National Bank of Serbia

May

2017

INFLATION REPORT

2017

May

INFLATION REPORT

NATIONAL BANK OF SERBIA
Belgrade, Kralja Petra 12,
Tel: +381 11 3027-100

Belgrade, Nemanjina 17,
Tel: +381 11 333-8000

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 an 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 statutory task of the National Bank of Serbia.

The May *Inflation Report* was considered and adopted by the NBS Executive Board at its meeting of 12 May 2017.

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

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
EU – European Union
FAO – UN Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
FOMC – Federal Open Market Committee
GDP – gross domestic product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NPLs – non-performing loans
OFO – other financial organisation
OPEC – Organization 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
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

As in other countries, movements in headline inflation in the first quarter of 2017 were determined by the recovery in global oil prices and by a higher than seasonally expected increase in fruit and vegetable prices due to cold weather early in the year.

Consistent with our expectations, year-on-year inflation moved within the target tolerance band of 3.0±1.5% as of January and equalled 3.6% in March. Quarter-on-quarter, price growth of 2.4% was higher than expected and largely determined by the rise in the prices of fruit and vegetables (1.2 percentage points), which hiked more than is usual for the season due to the extremely cold weather in January and early February. Price growth was also influenced by the rising prices of petroleum products and solid fuels (0.6 percentage points), as well as the January increase in cigarette prices (0.2 percentage points). Contrary to headline inflation and following zero growth in January and a fall in February, core inflation recorded a mild rise in March owing to an increase in the cost of mobile telephony services, which confirms that inflation movements in the first quarter were largely a result of one-off factors.

In the period since the February Report, developments in the international environment were marked by improved prospects of growth in the euro area and most of Serbia's other major foreign trade partners in 2017, increasingly diverging monetary policies of the leading central banks and inflation growth on account of rising energy and food prices.

The period since the February *Report* saw improved growth prospects for the euro area and most of Serbia's other major foreign trade partners in 2017, which should also have a positive impact on Serbia. Inflation in the global economy has been rising for the past several months, chiefly on account of higher prices of primary commodities. Rising prices of energy and food drove inflation in the euro area close to the target, though it is expected to decline moderately by the end of the year. Under such circumstances, the European Central Bank has continued its accommodative monetary policy, while the Federal Reserve, after the December hike, raised its fed funds rate again in March. Although it is anticipated that the Federal Reserve would continue increasing the rate, the question is now when it will start reducing its balance sheet, i.e. stop reinvesting the proceeds of bonds purchased under the quantitative easing programme. The increasingly diverging monetary policies of leading central banks add to the uncertainty regarding global capital flows toward emerging economies, including Serbia. Uncertainty was also present in the international commodity market and was associated with movements in oil prices which ranged between 50 and 56 dollars per barrel since the beginning of the year.

Following a cut to 4.0% in July 2016, the Executive Board kept the key policy rate unchanged.

In the period since the last *Report*, the Executive Board kept the key policy rate on hold at 4.0%, in consideration of the inflation outlook, the effects of past monetary easing and the lowering of the inflation target to 3.0±1.5% as of 2017. Additionally, uncertainty in the international commodity and financial markets, mostly regarding the pace of the Federal Reserve's policy normalisation and movements in the prices of primary commodities, mandated caution in the conduct of monetary policy in the period under review. It was assessed that better macroeconomic prospects at home, supported by the implementation of fiscal consolidation and structural reforms, full coordination of monetary and fiscal policies, the narrowing of external imbalances and, to a degree, the European Central Bank's monetary expansion, would be the key factors to mitigate the risks from the international environment.

Though depreciation pressures from end-2016 extended into early 2017, they started to wane over time and the dinar edged up in April.

Since the start of the year, movements in the foreign exchange market were strongly influenced by uncertainty in the international financial market relating primarily to the Federal Reserve's decision to continue its monetary policy normalisation, which also reflected on foreign investors' conduct in the domestic market, as well as by higher foreign currency demand of domestic energy importers. Factors acting in the opposite direction included export proceeds, foreign direct investment and foreign cash purchases from natural persons and, from February onwards, a rise in bank assets indexed to the currency clause. A contribution to the relative stability of the exchange rate also came from the National Bank of Serbia's interventions mitigating excessive short-term volatility of the exchange rate on the sale side in the first quarter, and on the purchase side in April. Additionally, the country's risk premium decreased considerably since the start of the year – to its lowest in almost ten years – owing to global factors, as well as improved macroeconomic fundamentals at home, as confirmed by Moody's which raised Serbia's credit rating.

Lending activity accelerated year-on-year, with the share of non-performing loans in total loans declining further.

Past monetary easing, low euro area interest rates, narrowing of internal and external imbalances, increased interbank competition and accelerated economic activity were conducive to lending growth which sped up to 4.3% year-on-year in March (excluding the exchange rate effect). Also, the share of non-performing loans in total loans dropped to its lowest level in seven years (16.8% in March) as banks intensified their efforts to resolve the issue of non-performing loans as of the beginning of 2016.

The planned structural fiscal adjustment of around 4% of GDP and the reduction of the share of public debt in GDP were achieved in 2016, a year earlier than planned, thanks to the results of fiscal consolidation, with positive developments continuing into the first quarter of 2017.

The three-year objectives under the fiscal consolidation programme relating to the volume of structural adjustment of the fiscal deficit and the share of public debt in GDP were achieved in 2016, a year earlier than planned, with positive developments continuing in the first quarter of 2017 as well. Fuelled by higher than expected growth in fiscal revenue, the consolidated budget surplus measured 11.8 billion dinars in the first quarter (1.2% of GDP). For the sake of comparison, the quantitative criterion under the arrangement with the International Monetary Fund allows a general government deficit of 32 billion dinars in the first quarter. Excluding interest expenses, a general government surplus of 6.1% of GDP was recorded. Substantial fiscal efforts helped trim central government public debt to 24.5 billion euros at end-March compared to 24.8 billion euros at end-2016.

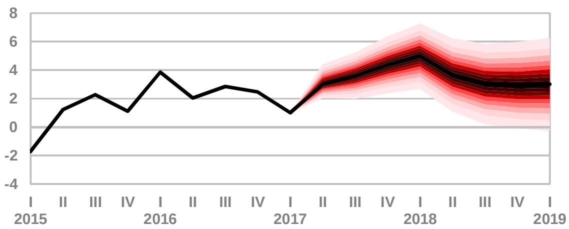
Euro-denominated commodity exports continued to post relatively high year-on-year growth (9.6%), despite the slowdown early in the year caused by adverse weather conditions.

According to estimates, the effect of the prolonged cold spell on foreign trade activity is temporary and export growth is likely to pick up later in the year. Imports, however, rose significantly (15.3%) driven by high energy imports and resulted in higher current account deficit (by 246 million euros) relative to the corresponding period last year. Yet, given the significant rise in exports in March already, we estimate that the negative effect of the cold spell on foreign trade movements will be counterbalanced in the coming period, and the current account deficit will be around 4% of GDP this year. Also, we expect current account deficit to remain fully covered by the net inflow of foreign direct investment. On the other hand, net inflow from remittances was more than 8% higher, and the financial account also registered a smaller outflow relative to the same period a year earlier which can be ascribed to reduced outflows from portfolio investment and financial loans.

Gross domestic product rose 1.0% year-on-year under the impact of the extremely cold weather at the start of the year.

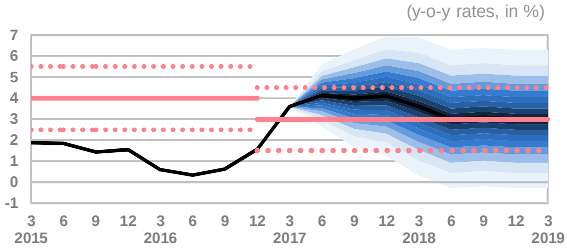
The manufacturing industry continued to provide a positive impulse to seasonally adjusted growth in gross domestic product of 0.2% (1% year-on-year) in the first quarter, aided by earlier investments, acceleration of euro area growth and continued recovery in domestic demand which also propped up growth in the majority of service sectors. Conversely, construction, agriculture and energy sectors slumped in the first quarter mostly under the impact of cold weather at the start of the year. On the expenditure side, household consumption was a positive contributor, largely owing to the higher real disposable income and increased inventories. On the other hand, faster growth in imports on account of energy and a slower rise in exports due to adverse weather resulted in a negative contribution of net exports to GDP.

Economic activity should accelerate to around 3% this year and around 3.5% in 2018.



Economic activity is expected to pick up in the coming period and to result in GDP growth of around 3% in 2017 and 3.5% in 2018. This will be supported by the economic recovery of Serbia's main foreign trade partners, diversified inflow of foreign direct investment and improved business and investment ambience. This year's growth will be largely driven by industry and services, and to a smaller degree by the construction sector, whereas the contribution of agriculture is expected to be negative due to last year's high base. On the expenditure side, GDP growth this year will be led primarily by investment and exports based on the continued intensive implementation of infrastructure projects and an improved investment ambience. A positive, gradually rising contribution is also expected from final consumption, chiefly on the back of higher private sector employment and wages. The biggest risks to the projection pertain to the pace of growth in the euro area and Serbia's other foreign trade partners, but also to developments in the international market of primary commodities (oil, base metals and cereals) and the international financial market.

According to our latest central projection, year-on-year inflation will move within the target tolerance band (3.0%±1.5 percentage points) until the end of the projection horizon.



We expect year-on-year inflation to continue to move within the target tolerance band (3.0±1.5%) until the end of the projection horizon, i.e. the first quarter of 2019. Also, as one-off price increases of certain products and services in the first quarter this year will be dropping out of the annual comparison, we expect inflation in the initial months of 2018 to be below its present level. A more inflationary impact in the period ahead will originate from the gradual increase in aggregate demand at home and inflation abroad (notably the euro area), while the high base for petroleum product prices will act as a damper. The risks to the projected inflation path are symmetric and have for quite some time now related primarily to developments in the international commodity and financial markets and, to a certain degree, to administered price growth and agrometeorological conditions.

The current inflation projection for 2017 is higher relative to the February one due to the faster than expected hike in the prices of unprocessed food from the beginning of the year, as well as to upward revision of assumptions regarding the rise in the prices of primary agricultural commodities and inflation in the euro area in 2017.

The new medium-term inflation projection for 2017 is higher than the one published in the February *Report*, while the projection for 2018 is almost unchanged. The higher projection for this year is primarily a result of a rise in the prices of fruit and vegetables and solid fuels early in the year which was faster than usual for the season and attributable to adverse weather conditions. Relative to the February projection, we assumed a higher increase in the prices of primary agricultural commodities in the global and domestic markets in 2017, which will be reflected to a degree in the costs of processed food, as well as a somewhat higher inflation in the euro area, Serbia's key trade partner.

Looking ahead, monetary policy decisions of the National Bank of Serbia will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors. Accordingly, the National Bank of Serbia will continue to closely monitor and assess movements and trends in the domestic market and in the international environment, including both the international financial market and the market of primary commodities. As before, the National Bank of Serbia will use all available instruments to make sure inflation remains low and stable over the medium term which, together with the preservation of financial stability, will contribute to sustainable economic growth.

The monetary policy stance in the period ahead will continue to depend primarily on developments in the international environment.

II. Monetary policy since the February *Report*

Since the February Inflation Report, the NBS Executive Board made decisions to keep the key policy rate on hold at 4.0%, above all taking into consideration the inflation outlook and key factors of inflation, the effects of past monetary easing and the lowering of the inflation target to 3.0%±1.5 pp as of early 2017. As assessed by the Executive Board, inflation will stay low and stable, moving within the new target band as of early 2017. It expected that inflation would be driven by the low base effect of fruit and vegetables, the low base effect of prices of petroleum products (until March), and the gradual increase in inflation abroad and aggregate demand at home, whereas low costs of raw materials in food production and, from March, the high base effect of prices of petroleum products would work in the opposite direction.

Monetary policy caution in the period observed was mandated by persistent uncertainties in the international commodity and financial markets, most notably in terms of the pace of normalisation of the Fed's monetary policy and the global prices of primary commodities. On the other hand, as originally assessed by the Executive Board, risks from the international environment would be mitigated by better macroeconomic prospects of our economy (reflecting successful fiscal consolidation and structural reforms and the narrowing of external imbalances), and to a degree the ECB's monetary accommodation.

Since the February Report, the Executive Board has kept the key policy rate unchanged (4.0%). The decisions to maintain the current degree of monetary accommodation were made in consideration of the inflation outlook and key factors of inflation, effects of past monetary easing and the lowering of the inflation target as of 2017.

The decisions on monetary policy in the period observed were based on the February inflation projection, which predicted that y-o-y inflation would move within the new target band (3.0±1.5%) from the start of this year until the end of the projection horizon. The Executive Board assessed that inflation would move within the new, lower target band in light of the improvement in Serbia's macroeconomic fundamentals, mainly the reduction in internal and external imbalances. It expected that the gradual growth in inflation would be driven by the low base effect of fruit and vegetables, the gradual increase in aggregate demand at home and inflation abroad. Last year's excellent agricultural season drove down prices of fruit and vegetables, which should bounce back following this year's anticipated average season. Inflation should also rise gradually on the back of the recovery in domestic demand, which is supported by past monetary easing. Interest rates in the domestic market have been on the decline for almost four years, stabilising at the lowest level in recent months. Considerably more favourable terms of financing contributed to growth in lending and investment, which led to an acceleration in economic growth.

Besides the recovery of domestic demand, the Executive Board assessed that external demand would recover as well. Following a slow global economic recovery in previous years, most economies seem to be showing visible signs of growth. In addition, inflation in the euro area, our most important foreign trade partner, was very low for an extended period of time, though its growth from such low levels was recorded in recent months, in line with expectations, mostly thanks to the rise in prices of petroleum products and food. Projections of relevant international institutions indicate that inflation in the euro area in 2017 will be higher than previously expected.

On the other hand, the Executive Board underscored that low costs of raw materials in food production and the high base effect (since March) of prices of petroleum products would be a drag on inflation. Anchored inflation expectations will help inflation stay within the target band – the financial and corporate sectors expect that price stability will be preserved in the short and medium term.

As regards economic activity, the projection was the same as in November – the GDP growth rate was expected to accelerate to 3.0% in 2017 and 3.5% in 2018, with the gradual closing of the negative output gap. Investment and exports will provide an incentive to economic activity, as will household consumption, backed by an increase in wages and employment in the private sector and credit activity.

In its considerations of monetary policy in the observed period, the Executive Board emphasised caution due to persistent uncertainty in international financial and commodity markets. Caution was advised primarily because of the reaction of the international financial market to the Fed's December and March policy rate hikes and uncertainties over the rate of further hikes in the period ahead. In addition to the rate of policy hikes, the question was increasingly asked as to when the Fed would start to reduce its balance sheet, i.e. end reinvesting in securities from the quantitative easing programme as they begin to fall due. Various assessments of investors regarding the pace of the Fed's monetary policy normalisation affect global capital flows, particularly to emerging economies.

On the other hand, the ECB is pursuing an accommodative monetary policy and is expected to continue to implement the quantitative easing programme by the end of 2017, thereby reducing the adverse effects of the Fed's policy normalisation. The ECB's moves are of particular importance for Serbia, given our financial links with the euro area, and the fact that the euro area is our most important trade partner. As regards the movement of oil prices in the global market, OPEC countries reached an agreement to cut production, which resulted in a recovery in oil prices, with a short-lasting fall in the second half of March. Still, as in the case of other primary commodities, the pace of oil price movement in the period ahead is still uncertain.

However, in making its monetary policy decisions, the Executive Board took into account that Serbia achieved significant structural improvements and is more resilient to potential adverse effects from the international environment owing to the reduction in internal and external imbalances. Moody's raised Serbia's credit rating from B1 to Ba3 in March, which is another confirmation of further improvement in Serbia's macroeconomic outlook and achieved results in terms of implementing structural reforms.

III. Inflation movements

Moving within the target tolerance band since early 2017, inflation came at 3.6% y-o-y in March. Inflation movements in this period were driven, like in other countries, mainly by the recovery of global oil prices in H2 2016 and a higher than seasonal rise in fruit and vegetable prices due to cold weather early this year. That inflation since the start of the year has been led by higher prices of several products is signalled by core inflation of 2.1% at end-Q1.

At quarterly level, the 2.4% price growth was driven by higher prices of fruit and vegetables, petroleum products, solid fuels, mobile telephony services and cigarettes. A seasonal drop in prices of travel packages, clothes and footwear worked in the opposite direction.

Inflation movements in Q1

Consistent with the expectations stated in the previous issues of the Report, y-o-y inflation has been moving within the target tolerance band of 3.0±1.5% since January and measured 3.6% in March. Relative to end-2016 when it stood at 1.6%, y-o-y inflation rose mainly on account of higher prices of petroleum products, fruit and vegetables, solid fuels, mobile telephony services and cigarettes. Y-o-y inflation was fuelled mainly by one-off factors, as confirmed by low core inflation (excluding prices of energy, food, alcohol and cigarettes) which equalled 2.1% y-o-y in March.

At quarterly level, consumer prices picked up by 2.4% in Q1, exceeding our expectations from February. Such an outturn was due mainly to exceptionally cold weather early this year, which reflected on higher than seasonal hikes in fruit and vegetable prices, as well as prices of solid fuels, notably firewood.[1]

Prices of **food and non-alcoholic beverages** gave the strongest boost to Q1 inflation (1.5 pp). They grew 4.8% in Q1, mainly on the back of higher prices of unprocessed food (11.7%). Within unprocessed food, fresh vegetable

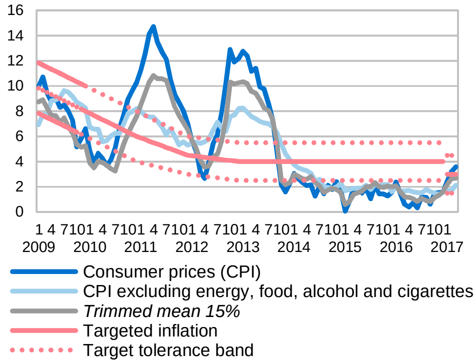
Table III.0.1 **Consumer price growth by component**
(quarterly rates, in %)

	Share in CPI	2016			2017
		II	III	IV	I
Consumer prices (CPI)	100.0	0.5	0.2	0.5	2.4
Unprocessed food	11.3	-0.6	-2.1	-3.0	11.7
Processed food	20.7	-0.3	0.4	0.0	1.3
Industrial products excluding food and energy	28.5	0.5	1.0	0.6	0.5
Energy	15.5	1.7	0.2	2.8	3.3
Services	24.0	1.1	0.2	0.8	0.8
Core inflation indicators					
CPI excluding energy	84.5	0.3	0.2	0.0	2.2
CPI excluding energy and unprocessed food	73.2	0.5	0.6	0.5	0.8
CPI excluding energy, food, alcohol and cigarettes	45.3	0.9	0.3	0.8	0.2
Administered prices	18.8	-0.4	1.4	1.1	1.1

Sources: SORS and NBS calculation.

[1] See Text box 1, p. 14.

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



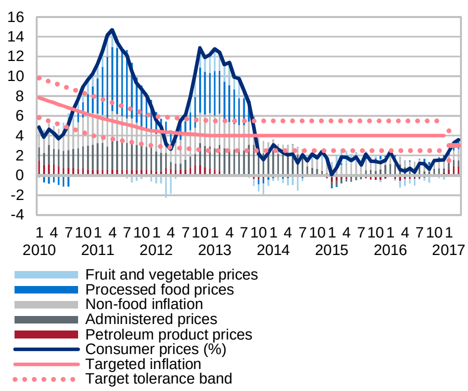
Sources: SORS and NBS calculation.

Table III.0.2 **Contribution to y-o-y consumer price growth**
(in pp)

	Dec. 2016	March 2017	Difference
Consumer prices (CPI)	1.6	3.6	2.0
Unprocessed food	0.0	0.6	0.6
Fruit and vegetables	-0.4	0.0	0.4
Processed food	0.2	0.3	0.1
Industrial products excluding food and energy	0.5	0.7	0.2
Energy	0.5	1.3	0.8
Petroleum products	0.3	0.9	0.6
Services	0.4	0.7	0.3

Sources: SORS and NBS calculation.

Chart III.0.2 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

prices increased more than usual for the season (25.3%, contribution: 0.9 pp) due to cold weather early this year. Fresh fruit prices edged up as well (15.6%, contribution: 0.3 pp). As a result, the contribution of fruit and vegetable prices to y-o-y inflation (-0.4 at end-2016) turned almost neutral in March. In contrast, fresh meat prices dropped 1.9% in Q1 (contributing -0.1 pp). Processed food prices went up 1.3% (contribution: 0.3 pp), with the main contribution coming from non-alcoholic beverages, notably coffee.

Energy prices added 3.3% in Q1 (contribution: 0.5 pp), primarily on account of higher prices of petroleum products (6.0%, contribution: 0.4 pp) and firewood (8.2%, contribution: 0.2 pp). The growth in firewood prices was fuelled by elevated demand and lower supply due to cold weather. Consistent with our expectations, the contribution of **petroleum products** to y-o-y inflation was up from 0.3 pp at end-2016 to 0.9 pp in March, mirroring a rise in global oil prices in H2 2016.

Service prices were up 0.8% (contribution: 0.2 pp), reflecting mainly a rise in prices of mobile telephony services and cable TV subscription, while the seasonal drop in prices of travel packages of 15.4% worked in the opposite direction (contribution: -0.1 pp).

At 0.5% in Q1, growth in **prices of industrial products excluding food and energy** was lower than a quarter earlier. It was driven primarily by the January 4.5% hike in cigarette prices (contribution: 0.2 pp), while the seasonal drop in prices of footwear and clothes of 3.9% was a negative contributor (-0.2 pp).

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) slowed down significantly from Q4 and arrived at 0.2% in Q1. Following the zero rate in January and a decline in February, core inflation picked up somewhat in March, largely as a result of rising prices of mobile telephony services. Higher prices of mobile telephony mildly lifted y-o-y core inflation – from 1.7% in January and February to 2.1% in March.

Administered prices rose at the same rate as in Q4 2016 (1.1%, contribution: 0.2 pp), fully on the back of the cigarette price hike in January. In y-o-y terms, administered price growth equalled 3.2% at end-Q1.

Producer and external prices

Similarly to Q4 2016, the first-quarter rise in **industrial producer prices in the domestic market** (1.5%) was led by higher prices in the production of petroleum products (reflecting an increase in prices of crude oil) and base metals, triggered by rising iron ore prices in the global market. Producer prices in the food industry increased somewhat as well, which may be associated with surging prices of primary agricultural commodities at home and abroad in Q4 2016. In contrast, in Q1 lower producer prices were recorded in the tobacco and textile industry, production of computers, electronic and optical products, and electricity, gas and steam supply. Y-o-y, industrial producer prices sped up from 2.2% in December 2016 to 3.1% in March 2017.

Agricultural producer prices continued up in Q1 (2.0%), though at a weaker pace than in Q4 (6.3%). The rise was led chiefly by higher prices in crop production, reflecting increased costs in the production of vegetables and cereals. Prices in the animal husbandry sector increased to a lesser degree. Y-o-y, agricultural producer prices were up 3.7% in March.

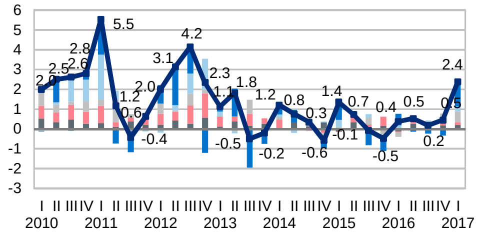
Prices of elements and materials incorporated in construction expanded by 3.4% in Q1. This, together with the low base effect, accelerated their y-o-y growth from 2.4% in December 2016 to 7.7% in March 2017.

The rise in **external prices** expressed in dinars[2] slowed in Q1 (0.8%) from a quarter earlier (2.8%). An impetus to external prices came not only from the continued rise in global oil and food prices, but also from prices of German exports (used to assess growth in external prices of equipment and intermediate goods), which were up 1.1% in Q1. On the other hand, euro area consumer prices (used to approximate external prices of services) stagnated in Q1. An impulse also came from mild nominal depreciation of the dinar against the euro. Despite slower quarterly growth, the low base from early 2016 spurred y-o-y growth in external prices to 6.5% in Q1.

Inflation expectations

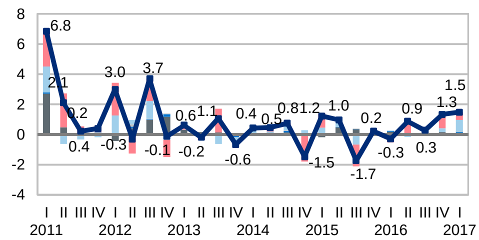
Results of inflation expectations surveys indicate that the financial and corporate sectors believe that price stability will be maintained in the short and medium term.

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



Sources: SORS and NBS calculation.

Chart III.0.4 **Contribution to quarterly producer price growth**
(in pp)



Sources: SORS and NBS calculation.

Table III.0.3 **Price growth indicators**
(y-o-y rates, in %)

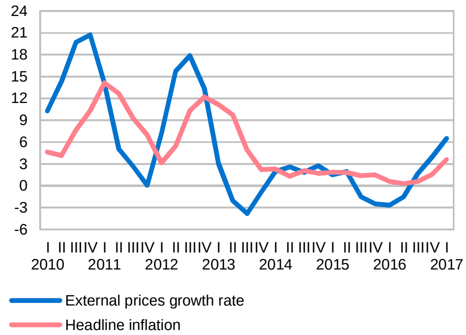
	2016			2017
	June	Sep.	Dec.	March
Consumer prices	0.3	0.6	1.6	3.6
Domestic industrial producer prices	-1.6	0.2	2.2	3.1
Agricultural producer prices	-0.4	-3.0	3.0	3.7
Prices of elements and materials incorporated in construction	-1.0	1.6	2.4	7.7

Sources: SORS and NBS calculation.

[2] The weighted average of the world oil and food price index, euro area consumer prices and export prices of Germany, one of our main trade partners, is used as an indicator of external prices.

Chart III.0.5 **Domestic inflation and external prices**

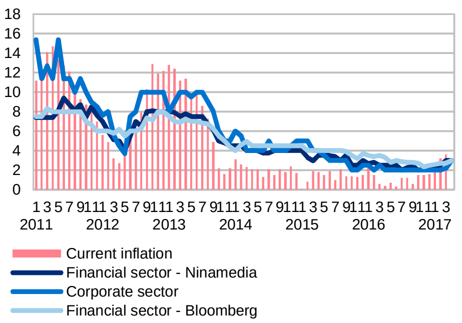
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

Chart III.0.6 **Current inflation and one-year ahead inflation expectations***

(y-o-y rates, in %)



Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

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

According to the Bloomberg and Ninamedia surveys, **one-year ahead inflation expectations of the financial sector** rose slightly from the start of the year. As expectations of the financial sector were extremely low in the previous period, they increased to the target midpoint. According to the **Bloomberg** survey, they rose to 3.0% in April (from 2.6% in January), while the March **Ninamedia**[3] survey indicated the same number (rising from 2.4% in January). They stayed at the same level in April. According to both agencies' surveys, one-year ahead inflation expectations have been within the target band (3.0±1.5%) since October 2013.

Ninamedia also conducts a survey of **expectations of the corporate sector**. After standing at 2.0% for a year, expectations of corporates rose to 2.2% in March, and 3.0% in April. Since last August, **inflation expectations of the household sector** have been somewhat higher and more volatile. Thus, in March they returned to 5.0%, where they had stood for almost a year prior to August 2016, only to rise to 7.0% in April. Lower inflation expectations of households in Q1 and their increase in April are also indicated by the qualitative survey[4]. Expected inflation is still lower than perceived inflation, which means that a part of the population, who feel that prices increased in the past twelve months, do not expect the trend to continue over the next twelve months.

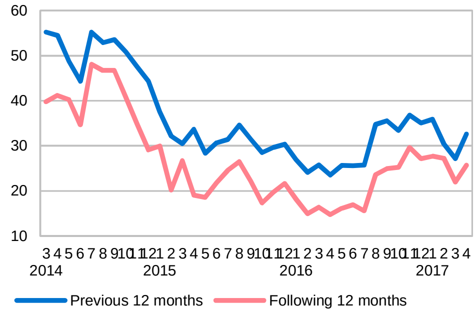
The financial sector expects that **two-year ahead inflation** will stay on target; these expectations stood at 3.5% in April. Medium-term expectations of corporates were at the target level of 3.0%. Expectations of households varied between 5.0% and 7.0% in the period observed.

[3] Ninamedia has been conducting a survey on expectations of economic agents since December 2014.

[4] For details on qualitative expectations of households, see Text box 2 of the February 2016 Inflation Report, p. 15.

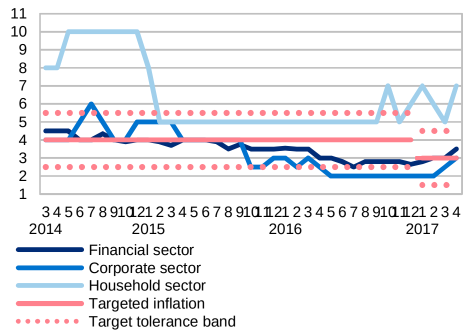
The dispersion of financial sector responses was still the lowest among all sectors, both according to Bloomberg and Ninamedia surveys. The dispersion of corporate sector responses was somewhat higher, though it remained relatively stable. Dispersion was higher, though also stable, among households.

Chart III.0.7 **Household perceived and expected inflation**
(in index points)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).
* The survey was not conducted in November 2014.

Chart III.0.8 **Two-year ahead inflation expectations***
(y-o-y rates, in %)

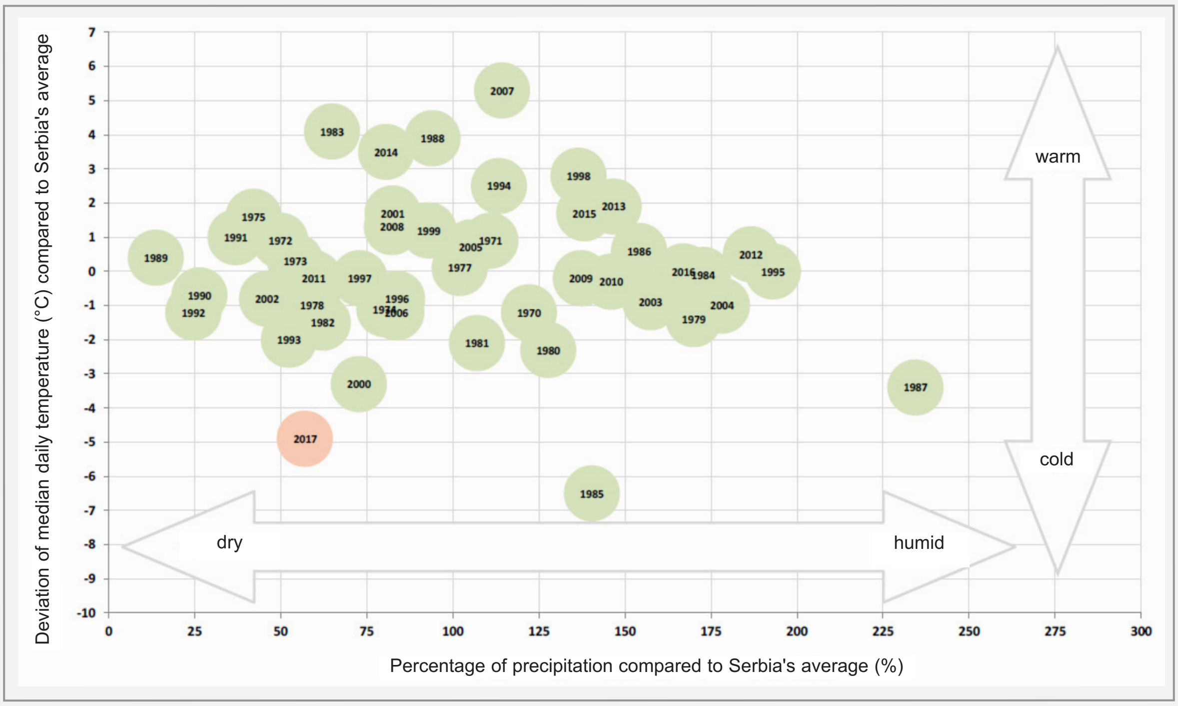


Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).
* The survey was not conducted in November 2014.

Text box 1: Impact of cold weather in early 2017 on inflation movements

In early January 2017, Serbia was hit by a cold wave unusual for the time of the year in terms of duration and the average temperature (Chart O.1.1). According to the Republic Hydrometeorological Service of Serbia, in January a large part of the country saw 31 days of frost, i.e. days with the minimum daily temperature below 0°C, and, depending on the part of the territory, 7-21 days of severe frost (with the minimum daily temperature below –10°C). Temperatures were lowest from 6 to 12 January, while periods from 19 to 24 January and 27 to 31 January were marked by less intense cold waves. In addition to low temperatures, snow covered a large part of the Serbian territory through most of January, which further hindered the normal functioning of economic activities.

Chart O.1.1 **Monthly agrometeorological bulletin for January 2017**



Source: Republic Hydrometeorological Service of Serbia.

Cold weather at the start of the year was among the key factors that impacted inflation in Serbia, which equalled 2.2% in January and February together. In this period inflation was mostly (around three-quarters) driven by the rising prices of three product groups – vegetables, petroleum products and solid fuels. Setting aside petroleum products, whose prices rose mostly as a consequence of a leap in global prices of crude oil in late 2016, inflation growth in the first two months of 2017 was primarily due to a larger increase in prices of vegetables and solid fuels than usual for the season, caused by the cold weather.

As a consequence of contracted supply (both domestic and from imports) and higher costs of production and transport, vegetable prices rose by a total of 25.7% in January and February, contributing 1.1 pp to growth in headline inflation in that period (Table O.1.1).

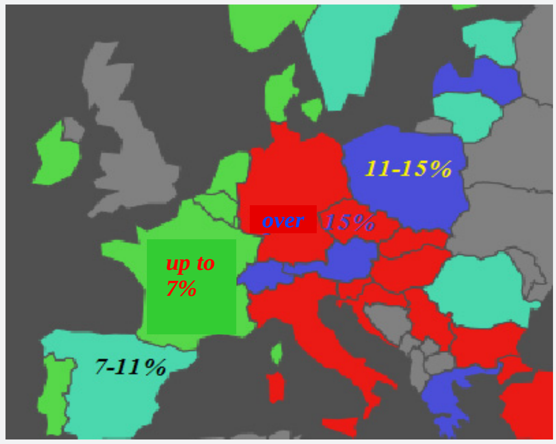
Table O.1.1 **Cumulative consumer price growth in January and February 2017**

	Cumulative growth	Share in CPI structure (%)	Contribution to headline inflation (in pp)
Headline inflation	2.2	100.0	2.2
Unprocessed food	11.9	11.6	1.3
Vegetables	25.7	4.2	1.1
Processed food	1.0	20.5	0.2
Industrial products excluding food and energy	0.5	28.7	0.1
Energy	3.4	15.5	0.5
Liquid fuels and lubricants	5.7	5.8	0.3
Firewood	9.4	2.0	0.2
Services	0.0	23.7	0.0

Sources: SORS and NBS calculation.

At the start of the year vegetable prices rose not only in Serbia, but also in most European countries, particularly in Central Europe and a part of Southern Europe that were, like Serbia, impacted by cold weather in that period (Chart O.1.2). Higher growth in vegetable prices in Serbia was caused by their relatively lower levels in H2 2016 that resulted from favourable agrometeorological conditions and an excellent agricultural season (Chart O.1.3). The rise in vegetable prices in Serbia had a considerable impact on headline inflation, owing also to a relatively high share of these prices in the structure of CPI.

Chart O.1.2 **Cumulative growth rates of vegetable prices in January and February 2017**

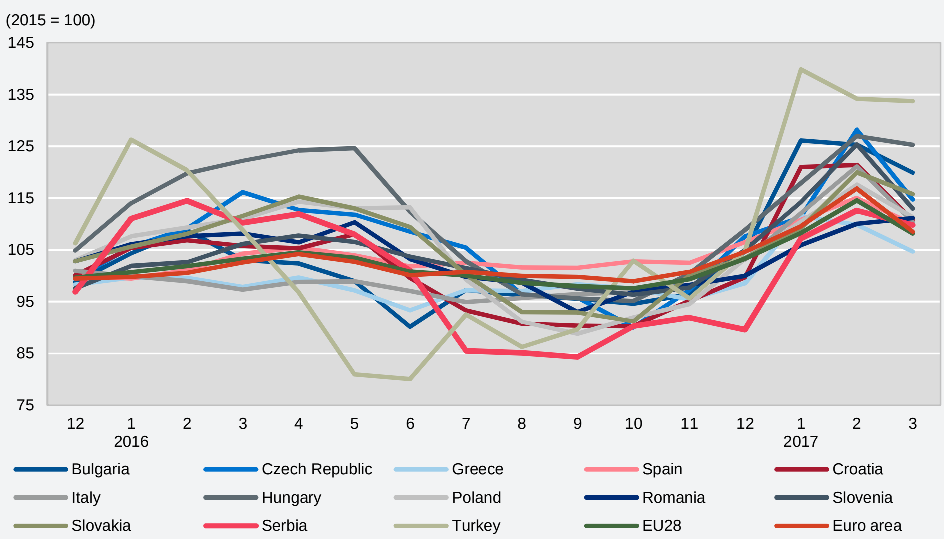


Source: *Eurostat.*

Cold weather also drove up prices of energy, mainly those of solid fuels (firewood, briquettes). Higher demand and the inability of supply to adjust at a short notice pushed up prices of firewood by 9.4% in January and February, contributing 0.2 pp to headline inflation. As in the case of vegetables, a higher share of this fuel in the structure of CPI contributed more to headline inflation than in the countries in the region.

As a consequence of the above developments in January and February, y-o-y inflation equalled 3.2% in February 2017 (vs. 1.6% in December 2016). The temporary nature of these price rises is indicated by the March movement in the prices of products that had a dominant impact on movements in headline inflation in the first two months. For example, in March vegetable prices fell by 2.5% (Chart O.1.3), prices of solid fuels by 1.2%, while prices of petroleum products practically stagnated (growth by 0.2%). In addition, core inflation was lower than headline inflation in Q1 (2.1% y-o-y in March). Further, the increase in fruit and vegetable prices will have a negative base effect on movements in y-o-y inflation early next year, as at that time these temporary price increases will drop out of the annual comparison.

Chart O.1.3 **Movements in vegetable prices in European countries**



Source: Eurostat.

The middle of April saw another cold wave that brought frost and snow to some parts of Serbia. However, we estimate that adverse weather conditions in April impacted inflation less than in January and will most probably reflect on yields of a smaller number of agricultural products (mainly raspberries and strawberries).

IV. Inflation determinants

1. Financial market trends

In Q1, interest rates in the interbank money market and the market of government securities displayed minor volatility, while private sector's costs of borrowing in dinars inched up slightly.

Though depreciation pressures from end-2016 continued into early 2017, they weakened with time and the dinar strengthened in April. Trends in the FX market in this period were largely influenced by uncertainties in the international financial market fuelled mainly by the Fed's decision to continue monetary policy normalization, which also affected the behaviour of foreign investors in the domestic market. Another determinant of FX market trends was heightened demand for foreign exchange among domestic energy importers. Exports-generated foreign exchange inflows, FDI and foreign cash purchases from natural persons worked in the opposite direction, as did the increase in bank FX- indexed assets from February onwards.

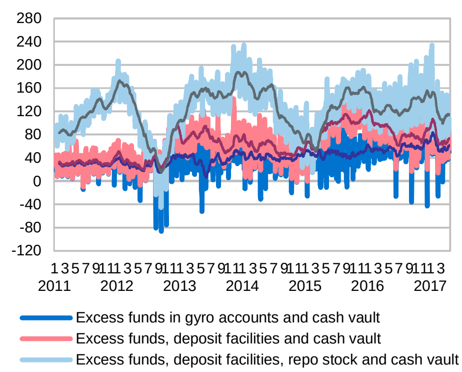
The results achieved in reducing internal imbalances and implementing structural reforms, as well as the resulting improvement in Serbia's macroeconomic outlook, were confirmed by a fresh upgrade of the country's credit rating and a further decline in the country risk premium.

Interest rates

Rates in the interbank money market remained stable in Q1, displaying minimum volatility and mirroring the average repo rate[5] which edged up slightly in Q1 (by 0.1 pp) and reached 3.0% at end-March.

In March 2017, BEONIA averaged 2.8%, unchanged from December. Average monthly BELIBOR rates also stayed broadly flat for shorter maturities, while rising by

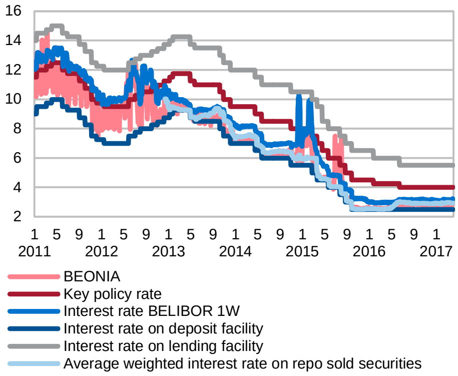
Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bln)



Source: NBS.

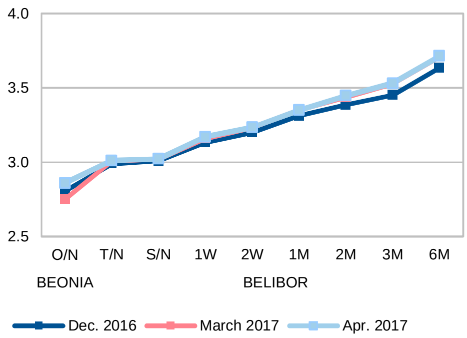
[5] The rate achieved at repo auctions weighted by the amount of sold securities.

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



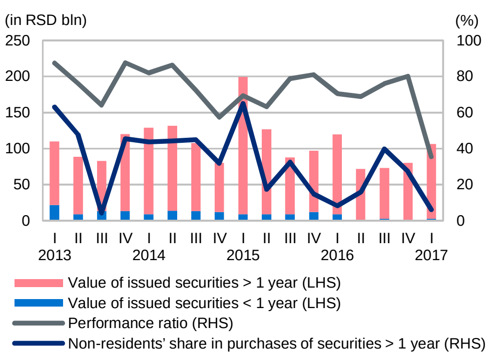
Sources: Thomson Reuters and NBS.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

0.1 pp for longer maturities. In March they moved between 3.0% for the shortest and 3.7% for six-month maturity. Activity in the interbank overnight money market was somewhat subdued – trading volumes in March averaged RSD 2.9 bln, down by RSD 0.2 bln from December.

In April, trading volumes in the interbank money market expanded somewhat, with BEONIA rising slightly and other rates remaining unchanged.

In the primary market of dinar government securities, rates on six-month (2.6%), one-year (3.5%) and seven-year (5.6%) securities remained almost unchanged in Q1 relative to Q4, while the rate on two-year securities (4.7%) increased by 0.4 pp from June 2016, the last time this maturity was auctioned in 2016. Owing to lower borrowing needs,[6] the government did not accept bids that would cause a significant increase in rates, which led to lower auction performance, with slightly over one third of offered securities (35.5%) being sold in Q1. Same as in the previous period, non-residents preferred to invest in the longest maturities, but that accounted for only a small share of primary trading. This could be associated with the Fed's rate hike in December 2016 and the expectation of faster normalisation of its monetary policy in 2017.

At auctions of three-year dinar securities in April, the government borrowed at somewhat higher rates (by 0.3 pp) compared to those recorded at the last auction of this maturity at end-2016.

The rates at auctions of euro-denominated government securities oscillated negligibly in both directions. Rates on one-year (0.7%) and two-year (1.1%) securities remained broadly flat, while the rate on three-year securities (1.9%) edged up by 0.2 pp from Q4 2016. On the other hand, the rates on five-year (2.7%) and ten-year (4.0%) securities lost 0.2 pp each since they were last auctioned, in September and May 2016, respectively.

Total trading volume in the secondary market of government securities reached RSD 144.1 bln in Q1, which is by almost a quarter more than in Q4 2016. Higher trading volumes in January and February were generated by non-residents, which were more active on the sale side, primarily due to expectations of faster normalisation of the Fed's monetary policy. This is also

[6] In Q1 2017, the general government recorded a surplus of RSD 11.8 bln. For the sake of comparison, the quantitative performance criterion under the arrangement concluded with the IMF allows the deficit of RSD 32.0 bln in Q1 2017.

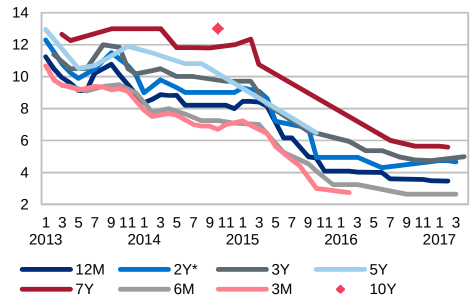
confirmed by the movement in yield rates, which were on the rise in January and February. They dropped mildly in March, ranging from 3.4% for the remaining two-month to 5.5% for the remaining 76-month maturity.

The average weighted interest rate on dinar loans to households dropped by 0.1 pp in Q1, measuring 10.7% in March. The fall was influenced by the lowering of rates on cash loans (including refinancing loans) to 10.9%, and on other loans to 9.8%, down by 0.3 pp each compared to their end-2016 levels, while housing loans (including refurbishment loans) were approved at a rate of 7.3% in March, an increase of 0.3 pp compared to end-2016. The average price of dinar corporate loans in March was 5.9%, or 0.5 pp more than at end-2016. Up by the same amount, the rate on current assets loans reached 5.4%, while the rates on investment and other loans rose by 0.7 pp each, to 6.4% and 6.7%, respectively. A higher cost of corporate loans, along with the increased share of new household loans that are costlier than corporate ones, led to a rise in the weighted average rate on new dinar corporate and household loans which equalled 9.4% in March.

The weighted average rate on new euro and dinar euro-indexed corporate and household loans inched up by 0.1 pp in Q1, to 3.3% in March. The average rate on corporate loans slid by 0.1 pp to 3.0% in March. Rates on current assets loans, as the most popular loan category, fell by the same amount to 2.9% in March. The rates on export and other loans also went down, to 2.0% and 2.9%, respectively. The price of investment loans (3.4%) remained unchanged, and only import loan rates went up (to 2.9%). The average rate on household loans increased slightly (by 0.1 pp to 4.5% in March) on account of a rise in the share of the costliest category of other loans, which were approved at 6.3% in March. As in case of dinar loans, the price of cash loans dropped to 3.2%, while that of consumer loans rose to 5.7%. Euro-indexed housing loans were approved at the same rate as at the end of 2016 (3.1%).

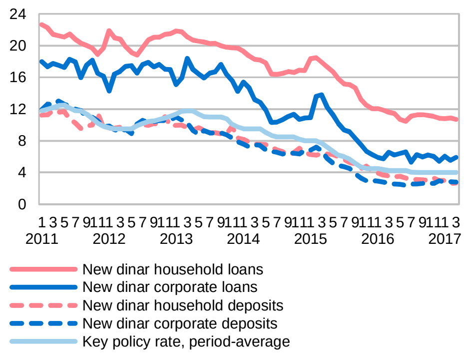
In Q1, banks slightly lowered their deposit interest rates. Rates on corporate deposits inched down 0.1 pp each, arriving at 2.8% for dinars and 0.4% for euros in March. Rates on household FX savings dropped by the same amount, arriving at 0.5%, while rates on dinars savings fell by 0.3 pp and equalled 2.7%.

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



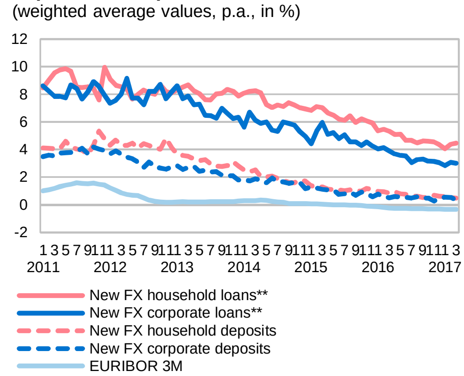
Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.6 **Interest rates on dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



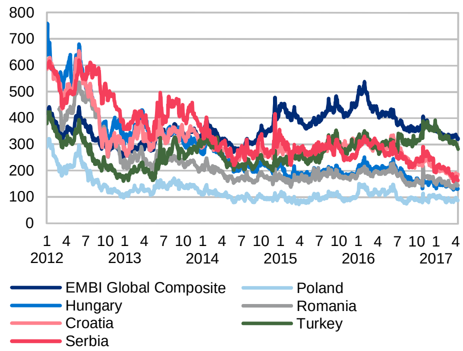
Source: NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.

Chart IV.1.7 **Interest rates on FX loans and deposits of corporates and households***
(weighted average values, p.a., in %)



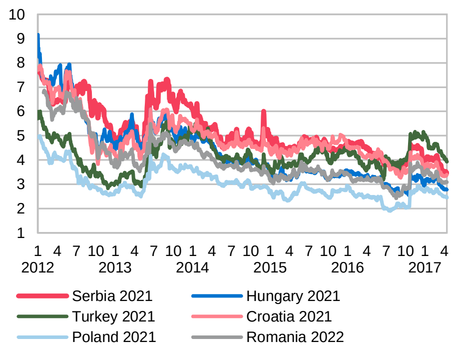
Sources: European Banking Federation and NBS.
* Excluding revolving loans, current account overdrafts and credit card debt.
** Euro and euro-indexed.

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



Source: JP Morgan.

Chart IV.1.9 **Yields on eurobonds of countries in the region**
(in %)



Source: Bloomberg.

Risk premium

Measured by EMBI, Serbia's risk premium decreased by 63 bp in Q1, and by a further 21 bp in April, dropping to 165 bp. In early April, it fell to 160 bp, its lowest level since July 2007. Risk premia decreased across the region, but Serbia recorded the sharpest fall. EMBI Global lost 34 bp in Q1, and 10 bp in April, arriving at 321 bp.

Serbia's risk premium, i.e. the difference in yields on Serbia's dollar eurobonds and US treasury securities, was under the impact of both global and domestic factors. Speaking of global factors, the risk perception in the international financial market improved since the beginning of the year, owing to a more favourable global economic growth outlook. Therefore, apart from expecting further increases in the Fed's key rate, markets have increasingly begun to wonder when the US monetary authority will start reducing its assets. This pushed up the yields on long-term US treasuries, which reached 2.63% in mid-March (from 2.44% at end-2016). However, though the Fed raised its fed funds rate in March, its rate projection remained practically unchanged from December, which led markets to assume that monetary policy would be more accommodative than expected prior to the meeting. This pushed down the yields on 10-year US treasuries to 2.39% by the end of the quarter. The fall extended until the last week of April, and was reversed as the new administration announced it would decrease the corporate income tax rate (from 35% to 15%) and as the stock exchange indices turned upward again.

The majority of emerging economies adjusted fairly well to the Fed's rate hikes so far. This is also indicated by eurobond yields of Serbia and countries in the region, which were on a decline in the observed period. Most of these countries, Serbia included, now have better macroeconomic fundamentals, i.e. more favourable fiscal and current account balances. In addition, the expected acceleration of economic growth on a global scale should facilitate these countries' adjustment to the scale down of liquidity in the international financial market.

Apart from the global factors, the fall in Serbia's risk premium was also aided by domestic factors, primarily the more favourable macroeconomic outlook resulting from successful implementation of fiscal consolidation and structural reforms. Further improvement of Serbia's macroeconomic outlook and the results of structural reforms were also confirmed by Moody's, which upgraded Serbia's credit rating in March from B1 to Ba3.

Foreign capital inflow

The cold wave that hit Serbia early this year led to slower growth in commodity exports and a considerable rise in energy imports, which led to an increase in the current account deficit by EUR 246 mln in Q1 compared to the same period last year. At the same time, the financial account recorded a net capital outflow, as the outflow in respect of portfolio investment and a reduction in resident foreign credit liabilities exceeded FDI inflow. This outflow was significantly lower compared to the same period last year.

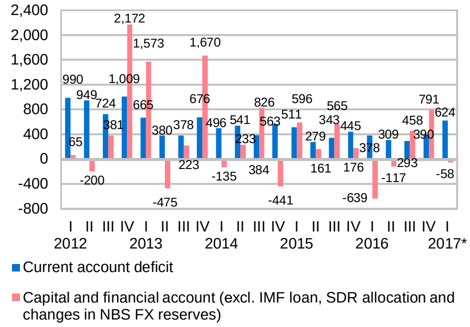
According to preliminary data, Q1 saw a net **FDI** inflow worth EUR 370.1 mln. Around two-thirds of investments[7] came from EU countries, followed by investment from Switzerland (7.8%), China (6.5%), Russia and UAE (4.7% each). The largest amounts were channelled to manufacturing, construction and telecommunications.

We expect that the achieved macroeconomic stability, continued structural reforms and the improvement in the investment climate will result in a net FDI inflow of around EUR 1.6 bln in 2017. That amount should fully cover the current account deficit, which is expected to be the same as last year (EUR 1.4 bln).

A net capital outflow in respect of **portfolio investment** was recorded in Q1 (EUR 219.4 mln). This outflow resulted from the sale of government securities in the secondary market by foreign investors who, since the start of normalisation of the Fed's monetary policy, have been reducing their exposure to emerging markets. At the same time, their purchases in the primary market were not high, in part due to the improved fiscal position and reduced government's need to borrow.

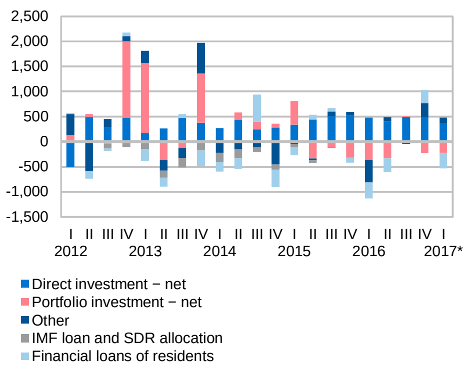
In Q1 residents net repaid EUR 319.6 mln in respect of **financial loans**. Of this, banks repaid EUR 271.1 mln net, the majority of which (EUR 207.9 mln) related to the repayment of short-term loans taken out in late 2016. The government also reduced its foreign liabilities (by EUR 41.5 mln), as did the NBS (by EUR 4.4 mln) and, to some extent, enterprises (EUR 2.6 mln net).

Chart IV.1.10 **Current account deficit and net capital inflow**
(in EUR mln)



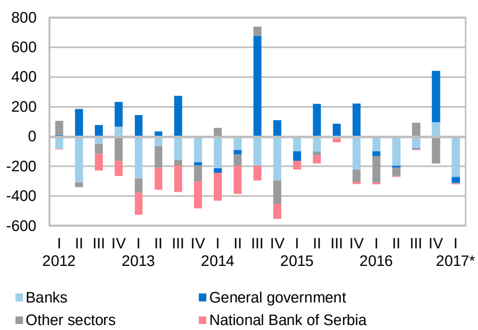
Sources: SORS and NBS.
* Preliminary data.

Chart IV.1.11 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

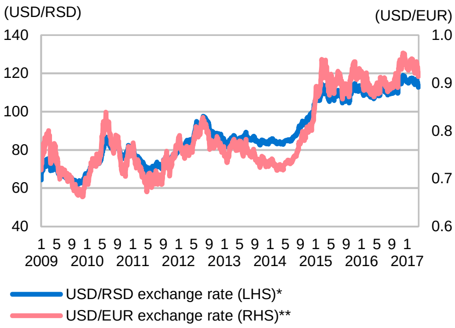
Chart IV.1.12 **Financial loans of residents – change in net borrowing**
(in EUR mln)



Source: NBS.
* Preliminary data.

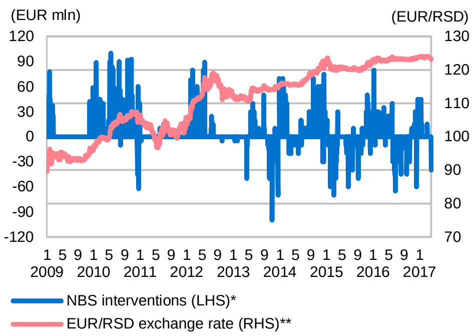
[7] Excluding reinvested earnings.

Chart IV.1.13 **Movements in RSD/USD and EUR/USD exchange rates**



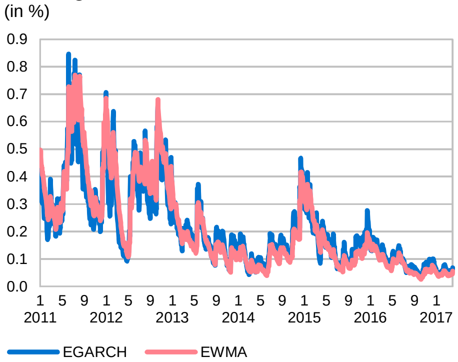
Source: NBS.
* 1 USD in RSD.
** 1 USD in EUR.

Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

Chart IV.1.15 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

Trends in the FX market and exchange rate

Depreciation pressures from late 2016 continued into January, only to weaken in February and March. End-of-period, in Q1, the dinar weakened against the euro by 0.4% and strengthened against the dollar by 0.9% owing to the euro's strengthening vis-à-vis the dollar.

Depreciation pressures on the dinar early this year were caused by the uncertainty in the international financial market and seasonal factors from the domestic environment. Expecting that the Fed's policy normalisation would be faster than in 2016, foreign investors continued to reduce their portfolios of government securities after the Fed's decision in December to raise its policy rate, which drove up depreciation pressures in Q1. This period was also characterised by higher FX demand of domestic enterprises, mainly energy importers.

Pressures on the FX market were alleviated by inflows from exports, despite the cold weather that slowed their growth. Pressures were also mitigated by the purchase of foreign cash from natural persons in exchange transactions and the rise in FX-indexed assets of banks in February and March.[8] FDI inflow continued, reflecting the favourable perception of foreign investors regarding long-term investment in Serbia.

Moody's raised Serbia's credit rating from B1 to Ba3 in March, which is another confirmation of further improvement in Serbia's macroeconomic outlook and the results achieved in terms of reducing internal imbalances and implementing structural reforms, which contributed to more stable trends in the FX market.

To ease excessive short-term volatility of the exchange rate, in Q1 the NBS intervened in the IFEM by selling foreign exchange. It sold a total of EUR 345.0 mln, most of it in January (EUR 225.0 mln), whereas in March it intervened once, selling EUR 15.0 mln.

In April, the dinar strengthened by 0.6% and the NBS intervened once, late in the month, by purchasing EUR 40.0 mln.

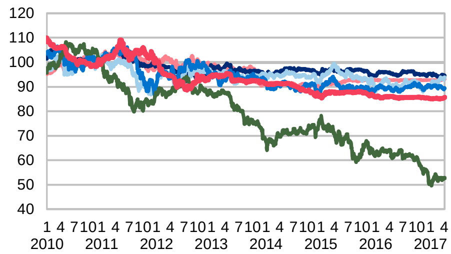
[8] In an effort to match their FX positions, banks increase their FX supply in the market.

After an increase in December 2016, trading volumes in the IFEM fell in Q1 to a daily average of EUR 18.1 mln, down by EUR 2.6 mln from Q4 2016.[9] Trading volumes were similar in all months, the highest being in March (EUR 18.6 mln daily average). Measured by EWMA[10] and EGARCH,[11] the volatility of the dinar against the euro stayed very low.

The volume of swap transactions increased in Q1. The NBS bought and sold EUR 48.5 mln at regular three-month auctions (up by EUR 12.5 mln from Q4 2016) and EUR 105.0 mln at two-week auctions (up by EUR 87.0 mln from Q4 2016). There was also a notable increase in the volume of interbank swaps. In Q1, it amounted to EUR 112.8 mln, exceeding the amount of these transactions in 2016 as a whole (EUR 111.0 mln).

Currencies of countries in the region running similar exchange rate regimes recorded different movements in Q1. The Turkish lira depreciated by a further 5.5% and the Romanian leu by 0.2%. The Czech koruna stayed unchanged vs. the euro with interventions of the Czech central bank on the purchase side. In April it announced that it would no longer use the exchange rate as an additional instrument of monetary policy easing. On the other hand, the Polish zloty and the Hungarian forint strengthened (by 4.8% and 0.8%, respectively).

Chart IV.1.16 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



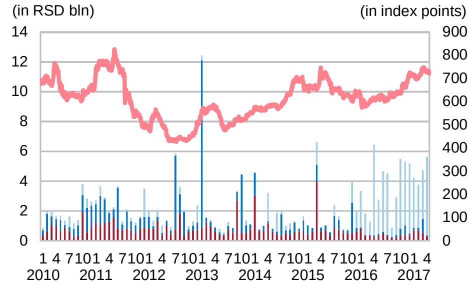
Sources: NBS and websites of central banks.
* Growth indicates appreciation.

Stock exchange trends

The growth of BSE indices begun last year continued into Q1 this year, with a mild delay in January. At end-March BELEX15, the index of the most liquid shares, stood at 732.5 index points, up by 2.1% relative to December 2016. At the same time, BELEXline picked up by 2.2% to 1,603.7 index points.

Though its values were still low, trading in shares increased in Q1 – by 37.8% from the previous quarter and 94.0% from the same period last year. Total trading in shares amounted to RSD 3.2 bln, more than a third of which related to MTP shares.[12] Transactions with foreign investors made up around 30% of trading, with foreign investors selling RSD 718.0 mln net.

Chart IV.1.17 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

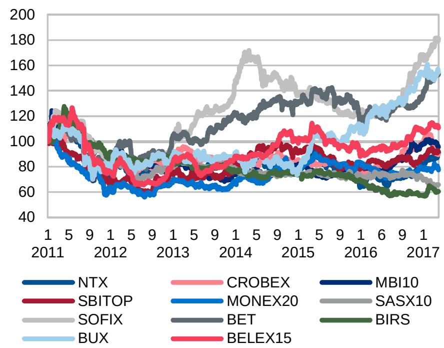
[9]

[10] EWMA – Exponentially Weighted Moving Average.

[11] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

[12] 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.

Chart IV.1.18 **Stock exchange indices across the region**
(in index points, normalised, 31 December 2010 = 100)



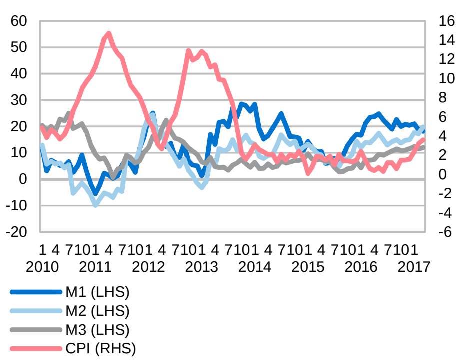
Sources: BSE and websites of regional stock exchanges.

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

	2016 June	2016 Sep.	2016 Dec.	2017 March	Share in M3 March 2017 (%)
M3	8.7	10.8	9.8	8.2	100.0
FX deposits	5.8	9.0	7.9	4.5	64.6
M2	14.8	14.3	13.3	15.6	35.4
Time and savings dinar deposits	-3.5	-4.9	-0.4	20.3	8.9
M1	22.1	21.9	18.6	14.1	26.5
Demand deposit	24.8	24.7	21.1	16.5	19.8
Currency in circulation	15.1	14.6	12.1	7.5	6.7

Source: NBS.

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



Sources: SORS and NBS.

In Q1 as well, the major portion of stock exchange trading (around 75%) concerned trading in bonds. Total trading came at RSD 9.5 bln, fully on account of trading in RS bonds.[13] Foreign investors participated in total trading in bonds with RSD 635.7 mln.

BSE market capitalisation was RSD 567.2 bln at end-March, down by RSD 18.8 bln from December 2016 due to reduced open market and MTP capitalisation. This was, among other things, caused by the withdrawal of some issuers from the market. The share of market capitalisation in estimated GDP declined by 0.7 pp and came at 13.4% at end-Q1.

The majority of indices in the region also increased in Q1. The strongest rise was posted by Bucharest (13.9%) and Banjaluka (8.8%) indices, whilst the Sarajevo index recorded the greatest fall (11.5%).

2. Money and loans

In Q1 monetary aggregates went down, mainly because of smaller dinar deposits of enterprises (primarily demand deposits), which is usual for the start of the year. At the same time, household savings (both dinar and FX) reached new heights. Total loans have risen since the start of the year, with y-o-y growth of 4.3% in March.

Monetary aggregates

Dinar reserve money lost 11.6% in nominal and 13.6% in real terms in Q1. Also, FX deposits of banks with the NBS went down, which contributed to a decrease in total reserve money of 10.2% in nominal and 12.3% in real terms in Q1. Y-o-y, in March, dinar reserve money was lower by 2.7% and total reserve money by 0.7% in real terms.

The largest contribution to the decrease in dinar reserve money came from the NBS FX sale in the IFEM (RSD 35.3 bln). Higher bank investment in repo securities worked in the same direction (by RSD 25.5 bln). The government also played a role in liquidity absorption, with RSD 5.4 bln. On the other hand, bank dinar liquidity grew mostly on the back of FX payment transactions with Kosovo and Metohija (RSD 12.7 bln).

Broader monetary aggregates also contracted in Q1. As dinar demand deposits and deposits of longer maturities

[13] In November 2015, trading in long-term government bonds on the BSE was enabled.

went down due to a seasonal decline in corporate accounts, M1 and M2 lost 7.0% and 6.6% in real terms, respectively. As a result, despite the rise in FX deposits, M3 decreased by 3.0% in real terms as well.

In Q1, dinar demand deposits fell notably, by RSD 16.2 bln. This resulted primarily from the decrease in accounts of enterprises in manufacturing, trade and construction, and to a lesser extent from the decrease in current accounts of households. Conversely, improved collection of fiscal revenue contributed to an increase in accounts of local authorities, while accounts of other sectors recorded some growth as well.

Dinar savings and term deposits of corporates declined less than demand deposits (by RSD 8.5 bln). As in the case of shorter maturities, deposits of enterprises in trade and manufacturing fell the most, and deposits of public enterprises in the energy sector were also on the decline due to payments for higher energy imports. Accounts of OFO also contracted somewhat, while deposits of other sectors expanded mildly.

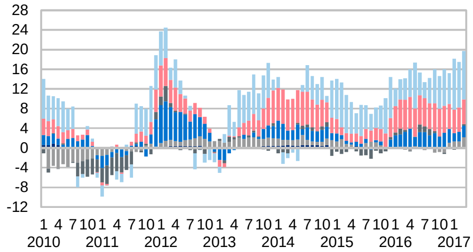
Dinar household savings continued up in 2017. In Q1 they rose by RSD 0.9 bln to RSD 51.3 bln in March, making up 4.5% of total household savings. Their growth was encouraged by an extended period of low and stable inflation, relative stability of the exchange rate, more favourable interest rates and tax treatment compared to FX savings. In March FX savings of households reached a new peak of EUR 8.8 bln, having risen by EUR 95.4 mln from the start of the year. Owing to this and to expanded corporate accounts, total FX deposits increased by EUR 126.7 mln in Q1.

Y-o-y, growth in M2 accelerated to 15.6% in Q1, while growth in M1 and M3 slowed down to 14.1% and 8.2%, respectively. Growth in monetary aggregate M3 was driven by high growth in dinar and FX deposits of corporates and households, resulting from growth recorded thus far and at the same time signalling future economic growth.

Loans

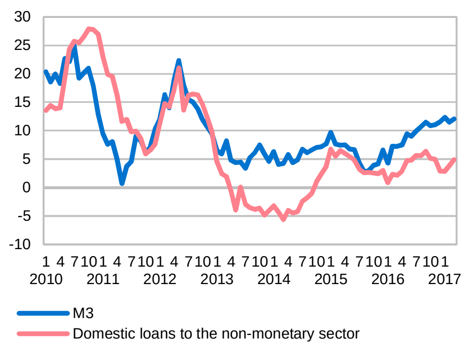
Y-o-y growth in domestic loans sped up in early 2017 and equalled 4.3% in March, excluding the exchange rate effect.[14] Specifically, growth in household loans accelerated further to 11.5% y-o-y, while the decline in

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



Source: NBS.

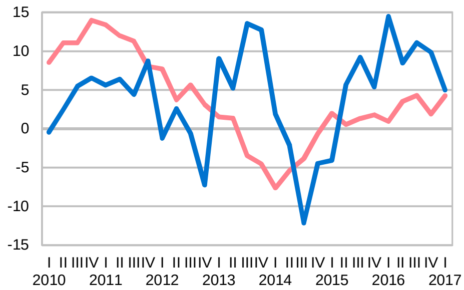
Chart IV.2.3 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.

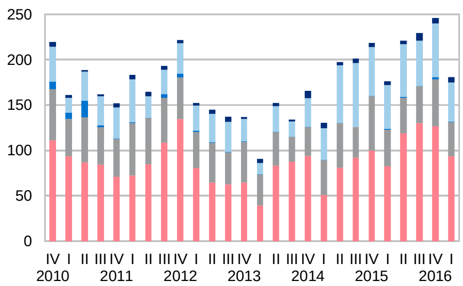
[14] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

Chart IV.2.4 **Lending activity and GDP**
(y-o-y rates, in %)



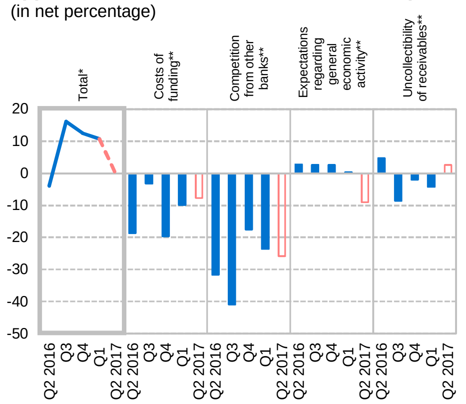
Sources: NBS and SORS.
* Excluding the exchange rate effect.

Chart IV.2.5 **Structure of new corporate loans**
(in RSD bln)



Source: NBS.

Chart IV.2.6 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)



Source: NBS.
* Positive values indicate tightening and negative easing of credit standards 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.

corporate loans slowed down to 0.6% y-o-y. Excluding the effect of NPL write-offs,[15] which banks stepped up in 2016, in March the y-o-y rise in corporate loans equalled 3.4%, and in total loans – 6.6%.

Domestic loans increased by 0.6% in Q1, excluding the exchange rate effect, while their share in estimated GDP equalled 47.4% in March, unchanged from end-2016. By sector, household loans continued up in Q1, while corporate loans drifted down because of seasonally lower activity at the start of the year and ongoing efforts of banks to resolve the issue of NPLs.

In view of the expected pickup in economic activity, past monetary policy easing through which the NBS helped slash interest rates on dinar loans, low interest rates in the international money market which reflected on a drop in interest rates on FX and FX-indexed loans, and increased interbank competition, we expect credit activity to continue to expand in 2017. Growth in 2016 was diminished due to intense efforts made by banks to resolve NPLs. However, this can have positive effects in the coming period, since the unburdening of banks' balance sheets from distressed assets creates space for new lending.

Following the seasonal decline in January, **corporate loans** increased in February and March, thus in Q1 corporate loans declined by 0.9% or RSD 10.3 bln from 2016, excluding the exchange rate effect. In Q1, RSD 3.6 bln of NPLs was written-off and RSD 5.1 bln was sold to non-banking entities, which resulted in a decrease in bank receivables from corporates. By purpose, most bank receivables from corporates included current assets loans (46.8%). In addition, thanks to a recovery in investment lending, this loan category has for an extended period accounted for around a third (33.0%) of corporate loan receivables, while loans with original maturity longer than two years made up around 63% of these receivables. By sector, from the start of the year, receivables from companies in construction, trade and energy sectors increased, while receivables from other sectors were on the decline.

On the other hand, total new lending to the corporate sector in Q1 (RSD 180.7 bln) went up by 2.6% from the same period last year. Companies still mostly use current assets loans, which made up slightly more than a half of

[15] From the start of 2016 to March 2017, banks wrote off RSD 45 bln worth of corporate NPLs.

new corporate loans (around 52%). Investment loans kept their relatively high share in new loans (around 24%).

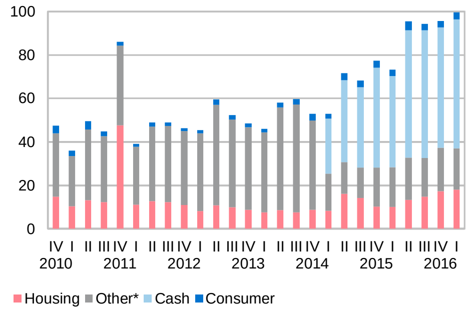
According to the results of the April bank lending survey,[16] banks mildly tightened credit standards for corporates in Q1, primarily with regard to required collateral, while no change is expected in Q2. As before, lower costs of funding and interbank competition worked towards the easing of standards, and so did the reduction in NPLs for the third consecutive quarter. Banks continued to lower their margins and associated costs and extend loan maturity, and in Q1 they relaxed the requirements regarding the maximum loan amount. On the other hand, in line with the extension of loan maturity and the increase in the maximum loan amount, requirements regarding collateral were tightened. Corporate loan demand continued up into Q1, driven equally by the need to finance current assets and investment, and to a lesser degree, by debt restructuring. The same factors should act as the main drivers of growth in loan demand in Q2.

Household lending continued rising, going up by 2.9% or RSD 23.1 bln in Q1, excluding the exchange rate effect. Most of this increase happened in March. Growth is still predominantly supported by cash loans (including refinancing loans), and increasingly more by elevated housing lending.

The volume of new household loans in Q1 (RSD 99.6 bln) was higher by 36.0% than in the same period last year. Cash loans made up almost 60% of new household loans and were almost entirely dinar-denominated (over 99%), with around 73% of them having a repayment period of over five years. Propped up by more favourable trends in the real estate market that prevailed since the start of 2016, housing loans continued up – on which account their share in newly approved loans came at 18%. Although the majority of this increase related to newly approved loans, there is notable higher refinancing of existing housing loans, which can be linked to the use of the option to borrow at more favourable terms, given the considerable decline in interest rates in the previous period. Credit card borrowing and current account overdrafts more or less kept the levels recorded in Q4 2016.

According to the results of the April bank lending survey, the easing of credit standards for households continued in

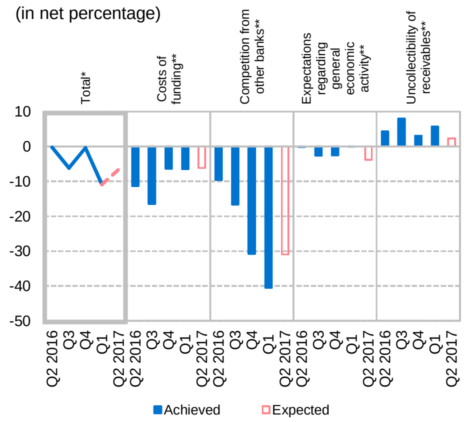
Chart IV.2.7 **Structure of new household loans**
(in RSD bln)



Source: NBS.

* Until December 2014, the 'Other loans' category included both cash and other loans.

Chart IV.2.8 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)



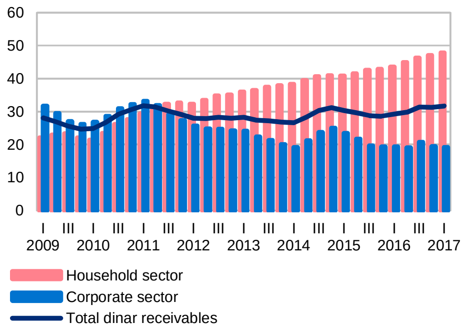
Source: NBS.

* Positive values indicate tightening and negative easing of credit standards 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.

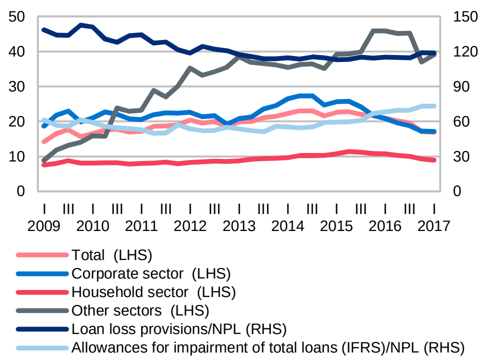
[16] The NBS has conducted the survey since early 2014. Participation is voluntary and the response rate almost 100%.

Chart IV.2.9 **Share of dinar in total bank receivables from corporate and household sectors**
(in %)



Source: NBS.

Chart IV.2.10 **NPL share in total loans, gross principle**
(in %)



Source: NBS.

Q1, with further easing expected in Q2. Standards were eased primarily under the sway of interbank competition and, to some extent, by cheaper sources of funding and greater readiness to assume risk. Households were offered longer loan repayment periods, interest margins and associated costs were additionally trimmed, and requirements regarding collateral were relaxed after some time. In line with expectations, household demand continued rising, with the greatest demand registered for dinar cash loans and refinancing loans and FX-indexed housing loans. This rise in demand was propelled primarily by real estate purchases and the need to refinance current obligations, and by a rise in employment and private sector wages. These same factors should remain key drivers of household demand in Q2.

Corporate and household loans in dinars expanded in Q1 by 0.5 pp from end-2016 to 31.7% at end-March. Specifically, the dinarisation of household loans continued growing, rising by an additional 0.8 pp from the start of the year, and reaching 47.9% in March. The dinarisation of corporate loans declined by 0.3 pp in 2017 to 19.1% in March.

The implementation of the NPL Resolution Strategy continues to yield goods results. According to the results of the recent bank lending surveys, the lower level of corporate NPLs has worked towards the easing of credit standards. On a gross basis, the share of NPLs decreased by an additional 0.2 pp to 16.8% in March. In the corporate sector, this share declined by 0.1 pp to 17.1% in March,[17] which is the lowest value of this indicator in the last eight years. With respect to households, it declined by 0.4 pp to 8.9%.[18] Further, allowances for loan impairment came at 73.1% of NPLs in March (5.0 pp more than a year earlier), while loan loss provisions, at 118.7% in March, continued to fully cover the amount of gross NPLs. Also, the capital adequacy ratio of 22.3% in March points to the high capitalisation of the domestic banking sector.

3. Real estate market

In Q1, the real estate market saw a mild rise in prices and a seasonal contraction in turnover, while the results

[17] Includes companies and public enterprises. If only companies are observed, the share of NPLs in total loans came at 17.3% in March, down by 0.3 pp from end-2016.

[18] With entrepreneurs and private households included, the share decreases by 0.4 pp to 9.6%.

of the lending survey indicate that banks expect real estate demand to increase in the coming period.

After three consecutive quarters of a decline, Serbia's average real estate price, as measured by DOMex,[19] increased by 5.4% in Q1. The increase was recorded across all regions, primarily in Vojvodina (7.4%). Y-o-y, a mild rise of 0.3% was driven by higher real estate prices in Šumadija and Western Serbia (4.8%), while Belgrade prices inched down by 1.0%.

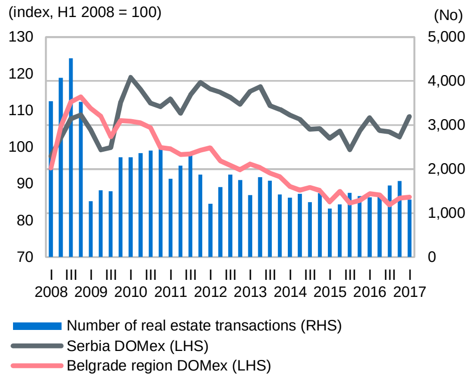
In Q1, the average real estate price in Serbia equalled EUR 897.6 per square metre. Since the prices in the traditionally most expensive Belgrade region recorded the smallest increase, their ratio to the average for the rest of Serbia dropped from 1.75 in Q4 2016 to 1.67 in Q1 2017.

Typical for the season, the number of real estate transactions[20] dropped (by 24.2%) relative to Q4 2016, while decreasing slightly y-o-y.

The number of construction permits for dwellings issued in the first two months of 2017 fell by around 10% relative to Q4, and by around 6% y-o-y. On the other hand, the number of construction permits for residential and non-residential buildings edged up by around 5%.

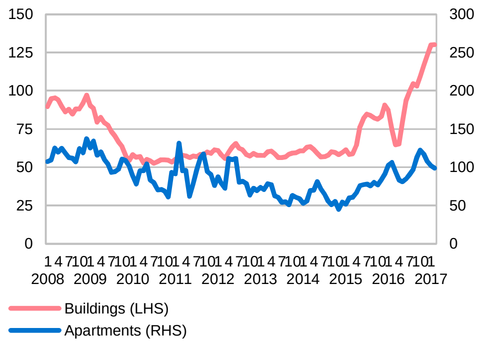
The bank lending survey indicates that housing loan demand increased in Q1. This trend is expected to continue in the period ahead, supported by lower housing loan rates and higher disposable income reflecting the recovery in the labour market.

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



Source: National Mortgage Insurance Corporation.

Chart IV.3.2 **Indices of the number of issued construction permits**
(3M averages s-a, 2016 = 100)

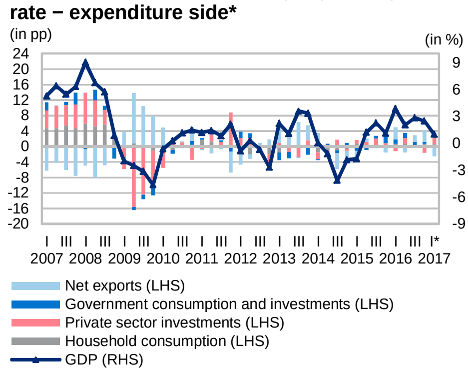


Sources: SORS and NBS calculation.

4. Aggregate demand

A positive contribution to GDP growth in Q1 (0.2% s-a) came from household consumption, primarily owing to higher real disposable income, and from an increase in inventories which stockpiled amid exports slow-down and subdued construction activity during the cold weather in January and early February. On the other hand, cold weather boosted energy imports, so net exports contributed negatively to GDP. According to the preliminary estimate of the Serbian Statistical Office, GDP growth in Q1 measured 1.0% y-o-y.

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

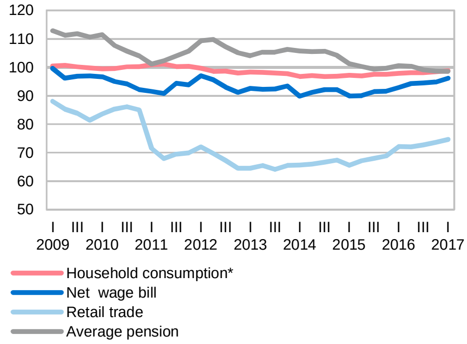


Sources: SORS and NBS calculation.
* NBS estimate for Q1 2017.

[19] The DOMex is published by the National Mortgage Insurance Corporation and relates only to the real estate purchased by insured loans.

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



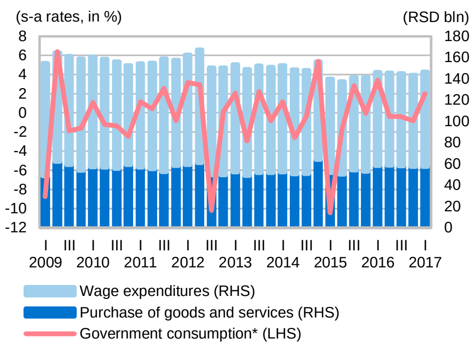
Sources: SORS and NBS calculation.
* NBS estimate for Q1 2017.

Table IV.4.1 **Movement in main indicators and sources of household consumption**
(real y-o-y growth rates in %)

	2016			2017
	Q2	Q3	Q4	Q1
Household consumption	**1.0**	**0.5**	**0.9**	**1.2***
Indicators				
Retail trade	7.2	6.8	6.9	3.7
Catering turnover	6.4	9.6	6.6	5.5**
Number of domestic tourists	14.2	11.2	10.9	2.7
Number of overnight stays of domestic tourists	13.0	11.6	9.4	-0.6
Consumer goods imports (BEC classification), nominal	6.6	1.3	-0.5	10.7
Sources				
Private sector wage bill	7.6	5.3	6.4	5.8
Bill of total social transfers	0.9	1.0	-5.2	-1.6
Pension bill	0.3	-0.2	-0.9	-2.2
Net inflow of remittances, nominal	-1.1	-5.7	-8.8	8.3
New consumer loans, nominal	26.7	-1.4	-0.1	6.1
New cash loans, nominal	56.2	59.1	20.0	41.9

* NBS estimate.
** January-February.
Sources: SORS and NBS calculation.

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q1 2017.

The expected recovery of investment in the coming quarters, coupled with continued positive effects of household consumption, is likely to speed up GDP growth which according to our estimate should reach around 3% in 2017. A positive contribution to GDP growth is also expected from net exports, owing to a boost in supply brought about by the implementation of past investment and an improved growth outlook in the euro area.

Domestic demand

According to our estimate, **household consumption** increase extended into Q1 (0.4% s-a), on the back of a continued rise in disposable income underpinned by the rise in wages and employment, primarily in the private sector, increase in pensions, higher remittances inflow and lower cost of household credit. Retail trade, as the most significant real indicator of household consumption, continued up in Q1 (1.4% s-a). Imports of consumer goods went up as well, by 2.8% s-a. Y-o-y, household consumption growth is estimated to have accelerated to 1.2% in Q1, giving a positive 0.9 pp contribution to GDP.

The rise in household consumption in Q1 is also signalled by the movement in its main sources in the same period. Real private sector wage bill accelerated its growth to 3.8% s-a in Q1, reflecting a combined contribution of growth in employment and average real wage. In addition, y-o-y growth in newly approved cash loans measured 41.9% in Q1, while net remittances inflow increased by 8.3% y-o-y.

Fiscal savings in the past period created room for a wage increase in one segment of the public sector in Q1. As a result, despite the rightsizing required by the continued fiscal consolidation, final government consumption is estimated to have picked up by 1.4% s-a. While wage expenditures increased, outlays for the purchase of goods and services remained almost unchanged compared to Q4. In Q1, government consumption continued to rise in y-o-y terms as well (2.0%), and its positive contribution to GDP is estimated at 0.4 pp.

Subdued construction activity due to unfavourable weather conditions early in the year indicates a decrease in fixed investment in Q1 (2.1% s-a according to our estimate), as confirmed mainly by the lower value of works performed (6.9 % y-o-y). On the other hand, the production of construction material continued to expand, which in one part translated into inventories growth. This may suggest construction growth in the coming quarters.

Such conclusion is also supported by the higher total number of construction permits issued in the first two months of 2017 and the value of works they envisage. Indicators of investment into equipment in Q1 are positive, given that equipment imports went up by 4.3% s-a and domestic production of machinery and equipment expanded by 32.1% s-a, part of which was exported.

In terms of the sources of investment financing, positive trends were recorded in internal sources of financing of companies, whose profitability improved in 2016, according to the preliminary data of the Business Registers Agency. In aggregate terms, companies recorded a positive net result of RSD 229.3 bln in 2016, significantly higher than in 2015 (RSD 67.2 bln). In terms of other sources of financing, FDI inflow contracted in Q1, while a decrease in newly approved investment loans is partly the result of a high base.

According to our estimate, a high positive contribution to GDP growth in Q1 also stemmed from a rise in inventories (1.3 pp). This is signalled by the stockpiling of industrial product inventories (4.3% s-a), reflecting mainly a slowdown in exports and aggravated domestic transport due to cold weather. The largest growth in inventories of finished products was registered in food and clothing production, and in export-oriented areas, such as electrical equipment, computers, chemical and pharmaceutical products. In addition, as the Danube was ice-bound in January and early February *and shipping was halted*, cereals could not be transported by that route, so the agricultural commodity exports underperformed the expectations. Interim cereal inventories thus remained relatively high, and some increase in cereal exports might be expected in the coming period.

Net external demand

Real exports growth in Q1 (2.7% s-a) slowed down relative to Q4 2016, mainly owing to negative effects of cold weather in January and early February. On the other hand, imports of goods and services accelerated in real terms (4.1% s-a), primarily owing to heightened demand and increased energy imports, which resulted in the negative contribution of net exports (1.3 pp) to GDP movements in Q1.

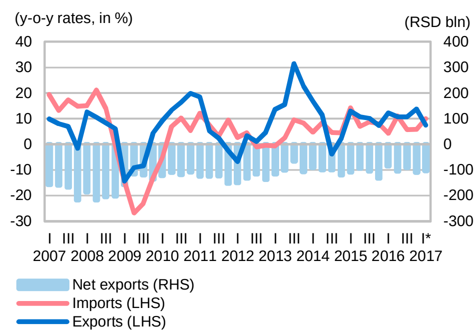
A high level of exports was maintained in Q1 mainly owing to increased external demand, signalled by the continued growth in the euro area and movements of the

Table IV.4.2 **Investment indicators**

	2016				2017
	I	II	III	IV	I
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	-0.7	0.1	6.7	-1.1	4.3
Industrial production of machines and equipment	6.6	1.3	-2.4	6.1	32.1
Exports of equipment*	22.1	5.9	0.2	6.4	-2.3
Imports of equipment*	4.7	-0.1	-0.9	1.0	4.3
Inventories of machines and equipment	18.3	6.3	0.0	-11.1	5.9
Industrial production of intermediate goods	2.7	3.9	-1.4	1.4	5.9
Exports of intermediate goods*	3.8	4.5	0.7	8.7	8.3
Imports of intermediate goods*	-3.7	0.7	1.3	6.1	6.6
Inventories of intermediate goods	2.8	1.1	7.0	0.1	3.5
Industrial production of construction materials	1.7	0.6	-5.1	4.1	7.9
Inventories of construction materials	6.7	-0.2	-0.7	3.7	13.4
Government investment**	6.6	3.8	-1.0	-8.1	-9.3

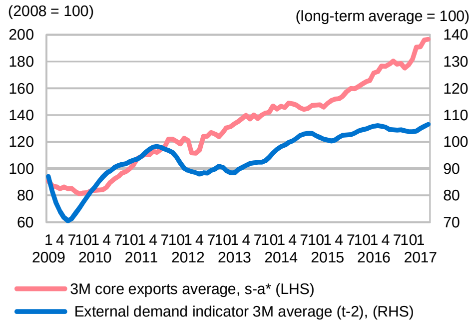
Source: SORS and NBS calculation.
* Exports and imports are denominated in euros.
** Government investment spending is deflated by the industrial producer price index.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q1 2017.

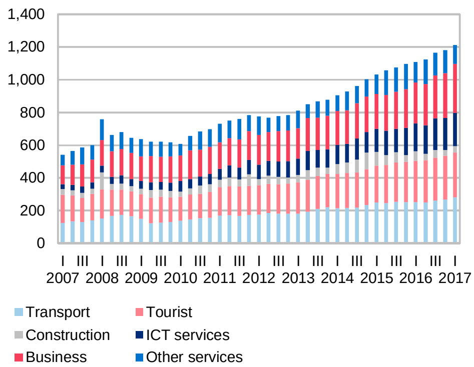
Chart IV.4.5 **Movements in external demand and core exports indicators**



Sources: European Commission, SORS and NBS.

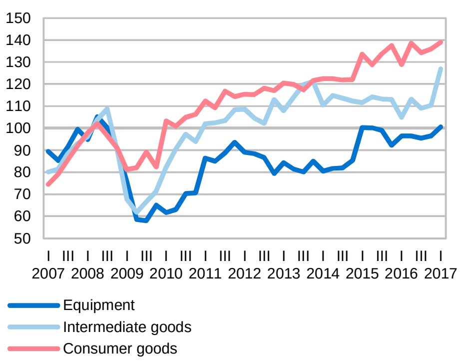
* Excluding agriculture, energy products, motor vehicles and base metals.

Chart IV.4.6 **Exports of services**
(s-a data, in EUR mln)



Sources: SORS and NBS calculation.

Chart IV.4.7 **Imports by key components**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

indicator of external demand[21] which edged up by 1.3% in Q1, displaying wide dispersion (growth in 17 out of 21 countries). Apart from demand, exports were also positively impacted by lower unit labour costs in manufacturing underpinned by higher productivity, which boosted cost competitiveness. On the other hand, terms of trade were less conducive to exports than in the previous period, given that faster growth of import compared to export prices continued from the start of the year.

In Q1, commodity exports rose by 3.9% s-a in euro terms, driven by the continuation of positive tendencies in all significant export-oriented areas of manufacturing. The greatest positive contribution came from the automobile industry, owing to the recovery of EU demand. Apart from the Fiat Automobiles Serbia, producers of automobile components are accounting for an increasing share in automobile industry exports.

Positive trends also continued in the majority of other branches of manufacturing, such as production of rubber and plastic products, chemical and pharmaceutical products and electrical equipment. In Q1, exports of petroleum products gained ground as well, mostly owing to an increase in petroleum product prices region-wide. In addition, exports of the metal complex, i.e. base metals, metal products and machinery and equipment, continued up. Base metals exports slowed down compared to Q4 2016 mainly due to the halted shipping of input raw materials and exported steel products via the ice-bound Danube in January and early February. In Q1, base metals exports increased by 117.1% y-o-y, reflecting the rise in production after the Steel Plant got a strategic partner.

Due to the Danube's freezing, exports of agricultural products (corn and wheat) underperformed the expectations in Q1. In terms of quantity, wheat exports dropped by around one forth and corn exports by around one third relative to Q4, with the greatest slump registered in January. February saw a gradual recovery, while in March the exported quantities bounced back to their Q4 average. Lower exports of cereals were compensated in part by higher fruit and vegetable exports which spiked by around 10% s-a in euro terms relative to Q4.

Apart from commodity exports, exports of services also went up in Q1 (by 2.5% s-a), driven mainly by higher exports of business and transport services. Positive trends

[21] The leading indicator of external demand for Serbian exports was constructed based on movements in the European Sentiment Indicator (ESI). It includes Serbia's 21 most important foreign trade partners – their shares in Serbian exports being used as weights.

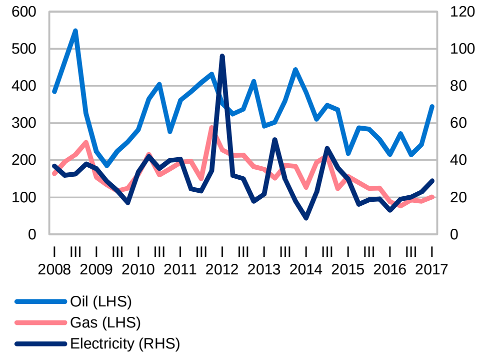
also continued in exports of tourist, information and computer services, while exports of construction services recovered as well. In y-o-y terms, exports of services rose by 11.4% in Q1.

In Q1, commodity imports recorded a relatively high growth in euro terms (6.2% s-a). The growth was mainly spurred by higher imports of intermediate goods, driven by higher imports of energy prompted by cold weather in January and increased needs in the manufacturing industry. In addition, higher household consumption resulted in increased imports of consumer goods, while the rise in equipment imports indicates a recovery of investment in the coming period.

That the bulk of imports growth in Q1 can be put down to increased energy imports is also confirmed by the movement of import components by economic destination of the EU. In Q1, energy imports were by about one third higher compared to Q4 2016, which was in part prompted by increased heating needs amid unusually cold weather for the greater part of January. Higher energy needs in the production of petroleum products and base metals also resulted in increased imports of crude oil and hard coal, which were imported at higher prices than in Q4. Other areas of manufacturing also recorded increased needs for raw materials and intermediate goods, which caused an upswing in their imports, while higher imports of durable consumer goods could be associated with the continued increase in household consumption.

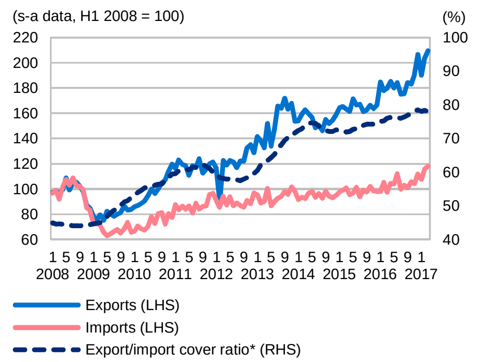
The indicators of commodity trade remained relatively favourable in Q1, given that the export/import cover ratio was close to its end-2016 level, reaching 78.1% in March. At the same time, commodity exports stood at 109.6% and commodity imports at 17.9% above their pre-crisis levels[22] in March.

Chart IV.4.8 **Energy imports**
(s-a data, in EUR mln)



Sources: SORS and NBS calculation.

Chart IV.4.9 **Commodity trade in euros**



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

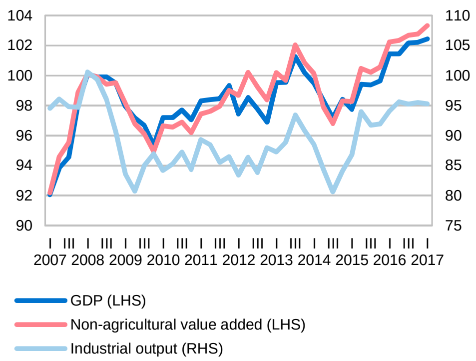
[22] H1 2008.

5. Economic activity

Continued positive developments in manufacturing and many service sectors reflected positively on GDP growth in Q1, which equalled 0.2% s-a according to our assessment. According to the preliminary estimate of the Serbian Statistical Office, y-o-y GDP growth measured 1.0% in Q1, mainly as a result of the negative impact of the cold wave early this year on activity in energy, agriculture and construction sectors, and of the high base from Q1 2016.

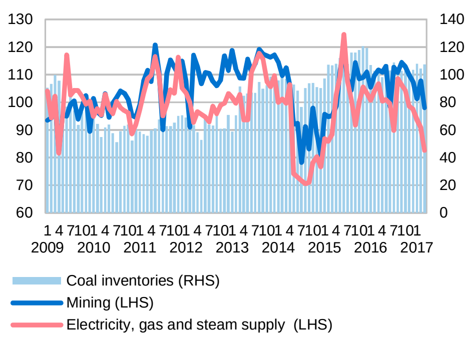
We expect that the slowdown in economic activity in Q1, which the NBS estimates to have been caused by temporary factors, will be compensated throughout the rest of the year, hence GDP growth of around 3% is expected in 2017. Growth should mostly be driven by industry and services, and to a lesser extent by construction, while agriculture is expected to make a negative contribution due to a high last year's base.

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 in energy and mining**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Manufacturing continued to push up GDP growth in Q1 by 0.2% s-a, driven by investment from the previous period, faster growth in the euro area, and the continued recovery in domestic demand, which positively affected growth in most service sectors. Conversely, construction and energy sectors went down in Q1, mostly on account of negative effects of the January cold weather.[23] Economic activity stayed above its pre-crisis level in Q1 as well – by 2.4% in terms of GDP, or 3.3% as measured by NAVA.

According to the preliminary estimate of the Serbian Statistical Office, y-o-y GDP growth slowed down to 1.0% in Q1 2017, which resulted from both slower quarterly growth and a high base from Q1 2016. According to the NBS estimate, a positive contribution to GDP growth was provided by service sectors and manufacturing, while construction and agriculture acted as a drag.

Continued positive developments were recorded in manufacturing, whose physical volume expanded by 4.0% s-a in Q1. On the other hand, mining and energy sectors saw less favourable movements, thus the physical volume of output of overall industry dropped slightly in

[23] See Text box 2, page 37.

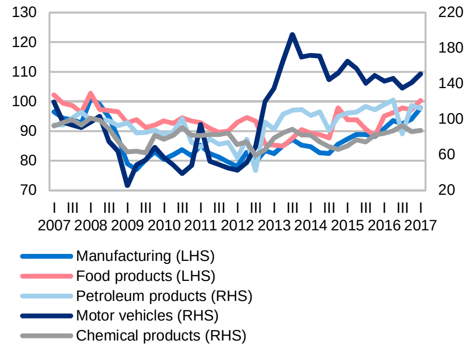
Q1 (0.2% s-a). Reduced exploitation of coal, crude oil and metals led to a decrease in the physical volume of output in mining (7.0% s-a), whereas the reduction in the physical volume of production in electricity, gas and steam supply was 3.6% s-a.

A total of 83% of manufacturing recorded growth in Q1. It continued in export-oriented sectors, such as the production of motor vehicles, metal products, machinery and equipment, rubber and plastic products, electrical equipment, which was supported by faster growth of our main foreign trade partners. Growth was recorded in the production of food, beverages, tobacco and construction material, which are largely intended for the domestic market, pointing to a positive contribution of the gradual recovery of domestic demand. Contracted volume of output was recorded in the production of petroleum products in Q1, due to higher prices of crude oil in the global market and its hindered imports during Q1 due to cold weather.

Y-o-y, the growth in the physical volume of industrial production slowed down to 0.7%. Specifically, growth accelerated in manufacturing (7.3%), which contributed positively to the movement of the physical volume of overall industry by 4.9 pp. The physical volume of production in mining declined by 6.3% in Q1, and in electricity, gas and steam supply it fell further down (14.5%), negatively contributing to the movement of overall industry by 0.5 pp and 3.7 pp respectively.

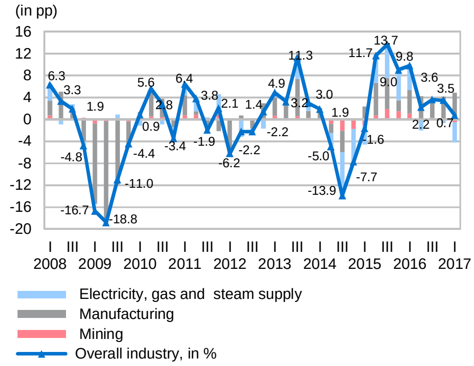
The only currently available indicator in the sector of agriculture for this year is the area sowed in the autumn sowing, according to which in this season there was a decrease in the amount of sowed wheat by 7% and in the amount of sowed barley by 13.4% compared to the previous season. We expect larger areas to be sowed with corn and industrial crops in the spring sowing. Without more complete information, we assess that the agricultural season in crop production will be at the level of the ten-year average. This would, due to the high last year's base, amount to a decline in the physical volume of agricultural production by around 4% in 2017. Also, cold weather early this year and in April had some negative effects on fruit growing, which is expected to contribute to a lower volume of agricultural production.

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



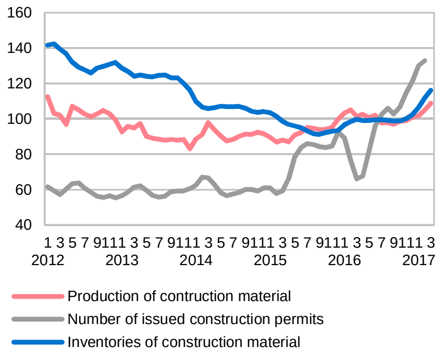
Sources: SORS and NBS calculation.

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



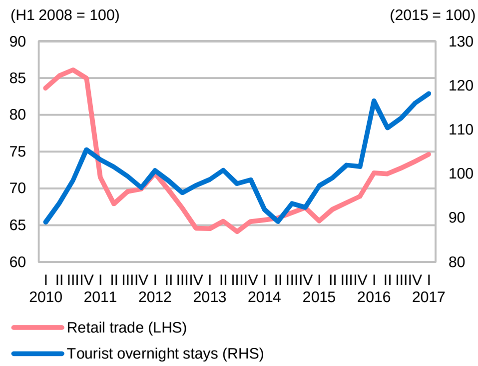
Sources: SORS and NBS calculation.

Chart IV.5.5. **Construction activity indicators**
(3M averages s-a, 2016 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.6 **Service sector indicators**
(s-a data)



Sources: SORS and NBS calculation.

Table IV.5.1 **Contributions to quarterly GDP growth**
(in pp)

	2016				2017
	Q1	Q2	Q3	Q4	Q1*
GDP (s-a, in %)	**1.8**	**0.0**	**0.7**	**0.1**	**0.2**
Agriculture	0.5	-0.2	0.5	-0.2	-0.3
Industry	0.7	0.2	-0.2	0.1	0.0
Construction	0.1	0.0	0.0	-0.1	0.0
Services	0.6	0.1	0.3	0.3	0.4
Net taxes	0.1	0.1	0.0	0.1	0.1

Sources: SORS and NBS calculation.
* NBS estimate.

Activity was greatly hindered in construction owing to cold weather in January, thus the value of executed construction works in Q1 dropped by 6.9% y-o-y. Still, in Q1 other indicators of construction moved up, such as the production of construction materials in Q1 and the number of issued construction permits in the first two months, indicating that reduced activity in early 2017 may be assessed as temporary and that construction could be expected to increase in the coming quarters. This is also suggested by the continued effects of factors that had contributed to its growth in the previous year, such as favourable legislation and ongoing implementation of infrastructure projects.

The greatest positive contribution to GDP growth in Q1 (0.4 pp) came from the service sector, which can be seen from continued positive movements of available indicators in trade and accommodation and food service activities. Supported by higher household consumption, retail trade turnover continued growing in Q1 (1.4% s-a), while the high base from Q1 2016 dragged its y-o-y growth down to 3.7%. Positive trends continued in the accommodation and food service sectors, where the number of tourist arrivals and real turnover in hospitality services continued up y-o-y in January and February. Higher positive contribution of service sectors was prevented, to an extent, by cold weather at the start of the year, which hampered the regular performance of economic activities, particularly in the areas of transport and trade.

The NBS estimates that GDP growth will be around 3% in 2017. It is estimated that developments in Q1 were mostly a consequence of temporary factors caused by adverse weather conditions, whose negative effects should be compensated in the rest of the year. More favourable outlook for the euro area, higher investment and improved business and investment environment should continue to positively impact industry and construction, while further recovery of final consumption should impact activity in service sectors. On the other hand, we expect a negative contribution of agriculture, since last year's production was above the ten-year average, which we expect in the current year.

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

In addition to its one-off impact on inflation,[1] the cold wave that hit Serbia early this year reflected negatively on other macroeconomic flows, mainly economic activity and foreign trade. Low temperatures and snow that persisted through most of January hindered internal transport of raw materials and finished products and, in addition to transport, adversely affected activity in industry, agriculture (primarily vegetables), construction and trade. Also, as the Danube froze over from 8 January to 10 February, shipping was suspended, which slowed down imports and exports of raw materials and finished products, negatively affecting foreign trade trends in the first two months.

The negative effects of cold weather on industrial output are indicated by movements in its physical volume, which fell by 2.4% s-a in January (Table O.2.1). The decline in the physical volume of output was recorded in mining (5.7% s-a), which is more sensitive to (adverse) weather conditions than other areas of industry, and in electricity, gas and steam supply (4.0% s-a), which was negatively affected by reduced coal exploitation and a poor hydrological situation. Some branches of manufacturing were also affected, particularly those that depend on imports of raw materials, such as production of petroleum products and chemical products, which went down by 5.6% s-a and 4.2% s-a, respectively. The cold weather and transport difficulties also reflected on retail trade turnover, which was lower by 1.2% s-a in January. In addition to industry and trade, whose monthly indicators are available and point to negative developments, cold weather in Q1 also affected other areas of the economy, such as construction and transport, and contributed much to the slowdown in y-o-y GDP growth from 2.5% in Q4 2016 to 1.0% in Q1 2017.

Table O.2.1 **Indicators of industry and external and internal trade**
(real s-a monthly growth rates)

	2016			2017		
	October	November	December	January	February	March
Physical volume of industrial production	-0.9	0.7	1.4	-2.4	2.4	-1.8
Mining	-1.4	-2.6	-2.3	-5.7	6.3	-8.9
Manufacturing	1.0	1.3	2.1	-0.3	3.1	1.0
Electricity, gas and steam supply	-1.8	-5.5	-1.1	-4.0	-3.2	-8.8
Inventories of industrial products	0.0	-1.1	0.2	3.8	0.9	0.4
Retail trade	-1.6	1.4	2.4	-1.2	-0.2	2.1
Euro commodity exports*	-0.6	4.2	8.2	-8.0	7.3	2.9
Euro commodity imports*	4.7	-1.4	7.4	-3.8	7.9	1.7

* Nominal.
Sources: SORS and NBS calculation.

Cold weather also affected foreign trade flows, given the above mentioned suspension of shipping on the Danube, via which considerable quantities of raw materials are imported for manufacturing (crude oil, iron ore, hard coal) and the majority of cereals are exported. Thus in January euro-denominated commodity exports declined by 8.0% s-a, with corn exports falling drastically – in terms of quantity, in January corn exports were 75% lower than the Q4 2016 average and around 25% lower than in January 2016, when Serbia exported smaller quantities of corn due to a poor agricultural season in 2015. Lower exports were also recorded in many export-oriented branches of manufacturing (food, tobacco, base metals, construction material), which brought about an increase in their inventories. Besides lower exports, in January commodity

Table O.2.2 **Y-o-y movement of GDP and economic activity and external trade indicators**
(real y-o-y growth rates)

	2016				2017
	Q1	Q2	Q3	Q4	January-February
GDP	3.9	2.0	2.8	2.5	1.0*
Physical volume of industrial production	9.7	2.2	3.6	3.5	0.7
Mining	14.3	-1.1	3.3	0.4	-2.9
Manufacturing	6.4	5.7	4.3	5.8	5.5
Electricity, gas and steam supply	17.9	-9.9	1.3	-3.1	-9.9
Retail trade	10.2	7.2	6.8	6.9	2.6
Euro commodity exports**	13.6	9.9	8.6	16.5	5.0
Euro commodity imports**	1.5	9.3	4.3	7.0	11.6

* SORS preliminary estimate for Q1 2017.
** Nominal.
Sources: SORS and NBS calculation.

[1] See Text box 1, p. 14.

imports also declined (3.8% s-a), primarily on account of diminished imports of intermediate goods (4.0% s-a), while cold weather and higher energy demand encouraged a rise in their imports (4.3% s-a).

Though the impact of cold weather is temporary in nature, it also affected the movements of macroeconomic flows in the first two months of 2017, as can be seen from the movement of y-o-y growth rates in industry and foreign and domestic trade (Table O.2.2). Thus, the physical volume of total industrial output, after growing by 3.5% y-o-y in Q4 2016, practically stagnated in January and February compared to the same period in 2016 (growth by 0.7%), whereas the growth in retail trade turnover slowed down from 6.9% y-o-y to 2.6% y-o-y in the same period. Negative trends were also recorded in foreign trade, with a deceleration in export growth and an acceleration in import growth, caused partly by the rise in import prices. As a result, the current account deficit increased in the first two months of 2017 by around EUR 100 mln relative to the same period last year. This mostly reflected the increase in the goods deficit (around EUR 170 mln), primarily due to contracted exports of agricultural commodities (around EUR 70 mln) and higher energy imports (around EUR 100 mln). Energy imports were higher partly because of increased demand of manufacturing for imports of crude oil and hard coal (which were imported at higher prices) that cannot be directly attributed to the effects of cold weather. However, a part of the higher energy imports is directly linked to the impact of cold weather, resulting from lower electricity exports (around EUR 10 mln) because of the poor hydrological situation, and increased electricity imports (around EUR 20 mln) due to higher consumption of electricity for heating purposes. The higher goods deficit was partially offset by continued positive trends in services, whose surplus was higher by around EUR 50 mln y-o-y in the first two months of 2017, and by a somewhat higher inflow of remittances (around EUR 20 mln y-o-y).

On the expenditure side, we estimate that cold weather drove down the GDP growth rate in Q1 through a negative contribution of net exports due to lower exports and higher imports, slower growth in investment (which will lead to a slowdown in construction), and slower growth in final consumption. On the other hand, we estimate that the highest positive contribution to GDP growth was made by an increase in inventories resulting from a slowdown in exports of manufacturing and agriculture.

Since the impact of cold weather on economic and foreign trade activity is temporary, any negative movements indicated by the Q1 data should be made up for in the remainder of the year. This can be seen from the recovery in the physical volume of industrial output as early as in February (growth by 2.4% s-a). Specifically, growth was recorded in manufacturing (3.1% s-a) and mining (6.3% s-a), while the poor hydrological situation that continued into February negatively impacted output in electricity, gas and steam supply, whose physical volume was lower by 3.2% s-a. Similarly, in February commodity exports jumped by 7.3% s-a, with the recovery in exports of agricultural commodities[2] and almost all export-oriented branches of manufacturing. Positive February results in manufacturing and commodity exports continued into March. The growth in the physical volume of manufacturing equalled 1.0% s-a in March, and was recorded across 80% of manufacturing. The growth in euro-denominated commodity exports (2.9% s-a) continued, with an increase recorded in 18 of 23 branches of manufacturing, as well as in exports of agricultural products. Also, retail trade turnover increased in March (2.1% s-a), pointing to a recovery in final consumption.

[2] In terms of quantity, exports of corn already doubled in February as compared to January, and in March reached the record monthly level for this season of around 360,000 tonnes (recorded in November 2016).

6. Labour market developments

Elevated economic activity was followed by a recovery in the labour market which saw a rise in wages and employment in Q1. Also, increased productivity in manufacturing in Q1 led to a reduction in unit labour costs and an improvement in cost competitiveness.

Wages and labour productivity

Continued economic growth and higher minimum wages from the start of the year provided a positive contribution to the rise in real net wages in Q1 which, in the previous period, was led by higher private sector wages (1.9% s-a). Moreover, unlike the prior quarter, Q1 also saw an increase in real net wages in the public sector (1.6% s-a) powered by a rise in wages in some parts of the public sector as of January. The wage gap between the public and the private sector in March measured 4.1%.

By sector, a rise in average wages in Q1 was recorded in the majority of service sectors, agriculture, construction and mining and energy. By contrast, sectors that drove average wages up in the prior quarter (manufacturing, information and telecommunications, financial services) registered a slight decline. In Q1, the majority of sectors saw an increase in average wages in y-o-y terms as well – 1.1% for the overall economy.

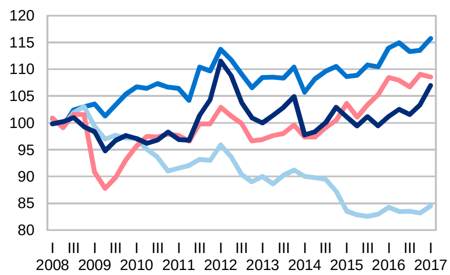
A steady rise in average wages, coupled with continued growth in formal employment, led to an increase in the real net wage bill in Q1 (1.4% s-a), which was more pronounced in the private (1.9% s-a) than in the public sector (0.5% s-a). The average nominal net wage in the Republic of Serbia equalled RSD 45,435 in Q1, up by 4.2% y-o-y.

Unit labour costs in the manufacturing industry were trimmed by 4.4% s-a in Q1 owing to higher productivity. To a degree, this improved the external cost competitiveness of the Serbian economy. In contrast, unit labour costs of the overall industry edged up slightly (0.3% s-a), largely due to subdued activity in the mining and energy sector.

Employment

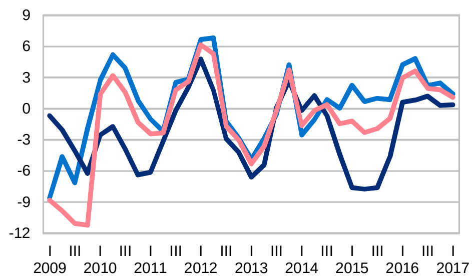
The rise in formal employment recorded throughout 2016 remained uninterrupted at the onset of 2017. We estimate that this can be ascribed to continued economic growth and stepped-up activities aiming to combat the grey

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



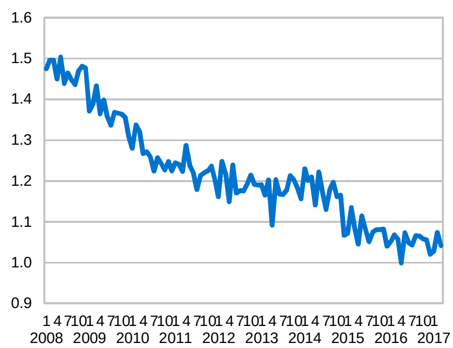
Sources: SORS and NBS calculation.

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



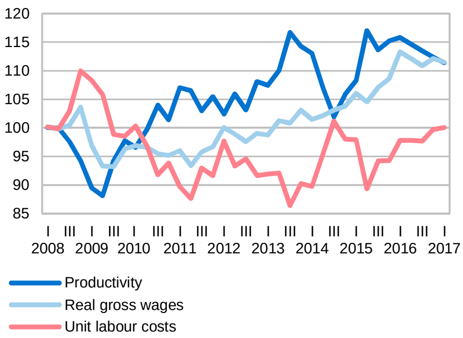
Sources: SORS and NBS calculation.

Chart IV.6.3 **Ratio of average nominal net wage in public and non-public sector**



Sources: SORS and NBS calculation.

Chart IV.6.4 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



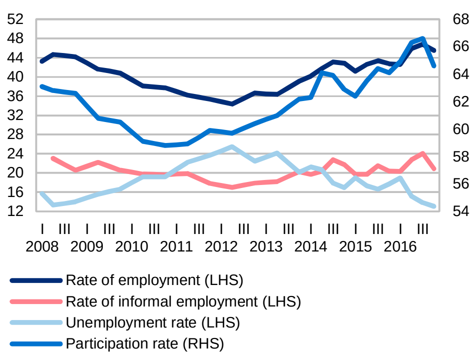
Sources: SORS and NBS calculation.

Table IV.6.1 **Movements in formal employment and unemployment**
(quarterly growth rates, end-of-period)

	2016			2017
	Q2	Q3	Q4	Q1
Total number of formally employed	1.6	0.6	0.1	0.5
Employed with legal persons	1.4	0.7	-0.1	0.5
Entrepreneurs and their employees	3.5	1.2	0.8	1.1
Individual farmers	-1.1	-1.5	0.2	-1.1
Unemployed persons	-5.7	-3.1	2.4	-1.9
First-time job seekers	-4.7	-2.8	0.9	-2.6
Used to be employed	-6.1	-3.2	3.1	-1.5

Sources: SORS and National Employment Service.

Chart IV.6.5 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

economy. According to the Statistical Office's Central Registry of Compulsory Social Insurance, formal employment inched up 0.5% in Q1 supported by the persistent rise in employment with legal entities and the number of private entrepreneurs and their employees, and a reduction in the number of individual agricultural producers. Relative to the corresponding period last year, the total number of formally employed persons in Q1 was up by 2.9%.

Higher formal employment was mainly a result of increased private sector employment, notably in manufacturing, construction, information and telecommunications, and professional, scientific, innovation and technical activities. On the other hand, the energy and financial sectors and administrative and support service activities registered somewhat lower formal employment in Q1.

The observed period saw a decline in unemployment figures owing to the implementation of a proactive labour market policy (training, retraining, job fairs) and increased demand for workers. According to the National Employment Service, unemployment in Q1 fell by 13,051 to 687,896 persons in March, or by 61,042 compared to the same period last year. Unemployment in Q1 declined across occupational groups, most notably in occupations associated with manufacturing and trade.

The Labour Force Survey data for Q4 reveal that the unemployment rate dropped further to its lowest (13.0%) since comparable data became available. Long-term unemployment also continued down (8.3%) as did youth unemployment (31.2%). Employment in Q4 fell by 1.3 pp to 45.5%, largely due to a decline in informal employment (by 3.2 pp to 20.9%) on account of subdued seasonal demand for workers in agriculture and construction.

7. International environment

The pick-up in global economic activity in H2 2016 continued at the start of 2017 owing to further positive economic trends in advanced and some emerging economies. The rise in euro area's GDP in Q1, still led by domestic demand, kept its pace from a quarter earlier, and was spread across a variety of sectors and regions. Domestic demand continued supporting GDP growth across Central and Eastern Europe countries as well, and its acceleration at the start of the year was partly based on greater external demand. Russia pulled out of

recession in Q4 2016 owing primarily to recuperating global oil prices and monetary policy easing, while China's economic growth outpaced expectations at the start of 2017 on the back of a rise in infrastructure investment.

The rise in global inflation was helped the most by increased cost-push pressures, primarily from higher prices of primary commodities in the global market. However, still modest demand across most countries, including the euro area and countries of our region, stands in the way of a more significant rise in prices, as confirmed by core inflation's trajectory below the long-term average, which is why central banks in these countries still pursue accommodative monetary policy. On the other hand, after December, the Fed again raised the federal funds rate in March, and the pace of its hike in the coming period, combined with future moves of the ECB, will largely shape the trends in the international financial market.

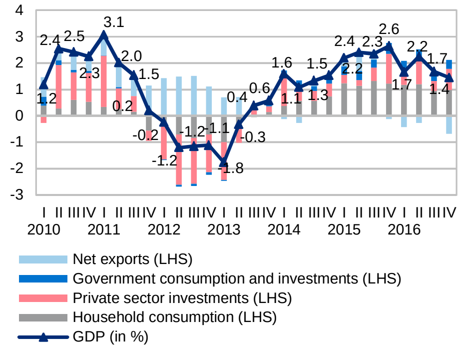
Economic activity

In Q4 2016, domestic demand continued to give the key impetus to **euro area's GDP growth** (0.5%, s-a) which picked up slightly from a quarter earlier (0.4%, s-a). Labour market improvements, reflected in shrinking unemployment and higher employment, along with stable consumer confidence, spurred household consumption, while favourable financing conditions and greater profitability of companies helped investment grow. On the other hand, net exports gave a negative contribution to GDP growth as the rise in imports outpaced that of exports.

According to the Eurostat flash estimate, the pace of GDP growth in Q1 was the same as a quarter earlier (0.5%, s-a). GDP growth was indicated by leading economic activity indicators (*PMI Composite* and *Economic Sentiment Indicator*), which in Q1 even exceeded their Q4 levels, and went above the multiannual averages. Their trajectory showed greater sectoral and geographical diversification of GDP growth as improvement was recorded in both production and service sectors, and also across most countries.

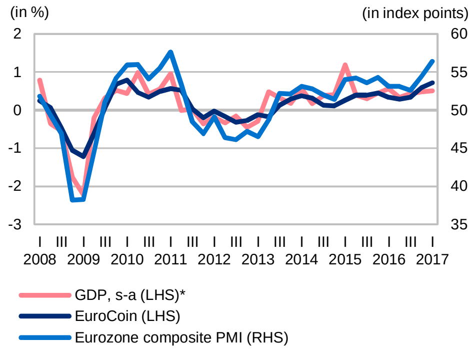
The largest countries in the euro area saw further economic growth in Q4 2016 – it accelerated in Germany and France, and lost some steam in Italy. Key indicators hint at a pick-up in Q1 in all three of these economies, with a stronger contribution anticipated from production sectors in Germany and Italy, and from service sectors in France.

Chart IV.7.1 **Contributions to y-o-y GDP growth rate of the euro area**
(in pp)



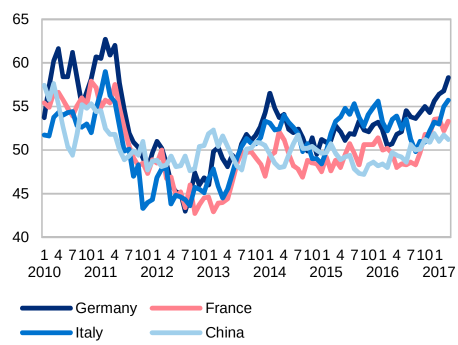
Source: Eurostat.

Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



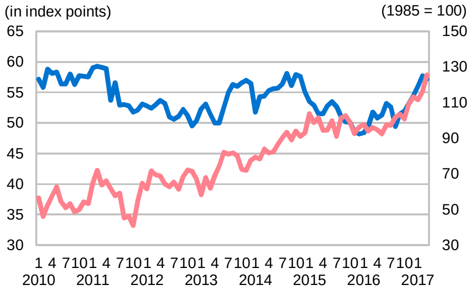
Sources: Eurostat, Markit Group and Banca d'Italia.
* Eurostat's preliminary flash estimate for Q1 2017.

Chart IV.7.3 **PMI Manufacturing for selected countries**
(in index points)



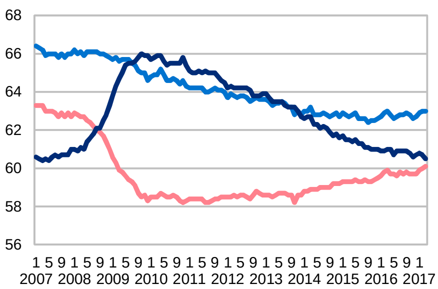
Source: Markit Group.

Chart IV.7.4 **Leading economic indicators in the US**



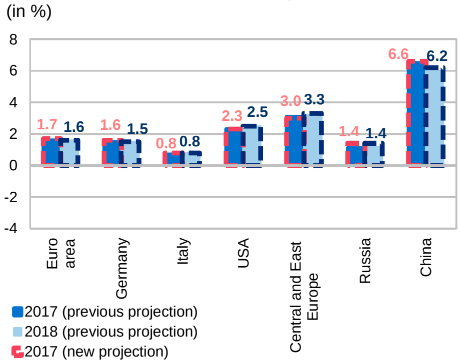
Source: Institute for Supply Management, Conference Board.

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



Source: Bureau of Labor Statistics.

Chart IV.7.6 **Revisions of real GDP growth forecasts for 2017 and 2018 by the IMF**
(in %)



Sources: IMF WEO Update (January 2017) and IMF WEO (April 2017).

Favourable trends in economic activity are expected in the remainder of the year, and should be supported by a rise in employment, favourable monetary conditions and gradual recovery in global trade, while the slower pace of structural reforms, adjustment of the balance sheet structure in some sectors and uncertainties surrounding Brexit could put a drag on growth. According to the ECB's March estimate, GDP growth is expected at 1.8%, having been revised upwards by 0.1 pp from December 2016. The latest *Consensus Forecast* and the IMF estimates indicate GDP growth of 1.7%, which is by 0.3 pp and 0.1 pp higher than their previous estimates, respectively. The ECB expects a similar pace in 2018 (1.7%), while the IMF and *Consensus Forecast* estimates are somewhat lower (1.6% and 1.5%, respectively).

Economic activity in the **USA** slowed down in Q4 2016 (0.5%, s-a) from Q3 (0.9%, s-a), but it was still higher than in H1. Alongside private consumption, which stayed the strongest impetus to growth, investment recovered in Q4 owing to the adjustment of investment activity in the energy sector and higher profitability of companies. On the other hand, declining exports and a rise in imports made net exports weigh on GDP growth as a negative contributor.

Further positive trends in the US labour market, i.e. low unemployment (4.5% in March), coupled with a rise in share and real estate prices, boosted consumer confidence which in March reached its highest level since end- 2000, as measured by the *Consumer Confidence Index*. Besides consumption, positive trends continued in manufacturing, as shown by *ISM Manufacturing* index, which in Q1 was on average 7% higher than a quarter earlier. According to the preliminary estimate of the US Bureau of Economic Analysis, in Q1 GDP growth measured 0.2%, s-a.

The anticipated fiscal incentives should spark private consumption and investment further, and so these components are expected to be the main fillip to GDP growth in the period ahead. The April IMF estimate projects GDP growth at 2.3% in 2017, and then at 2.5% in 2018, while the April *Consensus Forecast* hints at slightly lower growth rates (2.2% and 2.4%, respectively).

Compared to a quarter earlier, **GDP growth** sped up in Q4 2016 in most **Central and Eastern Europe** countries. Alongside further positive contribution from private consumption, which stayed the key driver of growth, most countries felt impetus from net exports, which can be linked to accelerating economic activity in the euro area. Readings of monthly indicators in the majority of countries indicate an additional pick-up in GDP growth in Q1, helped by further labour market recuperation, accommodative monetary policy and in some countries accommodative fiscal policy, as well as by the expected recovery of investment after its decline in 2016. GDP growth estimate for 2017 was revised upwards in the latest IMF report for most countries, and the region as a whole is expected to see GDP growth of 3.0%, anticipated to speed up to 3.3% in 2018.

A rebound in oil prices, improving business sentiment and easing financial conditions all reflected positively on investment, and, along with a further rise in exports, made room for **Russia's GDP** recovery in Q4 2016 (0.3% y-o-y). Owing to these factors, Russia's GDP is expected to grow further in 2017 and 2018 (1.4% in both years, according to the IMF estimate), helped also by the anticipated recovery in private consumption.

In Q1, **China's GDP** posted the highest growth in the last six quarters (6.9%, y-o-y), propelled largely by infrastructure investment on the expenditure side, and by manufacturing on the production side. Driven by higher domestic demand and higher prices of raw materials, imports soared in Q1, outstripping exports, which favoured from depreciation of the national currency and increased global demand. These trends were in line with the gradual transition of the economy and greater reliance on domestic demand as the chief source of economic growth and weaker reliance on net exports. Good economic results at the start of the year made the IMF revise upward its GDP growth estimate for China by 0.4 pp for 2017, to 6.6%, while slowdown is expected in 2018 – at 6.2% due to further adjustment to the new growth model.

Inflation movements

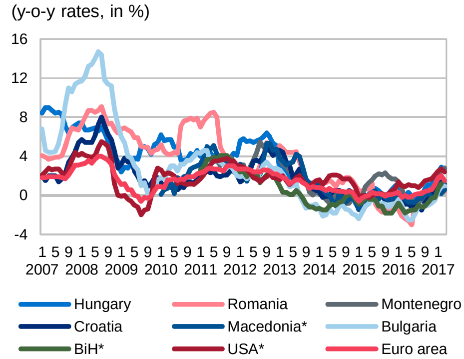
In recent months, global inflation has been on the rise, largely helped by a rise in the prices of primary commodities. In the **euro area**, our key trade partner, inflation edged up gradually due to a rise in the prices of energy and food. It came at 2.0% y-o-y in February, reaching its four-year record high, only to drop to 1.5% in March. Core inflation still treaded below its long-term average due to a still moderate rise in wages and weak pressures on the demand side. Observed individually, Serbia's key trade partners, Germany and Italy, also saw a rise in prices in recent months – though Germany somewhat above and Italy slightly below the euro area's average. Preliminary data for April indicate that headline

Table IV.7.1 **Economic growth estimate by country**
(in %)

	Consensus Forecast April 2017		IMF April 2017	
	2017	2018	2017	2018
Poland	3.3	3.2	3.4	3.2
Czech Republic	2.5	2.6	2.8	2.2
Hungary	3.2	3.1	2.9	3.0
Albania	3.7	3.9	3.7	4.1
Bulgaria	3.1	3.0	2.9	2.7
Bosnia and Herzegovina	3.0	3.3	3.0	3.5
Macedonia	3.1	3.4	3.2	3.4
Romania	3.8	3.2	4.2	3.4
Slovenia	2.7	2.5	2.5	2.0
Croatia	3.0	2.7	2.9	2.6

Sources: Consensus Forecast and IMF.

Chart IV.7.7 **HICP across selected countries**
(y-o-y rates, in %)

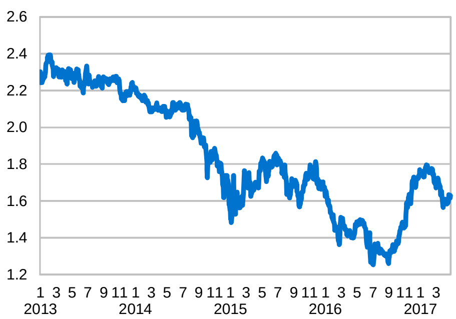


Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.
* CPI.

inflation increased to 1.9% and core inflation to 1.2% y-o-y, but most analysts claim that the y-o-y rise in prices came mainly as a result of different dates of Easter this (mid-April) and last year (end-March).

Y-o-y inflation in the euro area is expected to slow down by end-2017, and then to rise gradually in the following two years, primarily due to accommodative monetary policy and expected economic recovery. Still, it will probably move below the medium-term inflation target. According to the ECB March projection, inflation in the euro area will be at 1.7% in 2017, having been revised upward from 1.3% in late 2016. Inflation expectations will keep a similar pace according to the ECB Survey of Professional Forecasters published in late April – they are placed at 1.6% for 2017, 1.5% for 2018, and 1.7% for 2019. Compared to the previous expectations, published in January, April expectations are by 0.2 pp higher for 2017 and by 0.1 pp for 2019, while unchanged for 2018. Long-term inflation expectations (for 2021) are still at 1.8%. These survey-based expectations again came above long-term market expectations which after their 1.8% rise in January started declining and then dipped to 1.6% by end-April.[24]

Chart IV.7.8 **Long-term inflation expectations in the euro area**
(in %)



Source: Thomson Reuters.

Inflation also went up across most **Central and Eastern Europe** countries, and in Q1 moved in the positive zone in all observed countries. Even in Bulgaria, after nearly four years, y-o-y inflation was positive and ranged from 0.4% to 1.0% in Q1. Consumer prices rose slightly in Romania and Macedonia, and somewhat more in Hungary and Montenegro, but never went past 3%. The strongest impetus to the rise in consumer prices in this region came from global energy prices and food prices (vegetable prices went up at the start of the year due to cold weather). On the other hand, core inflation remained low in most countries due to still relatively weak pressures on the demand side, despite their upward trajectory. Among countries that faced relatively high inflation in the recent period, Russia managed to pull it down to 4.25% in March, while Turkey still posts relatively high inflation that measured 11.3% in March largely due to the depreciation of the Turkish lira in the prior period.

US y-o-y inflation rose all the way up to 2.7% in February. The Fed's preferred inflation measure, the personal consumption expenditures price index, slightly passed the 2% inflation target that same month and came at 2.1%. In addition to higher prices of primary commodities, inflation rose on the back of rising demand

[24] The five-year, five-year breakeven forward.

sparked by economic recovery, as indicated by a rise in core inflation (to 2.2% in February). For the first time after seven consecutive months of picking up, y-o-y inflation slowed down in March, which markets did expect, yet to a lesser extent (2.6%) than was actually recorded (2.4%). Monthly inflation declined by 0.3% s-a, for the first time in the last 13 months.

Still, it is believed that lower prices of gas and mobile telephony services put a temporary drag on inflation in March, and that this is the first time in the last several years that inflationary pressures have been sustainable.

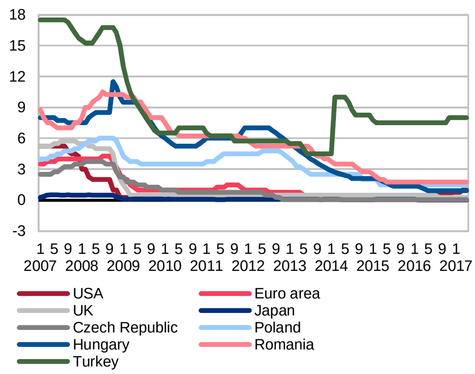
Monetary policy

Most central banks in advanced countries keep their interest rates at historically low levels, and some still use unconventional monetary policy measures. Besides the ECB, the central banks of Great Britain, Sweden and Japan implement asset purchase programmes, while the Swiss National Bank intervenes in the FX market to curb excessive appreciation of its currency. At the same time, the Fed continued its monetary policy normalisation, and expectations regarding its pace in the coming period, combined with the expected ECB moves, shape the trends in the international financial market.

Keeping its key rate at 0% and its deposit facility rate below 0%, the **ECB** continued to give credit support to the economy via its QE programme. As of April 2017, the monthly volume of asset purchases was reduced from EUR 80.0 bln to EUR 60.0 bln, and the programme is to be implemented until year-end. In its end-April meeting, the ECB said it continued to expect its key interest rates at present or lower levels for an extended period of time, and well past the horizon of their net asset purchases. Should economic prospects turn unfavourable, the ECB is ready to extend the QE programme.

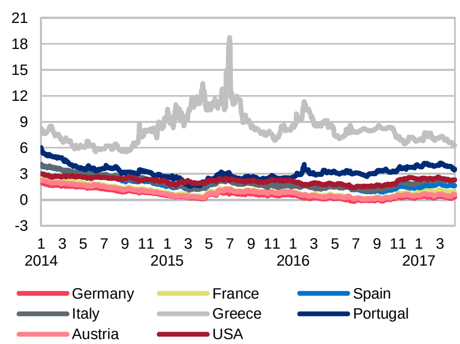
On the other hand, in March the **Fed** again raised the target range of its benchmark rate by 25 bp to 0.75%–1.0%. It highlighted that the decision to further raise the benchmark rate came in the light of continuous progress of the US economy towards the central bank's targets, full employment and price stability. In the coming period, the Fed expects a moderate rise in economic activity, alongside a gradual hike in the benchmark rate, further improvement in the labour market, and inflation stabilisation at around 2%. Its medium-term projection

Chart IV.7.9 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

Chart IV.7.10 **Yield on 10-year bonds of selected countries in the euro area**
(daily data, in %)



Source: Bloomberg.

for the federal funds rate stayed practically unchanged in March relative to December and was at 1.4% for end-2017, 2.1% for end-2018 and 3.0% for end-2019. The Fed still pursues its reinvestment policy, under which it reinvests securities purchased under the QE programme, but markets have increasingly been speculating about the timing of the Fed's shrinking of assets. At its meeting in early May, the Fed did not change its benchmark rate, but did say that the economic slowdown in Q1 caused a temporary stir in market expectations as the June rate rise odds jumped to 94%, according to the futures prices.

Central banks in most **Central and Eastern Europe** countries did not change their interest rates that stand at their historical lows, nor did they hint at prospects of a hike any time soon. However, the rise in inflation since the start of the year has slightly aroused expectations that these central banks will start raising their benchmark rates in 2018. The central bank of Turkey did not change its key policy rate, but did tighten its monetary policy during the review period by raising its lending overnight and late liquidity rate. As of April, the central bank of the Czech Republic stopped intervening in the FX market to curb its currency appreciation over the target level. On the other hand, owing to inflation slowdown, the central bank of Russia eased its monetary policy, cutting the key rate to 9.25%, down by 25 bp in March and by additional 50 bp in April.

The central bank of **China** pursued accommodative monetary policy, not only by means of record-low interest rates, but also by guaranteeing for medium-term loans to financial institutions. Still, it raised its interest rate on these loans in January 2017, for the first time since their introduction in 2014. This was also the first time it raised any of its interest rates since July 2011. At the beginning of February, it slightly raised its short-term interest rates and rates on reverse repo transactions (repo sale of securities), given the capital outflow and risk on the financial system caused by the economy's indebtedness. In recent months, due to capital outflow from China, besides tightening capital control, the central bank has been intervening in the FX market, which reflected on a reduction in FX reserves. Analysts do not expect the central bank of China to significantly raise its interest rates in the coming period, having in mind the likely adverse effects on economic growth.

Financial and commodity markets

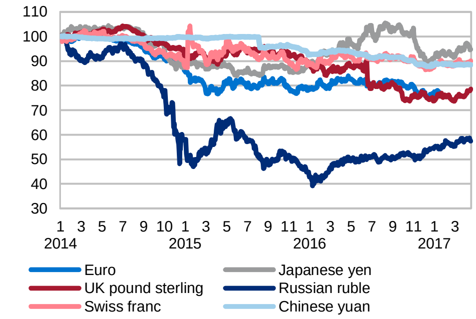
Since the start of the year, risk perception in the international financial market improved on the back of more favourable prospects of global economic growth, which prompted a rise in stock indices, inflation expectations and yields on long-term government securities across most advanced countries. Yet, during the review period, market trends often changed directions under the sway of undertaken measures, but even more by expectations regarding monetary policies of leading central banks – the Fed and the ECB, and uncertainties surrounding the reforms of the new US administration and the elections in some of the euro area countries.

Besides expectations of the Fed's further hike of its benchmark rate, the question that has become increasingly raised is the timing of the Fed's balance sheet shrinking, i.e. when the Fed would end reinvestment and gradually reduce assets as its securities under the QE programme start maturing. This helped the dollar strengthen and pushed up US Treasury yields in February. However, although the Fed raised its benchmark rate in March, it did not change the benchmark rate projection relative to December. This, and uncertainties surrounding the announced economic reforms, prompted markets to expect that monetary policy would be more accommodative than was estimated before the meeting, which reflected on the dollar's weakening and lower yields on government bonds in the wake of the March meeting.

Higher February inflation and the upward revision of economic growth and inflation projections gave rise to expectations that the ECB could reduce the monthly asset purchase volume or end the QE programme before year-end, which made the euro strengthen and yields on euro area central government bonds rise. Greater than expected inflation slowdown in March and prospects of its slow recovery after all, along with uncertainties regarding the elections, worked in the opposite direction – increasing the chance that the ECB would not change its monetary policy by year-end.

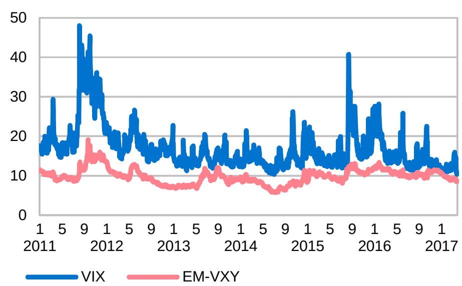
Changing expectations regarding monetary policies of leading central banks paved the way for a volatile trajectory of **yields on government securities in leading economies and exchange rates**. Yields on German ten-year government securities, referential for the euro area, went up in January and March to almost 0.5%, and the euro strengthened against the dollar. Conversely, these

Chart IV.7.11 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



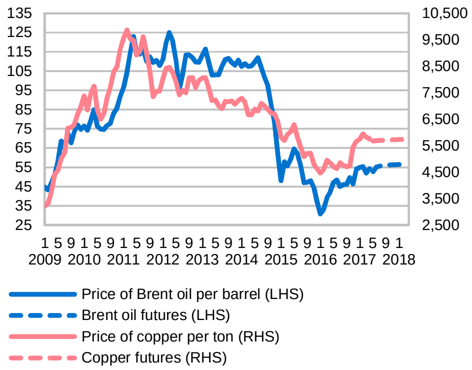
Source: IMF.
* Growth indicates appreciation.

Chart IV.7.12 **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.7.13 **Oil and copper price movements**
(average monthly prices, in USD)



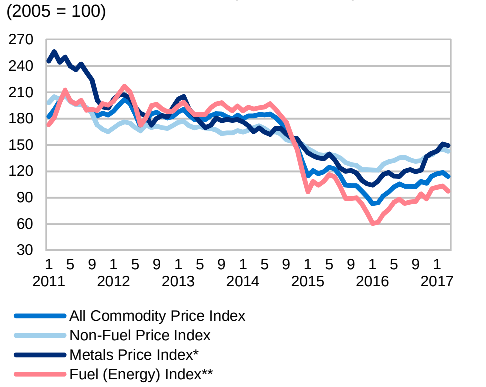
Source: Bloomberg.

yields dropped in February and April to below 0.2%, and the euro weakened vis-à-vis the dollar. Yields on ten-year US treasuries hovered around 2.4% from the start of the year, rose to 2.6% in March, only to slide to 2.3% by end-April. As a result, the spread between US and German government securities during the entire review period was over 200 bp, which is the widest spread since the euro was introduced. Ranging from 1.04 – 1.09 USD for 1 EUR, the euro was by 1.4% stronger at end-Q1 relative to a quarter earlier. Although the euro first declined in early April, it strengthened by the end of the same month by additional 2.2% against the dollar.

Despite changing expectations, the implicit measure of **financial market volatility** (VIX) fluctuated between 10.6% (in January) and 16.0% (in April). Although it did increase, in historical terms it still stands at a relatively low level. The EM-VXY index – which tracks volatility in emerging market currencies – also declined – from around 11% in January to 8–9% in March and April. Although implicit volatility measures did not increase significantly, investors stepped up their safe-haven demand for gold. After its Q4 decline, the price of gold rose by 8.6% in Q1, and then by additional 3.2% in April.

Global oil prices ranged between USD 50 to USD 56 per barrel since the start of the year. Compared to the same period last year, when it was exceptionally low (primarily in January 2016), the average global Brent crude oil price was by 57.5% higher in Q1 (and as much as by 78.2% y-o-y in January). This oil price hike comes largely as an outcome of the OPEC countries agreement on capping oil production as of January this year at the level from October 2016. The agreement was backed by Russia and other ten countries which are independent producers, which gave credence to market expectations of sustainability of the agreement. The data indicate curbed oil production in these countries, but not entirely as envisaged by the agreement. Also, the pressure working towards a more palpable rise in oil production was eased by a step-up in shale drilling in the USA (when oil prices go above USD 50 per barrel), and by the expected rise in production in countries that did not back the agreement. Continued sluggish recovery of oil demand in emerging markets, China included, worked in the same direction. Oil futures indicate that oil prices in December 2017 will be USD 50 per barrel and will stay close to that level until end-2018.

Chart IV.7.14 **IMF Primary Commodity Prices Index**
(2005 = 100)

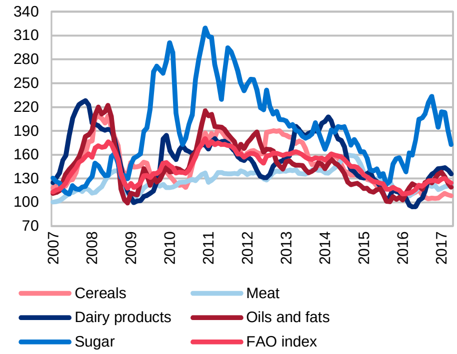


Source: IMF.
* Copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium.
** Crude oil, natural gas and coal.

Besides oil prices**, the prices of base metals** also strengthened since the start of the year, acting as one of the key inflationary pressures globally. Although dipping in March, at end-Q1 these prices exceeded by around 30% their last year's levels, as measured by the IMF metal price index.

Bleak prospects of main crops production pushed up **world food prices** in January, but they fell as the prospects improved in March. At quarter-level, measured by the FAO index, world food prices rose mildly (by 0.4%, both in nominal and real terms), driven by greater demand primarily in emerging markets. Both meat and cereal prices went up by 3.9%, while a decline was recorded for edible oil prices (8.4%), sugar (2.3%) and dairy products (1.5%). In April, world prices lost 1.8% in real terms, but still stood 9.9% above April 2016 figures. Prices of all types of food declined save for meat which rose by 1.7% in real terms during April, and gained 11.3% over the last year.

Chart IV.7.15 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

Text box 3: Importance of the international environment for growth in Serbia and other emerging economies

The international environment is exceptionally important for growth in emerging economies, Serbia included, given that these economies have become integrated into the global trade system and the international capital market. The international environment may, in different ways, provide a stronger or weaker growth impulse in emerging economies. Depending on their influence, external factors can be generally grouped into: 1) external demand conditions, 2) external financial conditions and 3) terms of trade. Over the past years, it has been particularly challenging to monitor the impact of external factors in emerging economies given their increasing complexity and divergence. For instance, slow global recovery and weak external demand have not been conducive to economic growth, in contrast to monetary accommodation of the leading central banks, globally low interest rates and high capital inflows.

The IMF has also analysed the impact of external conditions on growth in emerging market and developing economies[1] in order to assess the importance of all three groups of external factors and whether it evolves over time. On the sample of over 120 emerging market and developing economies, including Serbia, during the 1970–2014 period, the IMF concluded that external conditions and, in particular, external financial conditions, have become increasingly influential determinants of their medium-term growth. Measured by gross capital inflows, the contribution of external financial conditions to economic growth has become stronger particularly since 2005. The contribution of external demand has been relatively stable, with the increasing role of demand from emerging economies. As emphasised by the IMF, these economies are important today not just as centres of production but also as final destinations for consumer goods and services. They account for more than three-fourths of global growth, almost double the share of two decades ago. According to the IMF's analysis, while the contribution of terms of trade appears to be small, it is substantially higher for commodity exporters than for the average country in the sample because the beneficial impact from higher prices for commodity exporters is weighed down by their negative impact on economies that rely on imported commodities

Going forward, external conditions are expected to remain complex and highly uncertain. On the **external demand** front, following the slow global recovery over the past years and low inflation, it seems that the majority of economies are finally exhibiting the signs of faster growth. As assessed by the IMF, the global economy gathered pace in mid-2016 and is likely to grow at 3.5% this year (vs. 3.1% in 2016) and 3.6% in 2018. Expected positive macroeconomic trends at the global level and optimistic financial markets are gradually strengthening the confidence of consumers, who are likely to save less and spend more. Growth in the euro area, our key trading partner, is expected to be more widely dispersed, both by sector and country. Faster growth in the euro area should positively affect countries in the region, which are also our important trading partners, and thus Serbia as well. As it is likely to be led by domestic demand, euro area growth should be less prone to risks from the international environment. As underscored by analysts, the prospects for faster global economic growth go hand in hand with higher risks, not least because of the rising risk of protectionism in some advanced economies and geopolitical risks. Deeper problems relate to the chronically slow growth in productivity and population ageing, notably in advanced economies.

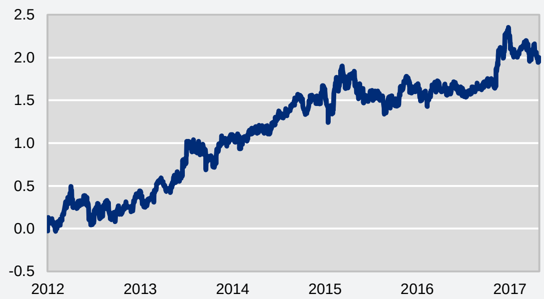
In regard to **external financial conditions**, the divergence of monetary policies of central banks will continue for some time yet. As signalled by central banks, we are to see increased divergence at least until late 2017. The ECB, Bank of England and Bank of Japan continue to pursue monetary accommodation, while the Fed has embarked on faster policy normalisation. Such divergence is best illustrated by the difference in yields on ten-year US Treasuries and German bonds, which became evident in 2013 and widened as of late 2016. The increasing divergence of monetary policies amplifies uncertainties as it makes it difficult to predict global liquidity and capital flows, particularly towards emerging economies, including Serbia.

[1] World Economic Outlook, April 2017 (Chapter 2: Roads Less Traveled: Growth in Emerging Market and Developing Economies in a Complicated External Environment).

The pace at which the Fed will continue to hike its rate, following the March increase, is an important topic in economic discussions. Most analysts assess that the process will be gradual, but that the Fed will – following two years of the slowest monetary normalisation in the modern history of central banks, raise the policy rate at a faster pace thanks to more vigorous economic growth, low unemployment and rising inflation. Judging by futures data of late April, compared to our expectations three months ago, the pace of normalisation is likely to be faster this and slower next year.

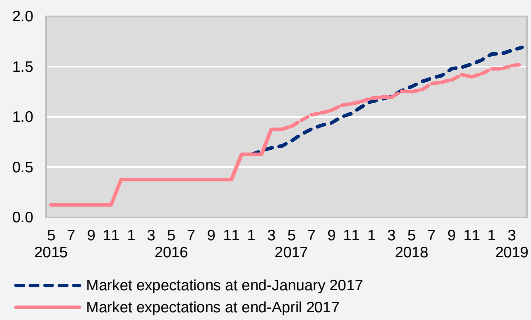
As the Fed normalises its monetary policy, global financial conditions in emerging economies, including Serbia, could be somewhat more unfavourable than in the prior period. However, monetary accommodation by central banks of the rest of the world, notably the ECB, should smooth the negative effects of the Fed's monetary normalisation, which opens room for emerging economies to make adjustments needed to achieve higher and sustainable growth in the coming period. ECB's monetary policy is more important for Serbia given the much stronger financial links. It is therefore favourable that exceptionally low interest rates are still expected in the euro area: the ECB's March projection assumes negative three-month EURIBOR this and next year (-0.3% and -0.2% respectively), and zero values in 2019.

Chart O.3.1 **Difference in yields on ten-year government securities of Germany and the USA**
(in pp)



Source: Bloomberg.

Chart O.3.2 **Achieved and expected Fed's rate***
(p.a, %)



Sources: Bloomberg and Fed.
* Market expectations based on futures.

The third aspect of the international environment – **the terms of trade**, is particularly important for commodity exporting emerging economies. As commodity prices gradually recover, the terms of trade will become increasingly more favourable for exporting countries, and their impact on economic growth will thus become stronger. However, it is little probable that commodity prices will reach the high levels from earlier global expansion episodes. Based on the latest available futures data, the global oil price is expected to reach around USD 50 per barrel by end-2017 and is likely to hover around that level in 2018. This is not a significant rise relative to the current, relatively low level, and is even six dollars lower than expected three months ago. Given that Serbia is a net crude oil importer, the relatively low global price should positively affect economic growth. On the other hand, particularly important for Serbia as an exporting country are agricultural commodity prices. According to futures data, these prices are likely to rise by around 14%, exceeding somewhat our expectations stated three months ago (9%). This growth is likely to reach around 5% in 2018.

All three sets of external conditions – external demand, external financial conditions and terms of trade, will have a varying impact on different emerging economies as their growth impulse is largely dependent on **domestic factors**. Namely, domestic factors are particularly important given that external conditions may provide a weaker growth impulse in these economies in the medium run than in the prior period. Economic policies and structural reforms are therefore of key importance and, in this regard, it should be noted that **Serbia has achieved macroeconomic stability and significant structural improvements**. Successful fiscal consolidation and structural reforms have brought down the fiscal deficit and the public debt to GDP ratio for the first time since 2008, a year earlier than expected. The current account deficit declined owing to faster growth in exports than imports and this trend is expected to continue. By narrowing internal and external imbalances, Serbia increased its resilience to external shocks and, at the same time, its capacity to avail of positive external impulses.

V. Inflation projection

Under our central projection, y-o-y inflation will be relatively stable and continue to move within the target tolerance band of 3.0±1.5% until the end of the projection horizon (in the next two years). The gradual rise in aggregate demand at home and inflation abroad will have a more inflationary impact in the period ahead, while the high base for petroleum product prices will slow inflation down. The risks to the projected inflation path are symmetric and relate primarily to future developments in the international commodity and financial markets, and to a certain degree, also to administered price growth and agrometeorological conditions.

Under our central projection, GDP growth will step up to around 3% in 2017 and further up to 3.5% in 2018. This year, growth will continue to be led by investment and net exports, but the contribution of household consumption will also increase. In 2018, GDP growth should be guided mainly by domestic demand, i.e. investment and consumption.

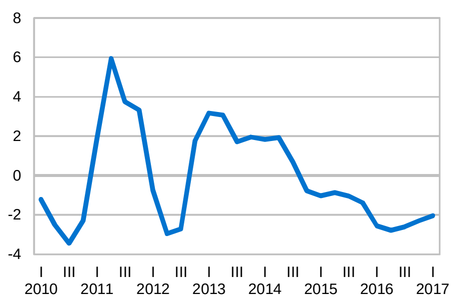
The medium-term inflation projection aims to show the expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. The projection assumes an active monetary policy which seeks to keep 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 previous issues of the *Report*, y-o-y inflation has moved within the target tolerance band since the start of the year, but, like in other countries, it was somewhat higher than expected in Q1. Y-o-y inflation growth was mainly driven by one-off factors, the recovery in the global prices of oil in H2 2016 (which was expected), as well as by a higher than seasonally expected increase in fruit and vegetable prices due to cold weather early in the year.

The value of the dinar against the euro remained relatively stable in Q1 – the dinar weakened 0.4% against the euro at end-Q1 (and gained 0.9% against the dollar as the euro strengthened vis-à-vis the US currency). Depreciation pressures were recorded in January, but waned in February and March; in April, the dinar strengthened against the euro. During this period, FX market developments were strongly influenced by uncertainty in the international financial market relating primarily to the Fed's decision to continue its monetary normalisation, which also reflected on foreign investors'

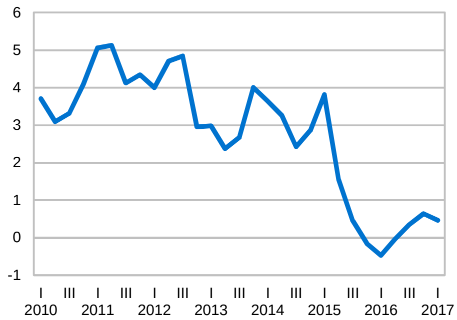
Chart V.0.1 **Monetary conditions index***
(in %)



Source: NBS.

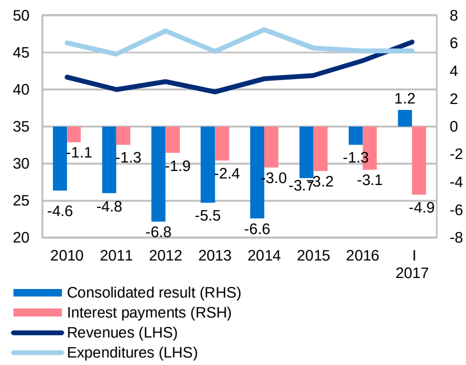
* The monetary conditions index is a combined indicator of the gap of the real interest rate and the gap of the real FX exchange rate. Value >0 indicates restrictive monetary conditions, and value <0 indicates expansionary monetary conditions.

Chart V.0.2 **Real interest rate**
(in %)



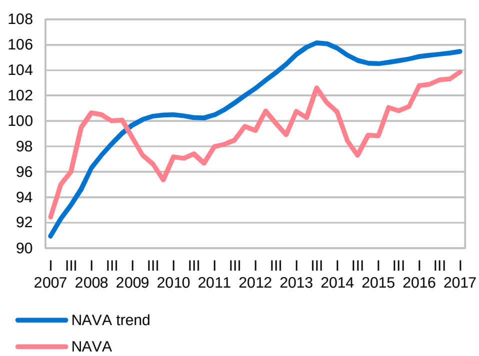
Source: NBS.

Chart V.0.3 **Fiscal trends**
(in % of GDP)



Source: Ministry of Finance.

Chart V.0.4 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

conduct in the domestic market, as well as by higher FX demand of domestic energy importers. The pressures on the dinar were mitigated by export proceeds, FDIs and purchase of foreign cash from natural persons in exchange transactions, and, from February onwards, by a rise in FX-indexed bank assets. Additionally, country risk premium, as measured by EMBI, dipped by 63 bp in Q1 and by a further 21 bp in April, to 165 bp.

The Monetary Conditions Index points to a slightly less expansionary monetary policy stance in Q1. This was due to both of its components – the narrowing of the negative real interest rate gap[25] and of the depreciation gap of the real exchange rate. The real interest rate went down as inflation expectations increased. The fall in country risk premium, however, led to a drop in the real interest rate trend (its neutral level), reducing the difference between the trend and the real interest rate. The depreciation gap of the real exchange rate narrowed as prices at home grew faster than those in the euro area.

Fuelled by higher than expected growth in fiscal revenue, the consolidated budget surplus measured RSD 11.8 bln in Q1 (1.2% of GDP), compared to the quantitative criterion under the IMF arrangement which allows a general government deficit of RSD 32 bln in Q1. Excluding interest payment expenses, a general government surplus of 6.1% of GDP was recorded. Substantial fiscal efforts helped trim central government public debt to EUR 24.5 bln at end-March (EUR 24.8 bln at end-2016), and its share in the projected GDP dipped to 69.2% (compared to 72.9% in late 2016).

In Q1, GDP gained 0.2% s-a, led by the manufacturing industry aided by earlier investment, acceleration of euro area growth and continued recovery in domestic demand which also propped up growth in the majority of service sectors. Conversely, construction, agriculture and energy sectors slumped in Q1 mostly under the impact of cold weather in January. Slower y-o-y growth of 1.0% also reflected the high base from Q1 2016.

NAVA[26] increased in Q1, prompting a further narrowing of the negative output gap[27] to around –1.6%. This means that the disinflationary pressures in respect of aggregate demand were slightly weaker than in the previous quarter.

[25] Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

[26] NAVA (non-agricultural value added) is GDP less agricultural production and net taxes.

[27] Output gap is calculated based on NAVA. NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

Led by domestic demand, euro area's first-quarter GDP growth retained its momentum from Q4, spreading broadly by sector and geography. Improvements in the labour market and stable consumer confidence fuelled household consumption while favourable financing conditions and greater profitability of corporates supported investment growth. However, the still relatively low demand stands in the way of a more notable price growth, as evident from core inflation moving below the long-term average, which is why the ECB has continued its accommodative monetary policy. On the other hand, after the December rate hike, the Fed raised its fed funds rate again in March, and the pace of its hikes in the period ahead will greatly influence movements in the international financial market.

Inflation projection assumptions

External assumptions

Like in the February projection, the assumption for euro area's GDP growth in 2017 has been revised upward in the current projection by 0.3 pp to 1.7%. The assumption for 2018 stayed unchanged (1.5%).[28] New data signal that the recovery in the euro area is spreading across sectors and countries of the euro area, while the downside risks are lower. As unemployment rates declined more than expected and confidence continued up, growth is likely to be robust in H1 this year. It will be led primarily by domestic demand, which in turn is supported by monetary accommodation and sustained improvement in labour market conditions. Investment recovery will continue to be aided by very favourable financing conditions and greater profitability of corporates. A positive contribution will also come from net exports on account of the expected recovery in global trade and the weakening of the euro in the prior period.

The assumption for euro area inflation in 2017 has been revised upward from the February projection by 0.1 pp to 1.6%, while the assumption for 2018 was kept at 1.4%. The upward revision was due to a rise in global oil prices in the prior period. However, expectations are that euro area inflation will continue to move below the medium-term target in both 2017 and 2018, and that the ECB will

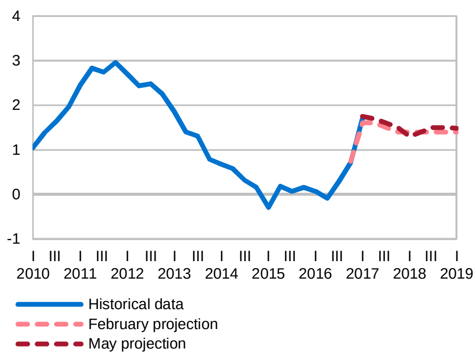
Table V.0.1 **Projection assumptions**

	2017		2018	
External assumptions	Feb.	May	Feb.	May
EU inflation (annual average)	1.5%	1.6%	1.4%	1.4%
ECB policy rate (year-end)	0.0%	0.0%	0.0%	0.0%
Euro area GDP growth	1.4%	1.7%	1.5%	1.5%
International prices of primary agricult. commodities (Q4 to Q4)*	9.0%	14.2%	3.2%	5.5%
Brent oil price per barrel (year-end, USD)	56	50	56	51
Internal assumptions				
Administered prices (Dec to Dec)	4.0%	3.8%	4.0%	4.0%
Trends				
Appreciation trend of the real exchange rate (average)	0.6%	0.6%	0.7%	0.7%
Real interest rate trend (average)	1.4%	1.0%	1.2%	0.8%

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

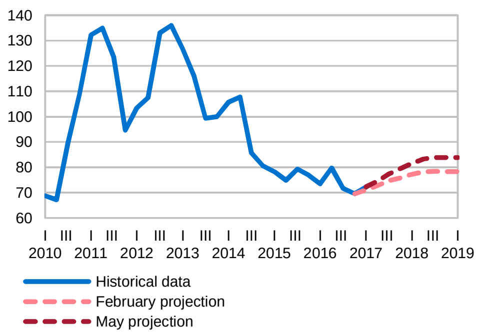
[28] The assumption for euro area's GDP growth in 2017 and 2018 is consistent with the April Consensus Forecast.

Chart V.0.5 **Assumption for euro area inflation**
(y-o-y growth, in %)



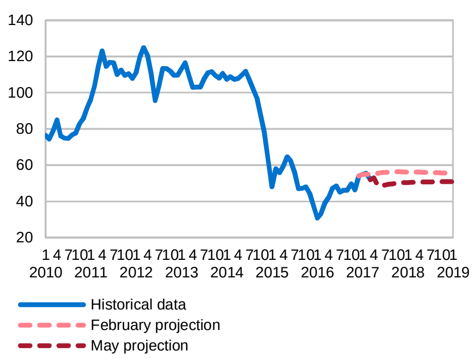
Sources: Consensus Forecast and NBS estimate.

Chart V.0.6 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.7 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

not change its main refinancing rate until the end of the projection horizon.

As a result of a good agricultural season worldwide, the prices of primary agricultural commodities (corn, wheat, soya bean)[29] slumped in H2 2016 to roughly 25% below their 10-year average. Thus, the first-quarter growth in the prices of these commodities (around 6%) came mainly from their gradual convergence to the equilibrium level. As futures movements indicate, primary agricultural commodities price growth is expected to measure around 14% in 2017, which is higher than expected in the February projection (9%), and to slow down to around 5% in 2018.

Based on the latest available futures, global oil prices are expected to amount to USD 50 per barrel at end-2017 and to be at a similar level in 2018 as well.[30] We revised downward our assumption of oil price growth relative to the February projection as we expected upward pressure on oil prices to be mitigated by both supply and demand side factors. On the supply side, effects are expected to come from higher oil production in the USA, the anticipated higher output in countries not party to the deal on production caps, and a possible non-compliance of some countries with the deal. Price growth will also be held back by the sluggish recovery in oil demand of emerging markets, including China.

Internal assumptions

In view of the outlook for international prices of primary agricultural commodities and the influence they have on their counterparts in Serbia, we have assumed that domestic primary agricultural commodity prices will record an increase both this and the next year.

The assumption for administered price growth in 2017 remains unchanged from February (around 4%, 0.75 pp contribution to inflation). For its major part, the rise in administered prices this year will come as a result of the January rise in cigarette prices (4.5%, 0.2 pp contribution to inflation) and the assumed increase in cigarette prices due to excise growth in July, as well as the adjustment of natural gas prices due to rising global oil prices and change in the price of electricity. We assumed that the increase in electricity prices will be similar to that of last

[29] Measured by the composite index which comprises dollar prices of wheat, corn and soya bean on benchmark commodity markets.

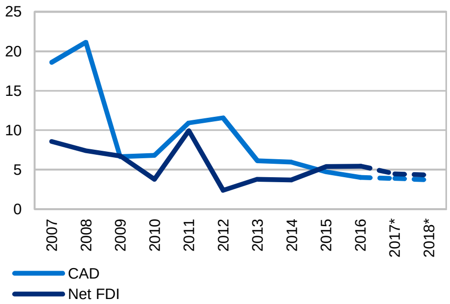
[30] Brent.

year. The projection assumes administered price growth rates to stay at 4.0% in 2018 as well.

Serbia's improved macroeconomic outlook and the narrowing of internal and external imbalances resulting from fiscal consolidation and the implementation of structural reforms led to a lowering of the country's risk premium and an upgrade in its credit rating. As positive macroeconomic trends are expected to be sustained in the coming period, the country's risk premium should stay relatively stable (at least in terms of domestic factors, as the impact of international factors may be more volatile and is currently difficult to estimate). In addition, relative stability in the FX market in the period ahead will be further supported by the expected continuation of export growth and FDIs which will continue to be more than sufficient to cover the current account deficit.

The projection operates on the assumption that inflation expectations will continue to move around the target midpoint in the period ahead, i.e. that they will remain anchored. We also assumed an appreciation trend of the real exchange rate, which is typical for transition economies and caused by the removal of price disparities (notably in terms of administered prices), and by the Balassa-Samuelson effect.[31]

Chart V.0.8 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.
* NBS projection.

Projection

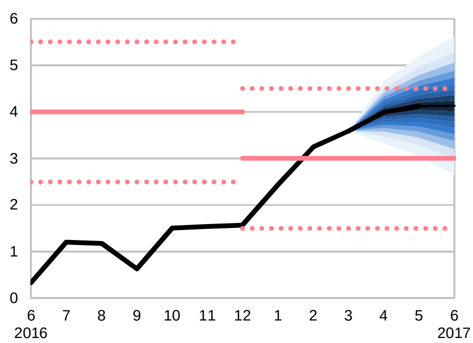
Inflation projection

Under our central projection, y-o-y inflation will continue to be within the target tolerance band of 3.0±1.5% until the end of the projection horizon.

Short-term inflation projection

Under the central short-term projection, y-o-y inflation will be stable in Q2, hovering slightly above its level in March. At quarterly level, CPI growth will be much slower than in Q1, as the rise in the prices of fruit, vegetables and solid fuels early this year was higher than usual for the season due to cold weather. Inflation movements will be determined by the increase in fresh meat prices, powered by a rise in these prices in the global market, as well as by higher prices of fruit and the seasonal rise in the prices of travel packages. Conversely,

Chart V.0.9 **Short-term inflation projection**
(y-o-y rates, in %)



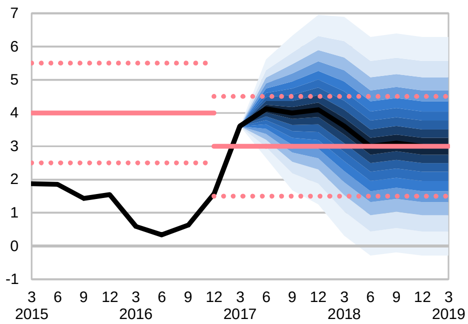
Source: NBS.

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

vegetable prices are expected to decline, given their robust growth in Q1. A negative contribution in Q2 will also come from energy, as the expected rise in petroleum product prices will be offset by the seasonal decline in solid fuel prices.

Y-o-y core inflation (i.e. change in CPI excluding food, energy, alcohol and cigarettes) should edge up slightly in Q2, due to the low base effect. At quarterly level, core inflation growth will be guided by the seasonal increase in the prices of travel packages.

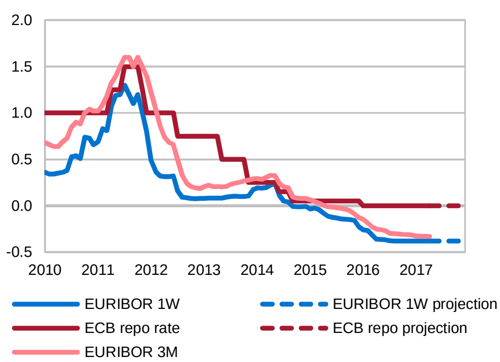
Chart V.0.10 **Inflation projection**
(y-o-y, in %)



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%. Each following shade includes 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected 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%.

Chart V.0.11 **Assumption of movement in interest rates in the euro area money market**



Source: European Money Markets Institute.

Medium-term inflation projection

We expect y-o-y inflation to continue to move within the target tolerance band (3.0±1.5%) until the end of the projection horizon, though it will decline in the initial months of 2018 as current one-off price increases drop out of the annual comparison. Higher inflation will reflect a gradual increase in aggregate demand at home and inflation abroad (notably, the euro area), while the high base for petroleum product prices will act as a damper.

This year is likely to see a further recovery in domestic demand, and weaker disinflationary pressures on account of the negative output gap. This gap opened back in 2008 following the spill-over of the global financial crisis to Serbia, but has been narrowing down for more than two years now, aided primarily by the rebound in employment and private sector wages and by growing external demand. The narrowing of the gap will be supported by past monetary easing of the NBS and the ECB's monetary accommodation. The monetary policy measures of the ECB contribute to Serbia's economic growth not only through stronger demand for our exports, but also through interest rates on euro-indexed loans,[32] given that low interest rates encourage credit and, by extension, economic activity. Still, we do not expect that the negative output gap will close entirely, i.e. that the disinflationary effects coming from domestic demand will be completely exhausted, until the end of the projection horizon.

The analysis of inflation components shows that the above waning of disinflationary pressures in respect of demand, together with the inflation rise in the euro area as our main trade partner, will reflect on the y-o-y increase in the prices of non-food products and services

[32] The markets expect 3M EURIBOR to stay negative until end-2018.

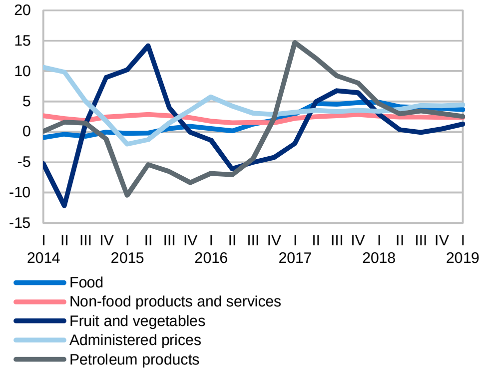
which, according to our central projection, will measure around 1 pp more at end-2017 than at present (2.3%). Still, with the expected easing of imported inflation in the period ahead, non-food inflation should fall to around its present level towards the end of the projection horizon. After rising robustly early this year on account of extremely cold weather and the fact that they had previously been at a very low level as a result of last year's excellent agricultural season, fruit and vegetable prices are now close to their neutral level. Assuming an average agricultural season this year, they should provide a positive contribution to inflation over the short run, but this effect will wear off early next year as a result of a higher base.

The prices of primary agricultural commodities (corn, wheat and soya bean), by which we approximate the prices of inputs in food production, increased from November 2016 onwards, which led to the closing of the negative RMCP gap.[33] On that basis, we estimate that the costs of food production inputs in Q1 were roughly neutral. Together with the base effect from the increase in the prices of fresh meat last summer and of some other products early this year (coffee, eggs) and the rise in food prices in the EU, this will lead to domestic food inflation (excluding fruit and vegetables) hovering around its present level in the remaining months of 2017.

As a result of the rebound in global oil prices begun last year and, to some extent, the strengthening of the dollar against the euro, the prices of domestic petroleum products gained 17% in March 2017 from a year earlier,[34] contributing 0.9 pp to inflation. However, as these price increases will be dropping out of the annual comparison, y-o-y inflation growth on this account will slow down in the period ahead assuming oil prices stay relatively stable. Though the contribution of petroleum product prices to y-o-y inflation should remain positive until the end of the projection horizon, it will get increasingly weaker and turn almost neutral by the end of the forecast period.

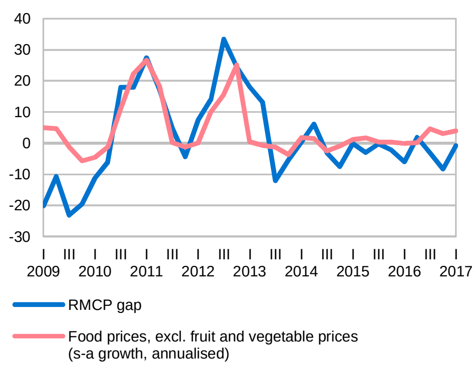
The risks to the projected inflation path relate primarily to future developments in the international commodity and financial markets and, by extension, to the prices of petroleum products and food at home, but also, to a degree, to administered price growth this and the next year and agrometeorological conditions (success of the agricultural season at home).

Chart V.0.12 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

Chart V.0.13 **Impact of RMCP on food prices**
(in %)



Source: NBS.

[33] Real marginal costs of processed food producers (RMCP) are calculated as the ratio of primary agricultural commodity prices and food prices. Negative RMCP gap opens when these costs fall below the trend level.

[34] Global oil prices soared by over 50% during the same period.

Based on the latest available data from the futures markets, we have assumed that global oil prices will be stable both this and in the next year. However, as these prices are generally very volatile and are currently determined by supply which is difficult to forecast, there is a likelihood of their departure from the assumed path. With regard to the prices of primary agricultural commodities in the global market, they have been rising from November 2016 onwards and are likely to continue up this and the next year, aided by the expanding demand of emerging markets. However, as in the case of oil prices, the prices of primary agricultural commodities may deviate in either direction – both upward and downward. Having in mind the impact of these prices on prices in Serbia, we may assume that actual inflation could also deviate from the projected path in either direction. The effect on domestic food prices, notably fruit and vegetable prices, will also depend on the success of the agricultural season at home, which we assume will be average.

The risks associated with developments in the international financial markets continue to be tilted to the upside, mainly because of the expected further normalisation of the Fed's monetary policy. In March, the Fed again raised its target range for the fed funds rate by 25 bp to 0.75–1.0%. Though the median projection of the Fed funds rate until end-2019 stayed unchanged in March relative to December, the question is now when the Fed will stop reinvesting in maturing securities purchased as part of the QE programme. The accommodative monetary policy stance of the ECB is working in the opposite direction. Still, the ECB cut its monthly asset purchases from EUR 80.0 bln to EUR 60.0 bln since April. Also, upward revisions of economic growth and inflation projections gave rise to expectations that the ECB could reduce the volume of monthly asset purchases or even end the QE programme before the year is out. This could dampen portfolio investment in emerging markets, Serbia included, possibly leading to depreciation pressures and, ultimately, some upward pressure on prices at home.

The projection operates on the assumption that administered prices will grow by around 4.0% this and the next year. Administered price growth in 2017 will largely reflect the rise in cigarette, electricity and natural gas prices. At this point, however, it remains uncertain whether electricity prices will be raised in 2017 and by how much. Absent this increase, y-o-y inflation would fall short of the projected trajectory by around 0.2 pp.

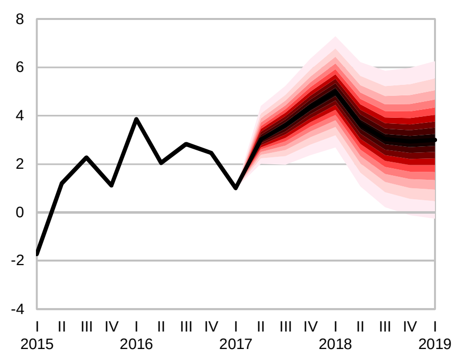
On balance, the risks to the projected inflation path are judged to be symmetric.

Looking ahead, monetary policy decisions of the NBS will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors. This means that the NBS will continue to closely monitor and assess movements and trends in the domestic market and in the international environment, including both the international financial market and the market of primary commodities. The NBS will as so far use all available instruments to make sure inflation remains low and stable over the medium term which, together with the preservation of financial stability, will contribute to sustainable economic growth.

GDP projection

According to our estimate, though GDP movements in early 2017 were affected by cold weather, the negative effects of this should be offset in the remaining part of the year. Bearing this in mind and the fact that growth prospects for the euro area have been revised upwards, we expect GDP growth to measure around 3% in 2017 (unchanged from the February projection).

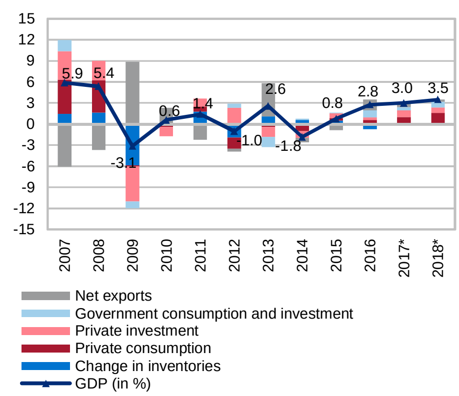
Chart V.0.14 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Continued upgrade of the business environment, higher profitability of the domestic economy in 2016, favourable financing conditions, FDI inflows and an improved global growth outlook provide a sound basis for further growth in investment which, according to our estimate, ought to remain the key driver of GDP growth in 2017. In addition, the implementation of earlier investments, largely concentrated in the tradable sectors, powered a rise in the export potential of the domestic economy. As a result of this, and of the stronger external demand signalled by improved growth prospects of our key foreign trade partners, the contribution of net exports to GDP growth should be positive. This contribution will be smaller than a year earlier due to rising needs of the economy for imports of equipment and intermediate goods and higher imports of consumer goods fuelled by the rebound in household consumption.

Chart V.0.15 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

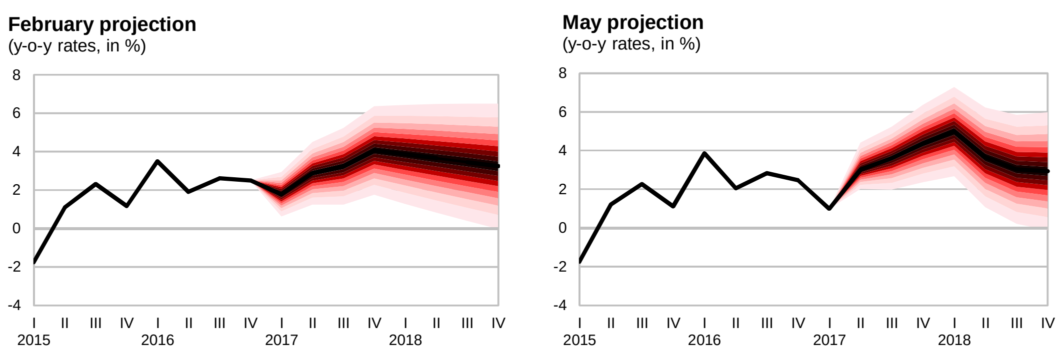
A positive contribution to GDP growth in 2017 is also expected from a rise in household consumption, underpinned by increased disposable income on account of higher real wages and employment, notably in the private sector, increased pensions and lower costs of borrowing for households.

On the production side, GDP growth in 2017 should be guided by the manufacturing industry and services and, to a smaller extent, by construction. The positive contribution of the manufacturing industry will reflect the anticipated rise in domestic and external demand. On the supply side, the manufacturing industry is supported by new production capacities resulting from already implemented investments. Higher demand at home will also encourage growth in a number of services sectors. After a sluggish start of the year, construction is expected to record growth. This is signalled by a rise in the production and stocks of construction materials in Q1, increased number of permits issued and higher anticipated value of works in the first two months, as well as by legislative improvements. On the other hand, agriculture is expected to provide a negative contribution this year, as last year's agricultural season outperformed the ten-year average while this year's season is expected to be at the level of this average.

GDP growth is expected to step up further to 3.5% in 2018, supported by sustained recovery of household consumption and a continued rise in investment and exports, which should reflect on faster growth in the manufacturing industry and service sectors. Further improvement of the business environment and sustained growth in the euro area and our other important foreign trade partners ought to contribute to the acceleration of GDP growth.

The implementation of reforms and improvement in the investment and business environment reflected in Serbia's progress on the international competitiveness rankings. With this in mind, we expect that a further upgrade of the business and investment environment, together with a continuation of structural reforms, will create conditions for faster sustainable growth in the coming years.

Chart V.0.16 **Current vs. previous GDP growth projection**



Source: NBS.

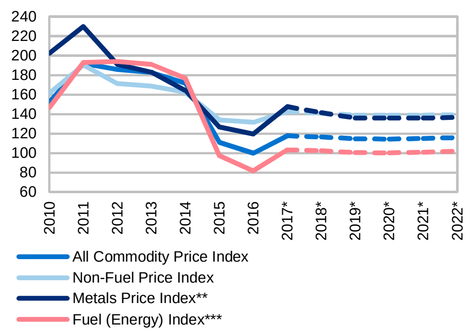
The risks to the GDP projection are mainly associated with the pace of growth of the euro area and other foreign trade partners and developments in the international financial and commodity markets. Faster than expected global recovery and continued monetary stimulus could push up growth in the euro area, resulting in stronger demand for our exports and faster investment growth, and thus, higher than projected GDP growth in Serbia. Conversely, a slower pace of implementation of structural reforms and uncertainties surrounding Brexit could to a degree slacken growth in the euro area. In that case, lower external demand and investment growth slowdown would lead to lower than projected GDP growth in Serbia.

The diverging monetary policy stances of leading central banks have reflected on capital flows in the international financial market and indirectly also on the costs of borrowing for emerging markets. If the Fed were to speed up its monetary normalisation and the ECB to reduce its monetary accommodation relative to market expectations, this could lead to lower capital inflows to emerging markets and, to a degree, to slowdown in economic growth.

In addition to developments in the financial market, the risks to the projection are also associated with developments in the commodity markets, primarily the global price of oil. A drop in oil prices would reflect positively on Serbia's GDP growth through an increase in households' disposable income and lower operating expenses of corporates, while any more significant oil price hike would work in the opposite direction. In addition to oil, also significant for Serbia are movements in global prices of primary commodities, particularly cereals and basic metals of which Serbia is the net exporter. A more substantial rise/fall in the prices of these products would have a positive/negative effect on Serbia's GDP movements.

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

Chart V.0.17 **Projection of movement in primary commodity prices**
(2005 = 100)



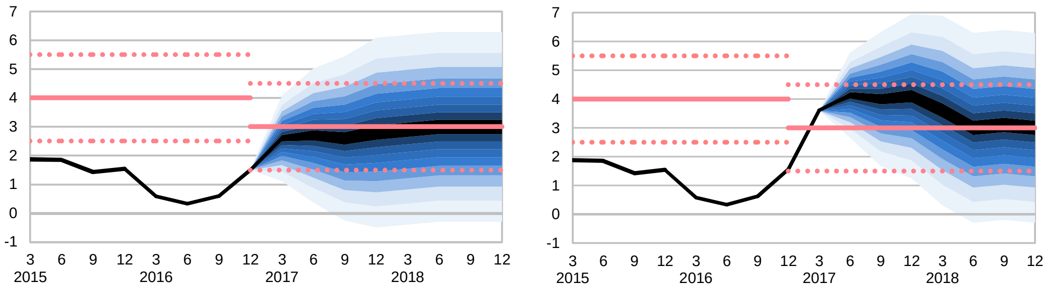
Source: IMF.
* IMF projection.
** Copper, aluminium, iron ore, tin, nickel, zinc, lead and uranium.
*** Crude oil, natural gas and coal.

Comparison and outcome of inflation projections

The new medium-term inflation projection for 2017 is higher than in February, while the projection for 2018 is almost unchanged. As the higher inflation projection for 2017 primarily reflects the faster than seasonally expected

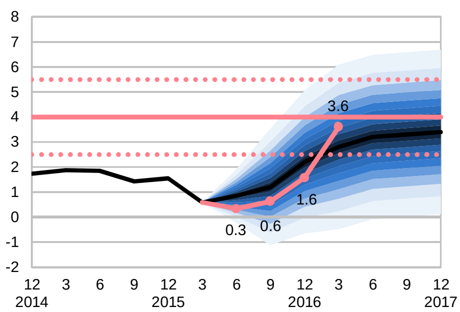
Chart V.0.18 **Current vs. previous inflation projection**

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



Source: NBS.

Chart V.0.19 **Achievement of May 2016 inflation projection**
(y-o-y rates, in %)



Source: NBS.

growth in the prices of fruit, vegetables and solid fuels early this year due to adverse weather conditions, once these price increases drop out from the annual comparison in early months of 2018 inflation will subside. Compared to February, we also assumed slightly higher euro area inflation and a larger increase in the prices of primary agricultural commodities in the global and the domestic market, which will, to some extent, reflect on the costs of processed food. As the increase in the prices of certain products and services in Q1 was only temporary in nature and will be dropping out of the annual comparison, we expect inflation to be below its present level early next year and to remain stable thereafter until the end of the projection horizon.

In the past year, inflation was moving within the range projected in May 2016, but hovered below the central projection rate until end-2016 as the prices of primary agricultural commodities did not record the expected growth. In terms of domestic factors, lower than projected inflation resulted from weaker than expected administered price growth[35]. Since the start of the year, inflation has been above the central projection rate from May 2016, mostly as a result of a faster than expected increase in the prices of petroleum products, fuelled by rallying global oil prices, a higher than expected increase in fruit and vegetable prices early this year resulting from extremely cold weather and individual unexpected increases in the prices of a number of products and services (mobile telephony services).

[35] 2.2% compared with 3.8%.

Projections of other institutions

The projections of key macroeconomic indicators for Serbia by other relevant institutions (IMF, European Commission, Consensus Forecast and Bloomberg) are similar to our projections.

Namely, consistent with our projection, also other institutions expect inflation to move within the bounds of the target tolerance band this and the next year. These institutions expect average inflation to move around the target midpoint in both 2017 and 2018. In terms of economic activity, other institutions also forecast Serbia's GDP to grow by around 3% this and around 3.4% next year, with the European Commission raising further its economic growth forecast for this and the next year to 3.2% and 3.6%, respectively. Also, they expect the consolidated budget deficit to contract further. According to their estimate, this deficit will measure 0.5–1.7% of GDP, and the European Commission has even projected a surplus in 2018. Besides, these institutions estimate that Serbia's current account deficit will be at around 4% of GDP in 2017 and 2018, which is consistent with our expectations, with the exception of the European Commission which expects the deficit to be slightly higher as a result of faster expected growth in domestic demand and the resultant increase in imports of equipment and consumer goods.

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

	2017		2018	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	2.4	2.6	3.0	3.0
European Commission	2.4	3.4	3.3	3.5
Consensus Forecast	2.6	3.0	3.2	2.9
Bloomberg	2.4	3.0	3.0	3.1
GDP (%)				
IMF	3.0	3.0	3.5	3.5
European Commission	3.0	3.2	3.3	3.6
Consensus Forecast	2.8	2.9	3.1	3.2
Bloomberg	3.0	3.0	3.2	3.3
Current account deficit (% of GDP)				
IMF	3.9	4.0	3.9	4.0
European Commission	4.2	4.3	4.2	4.7
Consensus Forecast*	3.8	4.2	3.9	4.2
Bloomberg	3.9	4.0	3.8	3.9
Fiscal result (% of GDP)				
IMF	-1.7	-	-1.3	-
European Commission	-1.2	-0.5	-1.0	0.3
Consensus Forecast	-	-	-	-
Bloomberg	-1.8	-1.7	-1.7	-1.6

Sources: IMF (Republic of Serbia: Sixth Review under the Stand-By Arrangement, Country Report No. 16/386 and WEO April 2017), European Commission (Winter 2017 Forecast and Spring 2017 Forecast), Consensus Forecast (January 2017 and April 2017) and Bloomberg Quarterly Survey (January 2017 and April 2017).

* Based on NBS projection of dollar GDP from February 2017 and May 2017.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Q1 2017
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	6.6	6.2	5.7
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.8	237.4	268.8	295.4	263.3	224.5	
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	29.7	31.0	29.9	28.4
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.0	13.4	14.2	12.0	12.9	9.8
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	33.0	32.7	25.7	25.4	17.6
EXTERNAL SOLVENCY INDICATORS (in %)													
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	74.8	77.1	78.3	77.9	
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.5	12.1	10.1	11.8	13.3	
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	167.8	153.6	
FINANCIAL RISK EXPOSURE INDICATORS (in %)													
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	278.1	250.2	207.3	208.4
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	196.6	209.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	97.7	103.1	109.1	121.3
MEMORANDUM: (in EUR million)													
GDP 1)	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	34,115	7,831 2)
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,234	26,592	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,595	4,724	4,024	4,390	764.8
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	10,378	10,205	9,730
Short-term debt 3)	951	968	1,044	1,832	1,852	1,758	612	455	196	99	303	690	
Current account balance	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-1,370	-624

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan/March/ June/Dec	March
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /positive	
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive	BB-/stable	
Moody's									B1 /stable			B1 /positive	Ba3/ 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.

External 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.

External 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 484.1mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 1,030.0 mln, of which EUR 449.0 mln relates to domestic banks and EUR 581.0 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	2015	2016	Q1 2017
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	0.8	2.8	1.0
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	1.5	1.6	3.6
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	10,378	10,205	9,730
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	15,631	17,314	4,346
- 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	8.2	10.8	10.1
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	18,899	19,895	5,154
- 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	4.4	5.3	14.3
Current account balance[3] (in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1577	-1,370	-624
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-4.7	-4.0	-8.0
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2[7]	17.7	15.3	
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	368.0	374.1	366.6
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	-6.3	-2.8	-0.2	0.7
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	-6.6	-3.7	-1.3	1.2
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	70.4	74.7	72.9	69.2
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	108.85	111.29	116.18
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	111.25	117.14	116.13
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	120.73	123.12	123.88
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	121.63	123.47	123.97
MEMORANDUM:													
GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	33,491	34,115	7,831[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 the break in the series for 2007, 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.

[7] Revised data for 2014 and 2015 according to the new methodology of Labour Force Survey.

Notes:

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

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

2016

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.50	0
11 February	4.25	-25
17 March	4.25	0
7 April	4.25	0
17 May	4.25	0
9 June	4.25	0
7 July	4.00	-25
11 August	4.00	0
8 September	4.00	0
13 October	4.00	0
10 November	4.00	0
8 December	4.00	0

2017

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.00	0
14 February	4.00	0
14 March	4.00	0
11 April	4.00	0
12 May	4.00	0
8 June		
10 July		
10 August		
7 September		
9 October		
9 November		
7 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 14 March 2017

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0%.

In making the decision, the NBS Executive Board was guided by inflation factors, the effects of past monetary policy easing and the fact that inflation has been moving within the target tolerance band of 3.0%±1.5 pp since early 2017, where it is expected to stay in the period ahead.

Y-o-y inflation equalled 3.2% in February, largely reflecting one-off factors. Similarly to other countries, consumer price growth was driven by the recovery of global oil prices in the second half of 2016 and a higher than seasonally expected increase in fruit and vegetable prices caused by adverse weather conditions early this year. Core inflation of 1.7% y-o-y in January and February also reflects the persistently low inflationary pressures.

The NBS Executive Board will continue to closely monitor international developments which mandate caution, most notably with regard to movements in the international financial market and global oil prices. Monetary policies of the leading central banks are likely to diverge still further by the end of the year, thereby increasing the uncertainty regarding their impact on global capital flows. Nevertheless, the NBS Executive Board underlined that the resilience of the Serbian economy to adverse impacts from the international environment has increased owing to more favourable macroeconomic prospects, primarily lower fiscal and external imbalances at home.

The next rate-setting meeting will be held on 11 April 2017.

Press release from Executive Board meeting held on 11 April 2017

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0%.

In making the decision, the NBS Executive Board was guided by inflation factors, the effects of past monetary easing and the expectation that inflation will continue to move within the target tolerance band of 3.0%±1.5 percentage points in the period ahead.

Since the start of the year, inflation has moved within the target tolerance band, equalling 3.2% y-o-y in February. Similarly to other countries, such inflation movements were primarily driven by the recovery of global oil prices in the second half of 2016 and the higher than seasonally expected increase in fruit and vegetable prices caused by adverse weather conditions early this year. Inflationary pressures remain low, as signalled by core inflation of 1.7% y-o-y in January and February, as well as by inflation expectations which are anchored within the target tolerance band.

In the coming period, the NBS Executive Board will continue to closely monitor the developments in the international environment, primarily trends in the international financial market and primary commodity price movements in the global market. Uncertainties in the international financial market stem mainly from divergent monetary policies of leading central banks – the Fed and the ECB, which may affect global capital flows towards emerging economies, including Serbia. Nevertheless, the NBS Executive Board underlined that the resilience of the Serbian economy to potential adverse impacts from the international environment has increased owing to more favourable macroeconomic prospects at home, primarily lower fiscal and external imbalances.

The next rate-setting meeting of the NBS Executive Board is scheduled for 12 May 2017.

Press release from Executive Board meeting held on 12 May 2017

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 4.0 percent.

In making the decision, the NBS Executive Board was guided by inflation factors, the effects of past monetary easing and the May inflation projection according to which inflation will continue to move within the target tolerance band of 3.0%±1.5 percentage points in the next two years.

Since the start of the year, inflation has moved within the target tolerance band, equalling 4.0 % y-o-y in April. Similarly to other countries, such inflation movements were driven, as expected, by the recovery of global oil prices in the second half of 2016. The increase in fruit, vegetable and firewood prices caused by adverse weather conditions early this year and the rise in fresh meat prices in April were higher than seasonally expected. As these one-off price increases will be dropping out from the annual comparison, we expect inflation early next year to be below its present level and to continue to move at that level until the end of the projection horizon. Since the beginning of this year, inflation movements were under the influence of one-off factors, as indicated by low and relatively stable core inflation of 2.0% y-o-y in April.

The NBS Executive Board is carefully monitoring the developments in the international environment, notably in the international financial market and trends in global commodity prices. Uncertainties in the international financial market emanate mainly from the divergence of monetary policies of the leading central banks – the Fed and the ECB, which may affect global capital flows to emerging economies, including Serbia. Uncertainties also relate to movements in global prices of primary commodities, particularly oil. However, as underscored by the NBS Executive Board, the resilience of our economy to potential negative shocks from the international environment increased owing to more favourable macroeconomic prospects, primarily the narrowing in fiscal and external imbalances, which contributes to a lower risk premium and improved credit rating of the country.

At its meeting today, the NBS Executive Board adopted the May Inflation Report, which will be presented to the public on Friday, 19 May, when monetary policy decisions and the underlying macroeconomic developments will be discussed in more detail.

The next rate-setting meeting will be held on 8 June 2017.

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