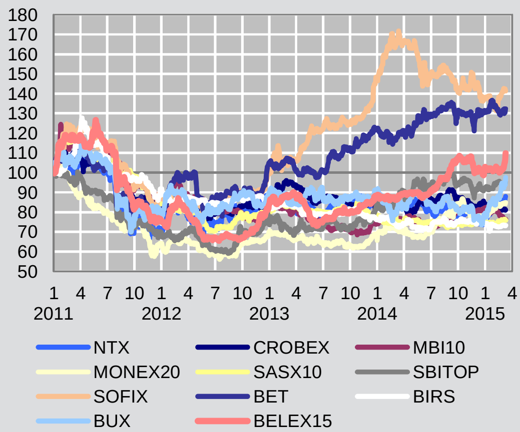
2. Money and loans

Y-o-y growth in monetary aggregates is slowing down, due to scaled-down government spending from accounts with the National Bank of Serbia and reduced lending to the private sector. Loan receivables declined, with banks approving fewer new loans, typically for the start of the year, and the first subsidized loan instalments falling due.

Monetary aggregates

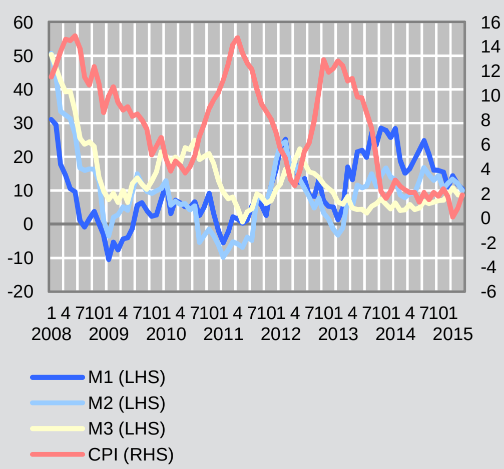
In Q1 2015 dinar reserve money gained 3.6% in nominal and 2.2% in real terms, by contrast to earlier years when it normally declined at the start of the year. The increase in total reserve money in Q1 (2.7% in nominal and 1.3% in real terms) was mostly due to movements in dinar reserve money. Y-o-y, real growth in dinar reserve money accelerated to 22.2%, while real decline in total reserve money slowed to 1.6%.

Chart IV.1.15 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

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



Sources: SORS and NBS.

[11] 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.

In Q1, the strongest impulse to dinar reserve money creation came from net FX purchases in the IFEM (RSD 11.1 bln) by the NBS, FX payment transactions with Kosovo and Metohija (RSD 9.8 bln) and reduced banks' investment in repo securities (RSD 7.5 bln).[12] The government, by contrast, mopped up liquidity in Q1 (RSD 17.1 bln). Balances in government accounts with the NBS swelled on the back of the first positive effects of fiscal consolidation, improved tax discipline, higher one-off inflows, but also inflows from sold securities.

In terms of the structure of dinar reserve money, overnight bank deposits with the NBS increased most (by RSD 48.3 bln). This confirms NBS's assessment that the decline in excess liquidity of the banking sector late last and early this year was only temporary. Balances in accounts of local authorities (RSD 2.3 bln), vault cash (RSD 1.8 bln) and dinar allocations of required reserves (RSD 1.9 bln) also went up. At the same time, balances in bank gyro accounts contracted by RSD 24.7 bln. Currency in circulation also declined (RSD 16.1 bln), as seasonally expected.

As all categories of dinar deposits shrank, M1 and M2 lost 9.3% and 8.8% in real terms, respectively. As a result, even with growth in FX deposits (EUR 200.9 mln), M3 also contracted by 3.0%. In y-o-y terms, real growth in money supply slowed in March—down to 8.4% for M1, 7.9% for M2 and 6.5% for M3. The withdrawal of M3 in Q1 resulted primarily from increased balances in government accounts and reduced lending to the private, and especially, to the corporate sector.

Broken down by M3 components, demand deposits decreased most (RSD 18.3 bln) in Q1, including primarily balances in accounts of enterprises working mostly in trade, construction and mining sectors. Enterprises from the same sectors scaled down their balances in longer-term dinar accounts as well, triggering a RSD 12.0 bln fall in this deposit category alone. Balances in household accounts, accounts of local governments and OFO accounts also contracted, with increase recorded for balances in public enterprises accounts only.

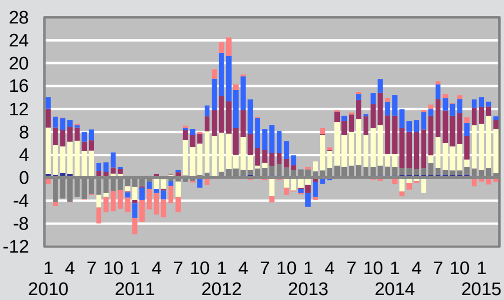
Of this, dinar household savings declined by RSD 1.5 bln to RSD 36.5 bln at end-March. Shorter-term deposits, primarily with maturities between six and 12 months, fell, while long-term savings increased slightly. By contrast to dinar savings, FX household savings gained EUR 106.3 mln, reaching EUR 8.4 bln at end-March. The strongest increase was recorded for FX demand deposits and time deposits with maturities of between six months and one year.

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

	2014			2015	Share in M3 March 2015 (%)
	June	Sept	Dec	March	
M3	3.5	4.4	6.8	6.5	100.0
FX deposits	0.2	17	5.2	5.9	69.1
M2	11.3	10.7	10.3	7.9	30.9
Time and savings dinar deposits	-6.8	4.1	13.2	6.7	9.3
M1	20.4	13.7	9.1	8.4	216
Demand deposit	28.5	16.6	11.1	11.7	15.4
Currency in circulation	4.0	7.3	4.8	1.1	6.2

Source: NBS.

Chart IV.2.2 **Contribution to y-o-y growth in M2, by sector**
(in pp)



Source: NBS.

[12] As the National Bank of Serbia did not organise repo auctions in the period from end-February until early April, banks did not invest in repo securities.

Loans

By contrast to the previous two quarters, domestic lending, exchange rate effect excluded[13], subsided in Q1 by 1.0%. Its share in estimated GDP contracted by 0.2 pp to 48.2% in March. The NBS has invested efforts to boost lending activity and reverse the above trends by cutting its key policy rate and amending reserve requirement regulations.

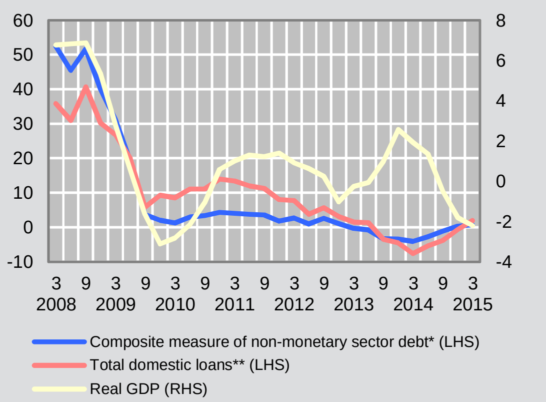
In y-o-y terms, however, growth in domestic lending picked up as a result of the low base from the prior year and the subsidised lending programme as a determinant of credit market activity in H2 2014. Y-o-y growth in domestic lending was 2.0% in March, at the programme exchange rate. Growth in corporate lending accelerated to 3.0%, while household lending increased by 3.5%, slightly less than at end-2014.

In Q1, corporate lending fell by 1.2% at the programme exchange rate. This was due to lower volume of lending activity usual for the start of the year, and the winding-down of the subsidized lending programme, as the key driver of recovery in H2 2014. Still, the value of new corporate lending in Q1 was somewhat higher than in the corresponding period a year earlier. Loans for current assets remained dominant, accounting for around 40% of new corporate lending. Despite inching up on a quarter earlier, the share of investment loans in new corporate lending continued low (around 22%) due to scarce investment projects on hand.

As indicated by the NBS April bank lending survey[14], banks did not tighten corporate lending standards in Q1. According to banks, this was due to loan market competition, despite persistent risks relating to the collection of claims and collateral and gloomy prospects for economic growth. As stated by banks, terms of borrowing by enterprises were more favourable because of lower margins, reduced accompanying costs and longer repayment periods, while bank criteria regarding collateral and maximum loan amount were tightened. At the same time, enterprises' demand for both dinar and FX loans drifted down from a quarter earlier but is expected to go up in the period ahead due to the need to restructure debts and finance current assets.

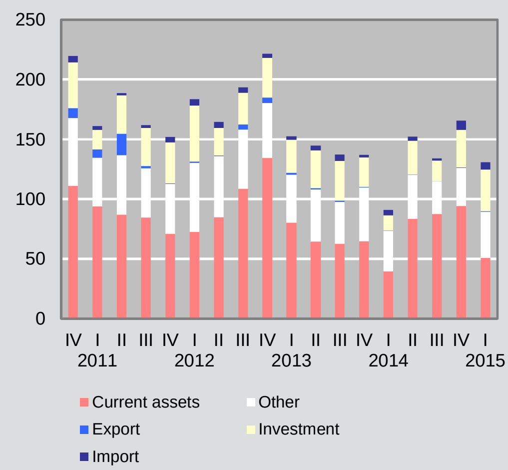
Household lending shrank as well, by 0.3%. The volume of new lending in Q1 stayed broadly unchanged from earlier months. As before, cash loans were predominant, making up almost a half of new loans. The share of housing loans in new loans remained low, which was expected given the relatively low household income and adverse trends in the real estate market. Disbursement of

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



Sources: NBS and SORS.
* As an indicator of total borrowing, it includes domestic loans to the private sector, public enterprises and local authorities, and cross-border borrowing of enterprises and households.
** Excluding the exchange rate effect.

Chart IV.2.4 **Structure of new corporate loans**
(RSD bln)



Source: NBS.

[13] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

[14] The NBS has been conducting the survey since early 2014. Participation is voluntary and the response rate almost 100%.

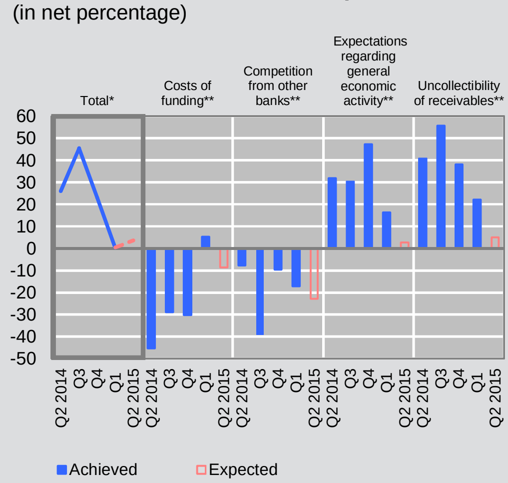
the least popular, consumer loans was lower than in Q4 2014. Within costlier loan categories, borrowing through credit cards and revolving loans decreased, while the value of current account overdrafts was slightly higher than in the prior months.

According to the April bank lending survey, competition prompted banks to relax standards for dinar household lending in Q1. Further relaxation of standards for both dinar and FX lending is expected in Q2. As stated by banks, interest rate margins and accompanying costs have shrunk, but criteria regarding repayment terms and loan security (collaterals, down payments and mortgages) have been tightened. Contrary to expectations, household demand for loans declined from Q4 2014, for almost all types of loans. Low household income and adverse trends in the labour and real estate markets were the key factors discouraging new household borrowing. Banks expect demand to pick up in the coming period, driven by the need to refinance outstanding obligations.

In February, the National Bank of Serbia issued a special decision[15] to help households overcome difficulties in the event of unilateral increase of interest rate margins by banks, as well as in the repayment of CHF-indexed loans. According to this decision, banks are required to treat any amount overcharged in respect of unilateral increase in margins prior to the start of application of the Law on the Protection of Financial Services Consumers as early loan repayment, regardless of the currency of indexation. Also, banks are required to offer their client beneficiaries of CHF-indexed loans the choice of four models of modified terms of loan repayment, while maintaining the existing collateral. Two models of conversion into a EUR-indexed loan were suggested, together with two models of maintaining the current indexation, with a lowering of the interest rate and extension of the loan repayment period or reduction of the monthly instalment over a three-year period and repayment of the amount of such reduction after the expiry of the original maturity date.

The rise in the share of dinar loans in corporate and household lending was halted after the winding down of the subsidised loans programme. At end-March, 30.3% of bank lending to these sectors was dinar-denominated, down by 0.9 pp from end-2014. The decline in the degree

Chart IV.2.5 **Impact of individual factors on changes in standards for the extension of loans and credit lines to enterprises**
(in net percentage)

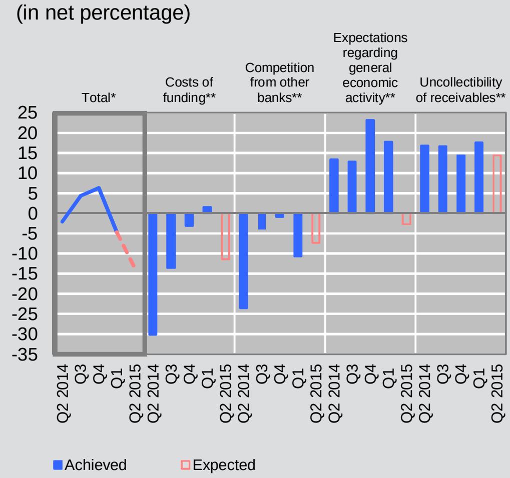


Source: NBS.

* Positive values indicate tightening of conditions and negative – easing, relative to the previous quarter.

** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

Chart IV.2.6 **Impact of individual factors on changes in standards for the extension of loans and credit lines to households**
(in net percentage)



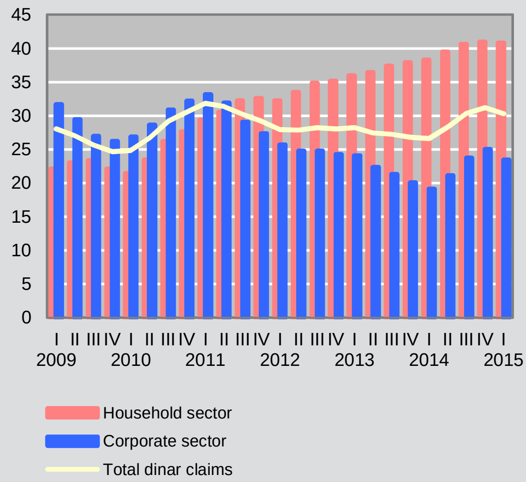
Source: NBS.

* Positive values indicate tightening of conditions and negative – easing, relative to the previous quarter.

** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

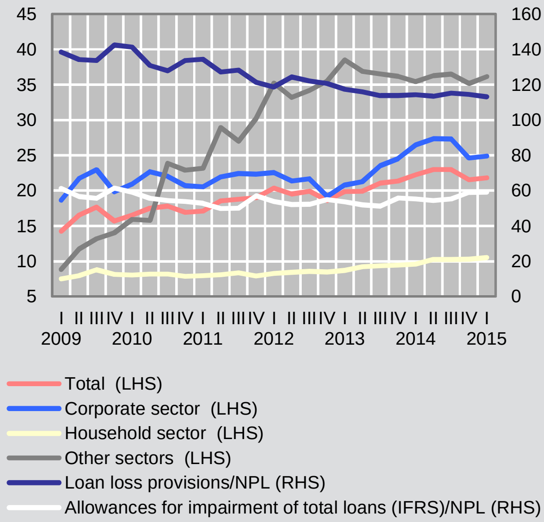
[15] Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign Currency-Indexed Loans, RS Official Gazette, No 21/2015.

Chart IV.2.7 **Share of dinar in total bank receivables from corporate and household sectors**
(in %)



Source: NBS.

Chart IV.2.8 **NPLs share in total loans, gross principle**
(in %)



Source: NBS.

of dinarisation of loans was more pronounced in the corporate (by 1.5 pp to 23.5%) than in the household sector (by 0.1 pp to 40.8%).

A relatively high level of NPLs restrains faster growth of lending activity. The share of NPLs in total loans (under the gross principle) edged up by 0.3 pp on end-2014 to 21.8% in February, partly as a result of a dip in lending at the start of the year. The share of NPLs rose by 0.2 pp for corporate and household sectors alike, reaching 24.9% for the corporate and 10.5% for the household sector.

However, despite the high share of NPLs in total loans, the capital adequacy ratio of 20.0% indicates unimpaired stability of the domestic banking sector. Allowances for impairment for total loans stood at 59.2% of NPLs in February. At 113.0% in February, loan loss provisions[16] continued to fully cover the amount of gross NPLs.

The adoption of a comprehensive NPL resolution strategy is an integral part of Serbia's economic programme for the period ahead, to which Serbia committed also at the time of concluding the arrangement with the IMF. The strategy, to be adopted by end-June 2015, will contain the following elements – strengthening banks' capacity for dealing with NPLs, removing obstacles to write-offs and asset sales, reinforcing the in-court insolvency system, introducing personal insolvency regime and promoting the mechanism of out-of-court debt restructuring.

3. Real estate market

Negative trends prevailed in the real estate market in Q1, as indicated by lower real estate prices, smaller trade volumes and fewer construction permits issued.

After levelling off in Q4, real estate prices, as measured by the DOMex[17], receded by 2.4% during Q1. Broken down by region, prices fell most sharply in the Belgrade region and somewhat more moderately in South and East Serbia. Real estate prices in Vojvodina, Šumadija and Western Serbia increased mildly. At EUR 848.3 per square metre in Q1, the average real estate price dipped by 3.6% from 2014.

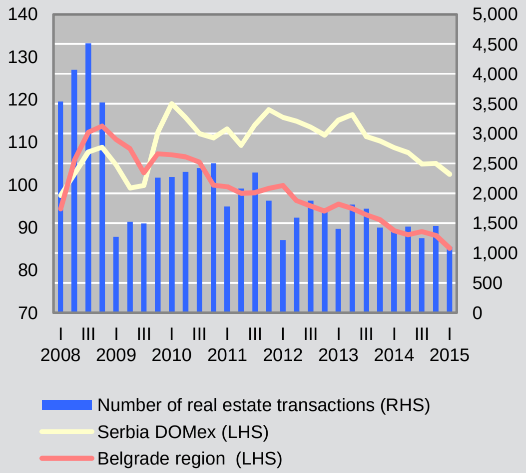
As the low purchasing power due to declining wages and high unemployment continues to pose the key obstacle to

[16] Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but only serve to calculate bank capital. They are calculated on a group basis by asset classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100%, of receivables classified in A, B, C, D and E categories, respectively).

[17] DOMex is published by the National Corporation for Insurance of Housing Loans and relates only to real estate purchased by insured loans. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror trends in the real estate market, considering high unemployment levels, declining wages and muted lending activity.

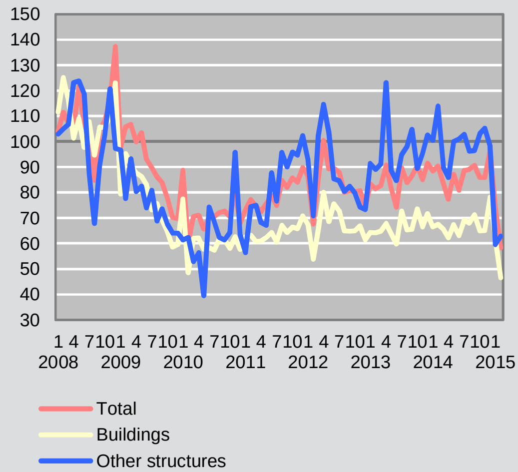
Chart IV.3.1 **DOMex and real estate transactions**

(index, H1 2008 = 100) (No)



Source: National Mortgage Insurance Corporation.

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



Sources: SORS and NBS calculation.

real estate market recovery, the above fall in prices did not result in higher volume of trade. The number of properties traded in Serbia[18] in Q1 was 1,103, which is the lowest quarterly figure since 2007 when statistics of this type were first collected. The share of real estate transactions by region remained stable in Q1, with Belgrade (44.2% of total trade) and Vojvodina (28.5%) regions accounting for the largest share.

In addition to the low purchasing power, demand for real estate was also dented by tighter bank standards for housing loans. Real estate demand could, however, go up in the period ahead, given the reduced appeal of other forms of investment.

Adverse trends continued in the real estate market on the supply side as well. The number of completed flats roughly halved in 2014 from 2013, with the number of construction permits for new flats down by 3.1%. In the first two months of 2015, the number of issued building construction permits for buildings declined (22.0% s-a), down by 27.2% from the corresponding period a year earlier. This could be due to investors' reluctance to apply for permits before March, when the new consolidated procedure for issuing construction permits, designed to speed up and simplify the process, came into force.

4. Aggregate demand

Exports rebound across much of the manufacturing industry and growth in private investments contributed positively to movements of aggregate demand in Q1 and neutralised short-term negative effects of fiscal consolidation on final consumption of households and government, as well as on government investments.

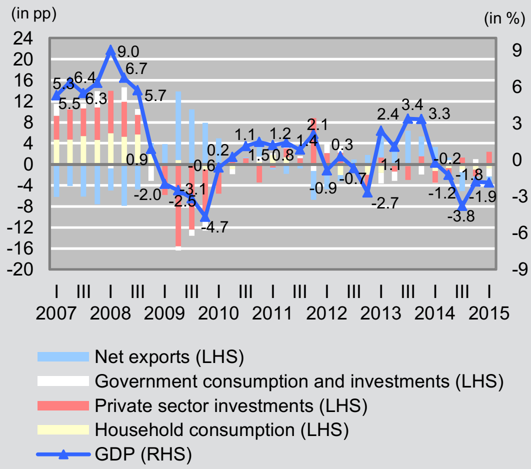
A y-o-y fall in aggregate demand in Q1, which the flash estimate of the Serbian Statistical Office puts at 1.9%, was driven by a negative contribution of net exports and final consumption of households and government, while the recovery of private sector investments worked in the opposite direction.

Domestic demand

Most indicators of **private consumption** point to further shrinking of this component of aggregate demand, which

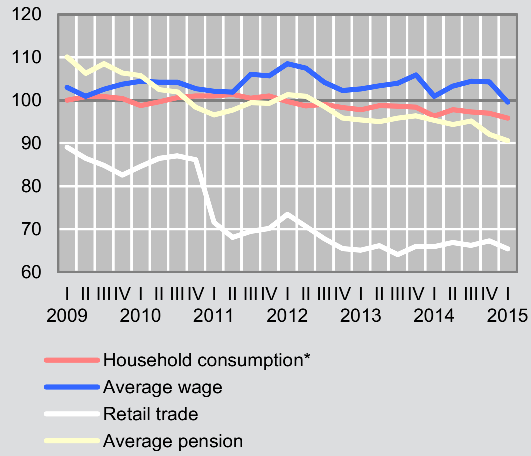
[18] The number of real estate transactions and flat prices per square meter also relate only to real estate purchased by insured loans.

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



Sources: SORS and NBS calculation.
Note: NBS estimate for Q1 2015.

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



Sources: SORS and NBS calculation.
* NBS estimates for Q1 2015.

is estimated to have dropped by 1.1% s-a from Q4 2014. Retail trade turnover edged down by 2.8% s-a, while imports of consumer goods additionally contracted. Y-o-y, private consumption continued its decline for the fifth consecutive quarter (1.0%) though at a slower pace relative to Q4, giving a 0.8 pp negative contribution to aggregate demand. The slowdown in the fall of private consumption against the backdrop of reduced salaries and pensions indicates that fiscal consolidation may have affected this component of demand less severely than initially expected.

This is partially confirmed by movements of sources of spending in Q1. The fall in the real wage was relatively small (1.2% y-o-y). Combined with the rise in employment from Q1 2014, this led to the real wage bill shrinking by a mere 0.8% y-o-y. A somewhat sharper y-o-y fall (3.2%) was recorded for social insurance transfers. On the other hand, higher sale of foreign currency on account of remittances from abroad and unchanged dynamics of approval of new loans for current consumption moderated the shrinking of the main sources of private consumption.

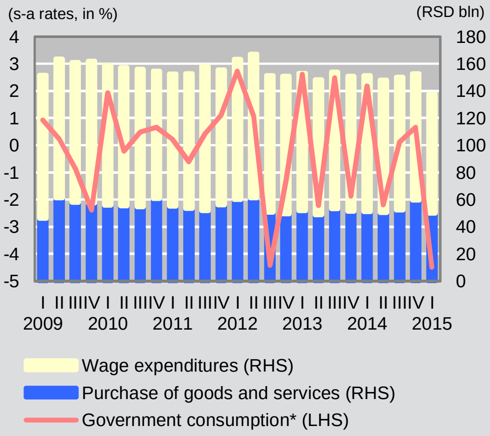
A positive contribution to total demand in Q1 came from **private investments** which, according to our estimate, grew by 4.1% s-a. This component of demand recovered

Table IV.4.1 **Investment indicators**

	2014				2015
	I	II	III	IV	I
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Hours worked in construction	4.0	-8.8	0.7	-17	-0.6*
Industrial inventories	-0.3	12	-2.2	-16	5.1
Industrial production of capital goods	-7.3	-0.5	-12	-0.7	16.5
Exports of equipment**	5.3	-3.7	-13	0.2	26.9
Imports of equipment**	-6.3	-13	12	2.0	6.1
Inventories of capital goods	-19.9	19	0.7	5.2	5.6
Industrial production of intermediate goods	-3.4	-6.1	2.1	-0.9	4.8
Exports of intermediate goods**	0.8	-13	0.1	0.6	13
Imports of intermediate goods**	16	-4.1	-2.0	12	-0.1
Inventories of intermediate goods	12	19	-0.2	-0.7	0.0
Industrial production of construction materials	8.5	-5.1	2.7	4.2	-10.5
Inventories of construction materials	-7.9	17	-3.2	-18	-2.6
Government investment***	39.1	37.5	-27.9	-9.1	-9.5

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

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q1 2015.

in y-o-y terms as well, reversing a four-quarter downward trend and recording a 1.8% increase in Q1, with a positive contribution (0.3 pp) to total demand in Q1. Such trends are indicated mainly by imports of equipment, which extended its upward path in Q1 (6.0% s-a). On the other hand, construction sector indicators point to shrinking of investments, given the smaller number of effective hours worked in construction and lower production of construction material. Q1 also saw a lower FDI inflow, while newly approved corporate investment loans upped only mildly from Q4.

Apart from fixed investments, investments in current assets also went up in Q1, as confirmed by the growth of physical volume of industrial product **inventories** by 5.1% s-a. Observed by category, inventories of capital goods expanded the most, motor vehicle inventories taking the lead, which should give an additional boost to exports in the coming period. In addition, inventories of non-durable consumer goods also increased, mostly on account of higher food product inventories.

The fall in **government consumption** was expected and is estimated at 4.5% s-a. Government consumption contracted also y-o-y (6.0%), giving a negative contribution to total demand (1.1 pp). As anticipated, public sector wage expenditures continued to decline, edging down by 6.2% s-a from Q4. The austerity measures reflected also on the expenditures for the purchase of goods and services, which were reduced by 16.2% s-a.

Slower implementation of capital expenditures in Q1 contributed to a continued fall **in government investments,** which went down by 9.5% s-a. The decline was also recorded y-o-y (25.1%), giving a negative contribution to total demand (0.4 pp).

Net external demand

Estimated real exports of goods and services continued to grow in Q1 (4.0% s-a). In contrast to Q4, when agricultural exports were predominant, the exports base widened in Q1 thanks to the recovery across export-oriented branches of manufacturing. Somewhat stronger growth (2.2% s-a) compared to the previous quarter was also recorded for estimated real imports of goods and services. Their structure also improved, due to higher imports of equipment. With exports of goods and services growing faster than imports in Q1, aggregate demand gained 0.5 pp.

Year-on-year, estimated contribution of net exports stayed negative in Q1 (2.0 pp), as the increase in real imports surpassed the rise in real exports of goods and services (9.0% vs 6.9%).

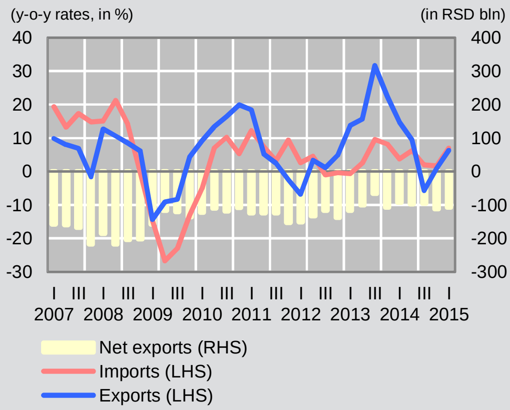
Serbian exports in Q1 were favourably affected by trends in the international environment and improved price competitiveness. Indicator of external demand[19] continued up in Q1 reflecting an improvement of economic climate, spearheaded by Italy which took the lead among Serbia's foreign trade partners in 2014. Furthermore, the depreciation of the nominal effective exchange rate of the dinar (3.1%)[20], partially offset by the faster growth of domestic vs. foreign prices (1.1%), weakened the real effective exchange rate of the dinar (2.0%) and, coupled with a continued decrease of unit labour costs in industry, led to an increase in competitiveness.

The growth of euro-denominated commodity exports accelerated further to 8.0% s-a in Q1. Up by 22.7% s-a, motor vehicle exports were again the major contributor after one year break. Exports of Fiat Automobiles

[19] 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.

[20] 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 $(EUR/RSD)^{0.8}*(USD/RSD)^{0.2}$.

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



Sources: SORS and NBS calculation.
Note: NBS estimate for Q1 2015.

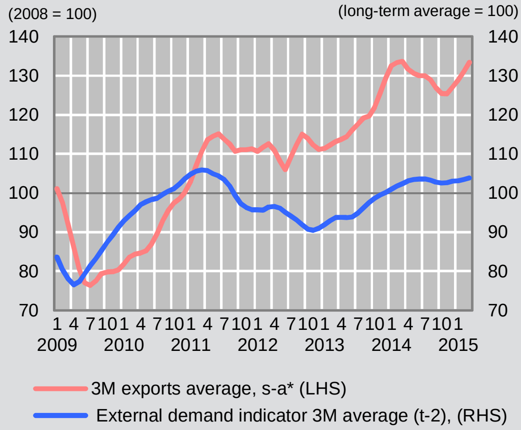
Serbia came at EUR 373.3 mln in Q1, reaching their Q1 2014 level. The increase may be associated with the growing demand in our major export markets, as indicated by around 10% increase in the Fiat group sales in the leading euro area economies (Germany, France, Italy) in Q1.

Apart from motor vehicles, base metals and metal products exports also gave a significant boost to commodity exports, having expanded by 11.8% s-a and 24.7% s-a, respectively. This may in part be put down to declining prices of raw materials in the world market (Text box 2, page 34), and is well illustrated by the fact that five companies from this branch of industry ranked among the fifteen largest exporters in Serbia.

High growth of agricultural commodity exports extended into Q1 (15.3% s-a). Generous inventories from the previous season supported the continuation of a relatively strong growth of corn exports (around 800 thousand tons in Q1). Although down by one third from the record Q4 level, Q1 exports still boast an 80% increase y-o-y. Exports-wise, the current mercantile year[21] outperformed the preceding one already in the first six months.

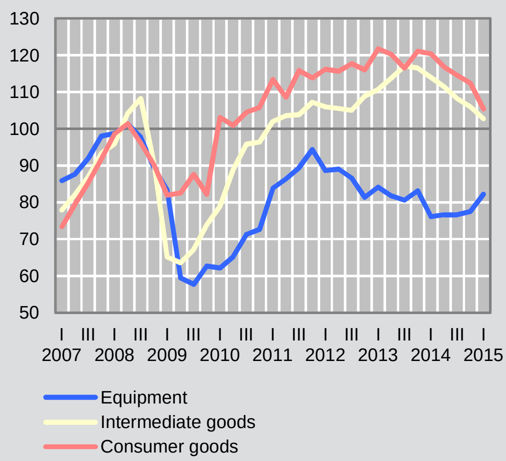
An uninterrupted growth of commodity exports in Q1 continued also for machinery and equipment, tobacco and

Chart IV.4.5 **External demand and Serbian exports**



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

Chart IV.4.6 **Imports by key components**
(s-a, H1 2008 = 100)

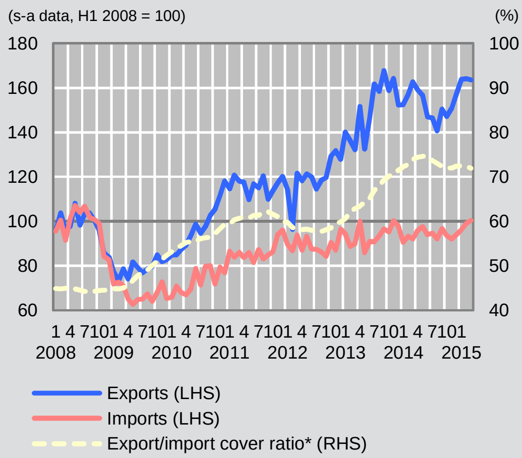


Sources: SORS and NBS calculation.

tobacco products and rubber and plastic products, while a rebound in chemical and pharmaceutical industry gave yet another boost to export results. On the other hand, plunging oil prices continued to reflect negatively on exports of petroleum products, which dropped by 18.8% s-a, while exports of electrical equipment continued down as well (8.7% s-a).

[21] October 2014 – September 2015.

Chart IV.4.7 **Commodity trade in euros**



Sources: SORS and NBS calculation.
* 12-month moving average.

Commodity imports rose by 5.7% s-a in euro terms in Q1. Observed by economic destination, equipment imports continued up in Q1 (6.0% s-a). Investment upturn could also be signalled by higher imports of non-classified goods, since capital goods are estimated to have played a part. On the other hand, imports of consumer goods slid down by 6.3% s-a, reflecting the reduction in final consumption due to the implementation of fiscal consolidation measures. Imports of intermediate products declined as well (3.0% s-a), mainly due to lower value of energy imports following a drop in oil prices and gradual recovery of the domestic energy sector.

The analysis of commodity imports by the economic destination of the EU also confirms this, reporting a 3.5% s-a decline in energy imports. Apart from energy, imports of non-durable consumer goods and capital goods also shrunk (9.3% s-a and 4.1% s-a, respectively), while imports of intermediate goods stagnated. The only imports category recording growth in Q1 under this classification are durable consumer goods, where imports upped by 13.2% s-a.

In March, commodity exports were 63.6% above their pre-crisis level[22], and after quite a while, commodity imports reached the level they had before the crisis. The export/import cover ratio[23] decreased slightly in Q1 (0.5 pp), to 71.9% in March.

[22] H1 2008.

[23] 12-month moving average.

5. Economic activity

The external demand-driven rebound in manufacturing and revitalisation of the mining-energy complex managed to counterbalance negative trends in the service sectors in Q1.

According to the flash estimate of the Serbian Statistical Office, Q1 GDP dropped 1.9% y-o-y, the downward pressure stemming from most sectors. Nevertheless, positive trends were recorded in manufacturing, where physical volume of production expanded y-o-y after three quarters of decline.

Owing to a faster recovery of the euro area and lower prices of industrial raw materials, GDP growth projection for 2015 was revised upward, mild recession giving place to stagnation.

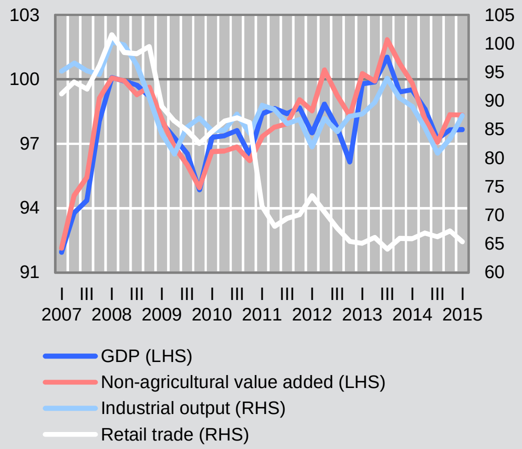
The recovery of industrial production in place since Q4 accelerated further and reached 4.9% s-a in Q1, offsetting negative trends in the service sectors. Hence, quarter-wise, GDP and NAVA remained almost unchanged. Though economic activity remains below its pre-crisis level[24](2.3% measured by GDP and 1.7% measured by NAVA), current trends instil optimism and anticipate a rebound in the near future.

The expected recovery of mining and electricity, gas, steam and air conditioning supply extended into Q1. Growth of the physical volume of production in the mining sector equalled 3.5% s-a and was fully driven by the increased coal exploitation (15.7% s-a), while crude oil, gas and metals output dropped slightly. Scaled up exploitation boosted coal inventories, as a result of a continued revitalisation of our largest coal mine Tamnava. Higher coal output boosted physical volume of production in electricity, gas, steam and air conditioning supply (11.6% s-a). Production in these sectors is expected to reach its pre-flood level in Q3.

Apart from mining and energy, vigorous growth of the physical volume of production was also recorded for manufacturing (5.1% s-a). Promisingly, such growth was wide-based, i.e. stemmed from a number of export-oriented branches, signalling that external demand is back on track, laying a sound foundation for further expansion in the coming quarters. Production of pharmaceutical and

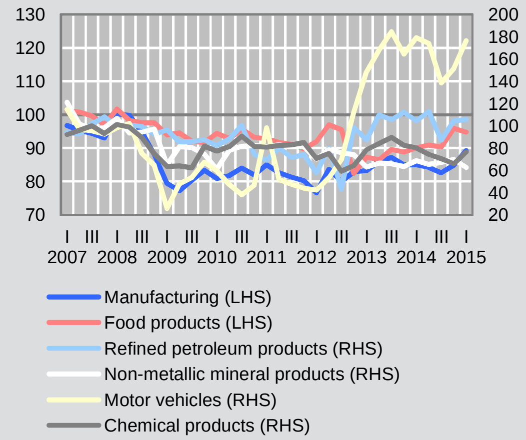
[24] H1 2008.

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



Sources: SORS and NBS calculation.

Chart IV.5.2 **Physical volume of production by branches of manufacturing**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

metal products gave the greatest positive contribution to the rise in manufacturing, while production of motor vehicles, rubber, plastics and petroleum products played a more moderate role. Chemical industry production recovered as well, which is associated with lower production costs caused by lower oil and gas prices. Physical volume continued to expand also in base metals production, thanks to more favourable prices of raw materials.

In contrast to the preceding period, food industry contracted mildly. Physical volume of production also shrunk for machinery and equipment and construction-related branches.

Construction is estimated to have contracted by 3.7% s-a in Q1. This is indicated by a reduced physical volume of production of non-metal minerals, furniture and wood processing, as well as by the decline in construction employment. The downsized construction activity may be partially put down to a lower volume of public investments, as capital budget expenditures have been implemented slower than expected.

Agricultural production stagnated compared to a quarter earlier. Since no concrete indicators are currently available, it is estimated that output in 2015 will linger around medium term averages, which set against last year's good results and high base, is likely to produce a decline on a yearly basis.

Table IV.5.1 **Annual GDP growth and contributions**

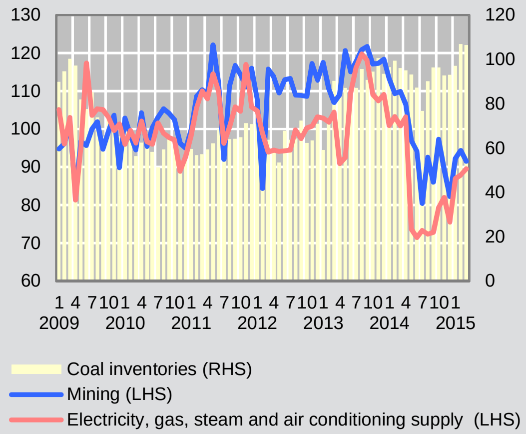
	2013		2014		2015*	
	%	pp	%	pp	%	pp
GDP	**2.6**	**2.6**	**-1.8**	**-1.8**	**0.0**	**0.0**
Agriculture	20.9	1.5	0.8	0.1	-3.9	-0.3
Industry	6.0	1.2	-7.1	-1.5	4.6	0.9
- Manufacturing	5.7	0.8	-1.7	-0.3	2.8	0.4
- Mining and energy	8.8	0.4	-21.3	-1.0	13.3	0.5
Construction	-3.9	-0.2	0.9	0.0	4.0	0.2
Services	0.3	0.1	-0.5	-0.2	-2.0	-1.0
Net taxes	-1.1	-0.2	-0.6	-0.1	0.6	0.1

Sources: SORS and NBS calculation.
* NBS estimate.

Economic activity in the majority of service sectors in Q1 remained under the influence of fiscal consolidation measures. Retail trade contracted by 2.8% s-a and after five quarters of unbroken growth edged down y-o-y as well. A mild decline was also recorded for information and communications, as well as for financial and real estate activities.

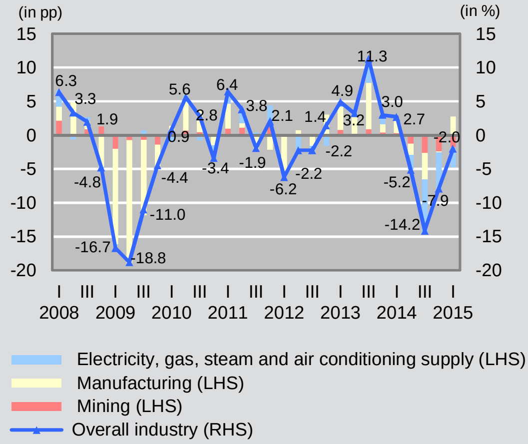
According to the flash estimate of the Serbian Statistical Office, GDP dropped by 1.9% y-o-y in Q1. Sector-wise, public administration, education, health and social care experienced the sharpest decrease, as a

Chart IV.5.3 **Physical volume of production in energy and mining**
(s-a, H1 2008=100)



Sources: SORS and NBS calculation.

Chart IV.5.4 **Contributions to y-o-y growth of the physical volume of industrial production**



Sources: SORS and NBS calculation.

result of fiscal consolidation measures. The fall in GDP continued in industry as well, but owing to gradual flood remediation and the recovery of external demand, it probably decelerated relative to Q4. Y-o-y, GDP decline is estimated to have stemmed also from agriculture, trade, transport, information and communications.

A marked deceleration of a y-o-y fall of industrial production in Q1 was prompted by a rebound of manufacturing. Having declined in the course of three consecutive quarters, physical volume of manufacturing grew by 4.2% in Q1, adding 2.8 pp to total industry. The upward push came from production of machinery and equipment, food, tobacco and pharmaceutical products, while the production of electrical equipment, construction materials and chemicals acted in the opposite direction. On the other hand, physical volume of production in mining and electricity, gas, steam and air conditioning supply continued to contract in y-o-y terms in Q1 (16.0% and 13.0%, respectively), giving a negative contribution to the physical volume of overall industry (1.8 pp and 3.0 pp, respectively). Still, as expected, the fall significantly slowed down relative to Q4.

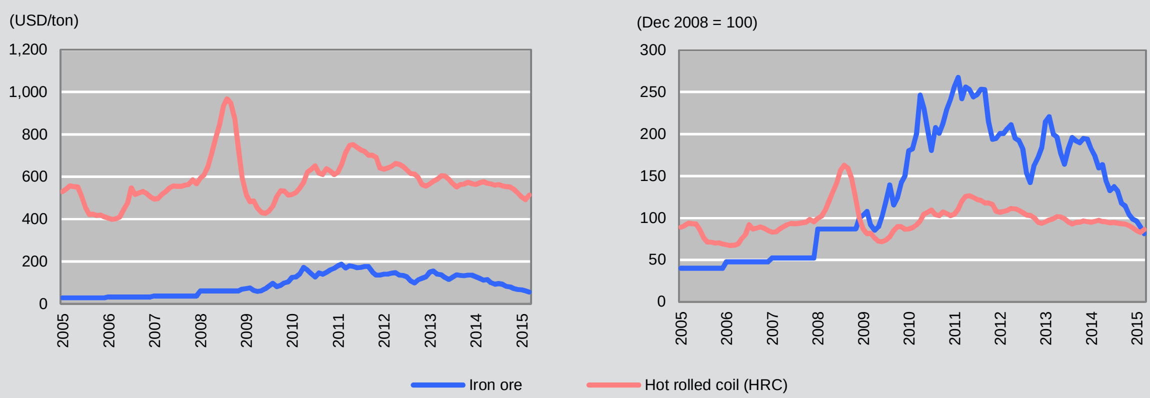
Faster recovery of our main foreign trade partners and lower prices of industrial raw materials in the global market boosted industrial production in Q1, giving rise to an upward revision of 2015 GDP, so that the 0.5% fall was replaced by stagnation. Apart from faster growth of export-oriented branches of manufacturing, output is expected to outperform projections in chemical industry, which profited from lower oil and gas prices, as well as in base metals production, thanks to the drop in iron ore prices in the global market. The GDP revision was also motivated by the lower than expected contraction in the service sectors, since fiscal consolidation affected final consumption less sharply than initially projected.

Text box 2: Current developments in the global iron and steel market and their impact on domestic production and exports

Major changes in the global iron market in the last decade affected economies in which the production of base metals occupies an important place. Until end-2008, iron ore prices were set in negotiations between leading miners and steelmakers, and the price set in this way was valid for the year. From this time onwards, the price was formed freely in the market, with Chinese import iron ore price used as the global benchmark, since China accounts for two-thirds of global imports of this commodity. High demand for iron ore pushed up its price vigorously. In mid-2011, iron ore price was 2.5 higher than at end-2008. This increased costs of production for steelmakers, though prices of finished steel products remained relatively flat (Chart O.2.1), which affected steelmakers' profitability. From early 2014 onwards, iron ore prices entered a sharp decline in the global market, falling by around 60% by April 2015. This is attributed to diminished demand from China and high stocks of steel, as well as tax incentives for domestic steelmakers introduced by the Chinese government.

In Serbia, most of the iron and steel is produced in the Smederevo steel plant. Until January 2012, the plant was owned by US Steel, a major global steelmaker, which facilitated access to markets of raw materials and finished products. As a result, despite the global steel industry crisis, production in Serbia was kept at an average monthly level of around 100

Chart O.2.1 **Global prices of raw materials and finished products in the steel industry**

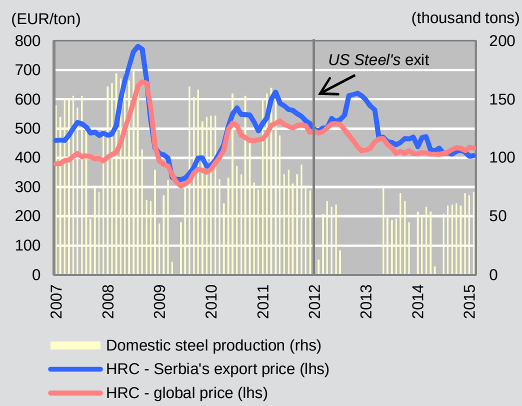


Sources: IMF, *www.steelonthenet.com* and NBS calculation.

thousand tons, with average monthly exports worth around EUR 50 mln[1] (Chart O.2.2). After US Steel's exit from the Smederevo steel plant, production volumes slumped as production became unprofitable in circumstances prevailing in the global market at the time.

Domestic steel production is highly reliant on imports of key raw materials (iron ore and coke), and is therefore exposed to the risk of price changes in international markets. This is confirmed by movements in domestic and global import prices of raw materials and export prices of finished products, which are closely related. With that in mind, the current fall in iron ore prices in the global market ought to be favourable for domestic steelmaking. In part, this could explain higher volumes of production and exports of this branch of industry from H2 2014 onwards,

Chart O.2.2 **Production and prices in the domestic steel industry**



Sources: *World Steel Association*, SORS and NBS calculation.

[1] Average monthly production and exports in the December 2008 – January 2012 period.

with the s-a index of base metals production rising steadily from August 2014 and the monthly value of steel product exports constantly exceeding EUR 20 mln. Although steel production and export levels in the Smederevo steel plant remain lower than during US Steel's ownership, further growth could be strengthened by continued favourable trends in the world market and introduction of professional management. This is borne out by forecasts of rising demand for steel in 2015 and 2016 in the EU market and countries of the region[2], as main importers of our steel products.

In view of the importance of the Smederevo steel plant for the domestic real and external sectors, a recovery of production in this plant ought to contribute to economic growth and improve Serbia's foreign trade position in the period ahead. In the first three months of 2015, Smederevo steel plant exported products worth EUR 80.9 mln, becoming Serbia's second largest exporter in the current year. According to our estimates, if production performances continue at their current level for the rest of the year, net exports of this company would amount to around EUR 70 mln, contributing about 0.1 pp to GDP growth. And while this is the direct effect, it should also be noted that an indirect effect is expected as well, in the form of substitution of imports of steel products. Also, a further boost to GDP growth could come after the activation of the second blast furnace which could take place during H2 if current favourable market trends persist.

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[2] http://www.worldsteel.org/media-centre/press-releases/2015/worldsteel-Short-Range-Outlook-2015---2016.html.

6. Labour market developments

Real net wages in the public sector continued down in Q1, followed by wages in the non-public sector which recorded a decrease after quite a while. Productivity increased thanks to the recovery of industrial production, pulling unit labour costs down and allowing for improved competitiveness of the domestic industry. Formal employment shrank further in Q1, while unemployment rose, partly due to factors of a seasonal nature.

Wages and labour productivity

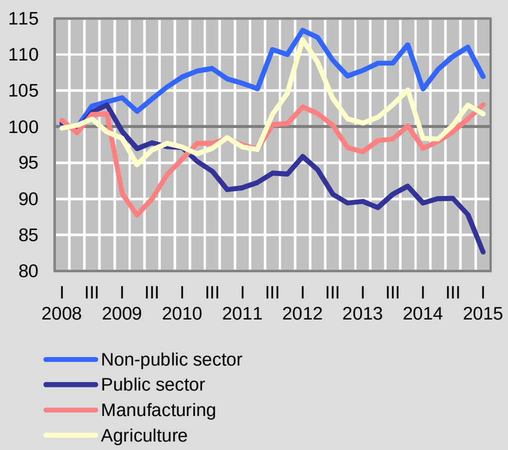
Following the period of stagnation in Q4, **real net wages** fell by 4.5% s-a in Q1. Such movement was driven by further reduction in real net wages in the public sector (5.9% s-a) caused by the implementation of fiscal consolidation measures and the 3.7% s-a decrease in wages in the non-public sector[25]. In comparison to the pre-crisis level[26], real net wages in the public sector declined by 17.4% in Q1, whilst real net wages in the non-public sector rose 6.9% above their pre-crisis level.

The decrease in real net wages in Q1 was registered in the majority of industries. The expected sharp fall was recorded for wages in public administration, education and healthcare and social protection which account for the largest portion of the total public sector employment, whereas a significant decrease was felt in sectors of administrative and auxiliary service activities, financial sector and transport and storage. However, real net wages in the manufacturing industry pursued their path further up, while, in contrast to a quarter earlier, the construction industry recorded positive trends.

The November cut in public sector wages drove y-o-y fall in real net wages of this sector further down in Q1 (7.7%), whereas real net wages in the non-public sector, having stagnated in Q4, recorded y-o-y growth of 1.5%. This growth was generated primarily by an increase in construction, manufacturing and agriculture, and to a lesser extent by wages in trade and information and communications. Service activities of the public sector, along with mining and electricity, gas and steam supply, which hire the majority of employees affected by fiscal consolidation measures, witnessed a y-o-y drop in wages.

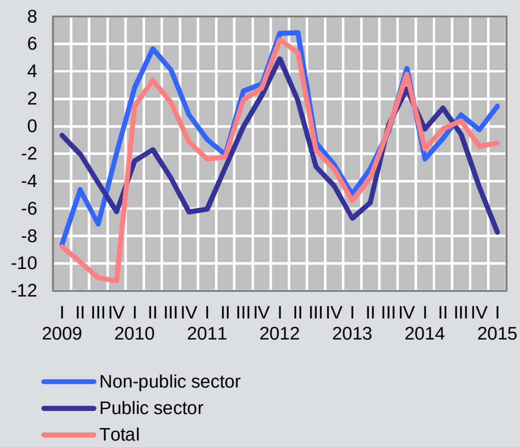
The real net wage bill in the public sector, recording s-a fall from September, dropped by 6.2% s-a in Q1. Reduction in the public sector wages was followed by a 4.1% s-a fall in real net wage bill of the non-public sector, which is partly the result of contracted formal employment. The average nominal take-home wage in Serbia was worth RSD 41,725 in Q1, down by 10.0% from Q4, which is in accordance with the expected seasonal trends. In y-o-y terms, the average nominal wage remained practically dormant (-0.3%).

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



Sources: SORS and NBS calculation.

Chart IV.6.2 **Real net wage movements**
(y-o-y growth, in %)

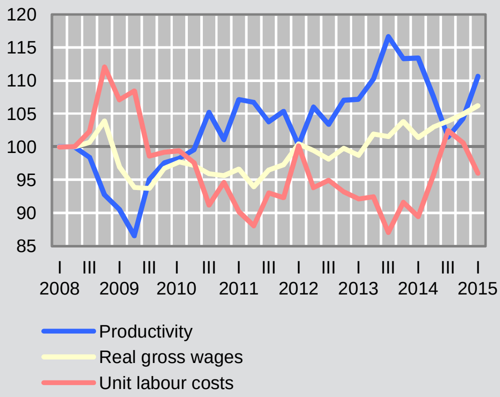


Sources: SORS and NBS calculation.

[25] All types of property excluding public property (private, mixed and social) fall within the non-public sector.

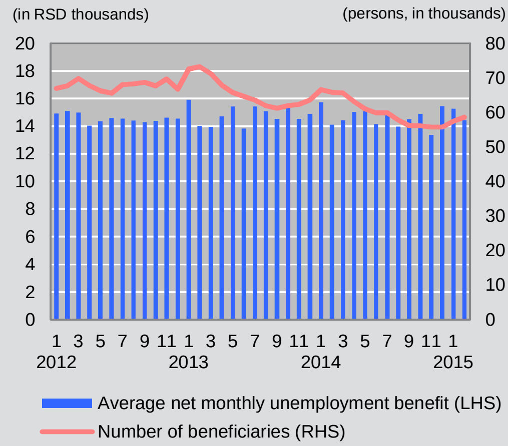
[26] H1 2008.

Chart IV.6.3 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.6.4 **Average monthly unemployment benefit**



Source: National Employment Service.

The recovery of the industrial production fuelled higher productivity in Q1, which, despite the increased real gross wages in the industry, led to a **reduction in unit labour costs** of 4.4% s-a. This reduction was somewhat less pronounced in the manufacturing industry (1.0% s-a), due to a steeper increase in gross wages in this sector compared to other industrial sectors. Nonetheless, reduction from Q4 in unit labour costs in manufacturing indicates improved competiveness of the domestic industry.

Employment

Given that the Labour Force Survey data for Q1 are still not available, our analysis of current employment and unemployment trends relies on data obtained from RAD research and administrative sources.

According to **RAD research**, formal employment fell by 7,126 persons, with reduction recorded in both the private and public sectors and across the majority of activities. The manufacturing sector was hit by the sharpest fall in employment, while a less dramatic drop was registered in mining and electricity, gas and steam supply. Moreover, employment slumped in construction and agriculture as well, partly due to seasonal factors. Lower employment in healthcare and social protection and public administration may be attributed to natural outflow, i.e. retirement and simultaneous restricted hiring

Table IV.6.1 **Employment and unemployment trends**
(in thousand, end-of-period)

	2014			2015
	Q2	Q3	Q4	Q1
Formal employment	**1,704.3**	**1,704.9**	**1,705.0**	**1,697.9**
Farmers	**449.9**	**454.2**	**450.5**	**450.5**
Total employment	**2,154.1**	**2,159.1**	**2,155.5**	**2,148.4**
Total unemployment	**773.4**	**748.5**	**741.9**	**766.5**
First time job seekers	264.9	261.4	256.3	259.5
Workers with previous job experience	508.4	487.2	485.6	507.0

Sources: SORS and National Employment Service.

in the public sector. On the other hand, accommodation and food service sector, administrative and auxiliary service activities and education took on a larger number of employees.

According to the **National Employment Service** data, the number of unemployed went up by 24,594 persons, while recording a y-o-y decrease of 24,001 persons. Furthermore, the number of the unemployed with previous job experience (21,411) rose substantially in comparison to first-time job seekers (3,183). Higher unemployment may be partly ascribed to seasonal factors, as the need for seasonal jobs in agriculture and construction was reduced during the period under review.

The increase in the number of the unemployed who were previously employed pushed up the number of the users of unemployment benefits by 2,885 in Q1. Still, this figure shrank by 7,197 in y-o-y terms, coming at 58,620 persons in February. Short-term growth in unemployment is likely in the near future once the status of enterprises under restructuring is finally determined.

7. International environment

The growth in economic activity in the euro area is slowly picking up owing to the monetary policy measures and the drop in oil prices, but is still notably slower than in the USA. Euro area recovery is spreading out to Central and Eastern Europe, where more robust growth is still constrained by adverse economic developments in Russia and Ukraine.

Along with economic activity, inflation in the euro area is also gradually increasing, so it would seem that prolonged deflation has been averted. The ECB's QE programme and low oil prices made room for central banks in Central and Eastern Europe to relax their monetary policies. On the other hand, the Fed is expected to start increasing its policy rate, which is likely to lead to further strengthening of the dollar.

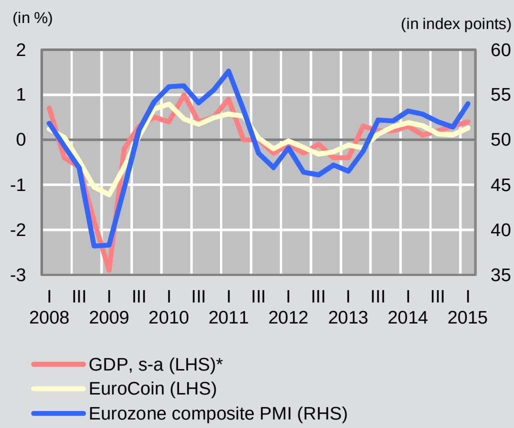
Economic activity

There were several factors at play which led to a pick-up in the euro area recovery – low price of oil, the ECB's accommodative monetary policy and the depreciation of the euro against other major world currencies. The growth of **GDP in the euro area** speeded up in Q4 (0.3% s-a) from a quarter earlier (0.2% s-a) on the back of the significant acceleration of the German economy (from 0.1% s-a in Q3 to 0.7% s-a in Q4). Unlike in the previous period, however, it now rests on a wider base, seeing that growth continued in Spain and France as well, while Italy came out of recession. The growth was chiefly contributed by external demand due to an expansion of exports and the contraction of imports following the euro's depreciation. In addition to net exports, euro area growth was driven by final household consumption which was spurred by the growth in disposable income after the fall in oil prices.

Judging by the movement of economic activity indicators, GDP in the euro area is expected to continue growing in Q1 at the same rate as in Q4. The composite index of economic activity (PMI Composite) steadily grew throughout Q1, reaching in March its highest value in eleven months (54.0), while the European Commission's indicator of economic conditions (*Economic Sentiment Indicator – ESI*) was at its highest since July 2011 (103.9 points). Thanks to the positive movements of economic indicators in Q1, GDP growth forecasts in 2015 were revised upward, to 1.5% according to the April *WEO* and *Consensus Forecast*. The greatest risks are the potential exit of Greece from the euro area and the ongoing Ukraine conflict. However, deflationary risks are lower than in the previous period thanks to the accommodative monetary policy measures taken by the ECB. Unemployment in the euro area fell by an additional 0.1 pp in Q1 and measured 11.3% in March, which is still relatively high compared to other advanced economies and continues to thwart faster economic growth.

According to the *Consensus Forecast*, the slump in economic activity in Russia and Ukraine should drive down **GDP in Central and Eastern Europe** by 0.4% in 2015. However, a 2.0% growth is expected in 2016,

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



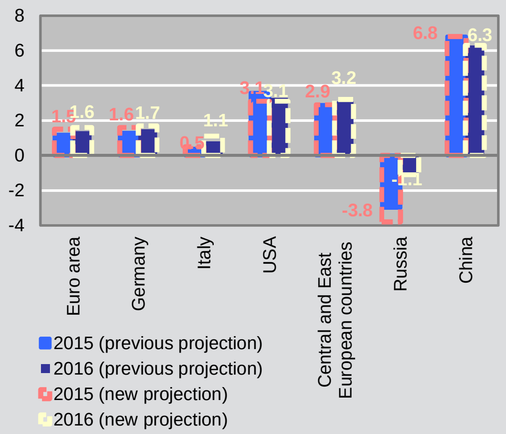
Sources: Eurostat, Markit Group and Banca d'Italia.
* Preliminary estimate for Q1 2015.

which should mainly be driven by the countries in Central Europe which are strongly linked to the euro area economy. Growth is expected to pick up on account of the positive effects of the ECB's accommodative policy and the low price of oil on domestic demand. GDP growth is expected in South-East European countries as well, thanks to the recovery from floods in some countries and the improvement in labour market conditions. Lower oil prices should also positively affect the growth in private consumption and net exports in Turkey, where a higher GDP growth is forecast despite relatively restrictive monetary conditions.

With the economic situation in Russia and Ukraine still very unfavourable, their GDP is expected to plummet in 2015 (by 4.0% and 6.4%, respectively), according to the *Consensus Forecast*. The drop in the price of oil and economic sanctions continued to push down economic activity in Russia, which was additionally encumbered by the decline in real disposable income following strong depreciation and high inflation. Unrelenting political tensions and depreciation of the hryvnia will significantly reduce economic activity in Ukraine in 2015 as well, but the agreement reached with the IMF could help to lessen these negative effects.

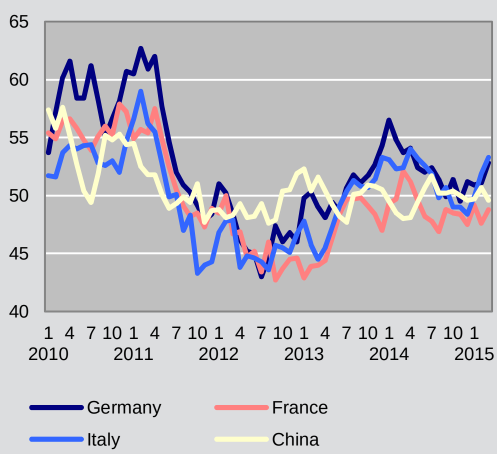
After a strong growth in Q3 (1.25% s-a), economic activity in the **USA** slowed to 0.6% s-a in Q4. The key driver of growth in Q4 was final household consumption, while increased imports, reduced government spending and a slower growth in investment had the opposite effect. Conditions in the labour market further improved. Unemployment declined by an additional 0.1 pp in Q1 and measured 5.5% in March,

Chart IV.7.3 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**
(in %)



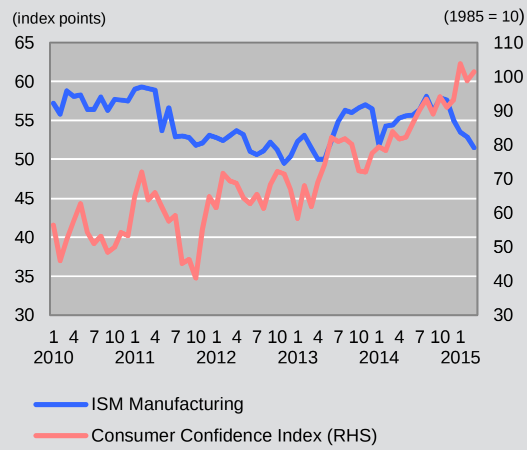
Sources: IMF WEO Update (January 2015) and IMF WEO (April 2015).

Chart IV.7.2. **PMI Manufacturing for selected countries**
(index points)



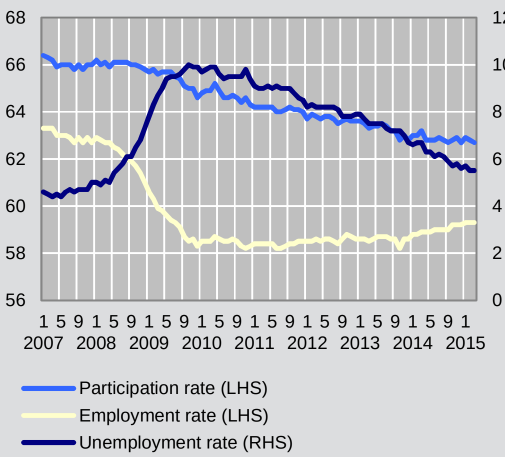
Source: Markit Group.

Chart IV.7.4 **Leading economic indicators in the United States**



Source: Institute for Supply Management, Conference Board.

Chart IV.7.5 **US labour market**
(monthly rates, in %)



Source: Bureau of Labor Statistics.

while nonfarm payroll employment remained at a high average of 200,000 per month.

The movement of economic indicators in Q1 points to a slowdown in GDP growth from Q4. The composite index of production activity (*ISM Manufacturing*) fell from 55.1% in December 2014 to 51.5% in March 2015, but is still in the expansion zone[27]. Positive movements in the labour market also reflected on an increase in consumer confidence, as measured by the *Consumer Confidence Index*, which rose to 101.3 points in March and is close to its six-year high. According to the preliminary estimate, GDP growth practically ground to a halt in Q1 (0.05% s-a), which was chiefly caused by a drop in exports and fixed investment and the slowing growth in final household consumption. The estimated GDP growth in 2015 is slower than previously expected – the latest projections of the IMF and the *Consensus Forecast* indicate that it is 3.1% and 2.9%, respectively, with the assumption that the improvement in labour market conditions, the growth in disposable income and the recovery of the real estate market will negate any potential adverse effects of the dollar's strengthening.

In Q1, **China's** GDP growth decelerated to 7.0% y-o-y (from 7.3% y-o-y in Q4), which is the lowest growth in the last six years and in line with the latest targeted growth rate. Slower GDP growth will mostly be caused by a lower growth in industrial output, measuring 5.6% y-o-y in March, or the lowest monthly growth since November 2008. The weak performance of the manufacturing sector is also signalled by the movement of the key indicator (*PMI Manufacturing*), which again slid below the neutral level of 50 points. According to the latest IMF forecast, GDP growth in 2015 remains at its January level of 6.8%, while the projection of the *Consensus Forecast* is 7.0%.

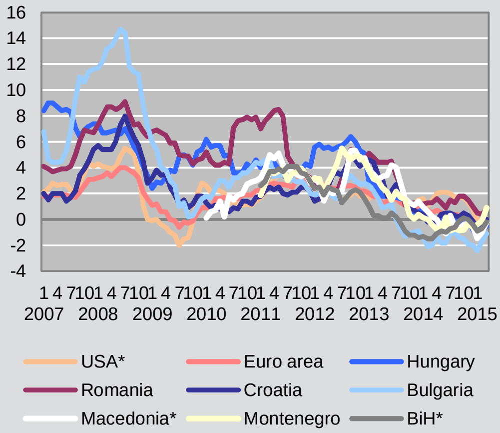
Inflation movements

Inflation remained in the negative zone throughout Q1, but analysts estimate that the euro area will avoid prolonged deflation and that a mild y-o-y growth or stagnation in prices will be recorded as early as in April. This was confirmed by the preliminary Eurostat estimate, showing that euro area inflation measured 0.0% y-o-y in April. However, the ECB's inflation target (below, but close to 2%) will be more difficult to attain and will primarily depend on the movement of oil prices, the euro's exchange rate and global economic growth. The Survey of Professional Forecasters published by the ECB in April indicates that euro area inflation will remain very low because of the fall in oil prices and will start rising only next year. According to the survey, inflation will measure merely 0.1% in 2015, rising to 1.2% in 2016 and 1.6% in 2017, which is still below the ECB's target, but notably above its current level nonetheless. Compared to the results of the January survey, the expected inflation in 2015 is revised down because of the drop in oil prices and upward for 2016 and 2017 because of the ECB's accommodative monetary policy and the movement of the euro's exchange rate.

Deflationary pressures persist across much of the **Central and Eastern Europe**. Deflation is most prominent in Bulgaria, where the y-o-y fall in prices has been moving between 1.0% and 2.0% for the last twenty consecutive months. In Hungary, negative growth in prices was recorded in eight of the twelve months of the previous year. Inflation continues in the negative zone in Poland, Macedonia and Bosnia and Herzegovina. Following eight consecutive months of deflation in Montenegro, it measured 0.9% in March. Few countries in the region have positive inflation rates, namely Romania (0.8% y-o-y in March) and Turkey (7.6% y-o-y in March), which still has the highest inflation rate due to growing food prices and the weakening of the domestic currency.

[27] Above 50%.

Chart IV.7.6 **HICP across selected countries**
(y-o-y rates, in %)



Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.
* CPI.

In the **USA**, y-o-y inflation continued down throughout Q1 due to falling energy prices. Consequently, consumer prices were 0.1% lower in March, while core inflation, which excludes volatile elements, such as food and energy prices, was significantly higher (1.8%). Inflation targeted by the Fed, the annual change of the price index for personal consumption expenditures (PCE), has stayed below its 2% target for thirty-five consecutive months. The Fed expects inflation will remain low in the short run, but will gradually approach the target in the medium run, in line with further improvements in labour market conditions and the waning of the effects of the energy price drop and other temporary factors. According to market indicators, inflation expectations are still low, but have not fallen from January.

Monetary policy

In early 2015, the ECB, central banks of Japan and China and central banks in Central and Eastern Europe and Russia sought to stimulate their economies with new accommodative monetary policy measures. In contrast, the Fed announced that it would start increasing its policy rate, without specifying as to when this might happen.

On 9 March, the **ECB** began implementing the programme of purchasing government securities of EU member states (*PSPP*) so as to combat weak economic growth and low inflation (see Text box 3 on page 45). Along with the Asset-Backed Securities Purchase Programme (*ABSPP*) and the Covered Bond Purchase Programme 3 (*CBPP3*) initiated in late 2014, this programme represents a part of the Expanded Asset Purchase Programme (*APP*). The APP's monthly purchases should amount to EUR 60.0 bln per month by September 2016, in order to inject a total of EUR 1,100 bln into the system. Including April, the ECB purchased a total of EUR 95.1 bln of government securities, making all securities purchased in the APP amount to EUR 175.9 bln. Starting from 2 April, purchased government securities are available for borrowing through national central banks in order to support liquidity in the securities and repo markets and limit the growth of costs arising from securities borrowing caused by the lack of collateral.

The initial results of the ECB's new monetary policy measures are encouraging. Real interest rates are falling and the euro is weakening, which should act to stimulate the economy. Inflation expectations based on market indicators have increased to levels consistent with mid-term price stability and it is expected that real interest rates will fall further down. At the same time, confidence in economic recovery has increased, creating a more favourable environment for new investment. However, ECB officials are emphasising that while monetary policy does play an important role in the short run, it cannot increase economic growth in the long run, as it is determined by factors acting on the supply side. Economic growth is improved by structural policies, while an accommodative monetary policy serves to increase demand and facilitate access to loans in order to limit potential adverse effects of structural reforms in the short run.

The ECB's quantitative easing programme has helped move yields on government securities into the negative zone in most euro area member states. While there used to be negative yields in only a few countries, they can now be found in almost all of them. After only six weeks of quantitative easing, yields were negative on more than a half of government debt of euro area member states. Spain sold short-term securities with negative yields in April, while Portugal sold securities with an almost zero interest rate. Yields on ten-year government securities fell to 1.7% in Portugal and 1.3% in Spain and Italy. Yields on ten-year government securities in Germany, the principal reference yields for investors in Europe, fell to 0.08% in April from 0.39%, the level immediately before the start of the ECB's QE.

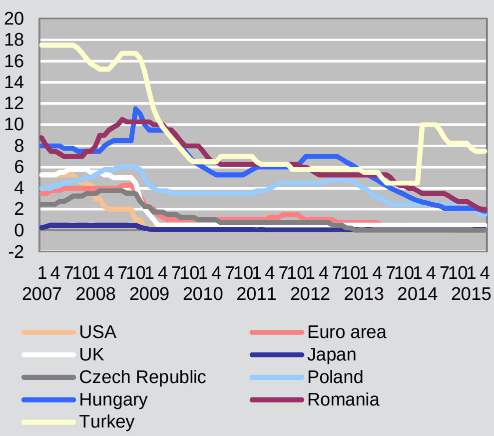
Greece is the only euro area member state where yields on government securities grew due to the investors' concern that it might exit the euro area and/or fail to service its obligations. Yields on ten-year government securities in Greece increased from 9.4% to over 13% in April, which is their highest level since December 2012, although they dropped back to 10.4% by the month's end. Fitch changed Greece's outlook from stable to negative in January, after which it reduced its credit rating in March (to CCC). Standard & Poor's also downgraded Greece's credit rating, first in February (to B–), and again in April (to CCC+), explaining that its financial obligations will be unsustainable without deep economic reform. In late April, Moody's also cut Greece's rating by one rank (to Caa2).

The ECB's accommodative monetary policy, low oil prices and negative or extremely low inflation in the countries in **Central and Eastern Europe** allowed central banks in this region to cut their policy rates. Namely, central banks of Romania and Turkey reduced their policy rates in Q1 by 75 bp each, to 2.0% and 7.5%, respectively. Poland cut its policy rate by 50 bp, to a new low of 1.5%, while Hungary cut it by 15 bp to 1.95%, and again to 1.8% in April. Monetary policy measures and exchange rate adjustment should help countries in this region to again become competitive in the global market. Monetary policy in this region is particularly affected by the ECB's accommodative monetary policy and low oil prices, which should continue to moderate the effects of contracted capital inflow and uncertainty over the high debt in most of these countries, the vulnerability of the banking sector and geopolitical and financial tensions in neighbouring countries.

The central bank of Russia also used these favourable circumstances and the strengthening of the ruble in Q1 to cut its policy rate from 17.0% to 14.0%. It opted to further decrease it to 12.5% in April. Standard & Poor's downgraded Russia's credit rating below investment grade (BB+) due to the ruble's depreciation and weaker economic growth outlook after the global oil price slump. Fitch and Moody's also downgraded Russia's rating in Q1, but left it at investment grade.

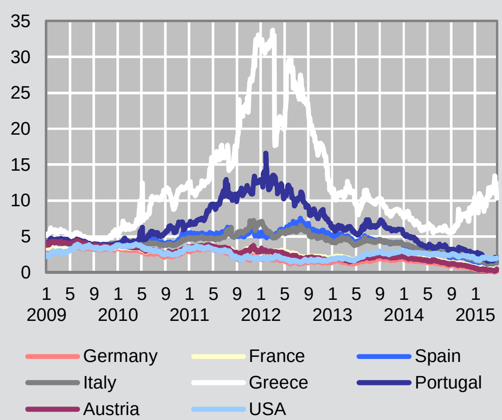
In order to achieve maximum employment and price stability, the **Fed** has left its policy rate unchanged for the time being (0.25%). There were hints in its March meeting that it could start increasing the policy rate in summer for the first time since June 2006. However, no specific announcements were made in the April meeting about when this could happen, as the month was marked by more unfavourable than expected data about conditions in the labour market and the American economy. Analysts estimate that the Fed's first policy rate hike could happen in Q3, while interest rate futures indicate that the Fed will wait until December. The Fed's officials also emphasise that the monetary policy

Chart IV.7.7 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

Chart IV.7.8 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

tightening will be mild and gradual and will, in fact, represent the move from the most extreme accommodative monetary policy in history to an extremely accommodative monetary policy.

Financial and commodity markets

Since the start of the year, movements in financial markets have been marked by uncertainty over several issues: when the Fed will start increasing its policy rate, what the economic effects of the dollar's appreciation will be, how the price of oil will move in the upcoming period and whether the latest data hint at a slowdown in the recovery of the American economy.

The expected Fed's rate hike and the start of the programme of purchasing government securities of euro area member states by the ECB led to a further strengthening of the dollar against major world currencies. The dollar strengthened vis-à-vis the euro by 12.7% end-period, reaching the rate of 1.05 dollars per euro, its highest value since January 2003. In April, the dollar weakened vis-à-vis the euro by 2.9%, but is expected to continue strengthening in the period ahead owing to diverging monetary policies of the ECB and the Fed.

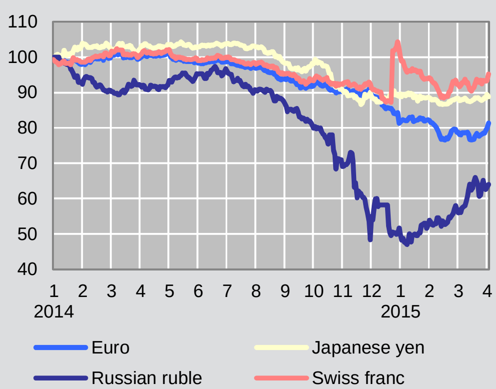
The global price of Brent crude in January continued the fall started in H2 2014, reaching its lowest level (USD 45.25 per barrel) since early 2009. In the following months it recorded a mild recovery and, with slight oscillations, moved between 50 and 65 dollars per barrel, which is still quite below its price in the previous period. The primary factors contributing to the low level of oil prices are high global supply, unwillingness of OPEC member countries to cut back on production and a slower-than-expected global economic growth.

There was prominent instability in financial markets in Q1 as well. The VIX, a measure of the implied volatility of Standard & Poor's 500 index options, stood at an average of 16.6 in Q1, up from 16.0 in the previous quarter. The VIX fell below 13 in April, which is under its 12-month moving average (14.5) and indicates a relative calmness in the market. Although financial market instability may not reach a record high, it is expected to be elevated as the interest rate hike in the USA draws nearer. High uncertainty was also signalled by the EM-VXY index which tracks volatility in emerging market currencies, as it rose from an average of 8.7 in Q4 2014 to 10.4 in Q1 2015.

A further drop in demand for gold caused by the dollar's strengthening and signals that the Fed would start increasing its interest rates drove the price of gold down by 1.6% in Q1. As the American economy grows stronger, this trend could continue in the period ahead, since investors will move from gold to higher-yield assets.

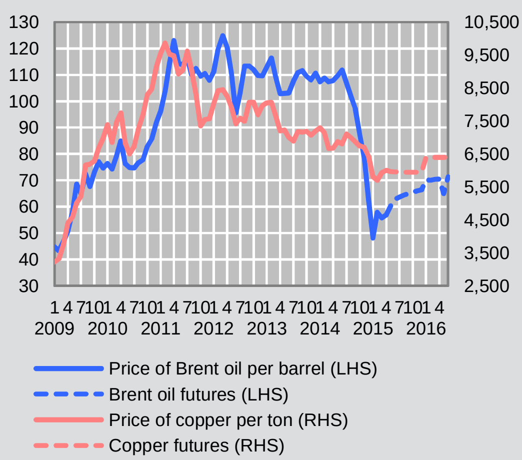
Although the price of copper grew after its low point in January, it is still at a low level. As in the previous period, the main reasons behind this are the sluggish growth of

Chart IV.7.9 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



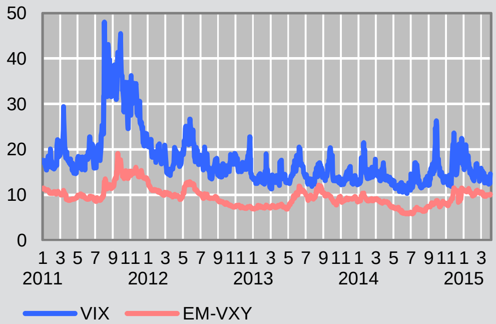
Source: IMF database.
* Growth indicates appreciation.

Chart IV.7.10 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

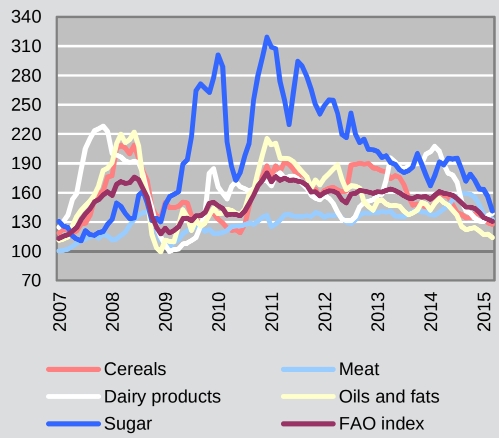
Chart IV.7.11 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.7.12 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

China, the world's leading consumer of copper (over 40%), the strengthening of the dollar, as well as the expectations that lower energy costs would stimulate copper output. The Q1 drop in copper price was also contributed by the seasonal character of copper supply, which tends to be high until April and falls from then on throughout the year. Although most analysts believe that the lowest copper prices are probably behind us and that they will grow in the medium run, short-term forecasts were revised downward due to the current and expected strengthening of the dollar, slowing growth of the Chinese economy, cheaper energy prices and other production costs. The strong growth of the American economy and high consumption of copper are not sufficient to reverse the declining global trend.

In Q1, world food prices, measured by the FAO index, continued the decline which started in April 2014. This index stood at 130.6 bp at end-Q1, indicating that the real world food prices declined on average by 6.7% in Q1 2015. The strongest decline was recorded for prices of sugar (13.8%), due to a better crop outlook, mainly in Brazil, the main world producer and exporter of sugar, and the continued weakening of the Brazilian currency against the dollar (by more than 10.0% in March alone). The prices of meat also fell (10.1%) due to reduced demand in Asia, where several countries recorded a growth in production, and in Russia due to the embargo on imports. The prices of cereals also dropped in Q1 (7.9%) on account of a more favourable outlook for this year's crop and strong competition among exporters. The sole component of the index which increased in Q1 was the price of dairy products (5.9%). The trend of falling dairy prices which lasted from March 2014 to January this year was interrupted due to a limited export supply in Europe and Oceania.

Text box 3: ECB's quantitative easing programme and assessment of its impact on Serbia and other emerging market economies

On 22 January 2015, the ECB's Governing Council decided to expand its private sector asset purchase programme to include bonds issued by euro area central governments, agencies and institutions. Under this programme, which is expected to last until September 2016 (or longer, if inflation continues to depart from the level consistent with ECB's definition of price stability over the medium term), securities with a remaining maturity between two and 30 years will be purchased. Combined monthly purchases will amount to EUR 60 bln. As of 2 April, purchased public sector securities were made available for lending by national central banks (NCBs) to support bond and repo market liquidity and contain the rise in the costs of borrowing securities due to shortages of collateral.

The programme has been designed to safeguard the singleness of the euro area monetary policy. It is coordinated by the ECB, which also controls the application of the defined eligibility criteria with regard to the volume and type of securities to be purchased, the collateral requested, etc. Purchases will be split across euro area members according to the ECB's capital key[1]. With regard to the sharing of hypothetical losses, purchases of securities of European institutions, which will be 12% of the programme and will be purchased by NCBs, will be subject to loss sharing. The rest of the NCBs' additional asset purchases will not be subject to potential loss sharing. The ECB will hold 8% of the asset purchases which will also be subject to loss sharing. This implies that 20% of asset purchases will be subject to a regime of risk sharing.

ECB's decision to resort to the above unconventional measures was driven by the fact that earlier measures – slashing the main interest rate to close to zero, negative rate on overnight bank deposits with the ECB, implementation of long-term refinancing operations (*TLTRO*) and private asset purchase programmes (*CBPP3* and *ABS*) – failed to produce the desired effects in terms of increased liquidity. In December, euro area inflation entered negative territory and inflation expectations went down. Also, according to the latest projection, inflation will not approach the "below, but close to, 2%" target in 2016 either, while euro area economy is recovering more slowly than expected.

According to the ECB, together with previous measures, this programme will work through several channels at the same time to help restore inflation to its target level and support faster economic recovery. First, the programme will strengthen confidence of economic entities in central bank's firm commitment to easing monetary conditions, which will result in rising inflation expectations and lower real interest rates. Secondly, it is expected that prices of other forms of assets will increase (and yield rates decline), triggering a fall in interest rates on loans and other forms of debt instruments. Further, owing to increased liquidity, banks will be able to change the structure of their portfolios and lend more abundantly to the private sector.

The ECB's QE programme may be expected to affect flows of money and capital to emerging market economies, including Serbia, through four main channels:

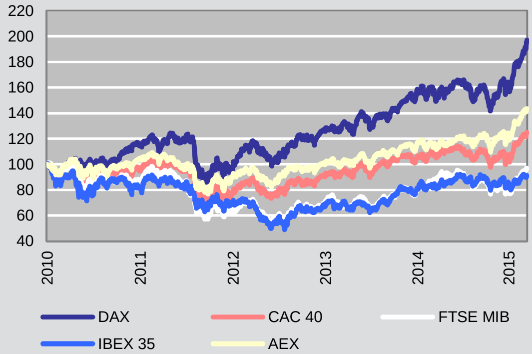
1. **signalling channel** – quantitative easing signals to investors that euro area interest rates will be lower than previously expected for a longer period of time, which prompts capital flows into emerging market economies due to higher yield rates;

2. **balance sheet channel** – increased liquidity coupled with reduced supply of government securities to private investors in the euro area should increase their demand for government securities issued by emerging market economies. This ought to result in lower country risk premium, higher asset prices, lower interest rates and increased availability of sources of funding in emerging market economies;

3. **exchange rate channel** – depreciation of the euro in response to a more accommodative policy of the ECB may lead to lower demand for imported goods in the euro-area, i.e. lower exports of emerging market economies, depending on their ability to turn to other markets instead, the composition of their exports (share of commodities), and volume of foreign trade with the euro area;

[1] The NCBs' shares in capital are calculated using a key which reflects the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting. Germany, Italy and France will thus have the largest share of over 60% of asset purchases.

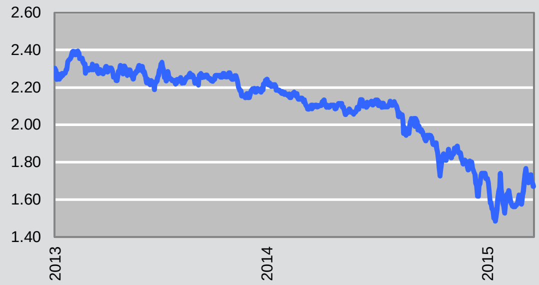
Chart O.3.1 **Euro area stock market indices***
(base indices, 4. 1. 2010 = 100)



Source: Bloomberg.

* *DAX* - Germany, *CAC* - France, *FTSE MIB* - Italy, *IBEX* - Spain, *AEX* - Holland.

Chart O.3.2 **Market inflation expectations in the euro area**
(in %)

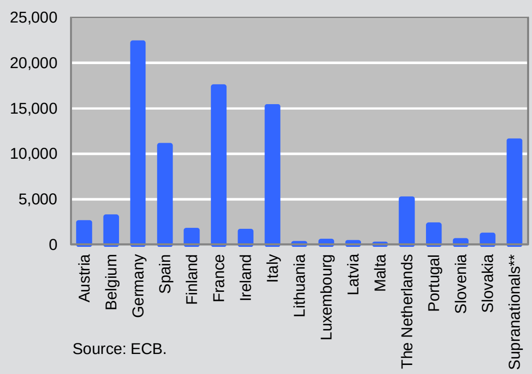


Source: *Thomson Reuters*.

4. **trade-flow channel** – QE ought to support faster economic activity and boost demand in the euro area, which would have a positive impact on exports of emerging market economies for which the euro area is an important trade partner. This may fully or partially offset the negative effect from the exchange rate channel on emerging-market exports.

For now, the programme is working according to plan. If this continues, at least EUR 1,100 bln will be injected in the system before the programme ends. Many economists believe that this will loosen monetary conditions and boost private sector lending within the euro area. As yield rates on securities issued by euro area central governments are currently at their historical low, while options for investment in debt instruments within the euro area are limited, these effects are expected to spill over into the money and capital markets of emerging economies as well. However, in view of comparisons with the Fed's QE programme, some economists hold that the expected effects on euro area economy might not play out after all, as the European financial market is much smaller than the US market and the two differ in terms of structure. The latter group believes that positive effects on emerging market economies will be more contained than at the time of the Fed's quantitative easing, and that the US could easily benefit most from the programme as its economic outlook is better than that of most emerging market economies.

Chart O.3.3 **PSPP* purchases**
(in EUR mln)



Source: ECB.

* PSPP - Public Sector Purchase Programme.
** Supranational institutions.

When it comes to Serbia, the ECB's QE programme is likely to boost exports and encourage higher inflow of capital to the country, which will, in turn, result in lower cost of borrowing for the government, banks and the real sector. Although these effects are difficult to quantify, and it is unclear to what extent they may be offset by a hypothetical worsening of geopolitical tensions and the expected tapering of the Fed's accommodative policy stance, it is evident that Serbia's country risk premium declined after the adoption of the programme, while non-resident demand for dinar securities went up. Thanks to the programme, projections of euro area economic growth have been revised upwards, which, if realised, and given our trade relations with the euro area, is expected to have a positive impact on domestic exports and trigger higher inflow of FDI into the country.

V. Inflation projection

Y-o-y inflation will return within the target tolerance band in the second half of the year and stay within the band until the end of the projection horizon. The expected inflation growth over the coming period will not be a result of dispersed price increases, but rather a consequence of a rise in a small number of CPI items (prices of cigarettes, petroleum products and electricity), which contributed considerably to the undershooting of the inflation target band in the past year. The risks to the projected inflation path are associated primarily with developments in the international environment, including prices of primary commodities, the movement of administered prices at home, and to a certain extent, the outcome of this year's agricultural season.

The projection of GDP growth for 2015 has been revised up from -0.5% to 0.0%. Owing to a faster recovery of the euro area and lower prices of oil, the growth in net exports is likely to be somewhat stronger this year and the fall in household consumption softer than expected earlier. The projection of GDP growth for 2016 has remained unchanged (1.5%).

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

Consistent with the expectations stated in the February *Report*, y-o-y inflation continued to move below the lower bound of the target tolerance band (4.0±1.5%) in Q1 and amounted to 1.9% in March. Q-o-q, inflation rose by 1.4%, driven almost entirely by the surging prices of food and non-alcoholic beverages. Due to the somewhat higher seasonal increase in fruit and vegetable prices, the prices of unprocessed food rose at a much faster pace than those of processed. Core inflation (CPI excluding food, energy, alcohol and cigarettes), also running below the target tolerance band since August, reached 1.9% y-o-y at end-March.

The undershooting of the inflation target tolerance band in the past year can be put down primarily to factors with a temporary effect – first, the unusually small growth in administered prices in 2014 (1.1%)[28] and their first ever y-o-y fall in Q1 2015, the decline in primary commodity prices in 2014 and the collapse of global oil prices from mid-2014.

Extended period of low inflation and anticipation of weak inflationary pressures in the period ahead have helped stabilise short- and medium-term inflation expectations. One-year ahead inflation expectations of the financial sector and businesses have been within the target band for more than a year now. Two year-ahead inflation expectations of both sectors are also within the target band.

Under the impact of global and local factors, depreciation pressures from Q4 2014 continued into January. They

[28] Due to the need for gradual removal of price disparities, this growth averaged 10% in the past several years.

lasted until February, when the dinar started strengthening. Appreciation pressures in the quarter under review reflect increased liquidity in the international financial markets resulting from the ECB measures, as well as the conclusion of a three-year stand-by arrangement with the IMF and robust non-residents' investment in domestic dinar securities. In order to ease excessive short-term volatility of the exchange rate, the NBS intervened in January by selling EUR 90.0 mln in the IFEM, whereas in the remainder of the quarter and in April it was the net buyer (EUR 370.0 mln in total).

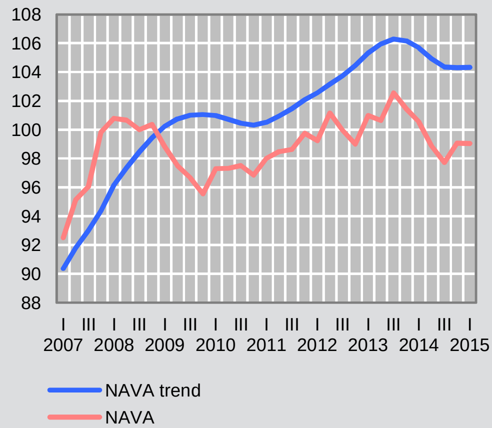
At 2.4% of GDP in Q1, consolidated budget deficit (including "below-the-line" transactions) was lower than the upper limit envisaged by the agreement with the IMF. Interest payments accounted for as much as 4.6% of GDP, reflecting, among other things, the strengthening of the US dollar. Lower-than-expected budget deficit is attributable to the increase in revenue, powered by the state-owned enterprises' profit payments on the one hand and on the other, by the somewhat improved tax discipline. We expect that this year's consolidated budget deficit will be lower than envisaged by the Fiscal Strategy, i.e. lower than 5.9% of GDP.

According to NBS estimates, GDP stagnated in Q1 in s-a terms (fell by 1.9% y-o-y). On the production side, significant positive contribution to GDP came from industrial production, i.e. the rise in manufacturing industry output and the pick-up in activity in the sectors of mining and energy which continue to recover after the May flooding last year. The largest negative contribution, on the other hand, came from services. On the expenditure side, the fall in government and household consumption, which may be linked to fiscal consolidation, was neutralised by the positive contribution of investment and net exports.

The negative output gap[29] is still wide. Its size indicates that the disinflationary pressures generated by aggregate demand will remain strong in the medium term. In the short term, these pressures will be strengthened further by the implementation of fiscal consolidation measures.

Faced with sluggish economic recovery and very low inflation, the ECB decided to engage in purchases of sovereign securities of the euro area members beginning from March. These purchases will complement the purchases of private securities launched in Q4. Owing to the accommodative monetary policy stance of the ECB, depreciation of the euro and the fall in oil prices, the economic recovery of the euro area is steadily gathering momentum. Economic activity indicators suggest that the euro area's GDP growth from Q4 2014 continued into Q1 2015. Nevertheless, this growth remains significantly slower than that of the US economy. Encouraged by positive developments in the real sector, the Fed ended its asset purchase programme by the end of last year and is likely to start raising its policy rate in the course of this year.

Chart V.0.1 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Inflation projection assumptions

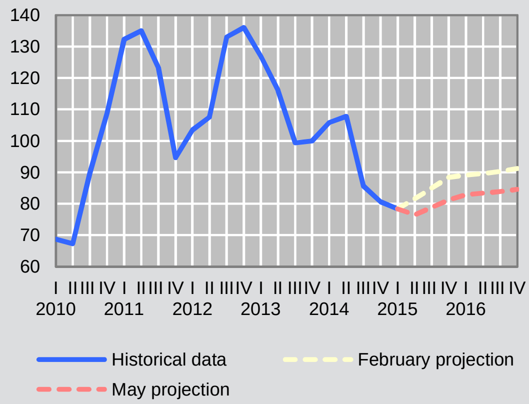
External assumptions

The assumption for the euro area's GDP growth in this and the next year has been revised upwards from the February projection – to 1.5% in 2015 and 1.8% in 2016.[30] To achieve these growth rates, domestic demand in the euro area should be supported by improvement in financial conditions, progress in the implementation of fiscal consolidation and structural reforms, and lower oil prices which would have a positive effect on real disposable income of households and profitability of businesses. Improved price competitiveness could also bolster the demand for euro area exports. At the same

[29] 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.

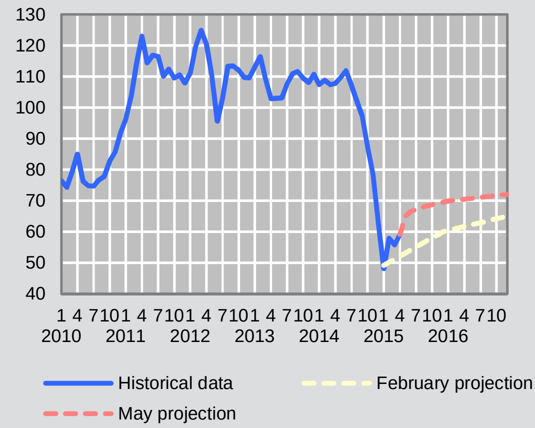
[30] The assumption for the euro area's GDP growth in 2015 and 2016 is consistent with the latest *Consensus Forecast*.

Chart V.0.2 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.3 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

time, the euro area is faced with the tepid pace of structural reforms and the need for balance sheet adjustment across a number of sectors, which will probably slow down its recovery.

Though in the negative territory since December, y-o-y inflation in the euro area increased from -0.6% in January to -0.1% in March, driven mainly by the rally in euro oil prices that began from mid-January. An important positive signal is the rise in inflation expectations which started in April as a result of unconventional measures of the ECB. Full implementation of these measures, coupled with the pass-through from the weaker euro to prices, should lead to a further gradual rise in inflation. This taken into account, we have assumed in the projection that the euro area will exit deflation in Q2 2015. Consistent with the announcements of ECB officials, the markets expect no change in the ECB's main refinancing rate over the coming twelve months (*Consensus Forecast*).

International prices of primary agricultural commodities[31] have stagnated over the last three months, i.e. food production costs remain relatively low. While commodity futures indicate no change in these prices in the coming period, we have been slightly more conservative in our projection, assuming they will increase modestly in both 2015 and 2016.

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

	2015		2016	
External assumptions				
EU inflation (Q4 to Q4)	0.5%	(-0.5)	12%	(-0.1)
ECB policy rate (year-end)	0.05%	(-)	0.05%	(-)
Euro area GDP growth	15%	(+0.4)	18%	(+0.2)
International prices of primary agricult. commodities (Q4 to Q4)*	10%	(-9.0)	4.0%	(+10)
Brent oil price per barrel (year-end, USD)	70.0	(+10)	72.0	(+7)
Internal assumptions				
Administered prices (Dec to Dec)	4.8%	(-2.2)	5.0%	(-2.0)
Trends				
Appreciation trend of the real exchange rate (average)	14%	(-0.1)	14%	(-0.2)
Real interest rate trend (average)	2.9%	(-)	2.8%	(-)

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

Given the faster-than-expected growth in Q1 and the movements in oil futures, the assumption for oil prices[32] has been revised up relative to the February projection.

[31] Measured by the composite index which comprises dollar prices of wheat, corn and soybean in the benchmark commodity markets.

[32] Brent oil.

That is to say, oil prices are expected to end this year slightly above their current level and to rise moderately in 2016.

Internal assumptions

Consistent with the expected movements in international prices of primary agricultural commodities, the projection assumes their local counterparts will also go up in this and the next year.

Following the extremely weak growth in 2014, administered prices are projected to rise this year by around 5.0%. The reason for the downward revision relative to the February projection lies in the changed assumption regarding the increase in electricity prices. Namely, the February projection assumed an increase of 15%, while the current projection envisages that electricity prices will go up by 7.5%. The increase is expected to take place in Q3. Administered price growth in 2016 should stay in the region of 5% as well.

The projection also operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and conditioned by the removal of price disparities, notably in terms of administered prices, and by the Balassa-Samuelson effect[33].

We have also assumed, consistent with the announcements from the Government, continued fiscal consolidation in the coming period that will ensure public finance sustainability and put public debt on a downward path from 2017 onward.

Projection

Inflation projection

Under the central projection, y-o-y inflation will return within the target tolerance band (4.0±1.5%) in the second half of the year and stay within the band until the end of the projection horizon. Its rise over the coming period will not be a result of dispersed price increases, but rather a consequence of a rise in three CPI items – prices of cigarettes, petroleum products and electricity.

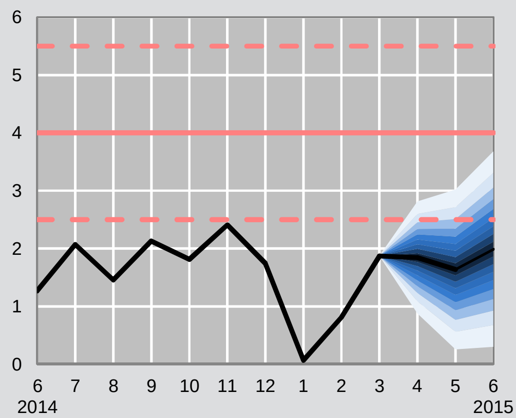
Short-term inflation projection

Under the short-term inflation projection, i.e. projection for Q2 2015, y-o-y inflation will continue to move below the lower bound of the target tolerance band, mainly as a result of postponing the electricity price increase for Q3.

At quarterly level, consumer prices are expected to go up in Q2, led primarily by the seasonal rise in unprocessed food prices (fruit, vegetables, fresh meat), the increase in cigarette prices (due to change in the business policies of major tobacco product producers)[34] and the rise in prices of travel arrangements.

Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been undershooting the target tolerance band since August, will continue to move below the lower bound of the band in Q2. Core inflation will grow at quarterly level, driven primarily by the rising prices of travel arrangements.

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



Source: NBS.

[33] In transition economies, the convergence of income levels towards the levels recorded in advanced economies is accompanied by the relatively faster growth in prices (price convergence).

Medium-term inflation projection

Looking at the main CPI components, inflation's return towards the target in H2 2015 will be led by administered and petroleum product prices, and to a lesser degree, by non-food prices. At the same time, food prices, notably those of fruit and vegetables, will dampen consumer price growth.

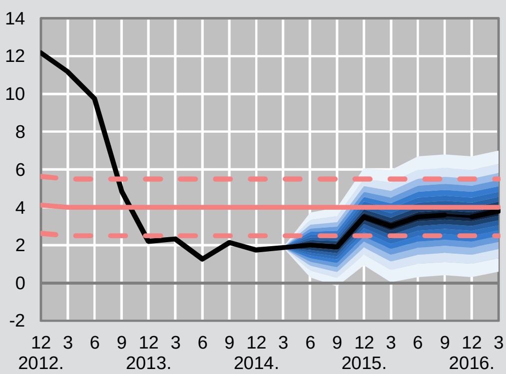
The contributions of administered and petroleum product prices to y-o-y inflation are currently negative because electricity prices were not increased in the past year and the international oil prices have declined since mid-2014. However, they are expected to become positive in the coming period and to exert decisive influence on y-o-y inflation growth during the remaining months of the year. Within administered prices, the largest impact on inflation will originate from prices of cigarettes and electricity. According to our estimates, due to changes in the producers' business policy and the government's excise policy, the prices of cigarettes will go up by around 10% until the end of the year (their contribution to inflation increasing from -0.4 pp in March to around 0.4 pp at year-end). As regards electricity, the assumed 7.5% price increase would add some 0.35 pp to inflation. The expected positive contribution of petroleum products to y-o-y inflation at the end of the year should come as a consequence of the drop-out of last year's price reductions from the calculation of y-o-y inflation, but also of the weakening of the dinar against the US dollar, which started to reflect on petroleum product prices from February.

As the pass-through effect of the exchange rate to prices comes with a certain time lag, the depreciation of the dinar vis-à-vis the euro in late 2014 and early 2015 could also play a role in inflation's return towards the target. This effect may work its way primarily through higher prices of imported consumer goods and domestic products with high import content. Still, the intensity of the exchange rate pass-through will depend on the importers/producers' ability to command higher prices against the backdrop of depressed domestic demand. The pressure on import prices in Serbia is likely to be additionally constrained by the very low inflation, i.e. deflation, in the international environment.

Within food prices, two different trends are expected in the coming period – the slowing of y-o-y growth in fruit and vegetable prices and a moderate rise in the prices of other food (industrial food products). Namely, fruit and vegetable prices are currently rather high, but are expected to lose pace and possibly even fall once the new agricultural season kicks in, given that their robust growth last year was triggered by one-off factors[35]. On the other hand, as primary agricultural commodities (corn, wheat) represent the key inputs in the production of food, it is reasonable to expect that the anticipated rise in their prices will lead to a rise in the prices of industrial food products. This rise is expected to take place in H2.

Low domestic demand continues to be the main disinflationary factor in the medium term. Its effect will be reinforced by the fiscal consolidation measures that will weigh down on government and household

Chart V.0.5 **Inflation projection**
(y-o-y, in %)



Source: NBS.

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%.

[34] Excise duties on tobacco products were raised on two occasions since January 2014 (in July 2014 and January 2015), but this was not accompanied with the increase in cigarette prices. These prices were last revised up in January 2014, only to be lowered in November and December.

[35] Low 2013 base and the May flooding.

consumption. The disinflationary effect of domestic demand could be moderated to a degree by the increase in external demand, especially taking into account improved growth prospects for the euro area, our key trade partner.

The risks to the projected inflation path relate primarily to developments in the international environment, including prices of primary commodities, and to the movement of administered prices at home. To a certain degree, the risks are also associated with the outcome of this year's agricultural season.

At this point, the key feature of the international environment is the divergence in monetary policies of leading central banks. This is why it is impossible to be sure about the direction of the effects on the financial markets of emerging economies, Serbia included. On the one hand, the ECB's monetary accommodation and consistent implementation of fiscal consolidation at home could give rise to capital inflows and help sustain disinflationary pressures, while on the other, the normalisation of the Fed's monetary policy, but also Greece's financial troubles, could result in more volatile capital flows to emerging markets in general. An increase in investor risk aversion in the global financial markets would probably dampen capital inflows, and consequently, put pressures on domestic prices.

The projection assumes that the prices of primary commodities (oil and primary agricultural commodities) will rise to some extent. Based on commodity futures, the risks are tilted to the downside for primary agricultural commodities, while being symmetric for oil prices (deviations from the assumption are possible in either direction).

Though fruit and vegetable prices are expected to be a disinflationary factor this year, a certain degree of caution needs to be maintained – since last year's agricultural performance was above average, an average season this year could lessen the intensity of the impact of that factor. Still, the risks regarding the effects of the new agricultural season on the prices of agricultural commodities are judged to be weaker than before thanks to the increased openness of our market to the EU.

As regards administered prices, deviations are possible in either direction, i.e. their growth could equally turn out to be higher or lower than assumed.

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

Looking ahead, monetary policy easing will depend primarily on the assessment of the potential impact of developments in the international environment on capital flows and Serbia's risk premium, as well as on the movement in oil and agricultural commodity prices. Further, consistent implementation of fiscal consolidation measures should be continued, since this opens up additional room for monetary policy easing.

GDP projection

GDP will most probably stagnate this year (its projection has been revised up by 0.5 pp from the February projection), whereas in 2016 it is expected to grow 1.5% (the same as in the February projection).

Looking at the expenditure side, consistent fiscal adjustment and implementation of structural reforms should lead to higher investment and net exports. On the other hand, because of continuing fiscal consolidation, final household and government consumption will provide a negative contribution to GDP. Higher net exports will be underpinned by the expected stronger recovery of external demand, notably demand from the euro area, this being at the same time the reason for the upward revision of projected GDP for this year. An additional reason lies in available household consumption indicators, which suggest a softer-than-expected decline in consumption since the beginning of the year, believed to be attributable to lower oil prices.

On the production side, the largest negative contribution to this year's GDP will come from the service sectors, whose activity will be influenced by weaker final consumption. A negative contribution will probably also come from agricultural production, given the high last year's base when agricultural performance was very good. On the other hand, the contribution of industrial production is expected to be positive as a result of the performance of the manufacturing industry and the rebound in the production of the sectors of energy and mining after significant damage was caused to their capacities by last year's floods.

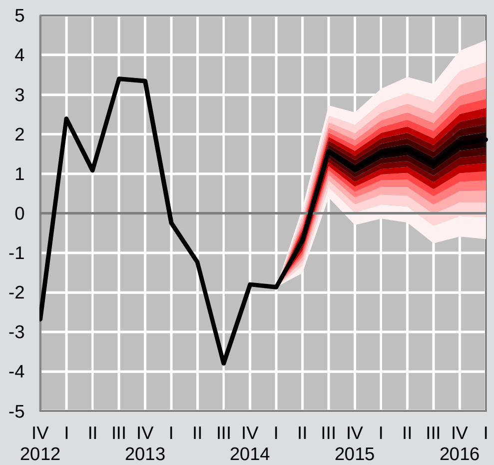
Table V.0.2 **Projections of key macroeconomic indicators for Serbia**

	2015		2016	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	2.7	-	4.0	-
European Commission	3.2	2.4	4.3	4.1
Consensus Forecast	3.1	3.0	4.0	4.3
GDP (%)				
IMF	-0.5	0.0	1.5	-
European Commission	-0.3	-0.1	12	12
Consensus Forecast	0.1	0.2	18	18
Current account deficit (% of GDP)				
IMF	4.7	-	4.7	-
European Commission	5.3	3.8	5.4	3.7
Consensus Forecast*	5.7	4.3	5.4	3.9

Sources: IMF WEO (April 2015), European Commission (Winter forecast 2015 and Spring forecast 2015) and Consensus Forecast (January and April 2015).

* Calculated based on the NBS projection of dollar GDP in January and April 2015.

Chart V.0.6 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Economic activity growth in 2016 is expected to be led by net exports and supported by investment and the recovery of household consumption. As the budget deficit reduction is expected to proceed, government consumption is poised for yet another yearly fall.

The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area and the pace and scope of fiscal consolidation and structural reforms at home.

Even though the sustained low level of oil prices and implementation of unconventional ECB measures could lead to its acceleration, the recovery of the euro area could be slowed down by an unfavourable turn of events regarding Greece's financial troubles, as well as by the tightening of the current geopolitical tensions. As regards internal factors, risks are associated with a potentially higher-than-estimated short-term negative impact of fiscal consolidation and structural reforms on GDP. To be more precise, if the pace and intensity of fiscal consolidation and structural reforms turn out slower and weaker than initially announced, the country's risk premium and the depreciation pressures will probably rise, indirectly causing a sharper real fall in domestic consumption, while under the opposite scenario, GDP will be affected through a stronger direct negative effect on domestic demand. At the same time, the possibility that the implementation of fiscal consolidation measures and structural reforms will result in a faster-than-expected economic recovery cannot be excluded either.

It should be noted that the projection does not include the potential positive effects associated with the Smederevo steel plant on GDP, which may reasonably be expected as a result of the fall in prices of the relevant raw materials and the introduction of professional management in that steelmaker. On the other hand, the outcome of this year's agricultural season represents to a certain extent a downside risk to GDP projection.

On balance, the risks to GDP projection are judged to be symmetric.

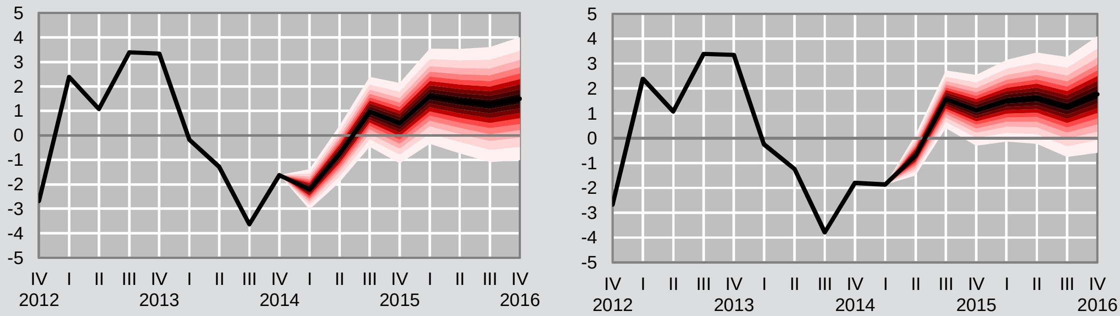
Comparison of projections and their outcome

Our new inflation projection is slightly lower than the one published in the February *Report*, primarily owing to the expected weaker growth in administered prices. The temporary slide of y-o-y inflation to the lower bound of the target tolerance band at end-Q1 2016 will be due chiefly to the base effect, i.e. drop-out of the hefty rise in fruit and vegetable prices in Q1 2015 from the calculation of y-o-y inflation.

During the last year, y-o-y inflation was moving below the central projection rate from the May 2014 *Inflation Report,* slipping at end-2014 slightly below the lower edge of the projection range. Inflation deviated from the central projection mainly under the impact of a smaller-than-anticipated increase in administered prices and a sharp fall in prices of oil and primary agricultural commodities.

Chart V.0.7 **Current vs. previous GDP growth projection**

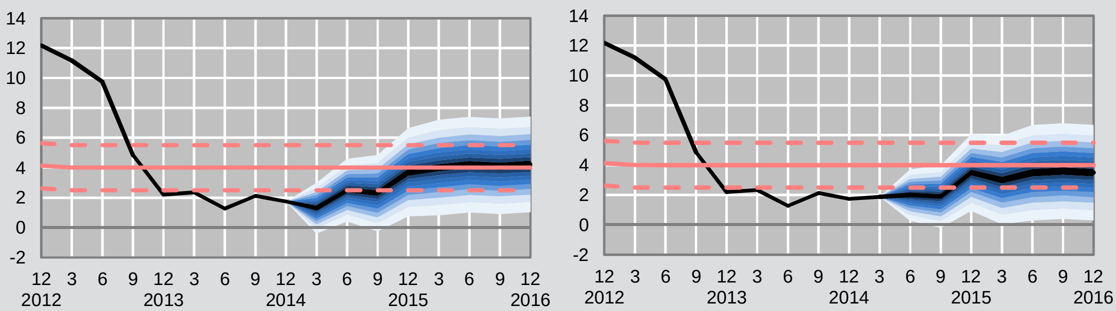
February projection (y-o-y rates, in %) **May projection** (y-o-y rates, in %)



Source: NBS.

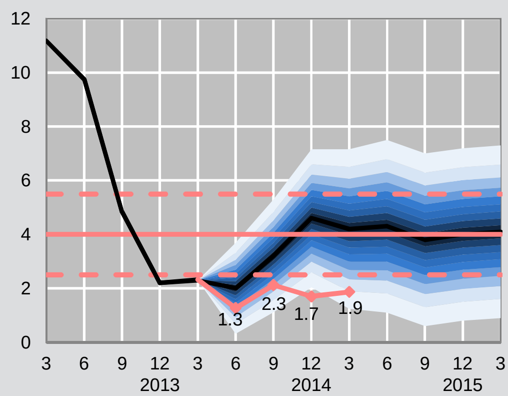
Chart V.0.8 **Current vs. previous inflation projection**

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



Source: NBS.

Chart V.0.9 **Achievement of May 2014 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Table A

Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015
EXTERNAL LIQUIDITY INDICATORS (in %)											
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.6	6.6	6,9[2)]
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.7	237.9	278.3	289.5	323.4
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	30.0	32.2
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.1	13.2	14.0	11.6
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.2	32.5	32.1	23.9
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.1	78.4	81.8
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.5	11.7	10.3	9.9
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.7	179.4	182.2
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	278.1	318.8
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	201.9
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	98.4	109.6[2)]
MEMORANDUM: (in EUR million)											
GDP (in EUR million)[1)]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,265[2)]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,746	25,925	26,735
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,151	4,532	4,645	843
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515
Short-term debt[3)]	951	968	1,044	1,832	1,843	1,752	601	455	197	115	183
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-450[2)]

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan
S&P	*BB- /stable*	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative		
Fitch	*BB- /stable*			BB- /negative		BB- /stable		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 (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment (excl. early repayment of a part of debt to 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) According to ESA 2010.

2) NBS estimate.

3) At original maturity.

Notes:

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

2. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.

3. As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and imports 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 the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4. In September 2010, the methodology of external debt statistics was changed – public sector external debt now includes liabilities under SDR allocation (EUR 462.6 mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 884.2 mln, of which EUR 393.7 mln relates to domestic banks and EUR 490.5 mln to domestic enterprises).

5. Foreign debt repayment does not include: short-term debt repayment and advance debt repayment.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015
Real GDP growth (in %)[1]	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	-1.9
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	1.7	1.9
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515
Exports (in EUR million)[3]	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	3,527[6]
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	6,7[6]
Imports (in EUR million)[3]	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	4,432[6]
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	7,1[6]
Current account balance[3] (in EUR million)	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-450[6]
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-6.2[6]
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	18.9	
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	379.3	344.0
RS budget deficit/surplus (in % of GDP)[4]	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.4	-2.4
Consolidated fiscal result (in % of GDP)[4]	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.7	-2.4
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	71.0	75.0
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.15
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	99.46	111.42
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	121.50
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	120.96	120.22
MEMORANDUM: GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,265[6]

[1] At constant prices of previous year.

[2] Retail prices until 2006.

[3] Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to methodological incomparability, exports and imports growth rates are not shown. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

[4] Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5] According to ESA 2010.

[6] NBS estimate.

Notes:

1. Data are subject to corrections in line with the official data sources.
2. Source for the data on unemployment: Labour Force Survey, Statistical Office
3. Source: MoF for public debt and NBS for estimated GDP.

Appendix 1. National Bank of Serbia's Letter to the Government of the Republic of Serbia on Reasons Why Inflation Departed from the Target

Belgrade, 19 March 2015

GOVERNMENT OF THE REPUBLIC OF SERBIA

Mr Aleksandar Vučić, Prime Minister

In accordance with the Agreement on Inflation Targeting Between the National Bank of Serbia and the Government of the Republic of Serbia (Section 6, paragraph 4), I am writing this letter to inform you that consumer price growth equalled 0.8% in February, which was the sixth consecutive month of inflation moving below the lower bound of the target tolerance band (4.0±1.5%), after the letter we had sent in September 2014 in order to explain the reasons for the undershooting. This letter explains why inflation has moved away from the target tolerance band, describes the measures that will be taken with a view to bringing back and maintaining inflation within the target tolerance band in the medium term, and sets out the period within which we expect inflation to return within the band.

The Executive Board of the National Bank of Serbia assesses that inflation was moving below the lower bound of the target tolerance band from September 2014 to February 2015 mainly on account of temporary factors – the absence of administered price growth and the fall in global oil prices.

The expectations that inflation would return within the target tolerance band by late 2014, which we expressed in the letter of September 2014, were based on the assumption of a 15% adjustment in electricity prices (contribution to inflation: +0.75 pp), which did not materialise. Had the adjustment taken place, inflation would have returned within the target tolerance by late 2014. This reflected, among other things, on overall movements in administered prices. Namely, year-on-year growth in administered prices fell from 3.5% (in September 2014) to -2.3% (in February 2015), contributing to a 1.2 pp decline in inflation in that period.

Moreover, a vigorous fall in global oil prices in the second half of 2014 resulted in lower prices of petroleum products, dragging inflation down by additional 0.5 pp from September to February. Please note that low inflation is not specific to Serbia only. In early 2015 the majority of European countries recorded negative inflation rates, i.e. deflation.

The National Bank of Serbia has taken measures within its remit to bring inflation back within the target tolerance band in the medium run. Monetary policy easing started back in May 2013. Since then, the key policy rate has been cut from 11.75% to 7.5%, while the weighted average rate on one-week repo operations of the National Bank of Serbia has been moving around 6%. Furthermore, to encourage credit activity and, indirectly, economic activity, the rate of FX required reserve allocations was cut in November, December and January.

Cautious monetary policy easing in the past period was mandated also by risks emanating from the international environment (geopolitical tensions and volatility of international capital flows).

Following the historical low recorded in January, which was due mainly to high last year's base caused by higher VAT and excise rates, year-on-year inflation began to rise in February 2015. We expect inflation to return within the target tolerance band (4.0±1.5%) in the second half of the year. Inflation's return will be supported not only by monetary policy easing, but also by the expected adjustment of electricity prices and the waning effect of the fall in primary commodity prices.

As so far, in pursuing monetary policy objectives, the National Bank of Serbia will act responsibly, will be open to the public and will seek to contribute to the creation of a stable and predictable business and investment environment.

Yours sincerely,

Dr Jorgovanka Tabaković

Submitted to:

– Mr Rasim Ljajić, Deputy Prime Minister and Minister of Trade, Tourism and Telecommunications
– Mr Dušan Vujović, Minister of Finance
– Ms Snežana Bogosavljević-Bošković, Minister of Agriculture and Environmental Protection

Index of charts and tables

Charts

Tables

Charts in text boxes

Table in text box

Executive Board meetings and changes in the key policy rate

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	8.50	-50
10 July	8.50	0
7 August	8.50	0
11 September	8.50	0
16 October	8.50	0
13 November	8.00	-50
11 December	8.00	0

2015

Date	Key policy rate (p.a, in %)	Change (in basis points)
15 January	8.00	0
12 February	8.00	0
12 March	7.50	-50
42103	7.00	-50
11 May	6.50	-50
11 June		
9 July		
13 August		
10 September		
15 October		
12 November		
10 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 12 March 2015

After reviewing current economic developments and considering the outlook for the period ahead, the NBS Executive Board decided in its meeting today to cut the key policy rate by 0.5 percentage points, to 7.5 percent.

In making this decision, the Executive Board was guided by the fact that consistent implementation of fiscal consolidation and structural reforms at home and the recent conclusion of a precautionary SBA with the IMF have helped increase investor interest in Serbia in conditions of ample global liquidity unleashed by the ECB's quantitative easing. The rise in investor interest is evidenced by the fall in the country risk premium and increased non-resident demand for government securities. These movements, as well as inflation expectations which have been revolving around the 4% target, have opened up the room for monetary policy to contribute to long-term sustainable recovery of the domestic economy.

The Executive Board concluded that year-on-year inflation, following a historical low in January due mainly to the high base effect caused by an increase in VAT and excise rates, began to rise towards the target tolerance band (4±1.5%) in February. Inflation is expected to return within the target tolerance band in the second half of the year, as a result of monetary policy measures and the waning effect of factors with a temporary disinflationary impact – notably low administered price growth and low prices of primary commodities in the international and domestic markets.

Movements in the key policy rate in the coming period will continue to depend primarily on the materialisation of risks in the international environment and their influence on inflation, including the effect of international and domestic prices of primary commodities on other prices, assessed the Executive Board.

The next rate-setting meeting of the Executive Board will be held on 9 April 2015.

Press release from Executive Board meeting held on 9 April 2015

In consideration of the current economic trends and forecasts for the coming period, the NBS Executive Board decided in today's meeting to cut the key policy rate by 0.5 percentage points, to 7 percent.

Apart from low inflation, continued monetary easing was motivated also by a further decline in inflation expectations, which have lingered within the target band for over a year now, and persisting disinflationary pressures stemming from low aggregate demand. Furthermore, low inflation rates, even negative ones, are seen across the international environment. In the Executive Board's judgment, the arrangement with the IMF confirms the economic policy makers' commitment toward a long-term sustainable recovery of the domestic economy. Global liquidity is increasing in response to the ECB's quantitative easing, which along with consistent implementation of fiscal consolidation and structural reforms stirs up investors' interest in Serbia.

Furthermore, consumer price growth recorded since the start of 2015 has been conditioned by one-off factors, notably by the fruit and vegetable price hike. It does not reflect a rise in inflationary pressures, as confirmed by low core inflation. Inflation is expected to return within the target tolerance band in the second half of the year, on the back of past monetary policy measures and the depletion of the effect of temporary disinflationary factors, primarily muted administered price growth and low prices of primary commodities in the world and domestic markets.

The next rate-setting meeting will be held on 11 May 2015.

Press release from Executive Board meeting held on 11 May 2015

At its meeting today, the NBS Executive Board lowered the key policy rate by half a percentage point, to 6.5 percent.

The Executive Board's decision to cut the rate was taken in consideration of the fact that inflation is moving below the lower bound of the target tolerance band and that inflationary pressures are persistently subdued. These movements reflect low aggregate demand and the absence of major cost-push pressures in an environment of exceptionally low inflation abroad, low prices of primary commodities and weak growth in administered prices. Inflation expectations, which have been within the target tolerance band for over a year, declined still further in the course of several recent months.

The Executive Board stated that developments in the international environment have improved and that global liquidity is rising on the back of the ECB's quantitative easing programme and the deferral of the increase in the Fed's rate. Along with more favourable prices of raw materials and energy, the above reinforces the prospects for the economic recovery of our key foreign trade partners and diminishes the risks which may evolve from the international environment.

As assessed by the Executive Board, the positive effects of fiscal consolidation measures and the conclusion of the arrangement with the IMF confirm the commitment of the Serbian economic policy makers to strengthening public finances and ensuring sustainable recovery of the domestic economy. This, at the same time, contributes to better perception of investors and their increased interest in Serbia.

At its meeting today, the Executive Board also adopted an amendment to the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy, narrowing the corridor of interest rates set in reference to the key policy rate from ± 2.5% to ± 2.0%. As assessed by the Executive Board, this measure should help stabilise interest rates in the interbank money market.

The Executive Board also adopted the May Inflation Report, containing an overview of current macroeconomic trends and monetary policy measures. The Report will be presented to the public on 20 May.

The next rate-setting meeting will be held on 11 June 2015.

CIP - Каталогизација у публикацији
Народна библиотека Србије, Београд

336.71(497.11)

INFLATION Report / National Bank of Serbia. - 2006- . - Belgrade (Kralja Petra 12) : National Bank of Serbia, 2006- (Beograd : Zavod za izradu novčanica i kovanog novca "Topčider") . - 30 cm

Tromesečno
ISSN 1820-9394 = Inflation Report (National Bank of Serbia)
COBISS.SR-ID 155775244