National Bank of Serbia

2019

May

INFLATION REPORT

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Introductory note

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

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

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide 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 9 May 2019.

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

Željko Jović, Vice Governor

Ana Ivković, Vice Governor

Dragana Stanić, Vice Governor

ABBREVIATIONS

bp – basis point
CPI – Consumer Price Index
EBRD – European Bank for Reconstruction and Development
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
FOMC – Federal Open Market Committee
GDP – gross domestic product
GVA – gross value added
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
LHS – left hand scale
mn – million
NAVA – non-agricultural value added
NPL – non-performing loan
OFO – other financial organisation
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
RHS – right hand scale
RMCP – real marginal cost of processed food production
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 regards the international environment, the period since the last Report was marked by somewhat less favourable global growth prospects, notably in the short run, subdued inflationary pressures and anticipation of slower normalisation of the monetary policies of leading central banks.

In the period since the last Report, global growth projections for this and next year were again revised slightly down. The growth outlook of the euro area, our key trade partner, has worsened, notably for this year, on account of dented external demand, which reflects global uncertainties, and specific supply-side factors in some of its members. Still, the positive effect of bolstered macroeconomic fundamentals is assessed to prevail in the medium run, primarily of the ECB's continued monetary accommodation. As assessed by relevant international institutions, though revised slightly down due to the anticipated slower euro area growth, economic growth of Central and Southeast European countries, which are also our important trade partners, will remain relatively high owing to domestic demand. The absence of any major inflationary pressures and the global economic slowdown reflect on slower than expected normalisation of the monetary policies of leading central banks. This, along with hints at a trade deal between the US and China, shaped the global financial conditions, which improved as of early this year.

Y-o-y inflation is within the target band. It temporarily got close to the midpoint in March on account of the low base for vegetable prices, which since early this year went up more than customary for the season. Conversely, even against the background of robust economic growth and positive labour market trends, core inflation is still below the lower bound of the target tolerance band.

Consistent with announcements from earlier *Inflation Reports*, inflation got temporarily closer to the midpoint since early this year and touched 2.8% y-o-y in March. This reflects a continued high rise in vegetable prices, driven by poor yields not only in Serbia, but in other parts of Europe as well. Over a half of the contribution to y-o-y inflation in March originates from this product group alone. In addition, cost-push and demand-side pressures remain low, as suggested by core inflation which moved at 1.2–1.3% y-o-y since early this year, as well as one- and two-year ahead inflation expectations of the financial and corporate sectors which are anchored around the target. The fact that their inflation expectations are anchored signals the credibility of monetary policy and higher resilience to the potential negative effects of developments abroad.

Economic activity recorded a positive growth rate for the eighteenth consecutive quarter.

The slowdown in external demand, primarily in the euro area, and the taxes imposed on products delivered to Kosovo and Metohija, reflect on lower manufacturing production. Together with the base effect for agriculture, given the last year's excellent season, this resulted in a lower y-o-y GDP growth rate in Q1, which stood at 2.3% according to the estimate of the Serbian Statistical Office. On the expenditure side, GDP growth is led by investment – thanks to the continued implementation of infrastructure

projects, improvement of the business environment and favourable sources of funding – as well as household consumption which reflects rising private sector wages and employment, higher public sector wages and pensions, and lower borrowing costs. On the production side, the main contribution to growth comes from the service sectors with the continuation of favourable labour market trends, and from construction, as indicated by elevated production of construction materials, value of construction works performed and government capital expenditure. In quarterly terms, s-a GDP growth reached 0.9% in Q1 2019, spurred by all key sectors, apart from agriculture, which means that the economy has been growing for eighteen quarters in a row.

Despite the two-digit y-o-y lending growth, the share of domestic loans in GDP remained broadly unchanged relative to end-2018. It stood at 43.3% in March, signalling that lending activity does not pose a risk to either price or financial stability.

The conditions of private and government sector financing remained favourable, with rates in the dinar segment of the lending market sliding to new lows early in the year. Together with the effects of economic growth and higher wages and employment, this contributed to stable y-o-y lending growth, which equalled 10.1% in March, excluding the exchange rate effect. A boost also came from the corporate and household sectors. The loan structure remained favourable, notably in the corporate sector, with the share of investment loans almost equalised with current assets loans. According to banks' assessment from the April bank lending survey, lending is fuelled both by supply- and demand-side factors, i.e. favourable credit conditions and elevated loan demand. Together with the continued NPL resolution efforts, lending growth supports a further drop in the NPL ratio – to 5.5% in March, down by close to 17 pp since the adoption of the NPL Resolution Strategy.

Economic growth and positive labour market trends are conducive to continued favourable fiscal trends. A considerable rise in government capital expenditure and rising public sector wages and pensions are the sources of financing investment and consumption, but not to the extent that would trigger major inflationary pressures.

Favourable fiscal trends continued in early 2019, as evidenced by the fiscal surplus of 0.9% of GDP in Q1, recorded against the background of much higher government capital expenditure and increased outlays for wages and pensions. Positive fiscal trends are underpinned by economic growth and positive labour market trends. At end-March, central government public debt was EUR 23.4 bn and its share in projected GDP 50.9% (vs. 53.8% at end-2018). Public debt is expected to remain sustainable and on the decline in the coming period as well.

Since early this year, the current account deficit was shaped by rising investment in Serbia and deceleration of external demand, and was largely covered by the net FDI inflow.

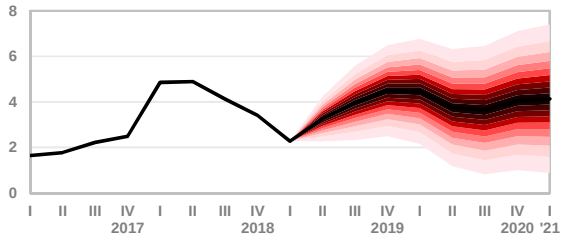
Since early this year, balance of payments trends were influenced by the continued investment growth and deceleration of external demand. Owing to the rise in production and export capacities, which reflects past investment, as well as considerable agricultural inventories from the previous agricultural season, Q1 exports continued to record a relatively high growth rate

of 7.9% y-o-y. However, goods import rose faster (9.9% y-o-y) on the back of increased import of raw materials and equipment for industrial purposes, which resulted in a 16.3% y-o-y widening of the trade deficit. Such import movements were expected given the high rise in investment. Considering that imported equipment will push up the export capacities of the Serbian economy, the current account deficit will narrow in the medium run. The 100% tariffs on products delivered to Kosovo and Metohija also exerted a negative impact on the current account. Still, the current account deficit was largely covered by the net FDI inflow, which in Q1 stood close to EUR 800 mn. The FDI inflow remained project-diversified and channelled predominantly to tradable sectors. With the downward trajectory of the external debt share in GDP, the high FDI inflow contributes to the sustainability of the country's external position.

In light of economic indicators since early this year and expectations for the period ahead, we have kept the GDP growth forecast for 2019 at 3.5%, with a slightly changed structure. As in the previous projection, GDP growth is envisaged to be fully led by domestic demand, whose positive contribution increased as a result of more favourable movement of final consumption and investment since the start of this year. On the other hand, mirroring adverse developments in the international market, net exports are now a more negative contributor than in the previous projection. On the production side, growth is likely to continue in the service sectors, industry and construction, while agriculture will most probably have a negative impact due to the base effect. GDP is expected to accelerate to around 4% in the medium run, supported by investment, exports and a sustainable rise in household consumption. Medium-term risks to the growth projection are assessed as symmetric. Short-term risks, i.e. those that may materialise during 2019 and emanate from the international environment, are assessed to be tilted to the downside, whilst the risks at home are tilted to the upside.

We kept the GDP growth forecast for 2019 unchanged (3.5%). Growth is expected to accelerate to around 4% in the medium run, driven by investment, exports and a sustainable increase in household consumption.

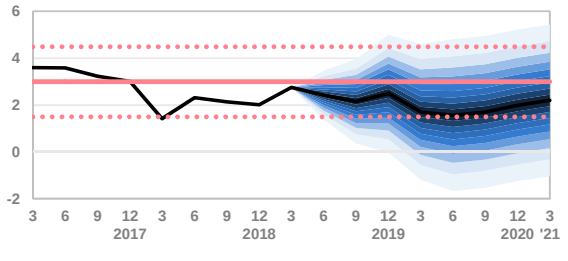
GDP growth projection
(y-o-y rates, in %)



Under the May projection as well, y-o-y inflation will continue to move within the target tolerance band until the end of the projection horizon. After reaching the midpoint in April, it will decline, getting close to the lower bound of the target in H1 2020, only to start its gradual return to the midpoint thereafter. Such inflation profile reflects several disinflationary factors, most notably the high base for vegetable prices, which will in this year and in H1 of the next year outweigh the impact of elevated aggregate demand, gradual waning of disinflationary pressures from past appreciation of the dinar and administered price growth. Compared to the

Y-o-y inflation will remain in the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band.

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



previous projection, the new projection is slightly higher for this year due to the sharper than expected rise in vegetable prices since the start of this year, and is lower until the end of the projection horizon as a result of the base effect for this product group and slower than expected closing of the negative euro area output gap due to a less favourable growth outlook. The uncertainty surrounding the inflation projection is associated primarily with movements in international commodity and financial markets, and administered price growth to an extent. Taken together, the risks to the projection are judged to be symmetric.

The key policy rate has been unchanged at 3.0% since April 2018, this being its lowest level in the inflation targeting regime.

Given the expected movement in inflation and its underlying factors at home and abroad, the NBS Executive Board kept the key policy rate on hold at 3.0%. It highlighted that domestic macroeconomic conditions have a positive bearing on economic activity and inflation, while developments in the international environment mandate caution in monetary policy conduct. Although the slackening of global economic growth and inflation caused slower normalisation of the monetary policies of leading central banks – the Fed and ECB, it remains uncertain to what extent the normalisation would diverge from market expectations, which might trigger volatility in global capital flows. Global oil prices have been on the rise since early this year, but their future movement is uncertain due to different factors on the supply- and demand-side. Moreover, while trade tensions between major world economies have loosened, international trade is still hindered by protectionism and geopolitical tensions, fuelling uncertainty in the international commodity and financial markets. This notwithstanding, the Executive Board pointed out that the resilience of our economy to potential adverse effects from the international environment has increased thanks to the improved outlook and macroeconomic indicators.

It is assessed that the key risks in the period ahead will emanate from the international environment and, as such, may affect the monetary policy stance.

Monetary policy decisions in the coming period will continue to depend on the assessment of the impact of domestic and external factors on inflation in Serbia. Given that the key risks to the projection emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on the local economy. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and strengthening of resilience to external uncertainties.

II Monetary policy since the February *Report*

In the period since the February Inflation Report, the NBS Executive Board has kept the key policy rate at its lowest level in the inflation targeting regime (3%), in consideration of the inflation outlook and the expected movement of its key factors in the domestic and international environment.

Inflationary pressures remained low in the face of strong economic growth, supported by coordinated monetary and fiscal policy measures, as well as by positive labour market trends, characterised by a further increase in wages and employment and a drop in the unemployment rate. In the Executive Board's judgement, inflation will continue to move within the target tolerance band over the next two years, the period for which inflation is projected.

The developments in the international environment mandated caution in the conduct of monetary policy. Global growth slowdown heightened global uncertainty, especially regarding the pace of further normalisation of monetary policies of the Fed and ECB, which could affect capital flows toward emerging markets. The rise in oil prices since the start of the year is another inflation factor calling for a watchful stance, while protectionism and geopolitical risks remain the sources of uncertainty in the international environment. Still, the Executive Board pointed out repeatedly that the resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects.

In the period since the February Report, the Executive Board has kept the key policy rate unchanged. The rate is still at 3%, its lowest level in the inflation targeting regime.

In the period February–April Executive Board decisions were based on the February inflation projection which was somewhat lower than the one from November and which forecast that until the end of the projection horizon y-o-y inflation would continue to move within the target band, most likely in its lower part. The movement of macroeconomic indicators and the information coming in after the release of the February projection did not change these expectations much.

As in the November projection, the factor expected to play the key role throughout the projection period was growth in aggregate demand. Besides, the disinflationary pressures on account of past appreciation of the dinar would gradually wane, while administered prices are expected to pick up slightly faster than in previous years. On the other hand, the key disinflationary effect in the coming period is anticipated from the high base for the fruit and vegetable group and petroleum product prices.

Speaking of economic activity, the February projection kept GDP growth for 2019 unchanged (3.5%). It was expected that GDP growth would be fully driven by domestic demand and that net exports would give a mildly negative contribution (as opposed to the neutral contribution envisaged by the November projection), due to less favourable movements in the international environment, primarily slower than the expected growth of the euro area. GDP growth was still expected to pick up in the medium-term, to around 4%, led by investment, exports and household consumption rising on sustainable grounds.

Monetary policy decisions of the Executive Board since the last *Report* were weighed out and made amid the crosscurrents of macroeconomic conditions at home, which exerted a positive impact on economic activity and inflation, and developments in the international environment, which warranted caution.

In the Executive Board's judgement, inflationary pressures remained low in the face of strong economic growth. This was mainly indicated by core inflation, which moved in the range of 1.2–1.3% y-o-y, while headline inflation, consistent with the Executive Board's announcements, under the impact of the low base in unprocessed food prices, temporarily approached the target midpoint, equalling 2.8% y-o-y in March. Low inflationary pressures were also indicated by the one- and two-year ahead inflation expectations of the financial and corporate sectors, anchored around the 3.0% target.

As assessed by the Executive Board, in the medium term inflation would approach the target mainly owing to the gradual rise in domestic demand. Namely, robust economic growth, continuation of positive labour market trends, characterised by the rise in wages and employment and the drop in the unemployment rate, would all contribute to the further rise in domestic demand. Domestic demand growth has also been supported by the NBS's past monetary policy easing through lower interest rates on new dinar loans and lower costs of repayment of outstanding loans, which reflected positively on households' disposable income. In addition, interest rates on euro-indexed loans remain low, aided by the still strong monetary accommodation by the ECB, as well as by stronger interbank competition and the fall in Serbia's risk premium.

The country's general macroeconomic stability and development prospects were also underpinned by positive fiscal movements. The consolidated budget has recorded a surplus since the start of the year and public debt-to-GDP ratio has been reduced further. According to the Fiscal Strategy for 2019, the fiscal policy stance in the coming period is likely to be mildly accommodative, absent any major upward pressures on inflation. Higher government capital expenditures will boost investment, while the rise in pensions and public sector wages will pave the way for sustainable consumption growth. The deficit of around 0.5% of GDP is planned for this year, which is a medium-term deficit target providing for the continued downward path of public debt in the coming years. Such public debt trend should continue to positively affect the country's risk premium and credit rating. Continued high FDI inflow boosts production and export capacities, thus contributing to the narrowing of external imbalances in the medium run, and, by extension, to further relative stability in the FX market.

The Executive Board stated that the dinar's past appreciation exerted a disinflationary effect via lower import prices expressed in dinars and that such effect would gradually dissipate. However, given the slower than initially projected price growth in the euro area, our most important trade partner (due to the expected softening in aggregate demand and economic growth), the Executive Board pointed out that the rise in dinar-denominated import prices was likely to stay relatively low.

Apart from domestic demand, the Executive Board also saw a likely further recovery of external demand, but pointed out that the slowdown in global trade and economic growth could be stronger than initially expected. The world economy has decelerated since Q3 2018, more than initially projected, amid rising uncertainties fuelled by trade tensions between the US and China, recession in some of the emerging markets (Argentina and Turkey) and indications of China's growth turning out slower than expected. Worth adding is that the US's generous fiscal stimulus, which still props up its economic growth, will gradually weaken in the coming period.

Speaking of factors in the international environment, the Executive Board particularly took into account the growth outlook of the euro area which, among other things, faces Brexit challenges. While the slowdown is projected for this year, the risks are still judged to be tilted to the downside. Significantly slower growth is expected in the short term due to the global growth softening and factors specific for some sectors and countries of the euro area, while favourable terms of financing, further improvement in the labour market, decrease in unemployment and the rise in wages should support a gradual pick-up in the medium term.

On the other hand, albeit softened, economic growth remains vibrant in the majority of Central and Southeast European countries which are also our important trade partners. This is mainly owing to domestic demand, which continued to drive economic growth, while the negative contribution of net exports is somewhat higher, reflecting the slowdown in external demand.

In the context of rising uncertainty over global growth prospects, the leading central banks recently changed their communication on future monetary policy actions. The Fed announced a patient approach, consistent with movements in economic indicators. No increases to the target range for the federal funds rate are expected this year, while financial conditions are assessed as less supportive of growth than they were earlier in 2018. The ECB also expects its key interest rates to remain at their present levels at least through the end of 2019, and in March it also announced a new, third series of quarterly targeted longer-term refinancing operations (TLTRO-III), starting in September 2019 and ending in March 2021,

aimed at preserving banks' favourable credit conditions. While the pace of normalisation of monetary policies of the leading central banks will be slower than expected, the NBS Executive Board pointed out it was uncertain to what extent that pace would diverge from market expectations, which could affect capital flows toward emerging markets.

Global oil prices also called for caution in the Executive Board's monetary policy deliberations. After a decline in late 2018, global oil prices surged by around 30% since the start of this year, despite global growth softening. The main underlying reasons are a further contraction in OPEC's output, Saudi Arabia's announcements of capping production to reduce inventories, and the unstable situation in Venezuela. Numerous factors on both the supply and demand side heighten the uncertainty surrounding global oil prices in the coming period.

While trade tensions between major world economies relaxed, protectionism in international trade still persists, as well as geopolitical tensions, giving rise to uncertainty in the international commodity and financial markets.

Starting from the May inflation projection, at its May meeting the Executive Board kept the key policy rate unchanged. Having estimated that the key risks in the implementation of monetary policy stem from the international environment, the Executive Board stressed it would continue to closely monitor and analyse trends in the international financial and primary commodity markets, especially markets of crude oil and primary agricultural commodities. The Executive Board pointed out that the resilience of the Serbian economy to potential adverse effects from the international environment has increased, owing to more favourable macroeconomic indicators and prospects. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium term. Together with maintaining financial stability, this will contribute to sustainable economic growth and strengthen the country's resilience to external uncertainties.

III Inflation movements

Consistent with our previous announcements, since the beginning of the year inflation gradually approached the NBS target midpoint, measuring 2.8% y-o-y in March. Such inflation movements reflected primarily the continued strong y-o-y rise in vegetable prices, due to poor yields not only in Serbia, but also in the greater part of Europe, which pushed the quarterly consumer price growth somewhat above our central projection from the February Inflation Report. Other than that, inflationary pressures remain basically low. This is indicated by the low and stable core inflation, which measured 1.3% y-o-y at end-Q1, and by the inflation expectations of the financial and corporate sectors, which were somewhat below the target midpoint of 3.0%.

At the quarterly level, prices rose by 1.5%, led by the prices of a small number of products and services, mainly of fresh vegetables and fruit, and by the February cigarette price hike. Working in the opposite direction was the decline in the prices of clothes and footwear, and travel packages, typical for this part of the year.

Inflation movements in Q1

Since the beginning of 2019, y-o-y inflation has moved within the target tolerance band (3.0±1.5%), reaching 2.8% in March. It gradually approached the target midpoint in Q1, mainly due to the low base effect from vegetable prices, which at the same time increased more than seasonally typical for this part of the year. In addition, relative to the end of the previous year, a contribution from industrial products excluding food and energy was slightly higher as the effects of the dinar's past appreciation gradually wore off. On the other hand, the contribution of the prices of petroleum products and services to y-o-y inflation decreased slightly. The fact that more than half of the contributions to y-o-y inflation in March came only from the prices of fresh vegetables (with a 3.5% share in consumer basket) indicates that inflationary pressures are still low. This is also evidenced by the low core inflation, ranging since the beginning of the year between 1.2–1.3% y-o-y, consistent with the expectations stated in the February *Inflation Report*.

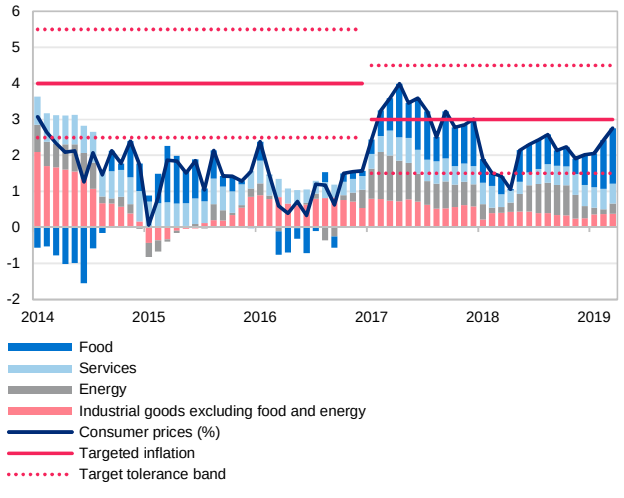
At the quarterly level, consumer prices recorded 1.5% growth, led – as in other countries of the region – mainly by the hike in prices of **food and non-alcoholic beverages** (4.5%, 1.4 pp contribution). This hike related primarily to the prices of **unprocessed food** (12.1%) due to higher prices of fresh vegetables (30.3%, 1.1. pp contribution) and fresh fruit (13.9%, 0.2 pp contribution). A positive contribution to consumer prices in Q1 came also from the rise in **processed food** prices (0.6%, 0.1 pp contribution), with lower prices of fresh meat working in the opposite direction (-3.7%, -0.1 pp contribution). The sharper than expected rise in fresh vegetable prices was

Table III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)

	2018 Dec.	2019 March	Difference
Consumer prices (CPI)	2.0	2.8	0.8
Unprocessed food	0.7	1.4	0.7
Fruit and vegetables	*0.6*	*1.4*	*0.8*
Fresh meat	*0.1*	*-0.1*	*-0.2*
Processed food	0.2	0.2	0.0
Industrial products excluding food and energy	0.2	0.4	0.2
Energy	0.3	0.3	0.0
Petroleum products	*0.3*	*0.2*	*-0.1*
Services	0.6	0.5	-0.1

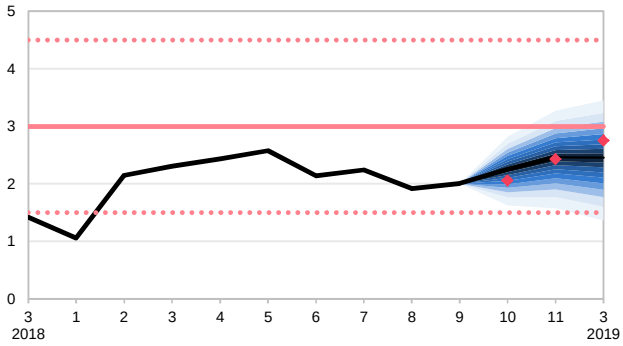
Sources: SORS and NBS calculation.

Chart III.0.1 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Chart III.0.2 **Short-term inflation projection from February 2019 and actual inflation**
(y-o-y rates, in %)



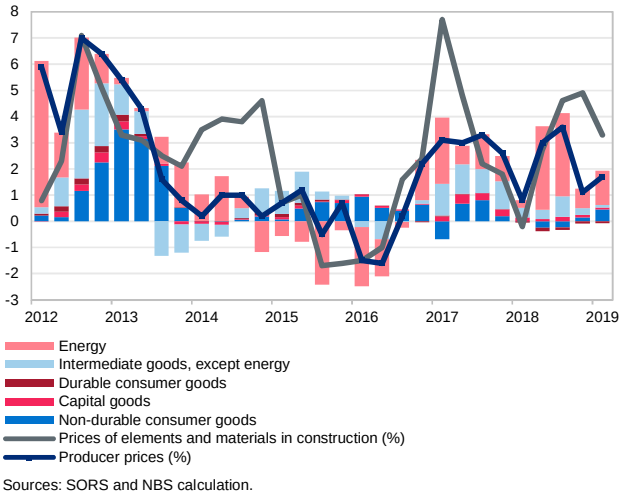
Sources: SORS and NBS calculation.

Table III.0.2 **Growth and contribution of components to consumer price growth in Q1 2019**

	Growth rates (%)	Contribution (pp)
Consumer prices (CPI)	**1.55**	**1.55**
Unprocessed food	12.09	1.26
Processed food	0.63	0.13
Industrial products excluding food and energy	0.40	0.12
Energy	0.17	0.03
Services	0.07	0.02
CPI excluding energy, food, alcohol and cigarettes	-0.13	-0.06
Administered prices	1.04	0.19

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

* Industrial producer prices for the domestic market.

what caused inflation in Q1 to be somewhat higher than the central projection from the February *Inflation Report*.

Industrial product prices excluding food and energy picked up by 0.4% in Q1 (0.1 pp contribution), driven predominantly by the cigarette price adjustment in February (3.8%, 0.2 pp contribution). Working in the same direction were higher prices of furniture and household appliances, as well as higher prices of medical and pharmaceutical products. In contrast, a negative contribution to quarterly inflation (-0.2 pp) came from the seasonal decline in prices of clothes and footwear (3.3%).

Energy prices stayed almost unchanged throughout Q1 (0.2% rise) as the seasonal increase in the prices of solid fuels (1.7%) was almost entirely neutralised by the lower prices **of petroleum products** (-0.3%) due to a fall in the global oil prices at the end of last year.

Also, **service prices** almost stagnated in Q1. In this category, the prices of transport services and TV subscription edged up (1.0% and 1.4% respectively, with an aggregate 0.1 pp contribution), while the seasonal drop in prices of travel packages (-10.3%) worked in the opposite direction to the same degree.

The **administered price** growth of 1.0% in Q1 (0.2 pp contribution) was almost entirely driven by the February cigarette price hike, based on the regular annual excise adjustment. In y-o-y terms, administered prices slowed down their growth to 2.3% in Q1 (from 2.4% at end-2018).

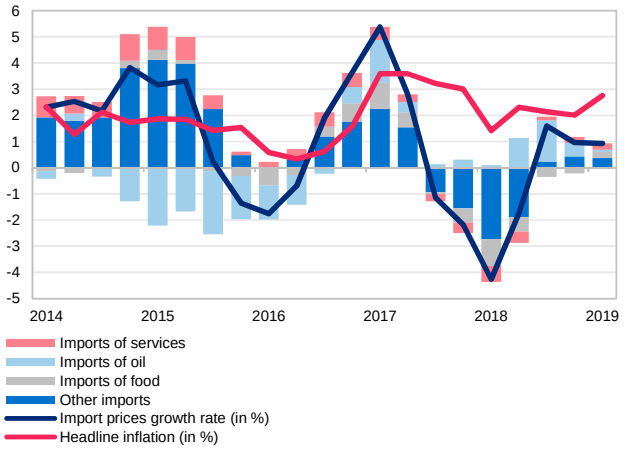
Producer and external prices

The cost-push inflationary pressures remained low since the start of the year. **Industrial producer prices in the domestic market** posted growth of 0.6% in Q1, which at y-o-y level stayed relatively low at 1.7%. As at end-2018, the strongest contribution to the y-o-y growth in producer prices came from **the prices in energy production** (around 1.3 pp), predominantly due to the increase in the global oil prices since the start of this year. The **prices of non-durable consumer goods** also rose y-o-y, mainly on account of higher costs of food production early this year, and so did the **prices of capital goods**. **The prices of intermediate goods** slowed their y-o-y growth influenced by the falling prices of chemicals and base metals, while the prices **of durable consumer goods** continued to drop, notably in response to dampened prices in the production of electrical equipment. **The prices of elements and materials incorporated in construction**, which are used to approximate cost-push pressures in this field, rose 0.8%

in Q1, while slowing down to 3.3% y-o-y in March (from 4.9% in December).

After a decline in Q4, the indicator used to track the pace in the prices of goods and services imported into Serbia shows that **dinar-denominated import prices**[1] increased by around 1.0% in Q1. This was supported by the higher food prices in the global market, which picked up by 2.4% at the quarterly average level. Dinar-denominated import prices increased also owing to the dinar's weakening against the dollar, which was caused by the euro's slide vis-à-vis the dollar. Conversely, despite the rise from the start of the year, global oil prices denominated in the US dollar in Q1 were by 6.8% lower on average than in Q4 2018. Consumer prices in the euro area, which are used to approximate prices of imported services, also dropped in Q1 (-0.7%), as did the prices of German exports (-0.1%), which are used to approximate prices of imported equipment and intermediate goods. Y-o-y, dinar-denominated import prices slightly slowed down their growth to 0.9% in Q1 (from 1.0% in Q4).

Chart III.0.4 **Contribution of individual components to y-o-y growth rate of import prices in dinars**
(in pp)



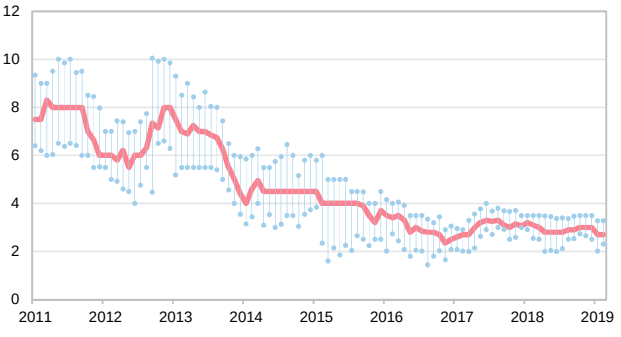
Sources: Destatis, FAO, Bloomberg, Eurostat, SORS and NBS calculation.

Inflation expectations

Anchored **one- and two-year ahead inflation expectations of the financial and corporate sectors within the NBS target band** (3±1.5%) indicate the confidence of market participants that price stability will be preserved over the medium run, which enhances the efficiency of monetary policy.

One-year ahead inflation expectations of the financial sector have moved below the target midpoint since the beginning of 2019, most probably on the back of low current inflation. According to the results of the Ipsos survey, after standing at 2.7% in Q1, short-term inflation expectations of the financial sector rose to 2.8% in April. Similarly, according to the results of the Bloomberg survey, the financial sector expects that inflation will move in the range of 2.5–3.0% next year. Looking at a longer horizon, the financial sector has expected price stability and inflation within the NBS target tolerance band for five and a half years now (since October 2013). Anchored inflation expectations are also reflected in the significantly lower dispersion of individual expectations of financial sector representatives.

Chart III.0.5 **One-year ahead inflation expectations of the financial sector**
(y-o-y rates, in %)

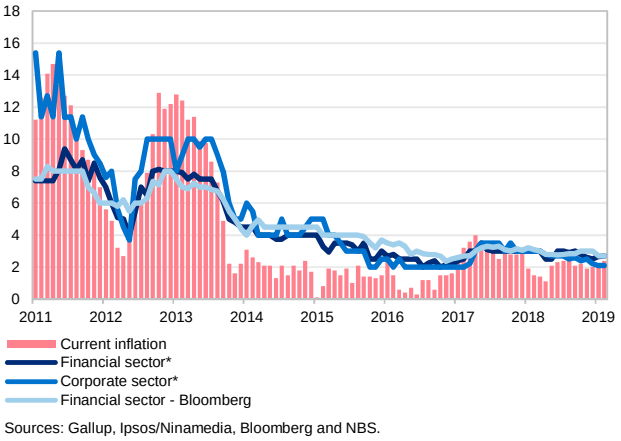


Source: Bloomberg.

* 10-90 percentile range.

One-year ahead inflation expectations of the corporate sector ranged between 2.1% and 2.5% in Q1, which can

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

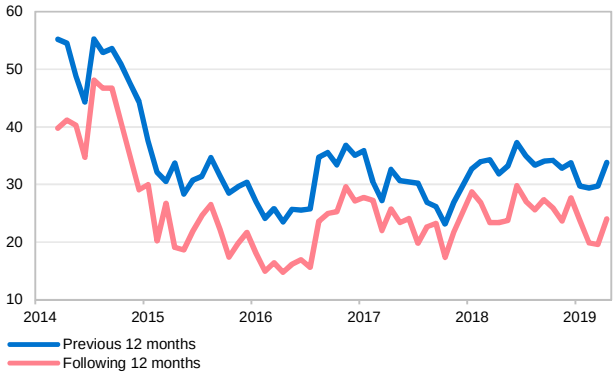


Sources: Gallup, Ipsos/Ninamedia, Bloomberg and NBS.

* Ipsos and Gallup until December 2014, Ninamedia since December 2014, and Ipsos since January 2018.

[1] The weighted average of the global Brent oil price and food price index (FAO index), euro area consumer prices, and export prices of Germany, one of Serbia's main foreign trade partners, is used as an indicator of import prices.

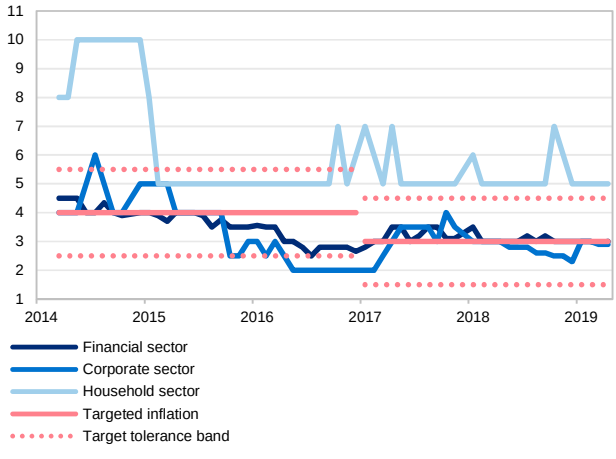
Chart III.0.7 **Household perceived and expected inflation***
(in index points)



Sources: Ipsos/Ninamedia and NBS

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

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



Sources: Ipsos/Ninamedia and NBS.

* Ipsos agency until December 2014, Ninamedia agency since December 2014, and Ipsos agency since January 2018.

be partly associated with the expected stability of the prices of production inputs – two thirds of corporates expect that the input prices would not change over the next twelve months. One-year ahead expectations of corporates edged up slightly in April, to 2.6%.

One-year ahead inflation expectations of the household sector are typically higher than those of other sectors. After standing at 6.0% in January, they dropped to 5.0% in February and March, only to return to 6.0% in April. The results of the qualitative survey of household inflation expectations[2] show that the index of expected inflation continued to record lower values than the index of perceived inflation, the same as at end-2018, indicating that households expect inflation to be lower in the next 12 months than in the past year.

Two-year ahead inflation expectations of the financial sector are anchored within the NBS target tolerance band since their monitoring began (March 2014), standing at the 3.0% target midpoint for the past seven months. Medium-term expectations of corporates measured 3.0% in January and February, falling somewhat to 2.9% in March and staying at that level in April. **Two-year ahead inflation expectations of households** have been stable at 5.0%.

Anchored inflation expectations are one of the preconditions of sustainable economic growth, which is corroborated by the positive expectations of the financial and corporate sectors regarding the improvement in business conditions over the next twelve months. In addition, the financial sector anticipates a rise in lending, while corporates expect an increase in fixed investment and higher loan availability.

[2] For more details on qualitative expectations of households see the February 2016 Inflation Report – Text box 2, p. 30.

IV Inflation determinants

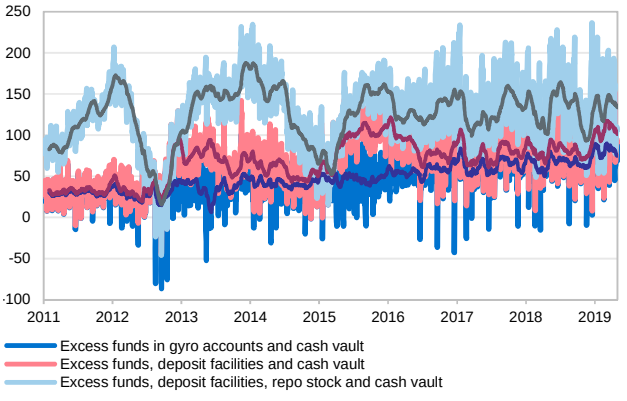
1. Financial market trends

Improved dinar liquidity of the banking sector drove down the average repo rate and interest rates in the interbank money market in Q1. In the dinar segment of the market, interest rates on corporate and household loans also declined in Q1, touching their new lows.

Interest rates

Lower interest rates in the interbank money market are a result of improved dinar liquidity in the banking sector, supported significantly by the additional FX swap auctions organised by the NBS. These auctions ensured the continued smooth functioning of the interbank money market. Besides, it should be noted that the average daily trading volumes went up by RSD 0.1 bn relative to Q4 2018, reaching RSD 3.8 bn.

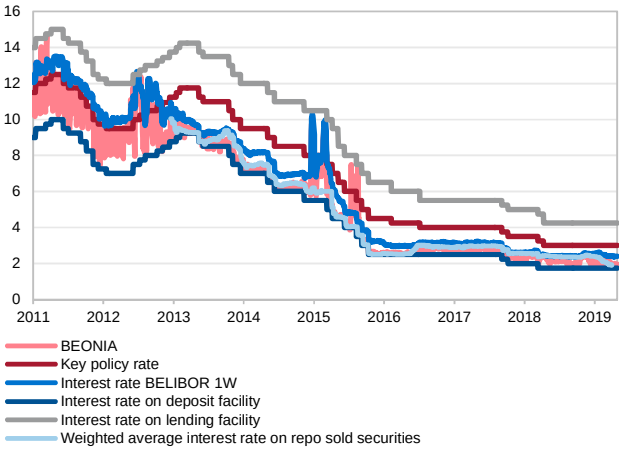
Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bn)



Source: NBS.

The average repo rate dropped by 0.5 pp in Q1, measuring 1.9% at end-March, while BEONIA declined by 0.4 pp to 2.0%. BELIBOR rates of all maturities also edged down, though to a somewhat lesser extent (by up to 0.1 pp), ranging at end-March from 2.3% for the shortest maturity to 3.1% for the six-month maturity.

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

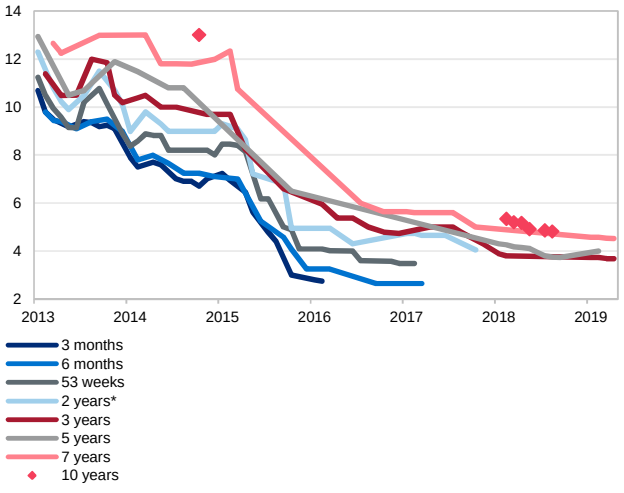


Sources: Thomson Reuters and NBS.

The downward trend of the average repo rate extended into April – it measured 1.83% at the month's end, while interest rates in the interbank money market mostly flatlined relative to March.

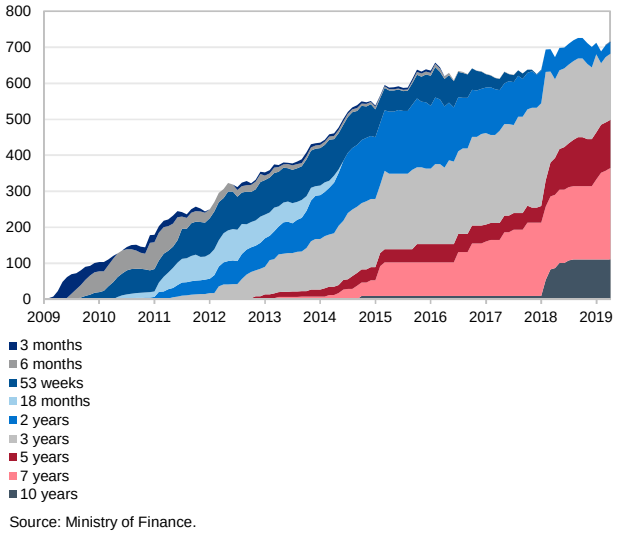
After Q4 2018, when there were no auctions of government securities, **in Q1 the government issued new** three- and seven-year maturity **benchmark dinar bonds** in the total nominal value of RSD 100 bn and RSD 150 bn, respectively. Higher government activity in the primary market in Q1 can be explained by the need to provide funds for the payment of matured securities. Seven auctions of benchmark dinar bonds were held by the end of March, resulting in the sale of securities worth nominal RSD 114.2 bn. The rates achieved were almost unchanged, moving between 3.7% for the three-year

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



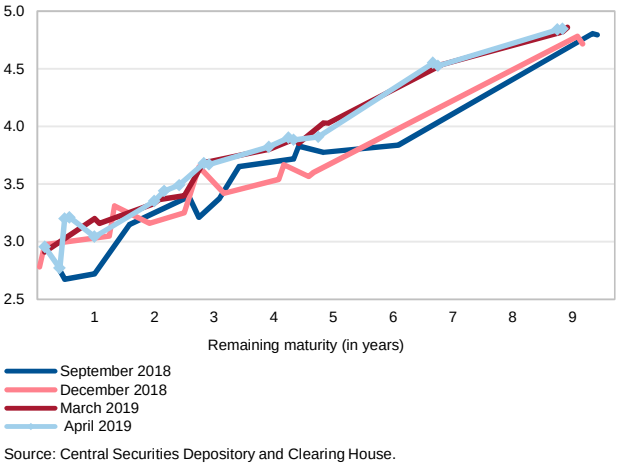
Source: Ministry of Finance.
* Excluding coupon securities with the rate linked to the NBS key policy rate.

Chart IV.1.4 **Stock of sold dinar government securities**
(in RSD bn)



Source: Ministry of Finance.

Chart IV.1.5 **Yield curve in the secondary government securities market**
(average values, p.a., in %)



Source: Central Securities Depository and Clearing House.

maturity and 4.5% for the seven-year maturity at end-March. In addition, there was another auction held in February, which offered five-year dinar bonds in the nominal amount of RSD 20 bn. The sale volume equalled RSD 10.6 bn in nominal amount, and the rate achieved was 4.0%. January and February saw the maturing of securities in the nominal amount of RSD 120.8 bn, including the first issue of three-year benchmark dinar bonds from 2016, so the stock of dinar securities sold in Q1 increased by RSD 4.0 bn to RSD 705.3 bn at end-March.

Two auctions were organised in April to sell three- and seven-year benchmark bonds, with the rates achieved almost unchanged relative to Q1.

Auctions of euro securities, last held in June 2018, were also organised since the beginning of the year. In Q1, the government sold euro securities with maturity of two years and longer. The rates achieved at these auctions ranged between 1% for the two-year maturity and 3.6% for the fifteen-year maturity. The sale volume, in nominal amount, was EUR 340.1 mn. Since Q1 saw the maturing of euro securities in the nominal amount of EUR 319.1 mn, the stock of sold euro securities increased by EUR 21 mn, to EUR 2,890 mn at end-March.

The turnover in the **secondary market** increased from RSD 70.9 bn in Q4 2018 to RSD 97.8 bn in Q1 2019, enhanced also by higher government activity in the primary market. The rates of yield to maturity stayed almost unchanged for shorter maturities, while they edged up slightly for longer maturities relative to December. In March, they moved between 2.9% for the remaining maturity of two months and 3.2% for the remaining maturity of twelve months, i.e. 4.9% for the remaining maturity of nine years (107 months).

In the **dinar segment of the loan market**, interest rates declined on both corporate and household loans in Q1. The weighted average interest rate on new dinar corporate loans reached its new minimum in January (4.0%), with lower interest rates for all types of loans, primarily for current assets loans. By March, interest rates on dinar corporate loans were revised to 5.2%, down by 0.5 pp relative to end-2018.

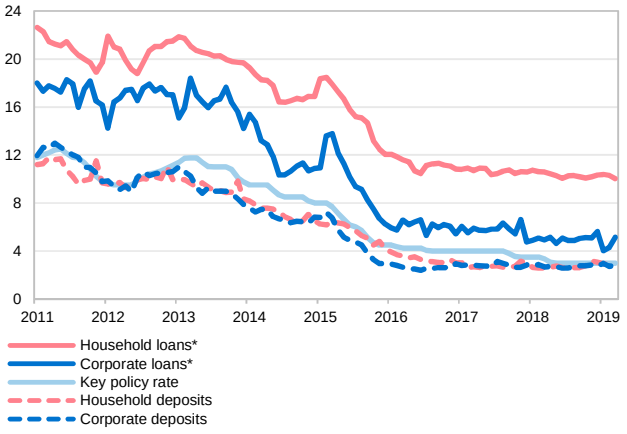
Interest rates on new dinar household loans fell by 0.3 pp relative to December, to 10.0% in March, this being their lowest level in the inflation targeting regime. In terms of category of new dinar household loans, interest rates on cash and consumer loans were cut, while the rates on other uncategorised loans went up.

Interest rates on euro-indexed corporate **loans** increased negligibly since the beginning of the year, measuring 2.8% in March. This rise reflects higher interest rates on current assets loans, which climbed from 2.4% in December to 2.7% in March. On the other hand, interest rates on investment loans remained unchanged (3.1%).

The average interest rate on euro-indexed household **loans** measured 4.2% in March, while interest rates on housing loans, which had a dominant share within this loan category, remained unchanged from May 2018, standing at 2.8% in March, i.e. their lowest level on record.

Interest rates on corporate and household **dinar savings** were slightly revised up from 2018. In March, the weighted average interest rate on household and corporate savings equalled 2.9% and 2.8%, respectively. **Interest rates on household euro savings** followed a similar path, going up to 1.1% in March, unlike interest rates on corporate time deposits which declined to 0.3%.

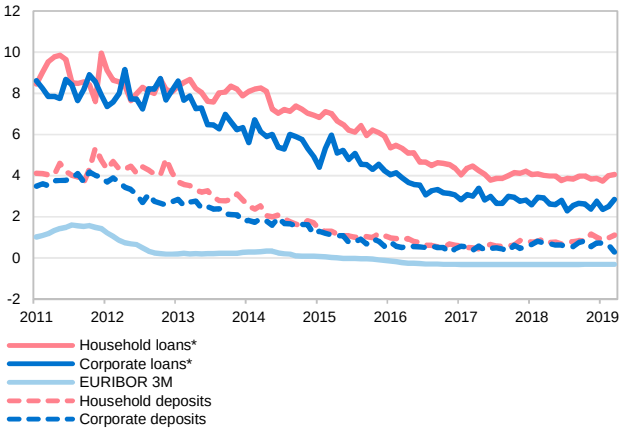
Chart IV.1.6 **Interest rates on new dinar loans and deposits**
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on new euro and euro-indexed loans and deposits**
(weighted average values, p.a., in %)



Sources: European Banking Federation and NBS.

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

Text box 1: Additional FX swap auctions

To counter a temporary decrease in the banking sector's excess liquidity and ensure smooth functioning of the money market, since the beginning of the year the NBS organised five additional FX swap auctions in which it bought foreign exchange, supplying banks with the needed dinar liquidity. With its proactive approach, the NBS showed once again that it would not allow any disruptions in the domestic financial market.

FX swap auctions are one of the standard instruments for regulating dinar and foreign exchange liquidity of the banking sector and their implementation is appropriate in case of a temporary reduction in excess dinar liquidity. By holding them at the right time, the NBS supplied banks with the necessary dinar liquidity, while at the same time preventing potential segmentation of the money market, i.e. concentration of excess liquidity with few banks, which could have caused a considerable rise in the interbank money market interest rates.

Public finances improved significantly over the past several years owing to fiscal consolidation, which was facilitated by appropriate monetary policy of the NBS, i.e. by the ensured and maintained price stability and relative stability of the exchange rate. All of this made it possible to finance government FX liabilities from dinar sources, which helped improve the currency structure of public debt. This explains why excess dinar liquidity in the banking sector went down in some periods.

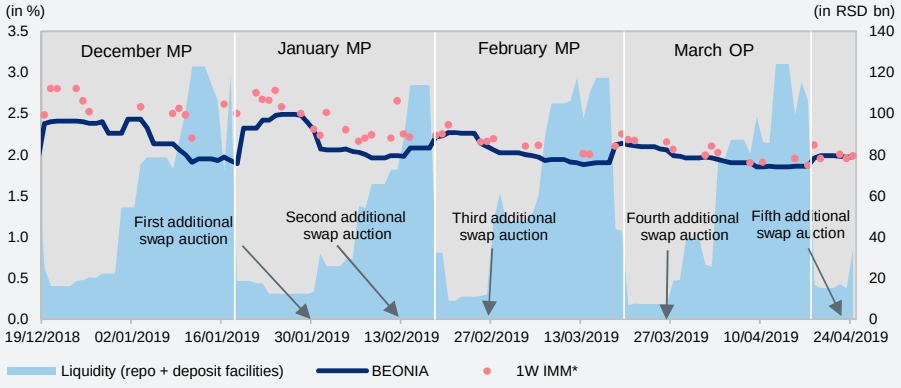
Positive fiscal developments continued into 2019. As there were no major amounts of dinar securities maturing in January and in the first half of February, excess dinar liquidity of banks decreased further. Assessing that this was a temporary decrease and that any major rise in money market interest rates on that account would be unjustified, the NBS organised the first additional FX swap auction on 28 January, providing banks with RSD 22.5 bn in exchange for EUR 190 mn for a period of two weeks. Banks were thus given access to the necessary dinar liquidity without causing any pressures in the money market. After that swap auction, and especially after its netting (30 January), interest rates in the interbank money market gradually declined (BEONIA fell by around 50 bp – from close to 2.50% to around 2.00%, and then plunged to its low of 1.85%). The first additional FX swap auction served its purpose of improving the liquidity of the banking sector and ensuring smooth functioning of the interbank money market at lower rates.

To enable banks to gradually adjust to improved liquidity in the money market, and having in mind the maturing of the previous additional swap auction, the NBS organised two new such auctions in February with the same maturity (two weeks), but with lower realisation. Thus, the liquidity supplied by the NBS through these transactions was gradually reduced. In the auctions held on 11 and 25 February, the NBS supplied banks with RSD 13.1 bn (in exchange for EUR 110.5 mn) and RSD 8.3 bn (in exchange for EUR 70 mn), respectively. In late February, liquidity was significantly boosted by government activity, most notably greater amounts of dinar government securities due than sold. The period of temporarily reduced excess liquidity was ended and a possibly unjustified rise in short-term interest rates in the interbank money market was precluded. Besides, the volatility of the said rates was moderated.

Given the effectiveness of additional swap auctions held, the NBS organised two more auctions amid a mild decrease in excess dinar liquidity, typical for the start of the required reserve maintenance period. More specifically, the NBS held the fourth additional two-week swap auction on 25 March and the fifth on 22 April, supplying banks each time with RSD 5 bn in exchange for EUR 42.0 mn and EUR 42.5 mn, respectively. The banking sector's dinar liquidity position was considerably more favourable than at the time of holding the previous three auctions, which is why lower volumes of the fourth and fifth auction were more than enough for fine-tuning liquidity and consequently, ensuring a more even movement in the interbank money market interest rates than at the start of the year (Chart O.1.1).

Constant monitoring, analysis of market developments and proactive approach of the NBS in terms of holding additional FX swap auctions have been assessed as positive by both financial market participants and analysts. In this way, the NBS has not only maintained stability in the money market and prevented excessive growth in short-term interest rates, but also demonstrated, as many times before, its flexibility and swift reaction in monetary policy conduct, i.e. capacity to regulate monetary conditions within a short period of time without changing the key policy rate.

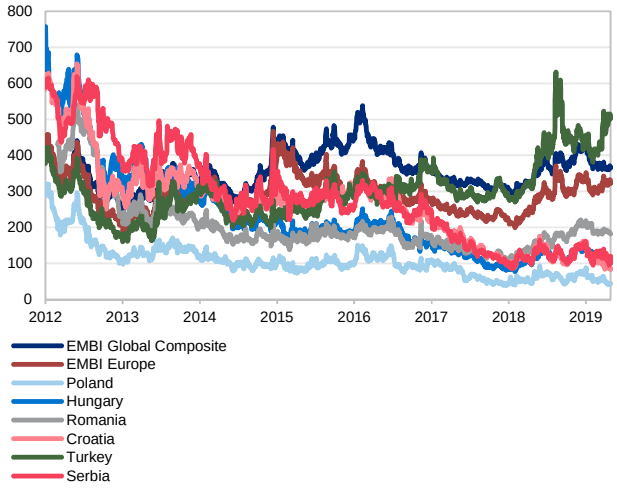
Chart O.1.1. **Impact of FX swap auctions on liquidity and interest rates in the interbank money market**



Source: NBS.
Note: MP – maintenance period; IMM – interbank money market
* Interest rate on 1W transactions concluded in the IMM.

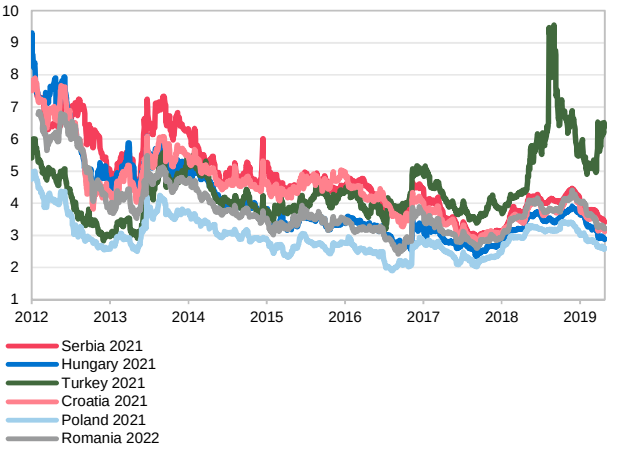
As so far, the NBS will carefully monitor and analyse movements in all segments of the domestic financial market and react when necessary with all instruments available in order to ensure its smooth functioning. In doing so, the NBS will continue to assess methodically and in detail the required intensity and dynamics of the application of those instruments. It should be noted that with the still present structural excess dinar liquidity in the banking sector, reverse repo operations remain the main instrument for regulating bank liquidity, as well as for signalling the monetary policy stance and movements in short-term market interest rates.

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



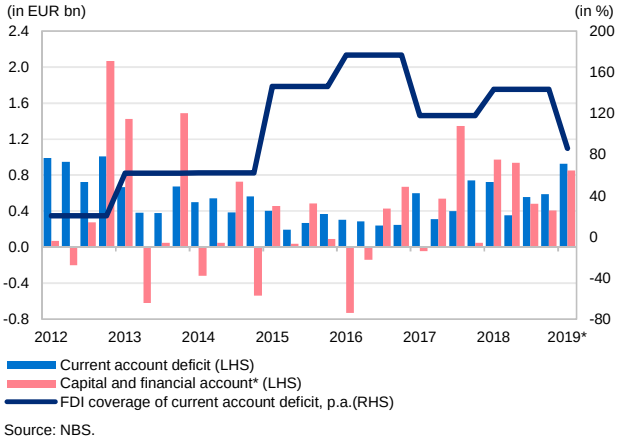
Source: JP Morgan.

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



Source: Bloomberg.

Chart IV.1.10 **Current account deficit and net capital inflow**



Source: NBS.

Preliminary data for Q1 2019.
* Excl. changes in NBS FX reserves.

Risk premium

Emerging markets' risk premia have been on a decline since the start of the year, thus largely offsetting their rally in the last quarter of 2018. EMBI Global Composite spread fell by 62 bp in Q1, to 373 bp, reflecting mainly the changes in expectations regarding the pace of normalisation of the Fed's monetary policy, which exerted a positive impact on investor sentiment towards emerging markets. The fall in EMBI Global was also supported by the progress in trade negotiations between the US and China. EMBI Europe edged down by 2 bp, to 337 bp, as a consequence of the rise in Turkey's risk premium (by 66 bp), as the Turkish economy plunged into recession late last year. The fall in the risk premia of other regional peers in Q1 ranged from 17 bp for Romania to 69 bp for Croatia, which can be linked to Standard & Poor's raising of Croatia's credit rating to investment grade.

Serbia's risk premium fell by 28 bp from end-2018, to 131 bp at end-Q1, which is still significantly below EMBI Global Composite and EMBI Europe. Serbia's risk premium recorded a decline even though the eurobond maturing in 2020, whose yield was lower than the yield on the eurobond maturing in 2021, dropped out from the calculation of EMBI for Serbia in late January. In early February, Serbia's risk premium plunged to 95 bp, then rebounded in March, rising under the impact of global factors, just as the risk premia of other countries in the region, only to retreat again in April and settle at 103 bp by the end of that month. Serbia's lower risk premium continues to be supported by domestic factors, notably by the significantly reduced internal and external imbalances, which reduced the borrowing needs, as well as by the favourable prospects for economic growth.

Serbia's increased resilience to potential shocks from the international environment was also recognised by Standard & Poor's which in December improved Serbia's credit rating outlook for long-term borrowing in the local and foreign currency to positive from stable, and affirmed the country's credit rating at BB. Furthermore, Fitch Ratings affirmed a stable outlook for Serbia in May, sending a positive signal to investors.

Foreign capital inflow

The balance of payments financial account recorded a net capital inflow in Q1 2019 as well. As before, FDI largely accounted for the inflows. There was also an inflow from financial loans as foreign borrowing of enterprises and

government increased, while portfolio investments recorded a marginal outflow.

Though there are some estimates that global FDI flows are decelerating, net **FDI** inflow to Serbia was relatively high in Q1 (EUR 796.7 mn) and up by 10.1% from the same period the year before. Investment was broad-based and the most of it went to transportation (24%), manufacturing (22%), trade (18%) and construction (10%). Thus the trend of strong investments in tradable sectors continued, contributing directly to a further enhancement of Serbia's external position. In Q1 the bulk of inflows (around two thirds) came from European countries, while Asian investments accounted for around 10% of FDI.

Portfolio investment recorded a EUR 48.6 mn net outflow in Q1 as the total stock of securities which matured or were sold in the secondary market exceeded the stock of securities bought by non-residents in the primary market. At the same time, residents intensified their investment in foreign securities in the international market and there was an outflow on these grounds.

Residents' liabilities under **financial loans** increased by EUR 112.0 mn, net in Q1. Corporate and government borrowing provided almost equal contributions to this increase (EUR 195.9 mn and EUR 191.8, respectively), while banks, on the other hand, net repaid their debts to foreign creditors by EUR 271.6 mn, primarily short-term loans. The liabilities of the NBS were also brought down by EUR 4.1 mn.

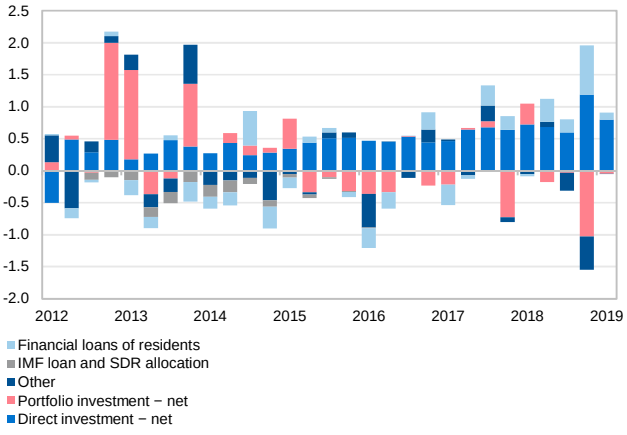
Trends in the FX market and exchange rate

After moderate depreciation pressures in January, conditioned primarily by the seasonally higher demand of energy importers for foreign currency, appreciation pressures, which prevailed in the past two years as well, renewed as of February. Observed at period-end, Q1 saw a nominal strengthening of the dinar against the euro by 0.2% and weakening against the dollar by 1.5%, the latter due to a further appreciation of the dollar against the euro.

Appreciation pressures were brought about primarily by the rising exports and FDI which considerably reduced the net sale of foreign currency to corporates since February. The increase in net indexed bank assets also fuelled appreciation pressures[3], particularly in March, as

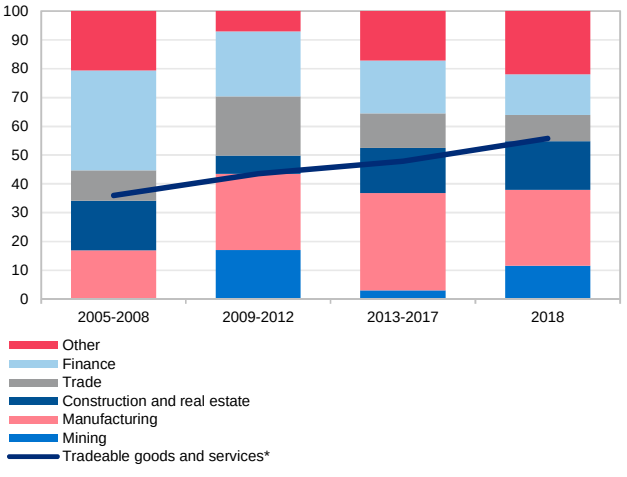
[3] Aiming to balance their open long FX position and thus reduce the exposure to FX risk, banks sell foreign currency, which leads to strengthening of the dinar.

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



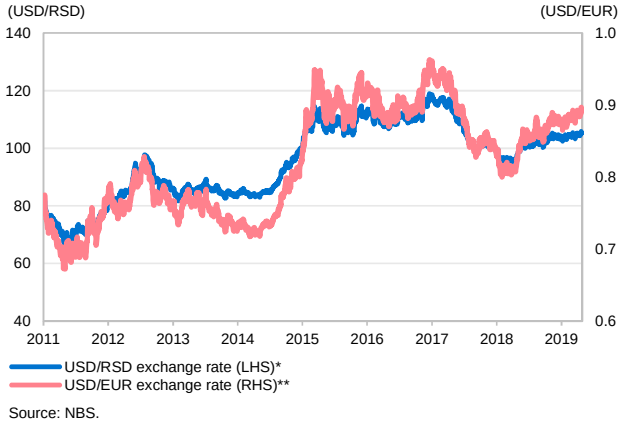
Source: NBS.
Preliminary data for Q1 2019.

Chart IV.1.12 **FDI structure by sector**
(in %)



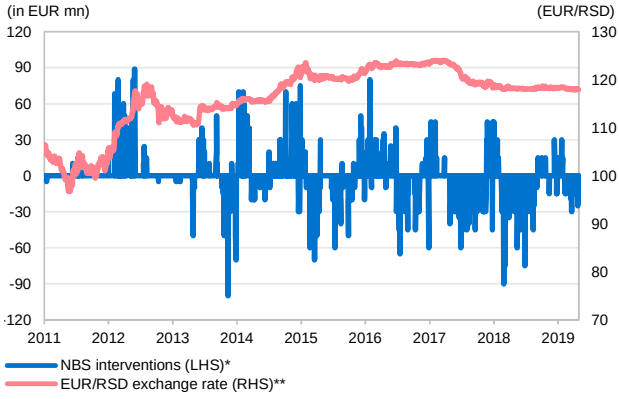
Source: NBS.
Preliminary data for 2018.
* Agriculture, industry, mining, transportation, catering, ICT.

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



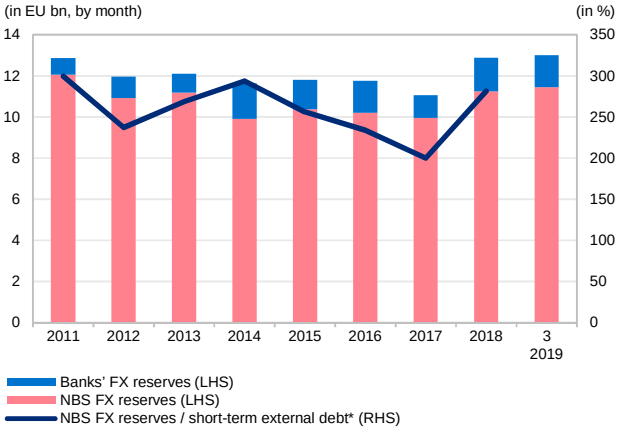
Source: NBS.
* USD 1 in RSD.
** USD 1 in EUR.

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



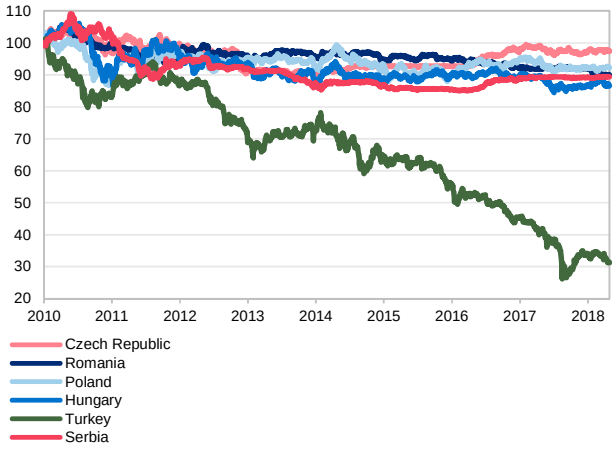
Source: NBS.
* + sale; - purchase.
** EUR 1 in RSD.

Chart IV.1.15 **FX reserves and coverage of short-term external debt**



Source: NBS.
* Short-term debt by remaining maturity.

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



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

did the net purchase of foreign cash, which was sufficient to cover for almost entire demand for foreign currency by residents and non-residents, and net lengthening of the FX position of banks on account of the use of payment cards by non-residents.

To ease the excessive short-term volatility of the dinar against the euro, in Q1 the NBS intervened in the IFEM purchasing EUR 35.0 mn net. In January it sold EUR 130.0 mn, and in February and March it purchased EUR 165.0 mn.

Appreciation pressures continued in April and the NBS intervened by buying EUR 75.0 mn, while at period-end the value of the dinar was unchanged from March.

Trading volumes in the IFEM[4] in Q1 averaged EUR 23.4 mn a day, with the highest value recorded in January (EUR 24.7 mn daily average). Compared to Q4 2018, the average daily trading volume was lower by EUR 4.4 mn and the exchange rate of the dinar against the euro was slightly less volatile.

Trading volumes in FX swap auctions organised by the NBS increased in Q1. The NBS swap bought and sold EUR 218.5 mn at regular two-week auctions (up by EUR 136.5 mn from Q4 2018) and EUR 14.0 mn at regular three-month auctions (down by EUR 41.0 mn from Q4 2018). Alongside that, the NBS organised four additional FX swap auctions of foreign currency purchase in Q1 and the fifth one in April. This enabled banks to provide dinar liquidity for two weeks amid reduced excess dinar liquidity, preventing potential segmentation and an unjustified rise in short-term interest rates in the interbank money market.[5] There were also interbank tradings in the FX swap market which totalled EUR 20.5 mn in Q1.

At period-end, of the regional peers under similar exchange rate regimes, besides the dinar, only the Hungarian forint appreciated (0.2%). The value of the Polish zloty was unchanged, while other currencies weakened – Czech koruna by 0.3%, Romanian leu by 2.1%, and Turkish lira by 3.3%.

[4] Excluding the NBS.

[5] See Text box 1, p. 16.

2. Money and loans

Growing by 10.1% y-o-y in March excluding the exchange rate effect, lending continued to boost monetary aggregates, whereas increased government deposits in the banking system – owing to the fiscal surplus posted in Q1 as well – worked in the opposite direction.

Monetary aggregates

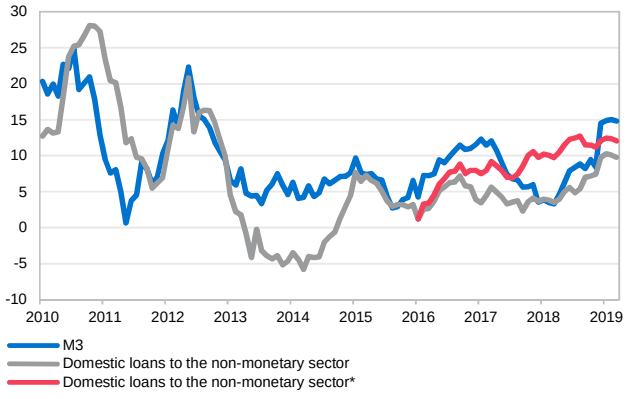
From the beginning of the year, monetary aggregates M1, M2 and M3 contracted by 7.1%, 4.2% and 0.7% respectively, primarily due to a seasonal withdrawal of funds in corporate transaction accounts (by RSD 47.8 bn) and, to a lesser degree, the decrease in currency in circulation. The balance of transaction accounts of other sectors at end-March is almost unchanged from end-2018.

Termed dinar deposits of non-monetary sectors in Q1 increased by RSD 12.9 bn, the increase being recorded in all sectors but corporate. Owing to preserved price stability and relative exchange rate stability, the dynamic growth in household dinar savings (22.2% in 2018) continued in early 2019. Household dinar savings increased by RSD 4.2 bn in Q1, reaching at end-March their new high of RSD 64.6 bn. The attractiveness of dinar savings is also confirmed by the latest Analysis of Profitability of Dinar and FX Savings in the period August 2012 – December 2018, which shows that it is more lucrative to save in the domestic currency over both long and short run.[6]

In Q1, FX deposits rose by EUR 243.0 mn, driven by FX household savings (up by EUR 256.3 mn) which reached a new peak (EUR 9.9 bn) in March.[7] In addition, corporate account balances also increased (EUR 38.3 mn), thanks to foreign currency inflow from FDI, exports, and corporate borrowing abroad. Deposits that increased the most were those of corporates engaged in transportation, construction and trade.

In y-o-y terms, the dinar components of money supply, M1 and M2 recorded slack relative to end-2018 primarily amid deceleration of transaction deposits. At the same time, M3 mildly accelerated, mainly on account of higher FDI inflow. Also, money supply growth continued to receive impetus from lending activity.

Chart IV.2.1 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.

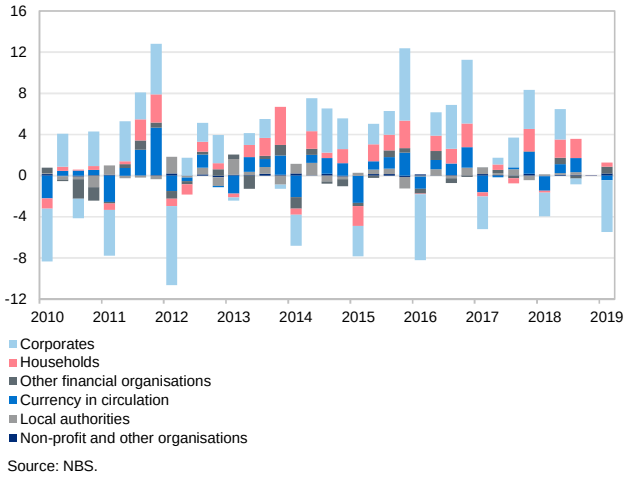
* Excluding the effect of NPL write-off and sale since early 2016.

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

	2018			2019	Share in M3 March 2019 (in %)
	June	Sept.	Dec.	March	
M3	7.9	8.2	14.5	14.8	100.0
FX deposits	4.6	5.2	13.2	13.9	62.3
M2	13.7	13.5	16.7	16.2	37.7
Time and savings dinar deposits	14.4	8.7	11.4	15.9	9.2
M1	13.5	15.1	18.3	16.4	28.4
Demand deposits	14.9	14.6	20.6	16.1	21.6
Currency in circulation	9.5	16.5	11.4	17.3	6.9

Source: NBS.

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

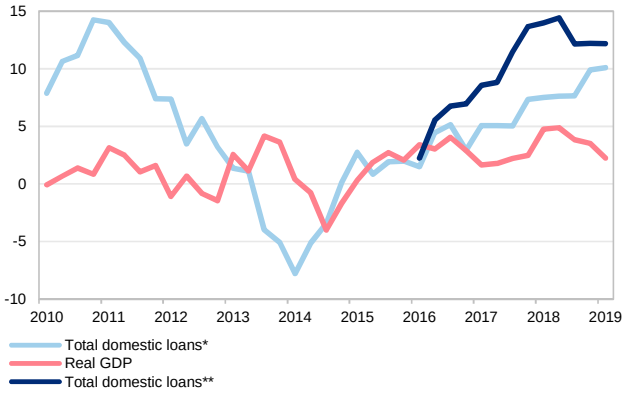


Source: NBS.

[6] For more details see the Analysis published on the NBS website on 1 February 2019. (https://www.nbs.rs/internet/english/90/analize/Analysis_dinar_and_FX_savings_2019_01.pdf).

[7] M3 covers only assets of residents. If assets of non-residents are also included, at the end of March, dinar and FX savings amounted to RSD 65.2 bn and EUR 10.2 bn, respectively.

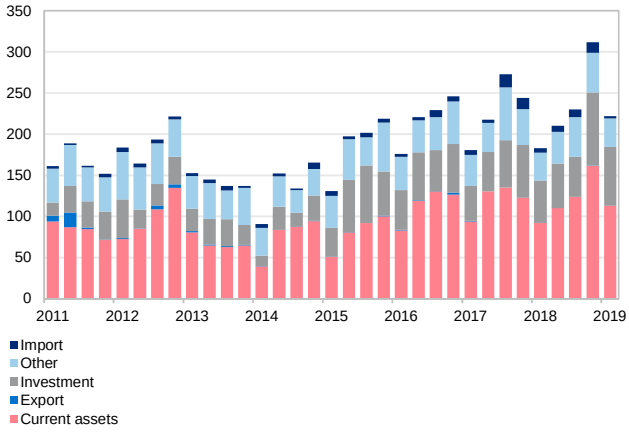
Chart IV.2.3 **Lending activity and GDP**
(y-o-y rates, in %)



Sources: NBS and SORS.

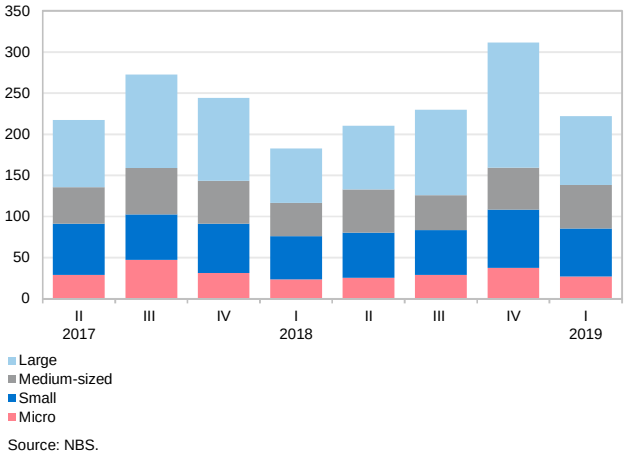
* Excluding the exchange rate effect.
** Excluding the effect of NPL write-off and sale since early 2016.

Chart IV.2.4 **Structure of new corporate loans, by purpose**
(in RSD bn)



Source: NBS.

Chart IV.2.5 **Structure of new corporate loans, by enterprise size**
(in RSD bn)



Source: NBS.

Loans

Excluding the exchange rate effect,[8] total domestic loans in March recorded 10.1% growth y-o-y, with corporate loans rising by 7.8% and household by 12.3%. Banks continued with their NPL resolution efforts in 2019. In Q1 they wrote off RSD 3.9 bn and sold RSD 1.4 bn-worth of NPLs to non-banking sector entities directly from their balance sheets. Excluding the effect of NPL write-off and sale[9], the y-o-y growth of domestic loans reached 12.2% in March 2019, with household loans going up by 12.9% and corporate by 11.3%.

As in the years before, the disbursement of corporate loans at the beginning of the year was weaker and thus they were higher by RSD 1.0 bn in Q1 2019 excluding the exchange rate effect. **By branch**, Q1 saw an increase in corporate loans first and foremost in construction and trade. **In terms of purpose**, liquidity and current assets loans continued to account for the bulk of corporate loans (41.8%), followed by investment loans (41.0%).

The stock of new corporate loans in Q1 (RSD 221.9 bn), excluding refinancing loans with the same bank went up by 12.8% y-o-y. All corporate loan categories recorded growth except for import loans. Current assets loans were the dominant corporate loan category in Q1 as well (50.8% of new corporate loans compared to 52.2% in 2018) with over 60% of these loans being placed in the micro, small and medium-sized enterprise market segment. Excluding refinancing loans with the same bank, the volume of investment loans in Q1 (RSD 71.7 bn) went up by 34.2% y-o-y, which indicates continuation of positive investment activity of corporates in 2019. Their share in total new corporate loans in Q1 amounted to 32.3% and they were mostly used by large enterprises.

The **April NBS Bank Lending Survey**[10] shows that corporate credit standards remained unchanged in Q1, for the third consecutive quarter. Banks estimated that the competition is strong and that it indicates standard easing, which is likely to happen in the coming quarter. Positive bank expectations regarding the general economic activity will also contribute to standard easing. Corporate credit conditions were more favourable in case

[8] 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), taking into account the currency composition of loan receivables.

[9] The NPL write-off and sale effect is excluded since the beginning of 2016. As at end-March 2019 banks wrote off RSD 186.3 bn worth of NPLs (of which RSD 138.5 bn from corporates, and RSD 42.9 bn from households), and sold RSD 90.2 bn worth of NPLs, that were in their balance sheets at the moment.

[10] The NBS has been implementing the Survey since the start of 2014.

of longer maturities and smaller interest margins when dinar loans are concerned[11]. Survey indicates rising corporate demand for FX and FX-indexed loans for financing current assets and capital investment, driven by the SME demand. Banks expect that credit standards will remain almost the same as in Q1[12]. At the same time, they also expect a further rise in the demand for corporate loans motivated by similar needs as in the previous periods.

Excluding the exchange rate effect, **household loans** increased by RSD 19.7 bn in Q1 2019. The bulk of loans were cash and housing loans, which picked up by ¬RSD 10.1 bn and RSD 6.4 bn in Q1, respectively. The share of cash loans in total household loans amounted to 40.7% in March, while the share of housing loans reached 37.8%.

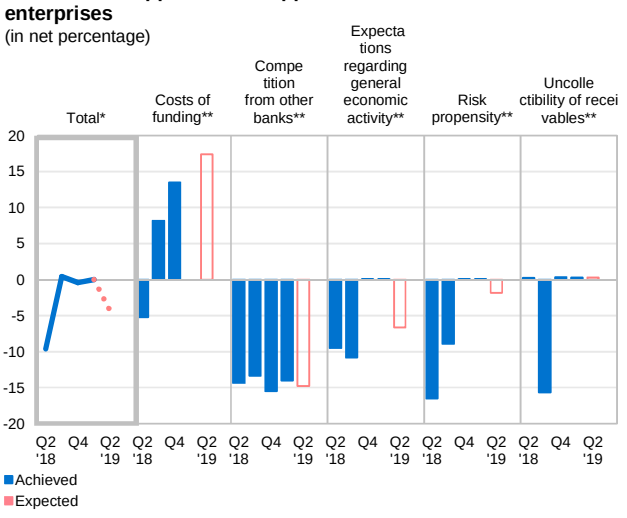
The volume of new household loans (RSD 105.5 bn) went down by 4.5% y-o-y in Q1, and up by 0.6% if refinancing loans with the same bank are excluded. In Q1 citizens continued to use predominantly cash loans and refinancing loans, which made up almost 57% of new household loans and were mainly approved in dinars (99%). The volume of new housing loans (RSD 19.5 bn) is up by 1.6% relative to the same period of the previous year, indicating that positive tendencies in the housing loans market continue for the third year in a row. At the same time, the amount of new cash loans in Q1 (RSD 60.1 bn) went down by 4.8% from the same period last year. This indicates that NBS measures from December 2018 aimed at unsecured non-purpose household loans with unreasonably long maturities yield results.

The **April Bank Lending Survey** indicates that credit standards for household loans slightly tightened in Q1, which is consistent with bank expectations stated in the January survey. In Q1 loan price conditions were eased, while standard tightening reflected only on reduced loan maturity. The need to buy property and durable consumer goods and to refinance current liabilities was the main driver of a slight increase in household demand for loans in Q1. Survey results indicate that banks expect the easing of standards for household loans in Q2 under the influence of competition in the sector, with further lowering in loan price, while banks will continue to reduce maximum maturity, primarily in case of dinar loans. Banks expect a more significant rise in household demand in Q2, aimed at dinar cash and consumer loans, as well as refinancing loans and FX-indexed housing loans.

[11] As opposed to FX and FX-indexed loans for which banks slightly raised interest margins.

[12] Except for the expected easing of collateral requirements in FX and FX-indexed loans which will be partially offset by the slight increase in interest margins.

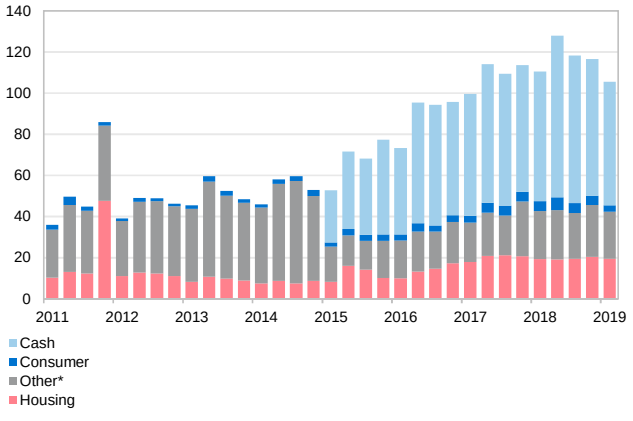
Chart IV.2.6 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)



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.

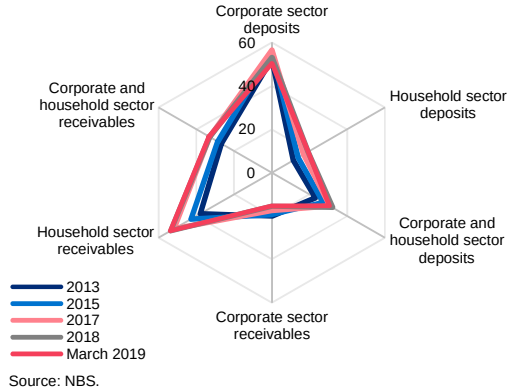
Chart IV.2.7 **Structure of new household loans**
(in RSD bn)



Source: NBS.

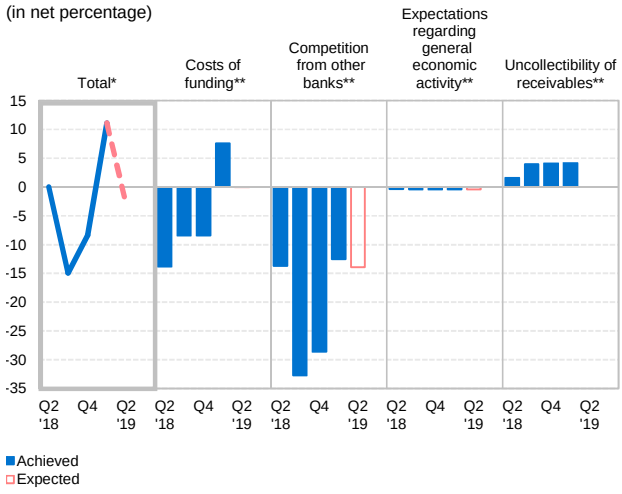
* Until December 2014, the 'Other loans' category included both cash and other loans.

Chart IV.2.8 **Dinarisation of corporate and household deposits and receivables**
(stock, in %)



Source: NBS.

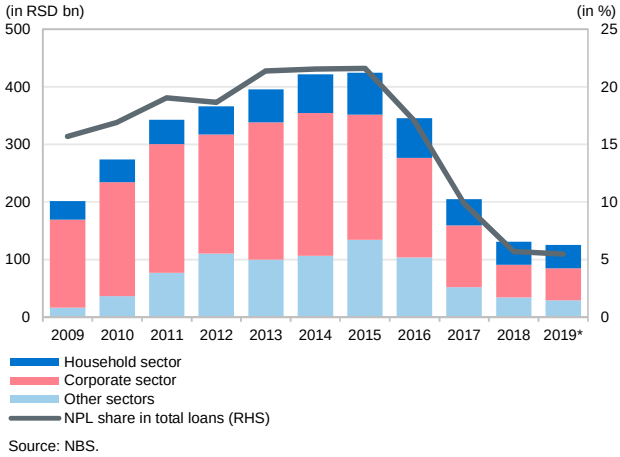
Chart IV.2.9 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)



Source: NBS.

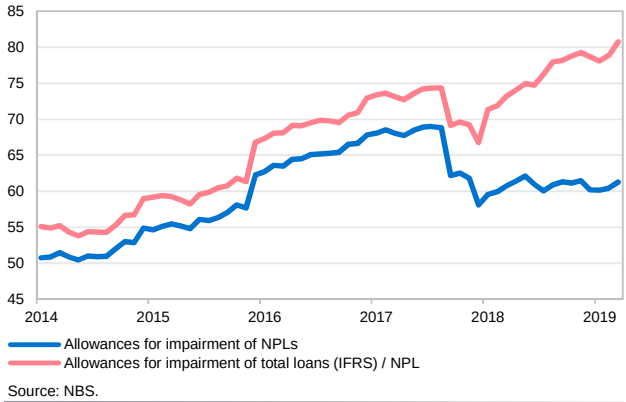
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.
** Positive values indicate the contribution of individual factors to tightening, and negative values indicate the contribution to easing of credit standards.

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



Source: NBS.
* March 2019.

Chart IV.2.11 **Selected banking sector indicators**
(in %)



Source: NBS.

The share of dinar receivables in total corporate and household receivables at end-March reached 33.3% (an increase of 0.3 pp relative to end-2018). The dinarisation of household receivables reached maximum 53.7% in March, while the dinarisation of corporate receivables remained at closely the same level as at end-2018 (15.3% in March).

Supported by favourable lending trends and sound and stable economic growth, the NPL Resolution Strategy continues to yield excellent results. In less than four years since the adoption of the Strategy, the **NPL stock** contracted by over 70%, and the NPL ratio dropped by 16.9 pp. Since the start of 2019, the NPL share in total loans decreased by 0.2 pp to 5.5% in March, with corporate NPL ratio going down by 0.1 pp to 5.0%[13] and the household ratio staying unchanged at 4.4%.[14] NPL coverage remains high – allowances for impairment of total loans stood at 80.7% of NPLs in March, while allowances for impairment of NPLs reached 61.3% of NPLs. Also, following the introduction of Basel III standards[15], capital adequacy ratio went up further, reaching 23.7% at end-Q1 2019 and testifying to the high capitalisation of the domestic banking sector.

[13] Includes companies and public enterprises. Looking at companies only, in March the share of NPLs in total loans stood at 5.0%, down by 0.2 pp relative to December 2018.

[14] If entrepreneurs and private households are included, the share is also at the same level as it was at the end of the last year (4.4%).

[15] The regulatory Basel III framework is applied as of 30 June 2017.

Text box 2: Synchronisation of economic and credit cycles of Serbia and the euro area

Given Serbia's strong economic and financial linkages with the euro area, evidenced by the external trade data which indicate that around 40% of the total trade is with the euro area economies (primarily Germany and Italy), and that over 60% of FDI inflows to Serbia originate from these countries, it is realistic to expect that macroeconomic developments in the euro area, as well as the ECB's monetary policy measures, have a significant impact on the economic and credit activity in Serbia.

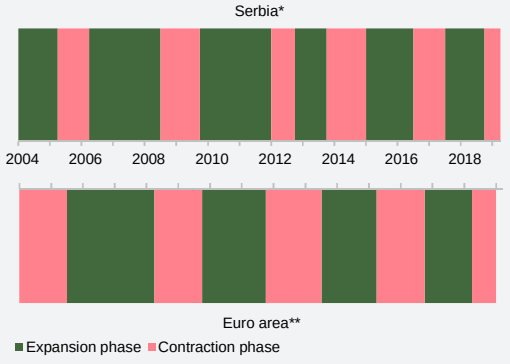
In order to get a more comprehensive view of the connection between economic developments in Serbia and in the euro area[1], we have analysed the synchronisation of their economic and credit cycles, i.e. cyclical movements of economic and credit activity in Serbia and in the euro area. The analysis used the following data series:

– As a measure of economic activity: seasonally-adjusted real GDP and non-agricultural value added (NAVA) on a quarterly basis;

– As a measure of credit activity: seasonally-adjusted quarterly series of the stock of banks loans approved to the domestic non-monetary sector, deflated by the CPI.

The analysis covered the period from 2004 until Q1 2019, i.e. starting from the time when comparable data on bank loans to the non-monetary sector are available. By using the Christiano–Fitzgerald filter we identified the long-term trend of economic and credit activity, and the cyclical component of the above data series was determined as a deviation from the trend. By applying the so-called Bry Boschan procedure (BBQ algorithm), which Harding and Pagan[2] adjusted for quarterly data series, we identified the turning points of the cycle and assessed the characteristics of its phases (length, amplitude and cumulative gain/loss in the expansion/contraction phase). When interpreting the results it should be borne in mind that they demonstrate only the cyclical component of economic and credit activity, whereas expansion and contraction are defined as upward and downward deviations from the long-term trend. In other words, when the cyclical component of, for example, economic activity is in the contraction phase, that does not necessarily entail the economy's entry into recession, but rather the slowdown of economic activity, i.e. its growing slower compared to the trend. Generally, cycles are a normal phenomenon and can be identified only if a sufficiently long period is analysed. Identification of cycles and gathering information about their average length and amplitudes facilitates future forecasting.

Chart O.2.1 **Economic cycle phases of Serbia and euro area measured by GDP**



Source: NBS calculation.
* As at Q1 2019.
** As at Q4 2018.

Table O.2.1 **Characteristics of economic cycle phases of Serbia and euro area measured by GDP**

	Average duration (in Q)		Amplitude (in %)		Average cumulative change (in %)	
	Contraction	Expansion	Contraction	Expansion	Contraction	Expansion
Serbia	3.7	6.3	-2.3	2.9	-6.5	9.6
Euro area	5.4	8.0	-1.7	2.5	-6.5	13.1

Source: NBS calculation.

The results of the analysis show that the movements of the cyclical component of Serbia's and euro area's economic activity significantly overlap, as measured by the real GDP (Chart O.2.1). The value of the index which measures the degree of synchronisation of cycles in Serbia and the euro area (concordance index) at 0.52 shows that Serbia and the euro area's economic cycle phases were in a synchronized regime for more than half of the quarters in the period observed. Serbia's contraction and expansion phases on average lasted shorter, but with slightly more pronounced amplitudes, as generally expected for small and open economies. On average, the contraction phase of the Serbian economy lasted around a year, while the expansion phase extended for more than six quarters.

[1] We used the data for 12 countries which initially joined the euro area.
[2] Harding D., and A. R. Pagan (2002), Dissecting the Cycle: A methodological Investigation, *Journal of Monetary Economics*, vol. 49(2), pp. 365–381.

Observed by period, after the outbreak of the global financial crisis, Serbia entered the contraction phase with a quarter delay compared to the euro area. Also, the euro area slowdown begun in the last quarter of 2011 spilled over to Serbia after one quarter, dragging down its economic activity.

However, the mentioned slowdown phase in Europe persisted for almost two years, primarily due to the public debt crisis troubling some members, while Serbia entered the expansion phase already after three quarters. The phases of acceleration of economic activity in Serbia after 2013 were interrupted by one-off effects mainly caused by adverse weather conditions (floods in 2014 and droughts in 2017, which negatively affected agricultural production).

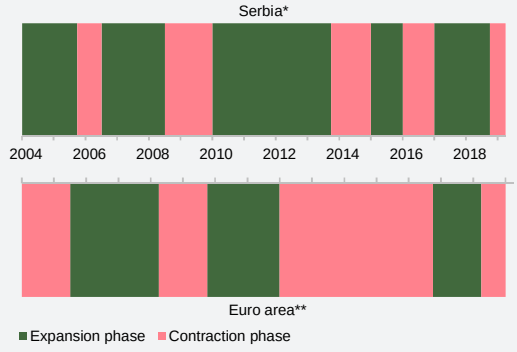
The achieved and preserved macroeconomic stability, mostly reflected in low and stable inflation, anchored inflation expectations and relative stability of the exchange rate, together with timely and well-balanced decisions of monetary and fiscal policies, helped Serbia's economy to enter the expansion phase as of Q3 2017 and to record in 2018 the highest growth in the last ten years.

The synchronised cyclical dynamics of the economic activity in Serbia and the euro area becomes even more pronounced if NAVA is used as a measure of economic activity. This eliminates the impact of agriculture on the overall economic activity, as a sector most vulnerable to seasonal factors and weather conditions. The results of the analysis indicate a higher degree of synchronisation of economic cycles of Serbia and the euro area – the correlation is statistically significant[3], and the concordance index for the period observed is 0.62. When using NAVA as a measure of economic activity, the contraction phase in Serbia (around four quarters on average) lasts shorter, and the expansion phase (around eight quarters on average) almost the same as in the euro area.

The results of the analysis of cyclical movements of economic activity (measured by both GDP and NAVA) in the euro area indicate that it has been in the slowdown phase since the second half of 2018, as confirmed by the lower s-a growth in Q3 and Q4 compared to the first half of the year. The results also suggest that the lower external demand from the euro area reflected on the deceleration of economic activity in Serbia, starting from Q3 2018. Bearing in mind that the economic deceleration phase in Serbia lasts four quarters on average, we may expect economic activity to pick up again as of the third quarter this year.

Given that credit activity is an important channel through which central banks can impact economic activity, we analysed the synchronisation of credit and economic cycles in Serbia. For

Chart O.2.2 **Economic cycle phases of Serbia and euro area measured by GDP**



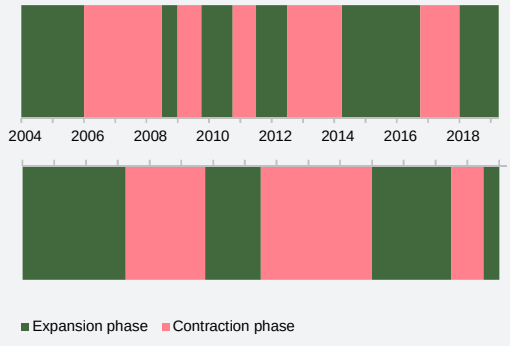
Source: NBS calculation.
* As at Q1 2019.
** As at Q4 2018.

Table O.2.2 **Characteristics of economic cycle phases of Serbia and euro area measured by NAVA**

	Average duration (in Q)		Amplitude (in %)		Average cumulative change (in %)	
	Contrac-tion	Expan-sion	Contrac-tion	Expan-sion	Contrac-tion	Expan-sion
Serbia	4.0	8.0	-2.5	3.1	-8.8	15.8
Euro area	8.3	8.7	-2.2	3.4	-13.1	19.2

Source: NBS calculation.

Chart O.2.3. **Credit cycle phases of Serbia and euro area**



Source: NBS calculation.
* As at Q1 2019.
** As at Q4 2018.

Table O.2.3 **Characteristics of financial cycle phases of Serbia and euro area**

	Average duration (in Q)		Amplitude (in %)		Average cumulative change (in %)	
	Contrac-tion	Expan-sion	Contrac-tion	Expan-sion	Contrac-tion	Expan-sion
Serbia	5.6	5.3	-6.4	6.8	-28.9	25,07
Euro area	9.3	7.8	-2.5	2.5	-16.3	14.8

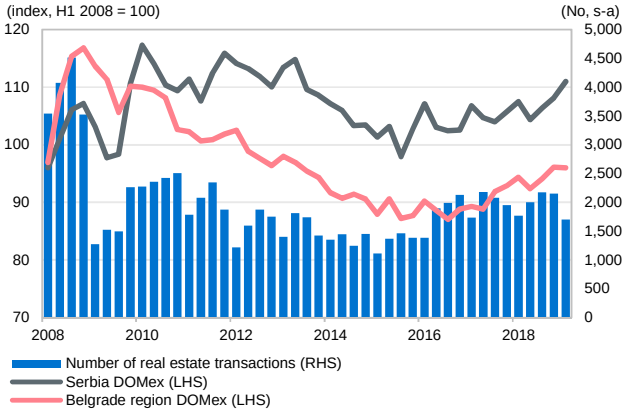
Source: NBS calculation.

[3] With the estimated correlation coefficient of 0.47 at the confidence level of 95%.

more than half of the 60 quarters analysed, economic and financial cycles in Serbia were phase-synchronised, as indicated by the concordance index of 0.52. The credit cycle downturn phase lasts longer than the economic cycle downturn (by around 1.4 quarters), while credit expansion phase is shorter than the economic one (by around 1.2 quarters).

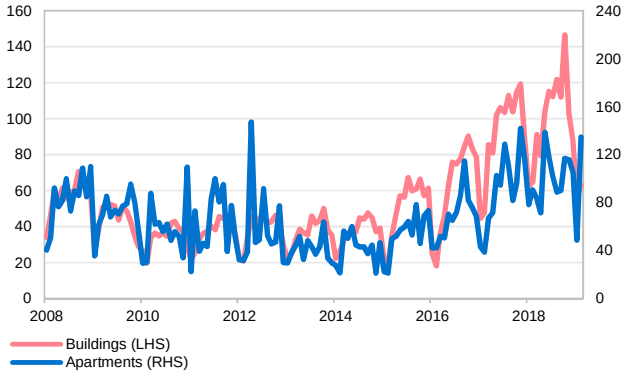
Compared to the euro area credit cycle, the results show that in the period 2004–2018 credit activity in Serbia underwent a greater number of cycles, with the average length of both cycle phases being shorter, though with more pronounced amplitudes. It can also be inferred from the analysis that subsidised lending programmes in Serbia yielded positive results, because soon after them credit activity would enter the expansion phase. As of May 2013, credit activity was additionally encouraged by the NBS's monetary policy easing, which led to a fall in interest rates on dinar loans (by over 10 pp). In addition, low interest rates in the euro area, together with the low country risk premium, further boosted credit activity in Serbia, in expansion since the beginning of last year. The concordance index of 0.63 shows that credit cycles of Serbia and the euro area were synchronised for almost full 38 quarters, out of the 60 quarters observed. In that sense, given that the ECB announced slower monetary policy normalisation, the expected prolongation of the period of low interest rates in the euro area should continue to positively impact credit activity in Serbia.

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



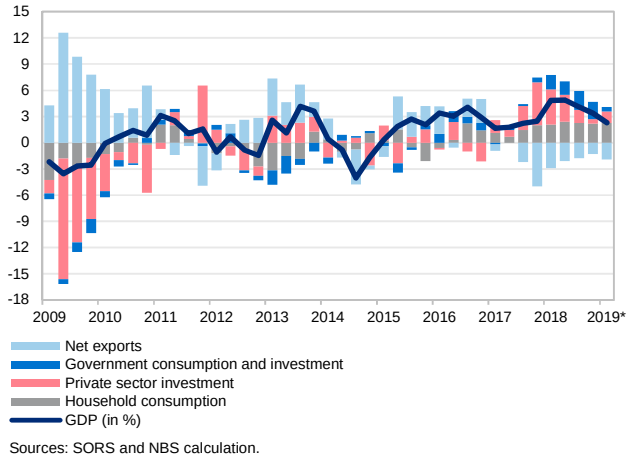
Source: National Mortgage Insurance Corporation.

Chart IV.3.2 **Indices of the number of issued construction permits for new construction**
(quarterly averages s-a, 2018 = 100)



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q1 2019.

3. Real estate market

Real estate prices went further up in Q1 and supply and demand indicators suggest that the recovery of the real estate market may continue going forward.

As measured by DOMex,[16] the average price of real estate in Serbia increased by 2.6% in Q1. Prices rose in the regions of Vojvodina (5.4%) and Šumadija and West Serbia (4.1%), while dropping slightly in Belgrade and South and East Serbia regions (0.1% and 0.7%, respectively).

In Q1, the average real estate price in Serbia equalled EUR 934.0 per square metre. Real estate remained the most expensive in the Belgrade region, with the average price of EUR 1,217.9. The ratio of average prices in Belgrade and other regions equalled 1.77.

In Q1, the number of real estate transactions[17] dropped by 7.2% s-a, mainly due to the lower turnover in the region of Vojvodina (14.8% s-a). In y-o-y terms, the turnover decreased less, 3.9%.

As suggested by supply and demand indicators, favourable trends may be expected in the real estate market going forward. Namely, the number of construction permits issued in residential construction went up in January and February by 8.7% y-o-y. Higher activity in construction was accompanied by the rise in lending to companies in this sector. Also, positive trends in the housing loan market extended into the third consecutive year. According to the Bank Lending Survey, banks expect a significant rise in households' housing loan demand. The labour market also saw the continuation of favourable trends, i.e. the rise in wages and employment.

4. Aggregate demand

Positive labour market trends, as well as favourable borrowing terms, encouraged a further increase in fixed investment and household consumption, leading to 2.3% y-o-y GDP growth in Q1. In quarterly terms, GDP growth accelerated to 0.9% s-a in Q1.

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

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

Domestic demand

In the NBS's estimate, Q1 saw a continued stable rise in **household consumption** of 3.5% y-o-y, which added 2.3 pp to GDP growth. Same as in 2018, consumption growth was supported by disposable income, rising on the back of higher wages and employment, as well as by more favourable terms of new household loans and lower costs of repayment of outstanding ones. This is also confirmed by the movement of key indicators of household consumption. Y-o-y, retail trade turnover increased in real terms by 8.6% and the number of domestic tourist arrivals by 3.5% in Q1. Q-o-q, household consumption stepped up 1.0% s-a, adding 0.7 pp to GDP growth.

The wage bill, which is the main source of household consumption, rose by 11.9% y-o-y in real terms in January and February, reflecting higher employment and wages. Real growth was also recorded for the pension bill (7.9% y-o-y), and remittances inflow, which was 2.6% higher than in the same period last year.

Government consumption is also estimated to have picked up by 3.5% y-o-y in Q1, contributing positively to GDP growth by 0.6 pp. Greater government consumption reflects higher wages in the public sector, i.e. real increase in public sector employment expenditures by 4.3% y-o-y, and higher expenditures for the purchase of goods and services. In quarterly terms, government consumption mildly accelerated, to 0.8% s-a, adding 0.1 pp to GDP growth.

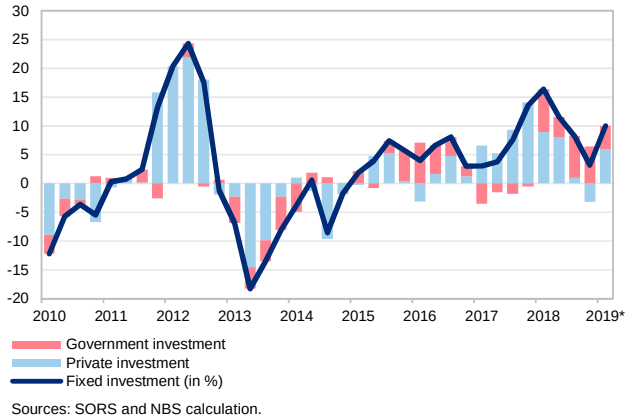
Fixed investment continued up in Q1 (10.0% y-o-y), giving a 1.8 pp positive contribution to GDP movements, mainly owing to the increase in private investment (contribution of 1.1 pp), benefiting from further improvements in the business environment. According to the NBS's estimate, government investment increased by around 20% y-o-y in Q1. The intensified finalisation of government-financed infrastructure projects had a special effect on construction which recorded higher production of construction material (by 10.6% y-o-y) and value of works performed (by 13.6% y-o-y), as well as higher employment in Q1. In addition, Q1 saw a higher volume of production of capital goods by 4.8% y-o-y, with the volume of production of machinery and equipment expanding by 16.1% y-o-y, and equipment imports rising by the same percent. Q-o-q, private investment was 8.0% s-a stronger in Q1, giving a positive 1.3 pp contribution to GDP growth. Government investment also continued up in Q1 (4.7% s-a), so total fixed investment contributed 1.5 pp to GDP growth.

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

	2018			2019
	Q2	Q3	Q4	Q1
Household consumption	**3.1**	**3.4**	**3.3**	**3.5***
Indicators				
Retail trade	3.3	4.8	4.8	8.6
Catering turnover	10.7	11.0	9.1	8.3**
Number of domestic tourists	8.7	8.6	5.8	3.5
Number of overnight stays of domestic tourists	13.6	10.2	6.7	1.3
Consumer goods imports (BEC classification), nominal	6.0	10.6	16.4	10.2
Sources				
Total wage bill, nominal	8.9	9.9	11.3	14.2***
Net remittances inflow, nominal	15.6	35.5	6.4	2.6
New consumer and cash loans, nominal	17.5	10.8	7.0	-6.8

Sources: SORS and NBS calculation.
* NBS estimate.
** January (SORS estimate).
*** January–February.

Chart IV.4.2 **Fixed investment**
(y-o-y growth, in pp)



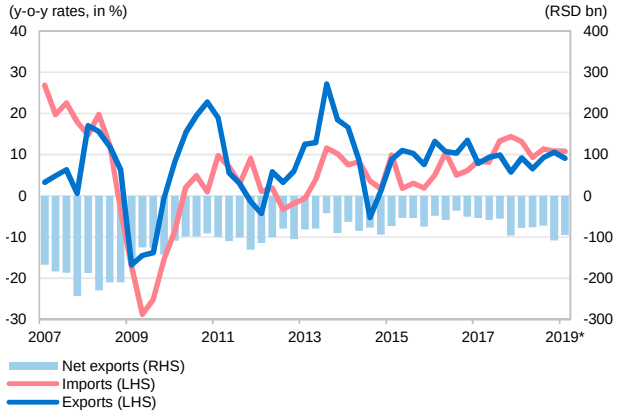
Sources: SORS and NBS calculation.
* NBS estimate for Q1 2019.

Table IV.4.2 **Investment indicators**

	2018				2019
	Q1	Q2	Q3	Q4	Q1
Real y-o-y growth rates (in %)					
Fixed investment (national accounts)*	16.4	11.5	8.3	3.2	10.0
Construction (national accounts)*	26.7	20.4	9.9	2.7	10.0
Government investment*	47.0	28.9	51.9	41.9	20.0
issued**	14.4	6.9	6.3	-1.8	-0.7**
Production of construction material**	7.3	7.0	11.0	5.5	10.6
Value of works performed	29.5	22.9	10.5	3.1	13.6
Imports of equipment, nominal**	28.1	13.0	15.8	8.5	16.1
Production of domestic machinery and equipment**	5.4	14.1	3.4	8.7	16.1
Finished product inventories in industry**	10.4	9.4	13.6	9.9	3.9

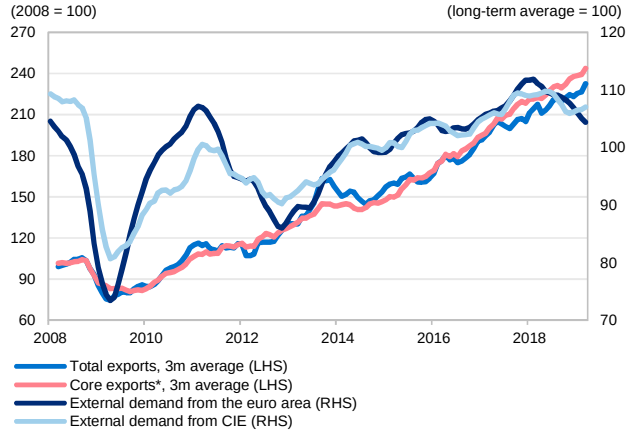
Sources: SORS and NBS calculation.
* NBS estimate for Q1 2019.
** January–February.

Chart IV.4.3 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
* NBS estimate for Q1 2019.

Chart IV.4.4 **Movement of indicators of external demand for Serbian exports**
(3m moving avarage, s-a)



Sources: European Commission, SORS and NBS.
* Core exports are total exports excluding exports of agricultural products, base metals, motor vehicles, petroleum products and electricity.

The bulk of investment was financed from own sources, as evidenced by higher company profitability and positive corporate financial result in 2018 of close to RSD 500 bn. Also, better business environment and continuous improvement in investment environment supported further growth in FDI inflows which in Q1 reached EUR 796.7 mn, having risen by 10.1% from the same period last year. Investment financing also benefited from favourable borrowing terms, as evidenced by the rise in new investment loans.

It is estimated that inventories declined further in Q1, dragging quarterly GDP growth in Q1 down by 0.6 pp. Agricultural product inventories particularly contracted, given a significant rise in their exports in Q1.

Net external demand

Despite the global growth slowdown, in Q1 goods and services exports continued their relatively high real growth (9.1% y-o-y), driven by a further rise in exports of services, manufacturing industry and agriculture. On the other hand, the ongoing investment cycle, and in part also higher energy imports and the recovery of private consumption were the key factors driving the real growth of goods and services imports (10.8% y-o-y) somewhat above the exports growth. Consequently, the negative contribution of net exports to GDP extended into Q1 (1.9 pp).

Led by manufacturing exports, with the rising positive contribution of agriculture, commodity exports in euro terms continued to enjoy a relatively high growth rate in Q1 (7.9% y-o-y), according to the balance of payments data. The slowdown in euro area demand was largely offset by the higher exports to markets outside the euro area (Central and East Europe). According to the foreign trade data, manufacturing exports increased by 4.4% y-o-y, with growth recorded in 14 of 23 branches. The greatest contributors were exports of electrical equipment, increasing by 20.3% y-o-y, and of machinery and equipment (28.3% y-o-y). As before, high impetus also came from exports of food products, and rubber and plastic products. On the other hand, temporary interruptions in the production of Fiat Automobiles Serbia drove down motor vehicles exports (8.8% y-o-y), though this fall was largely compensated for by the rise in exports of other automobile industry manufacturers. As a result of adjustment to EU steel import quotas, base metals exports edged down by 8.4% y-o-y.

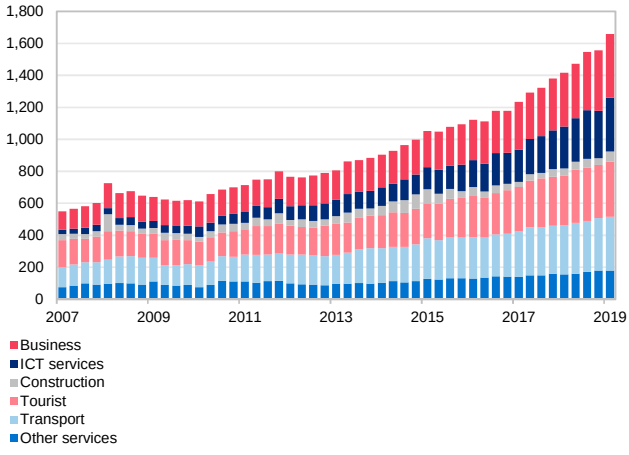
A significant positive boost came from agricultural exports, which increased by 51.4% y-o-y in Q1. This was mainly owing to the higher exports of cereals, which reached EUR 198.9 mn in Q1, rising by EUR 30.7 mn from Q4 2018. Given that the extraordinary agricultural season in 2018 generated a good export base, and that the exports were partly postponed for this year due to the low water levels of the Danube, relatively high exports of cereals may extend into Q2 as well.

Services exports sped up to 17.5% y-o-y in Q1, mainly on the back of the thriving exports of information-communication (29.0% y-o-y) and business services (18.7% y-o-y). A relatively high contribution also came from the exports of transportation and tourist services.

According to the balance of payments data, commodity imports in euro terms rose by 9.9% y-o-y in Q1, mostly reflecting the imports of intermediate goods (rising by EUR 126.5 mn). A little more than half of this growth is attributed to higher energy imports (by EUR 61.4 mn) due to stronger needs of the manufacturing industry. Consistent with the ongoing investment cycle, equipment imports went up by EUR 101.6 mn, while higher imports of consumer goods (by EUR 100.5 mn) indicate a recovery in household consumption. Similar trends are confirmed by the imports structure according to the EU classification into end-use categories, which shows that the greatest contributions to imports came from intermediate goods, followed by energy and non-durable consumer goods, and, to a lesser extent, from capital goods.

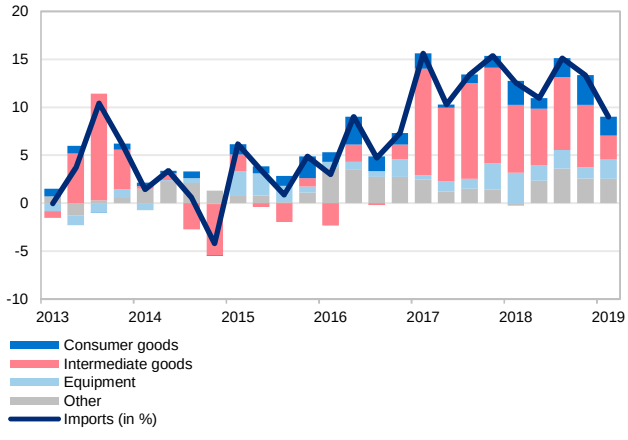
In March 2019, the commodity exports-to-imports ratio measured 74.1%, or 83.5% if services are included, similar as at end-2018. In March, exports of goods were 132.8%[18] and imports 38.2% above their pre-crisis levels.

Chart IV.4.5 **Exports of services**
(s-a data, in EUR mn)



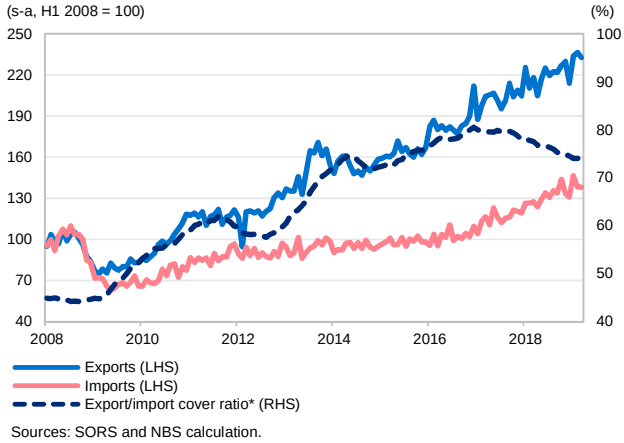
Sources: SORS and NBS calculation.

Chart IV.4.6 **Movement of key import components**
(contributions to y-o-y growth, in pp)



Sources: SORS and NBS calculation.

Chart IV.4.7 **Trade in goods in euros**



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

[18] Level from H1 2008.

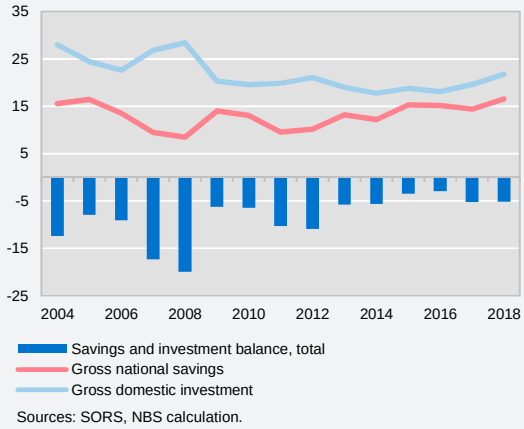
Text box 3: Analysing the dynamics of Serbia's savings and investment balance

One of the key aspects of macroeconomic analysis, and thereby of formulating the future economic policy of a country, is most certainly its savings and investment balance. Practically, this means that by applying the system of national accounts, we can analyse the extent to which the domestic sources of capital (gross national savings, i.e. the difference between GDP and spending) are able to provide funding for investments, as well as the role of the private and public sector in this matter. Countries characterised by a negative savings and investment balance are in fact the ones that finance their current account deficit with cross-border capital borrowing, while those that save more than they invest in their economy at home achieve a surplus under current transactions.

A shared characteristic of most emerging countries, including Serbia, is that domestic sources of funding are insufficient to finance investment, therefore the bulk of these funds is provided from abroad. As for Serbia, the presence of a negative savings and investment gap, i.e. current account deficit in the pre-crisis period did not pose a problem in itself, but in the fact that the rise in gross investment was not accompanied by a rise in gross national savings, because revenues were increasingly used for spending, which acted as an incentive for import. The negative savings and investment gap peaked in 2008, when it reached 20% of GDP, and the global economic crisis only accelerated the awareness that economic growth is not sustainable if it is driven by consumption and financed by capital inflows from abroad.

After the outbreak of the crisis, which imposed the necessity to ensure funds for the settlement of existing liabilities in conditions of lower financing options from abroad, the savings and investment gap narrowed to around 6.4% of GDP as a consequence of lower investment (whose share declined from 28.4% GDP in 2008 to 19.6% of GDP in 2010), as well as of increased savings (from 8.5% of GDP in 2008 to 13.1% of GDP in 2010). During 2011 and 2012, the negative savings and investment gap again expanded to more than 10%. To a lesser extent, this was a result of increased private sector investment, notably in the automobile and petroleum industries, and to a larger extent it was attributable to contracted savings amid higher fiscal policy expansiveness. However, when these investments in the automobile and petroleum industries began to yield positive effects on net exports in 2013, gross national savings of the private sector increased, therefore the negative savings and investment gap narrowed to below 6% in the period 2013–2014. The gap continued to narrow during the following two years as well, while savings and investment posted a significant increase in this period. The rise in gross national savings, which exceeded investment growth in this period, was primarily influenced by the successful implementation of the fiscal consolidation programme, which eliminated the fiscal deficit, reversed the growing trajectory of public debt and brought public debt down within sustainable bounds. Fiscal consolidation measures redirected a portion of the funds from spending to investment and, given that the results exceeded the expectations, additional room was created for public investment growth. As for private investment, their growth was facilitated by the improved investment climate resulting from the achieved price and overall macroeconomic stability, implementation of structural reforms and fiscal consolidation, as well as the decline in the country risk premium, more favourable credit rating and lower borrowing costs. This assertion is illustrated by the data that during the ongoing investment cycle, which began in 2015, the total gross fixed investment recorded robust growth – in 2018 relative to 2014 they rose by around 30% in real terms. The share of gross investment in GDP increased by 4 pp relative to 2014 and measured 21.8% of GDP in 2018. The rise in gross investments was stepped-up in 2017 and 2018, and was mirrored by the temporary widening of the savings and investment gap in this period to 5.2% of GDP.

Chart O.3.1 **Savings and investment balance**
(in % of GDP)



Sources: SORS, NBS calculation.
* NBS estimate.

All of the above is even more evident if we observe the savings and investment balance of the private and public sector separately.

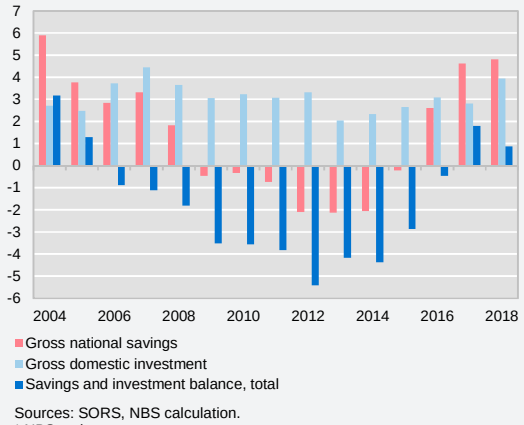
When it comes to the public sector, we may notice that until 2009 the government did not contribute to the narrowing of the negative savings and investment gap to the extent in which this might have been expected, given that government

investment was not high (3.4% on average in the period 2004–2008) and that it recorded significant inflows from privatisation. When government revenue contracted sharply after the outbreak of the crisis, and at the same time current expenditures increased further, primarily owing to a rise in discretionary expenses and outlays for pensions and wages in the private sector, government savings declined significantly and entered negative territory, thereby deepening the total savings and investment gap. It was only when the fiscal consolidation programme began and was successfully implemented that the current revenues exceeded current expenditures, and the share of gross government savings in GDP increased, reaching 4.8% in 2018. As a result of intensive implementation of infrastructure projects, the share of government investment increased to 3.9% of GDP in 2018, which is around 2 pp more than its minimum in 2013. It is important to note that although the implementation of fiscal consolidation enabled an increase in public sector wages and pensions, over the past two years the government did not influence the rise in the current account deficit – to the contrary, it still acted towards its reduction by ensuring investment funding from local sources.

As for the private sector, the share of investment in GDP in the pre-crisis period had a changing dynamics, but was significantly higher than savings, which in this period contracted as a consequence of higher spending, leading to a significant deepening of the private sector's negative savings and investment gap. Another problem was that investment was mainly channelled to the non-tradable sectors, which additionally stimulated spending and exacerbated the current account deficit. With the onset of the crisis and the inability to ensure adequate sources of funding from abroad, investment contracted significantly. At the same time, as a consequence of the crisis and the considerable worsening of labour market conditions, spending propensity declined and the share of savings in GDP increased. The recovery of the labour market as of 2015, i.e. increase in employment and wages in the private sector, led to a gradual rise in private sector spending, though it remained within sustainable bounds, having risen slightly slower than GDP. As a result of the new investment cycle, private investment reached 17.8% in 2018 and was accompanied by an increase in the import of equipment and intermediate goods, resulting in the current account deficit trending temporarily at 5.2% of GDP in 2017 and 2018.

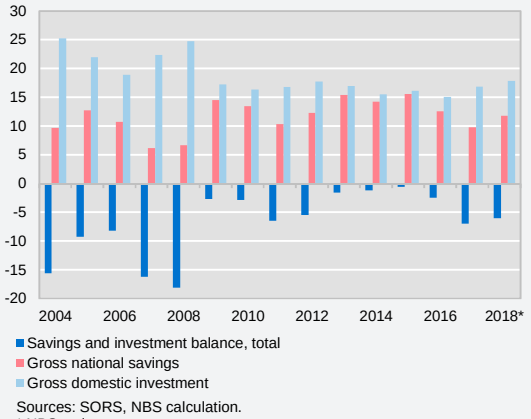
As domestic sources are still insufficient to ensure the full amount of funds needed for investment and the completion of Serbia's real convergence to the EU, it is likely that the current account deficit, i.e. the negative savings and investment balance, will be present in the medium term as well. However, it is important to stress that investments are now mainly directed to export-oriented sectors, whose positive effects on export are expected in the coming period. This will gradually reduce the external imbalance and in turn the negative gap between savings and investment. The rise in spending slightly slower than GDP growth, which is expected in the coming period as well, will also contribute to the narrowing of the savings and investment gap. Another important point is that in the period ahead, as in the previous four years, we expect the savings and investment gap to be more than fully covered by net inflows from FDI. Besides being the most stable and desirable external source of financing, FDI impacts the growth and expansion of production and export capacities and employment, as well as the transfer of knowledge and technology, thus improving competitiveness and the living standard of citizens.

Chart O.3.2 **Government savings and investment balance**
(in % of GDP)



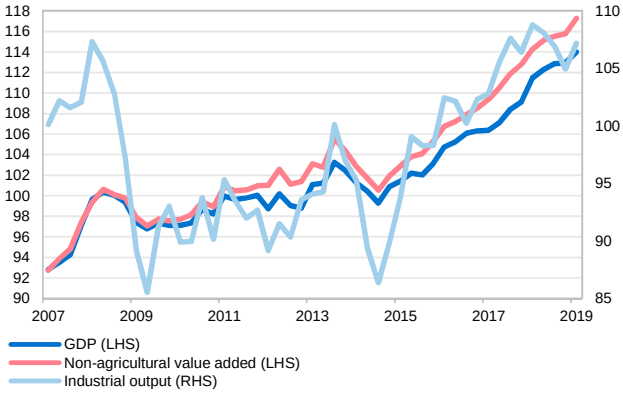
Sources: SORS, NBS calculation.
* NBS estimate.

Chart O.3.3 **Private sector savings and investment balance**
(in % of GDP)



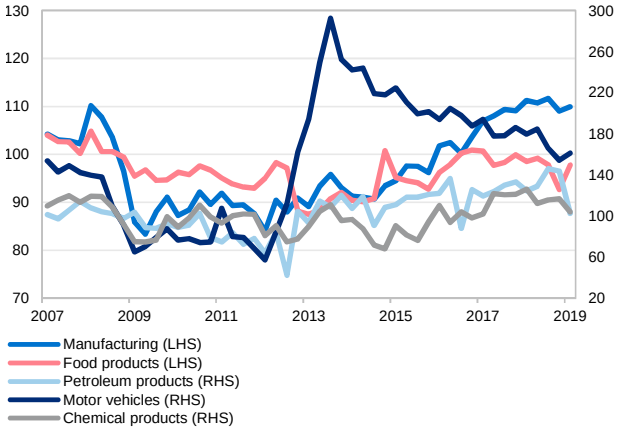
Sources: SORS, NBS calculation.
* NBS estimate.

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



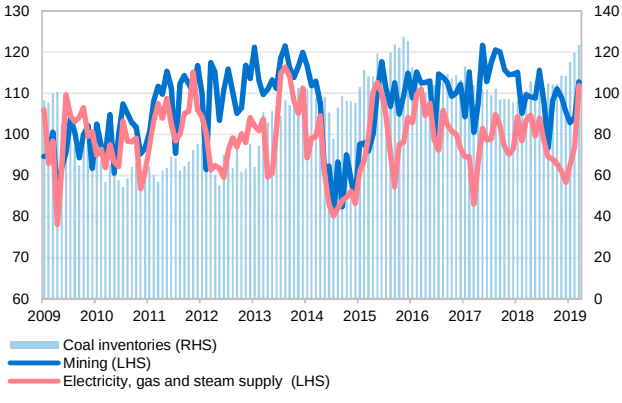
Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

5. Economic activity

According to the estimate of the Serbian Statistical Office, GDP growth measured 2.3% in Q1. The slowdown relative to 2018 reflects the base effect in agriculture, softer euro area growth, EU steel import quotas, and tariffs on products delivered to Kosovo and Metohija. Positive contributions came from construction and service sectors, which indicates that this year's economic growth will be driven by domestic demand.

GDP growth continued into Q1, and is estimated at 0.9% s-a. The greatest contributor was the rebound in industrial production, which had been affected by the euro area slowdown for most of 2018. Industrial production is estimated to have risen by 2.5% s-a in Q1, with a 0.5 pp contribution to GDP. Similarly as in 2018, a positive impetus also came from service sectors (0.4 pp aggregately), which benefited from continued favourable trends in the labour market, i.e. rising wages and employment, and from construction (0.1 pp), thanks to uninterrupted implementation of infrastructure projects. On the other hand, assuming an above-average agricultural season this year and taking into account the excellent season last year, the agricultural contribution in Q1 is estimated to have been negative, at 0.4 pp.

Economic activity continued up for the eighteenth consecutive quarter – rising by 14.0% in Q1, as measured by GDP, or by 17.3%, as measured by NAVA, relative to the pre-crisis period[19].

In terms of the physical volume of production, it can be observed that the rebound in **industrial production** originated mainly from energy and manufacturing. The total physical volume of industrial production is estimated to have expanded by 2.1% s-a, with electricity, gas and steam supply adding 1.8 pp. The 10.8% s-a growth in electricity production may be attributed primarily to better use of electricity generation capacities after the general overhaul in the previous period. The physical volume of production in manufacturing increased by 0.8% s-a and the growth was dispersed across the majority of branches (15 out of 24). The greatest contributor to the increased physical volume of production in manufacturing was the food industry, which expanded by 5.4% s-a in Q1. Conversely, the greatest negative contributor (-1.5 pp) was oil production and

[19] Level from H1 2008.

processing, which contracted due to the March overhaul in the Pančevo refinery.

The physical volume of production in mining decreased by 1.8% s-a in Q1, primarily due to the lower volume of exploitation of metal ores (-19.9% s-a), and to a lesser extent also due to the lower volume of exploitation of crude oil (-1.3% s-a). On the other hand, the volume of coal exploitation rose by 2.8% s-a.

Early in the year, **construction** saw positive trends, rising by 3.4% s-a in Q1. This is suggested by indicators of construction activity – production of construction material expanded by 2.1% s-a, the number of construction permits issued continued up in January and February (10.5% and 1.3% s-a, respectively) and the employment in the sector also increased.

Q1 saw further growth in **service sectors** (0.7% s-a). The greatest impetus came from trade, with retail trade turnover expanding by 3.8% s-a in Q1.

According to the estimate of the Serbian Statistical Office, GDP grew 2.3% y-o-y in Q1. The deceleration relative to 2018 reflects the base effect in agriculture and unfavourable effects of external factors – the slowdown in the euro area and preparations for the introduction of EU steel import quotas. Further negative impact came from the tariffs on products delivered to Kosovo and Metohija. Consequently, industrial production shrank by 1.9% y-o-y, while service sectors expanded by 4.0% and construction by 10.0%.

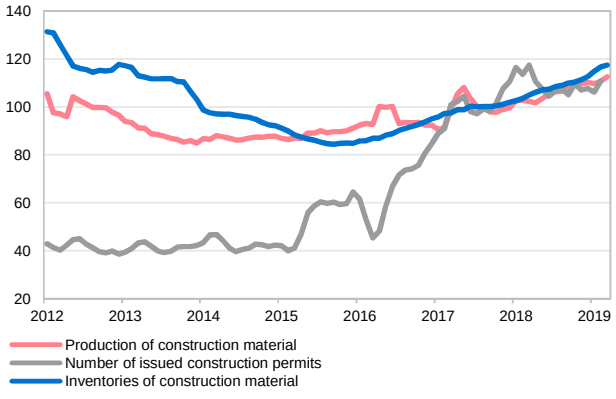
In view of the above-average results of the last year's season, agriculture is expected to give a negative contribution to GDP growth in 2019, of 0.3 pp.

Table IV.5.1 **Contributions to y-o-y GDP growth**
(in pp)

	2018				2019
	Q1	Q2	Q3	Q4*	Q1*
GDP (in %, y-o-y)	**4.9**	**4.9**	**4.1**	**3.4**	**2.3**
Agriculture	0.7	0.8	1.2	1.0	-0.2
Industry	1.3	0.5	-0.2	-0.6	-0.4
Construction	0.7	0.8	0.4	0.1	0.3
Services	1.7	2.1	2.0	2.2	2.1
Net taxes	0.5	0.6	0.5	0.5	0.4

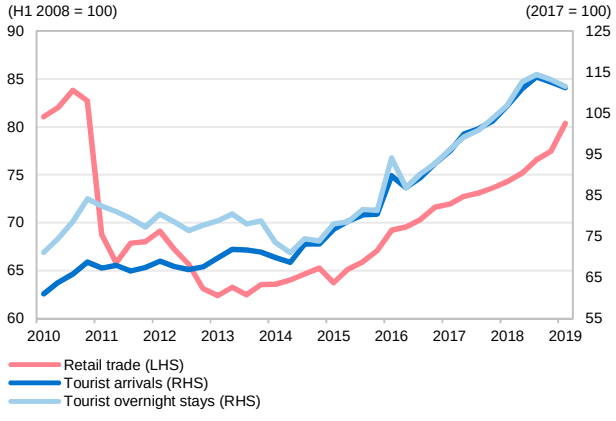
Sources: SORS and NBS calculation.
* NBS estimate.

Chart IV.5.4 **Construction activity indicators**
(quarterly averages s-a, 2017 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.5 **Service sector indicators**
(s-a)

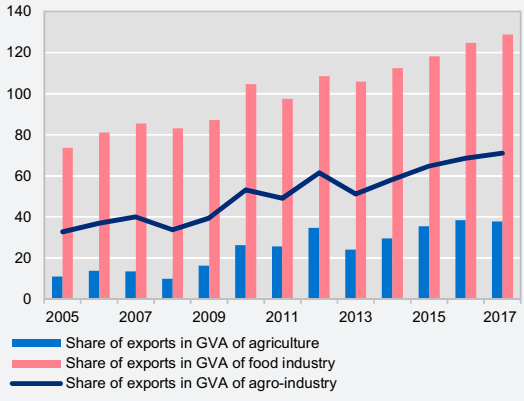


Sources: SORS and NBS calculation.

Text box 4: Analysis of trends in the market of agricultural and food products in Serbia

The achievement and maintenance of low and predictable inflation over the past six years, as well as of macroeconomic stability in general, have contributed to sustainable economic growth and greater integration of our economy in the global market. Changed macroeconomic circumstances positively affected the growth model in the agro-industry, i.e. agricultural production and food industry, which was expected given that these activities entail long-term investment, with agriculture featuring a low asset turnover ratio. In turn, the development of the agro-industry, along with trade liberalisation, stabilised the food market and reduced the volatility of food prices and headline inflation. Although the supply of agricultural and food products was often under a strong impact of non-economic factors, such as changeable agrometeorological conditions relating to climate change effects, thanks to its comparative advantages the domestic agro-industry increased its production and notably exports in the global market.

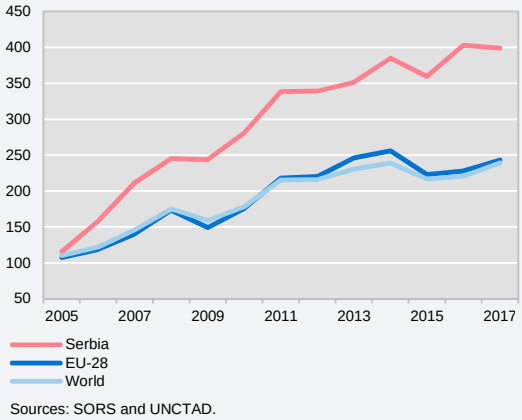
Chart O.4.1 **Share of exports in GVA by activity of the agro-industry**
(in %)



Sources: SORS and NBS calculation.

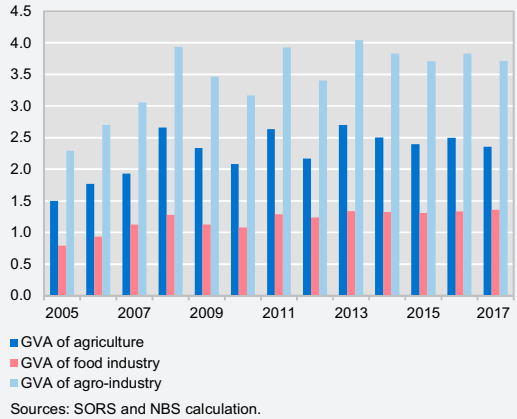
For twenty years already, Serbia has been recording a positive balance in foreign trade in agricultural and food products, with a clear tendency of its improvement as the export base widens. The share of exports of agricultural and food products in GVA of the agro-industry is on a stable upward path – it rose from 32.7% in 2005 to 71% in 2017 (Chart O.4.1). **This means that Serbia is increasingly successful in exporting its product surpluses in the global market, thus stabilising the domestic market of agricultural and food products, and ensuring funds to import those products whose demand cannot be fully satisfied from domestic supply**. In terms of improving the supply of products in a higher processing phase, it is worth noting that as of 2012 food exports have exceeded the GVA of the food industry. In the past twenty years, the exports-GVA ratio of the food industry increased by over five times – from around 24% in 1996 to 128.8% in 2017. The versatility and regularity of agricultural and food supply in the domestic market are partly ensured through higher imports, whose share in the agricultural GVA picked up from 24.4% in 2005 to 43.2% in 2017 (Chart O.4.2). At the same time, the agricultural GVA was up from EUR 2.3 bn in 2005 to EUR 3.7 bn in 2017 (Chart O.4.3).

Chart O.4.6 **Exports of agricultural and food products in the agro-industry**
(in current prices, USD, 2004 = 100)



Sources: SORS and UNCTAD.

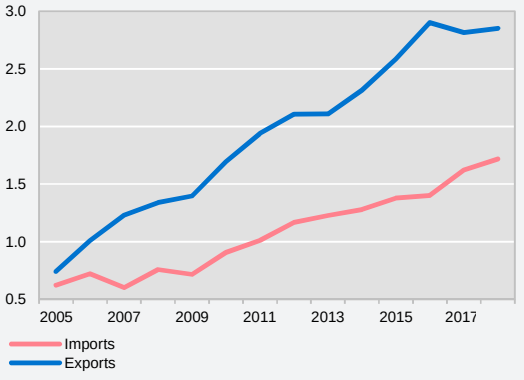
Chart O.4.3 **GVA by activity of the agro-industry**
(in EUR bn)



Sources: SORS and NBS calculation.

The improved agricultural performance is also confirmed by data on foreign trade in some groups of agricultural and food products in the 2004–2018 period – euro exports were up by 11.1% p.a. on average, exceeding the average rise in imports of 8.1%.[1] Relative to 2004, when exports and imports were practically matched (EUR 650 mn), in 2018 they soared to EUR 2.9 bn and EUR 1.7 bn respectively (Chart O.4.4). **A positive trade balance of over EUR 1.1 bn (2.7% of GDP) in 2018 reflects the rising surplus in trade in cereals and cereal-based products** (43.4%), fruit and vegetables (32.9%), beverages (9.1%), solid vegetable fats and oils (8.4%), and products of the tobacco and sugar industries (7.6% cumulatively) (Chart O.4.5). Due to elevated imports, a negative balance in coffee and fish trade (EUR -0.2 bn cumulatively) worked in the opposite direction, but was fully offset by vibrant exports of other product groups.

Chart O.4.4 **Exports and imports of agricultural and food products in the agro-industry**
(in EUR bn)



Sources: SORS and NBS calculation.

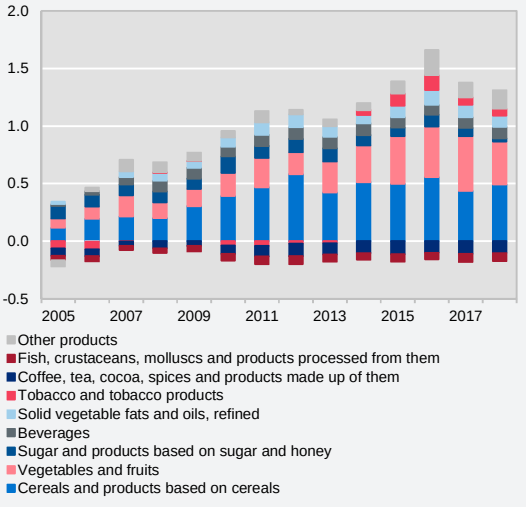
The upward export tendency was noted for all product categories of the agro-industry, except for sugar and sugar products. The highest average annual growth rates were observed for the exports of tobacco products (35.4%), livestock (23.1%), oilseeds and pulses (26.0%), fish (19.0%), fodder (18.5%) and dairy products (16.2%). Positive growth rates were also recorded for the imports of agricultural and food products, primarily the imports of leather and fur (27.3%), as well as meat and meat products (21.0%). Still, **in the past fourteen years, ending with 2018, the exports growth rate in 14 observed product groups (of total 18) exceeded the imports rate, on average. This suggests that the trade balance in the agro-industry improved also owing to higher product diversification, particularly in the food industry**. Such diversification helps more efficient use of Serbia's comparative advantages in this field, and further encourages the development of production capacities and improvement of export performances.

The exports of agricultural and food products were exceptionally robust in the international context as well. **In the 2004–2017 period, dollar exports of these products were up four times in Serbia, and less than 2.5 times on a global scale and in EU-28** (Chart O.4.6). As a result, Serbia increased its share in the global exports of agricultural and food products from 0.16% to 0.27%. The widening of Serbia's foreign trade surplus with the world in regard to agricultural and food products reflects robust export supply, and is important in manifold ways:

• First, the exports of production surpluses in the global market stabilise the domestic market of agricultural and food products, and improve the terms of operation in the field of food production and processing.

• Second, the imports of agricultural and food products are rising much slower than exports, but are supplementing domestic supply, which is becoming more diverse and tailored to consumers, whilst a relatively lower rise in the prices of

Chart O.4.5 **Trade by group of agricultural and food products in the agro-industry**
(in EUR bn)



Sources: SORS and NBS calculation.

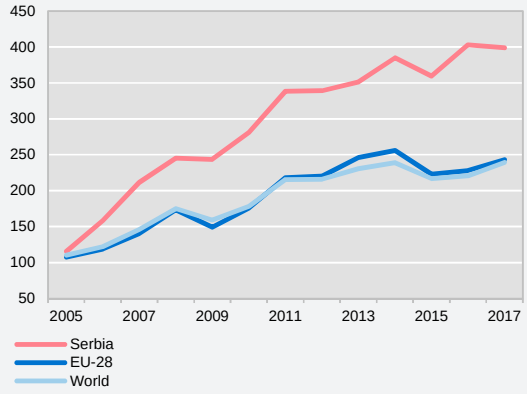
[1] The analysis of foreign trade in agricultural and food products relies on the Standard International Trade Classification (SITC).

agricultural and food products and their diminished volatility as of 2013, with a concurrent rise in disposable income, have led to smaller percentage expenditure on food.

• Third, the widening surplus in trade in these products, coupled with the above effects, contributes to a more favourable foreign trade position of the country and the strengthening of overall macroeconomic stability.

In light of the above, most notably comparative advantages and potentials of agriculture and food production, as well as agricultural exports that are rising year after year, there is room for the Serbian agro-industry to continue to considerably prop up the country's economic growth.

Chart O.4.6 **Exports of agricultural and food products in the agro-industry**
(in current prices, USD, 2004 = 100)



Sources: SORS and UNCTAD.

6. Labour market developments

Positive labour market trends recorded since mid-2014 continued into Q1 2019, manifesting as a further rise in average wages, increase in formal employment and reduction in unemployment. Positive developments were recorded in almost all branches of the economy indicating broad-based labour market recovery and economic growth.

Wages and labour productivity

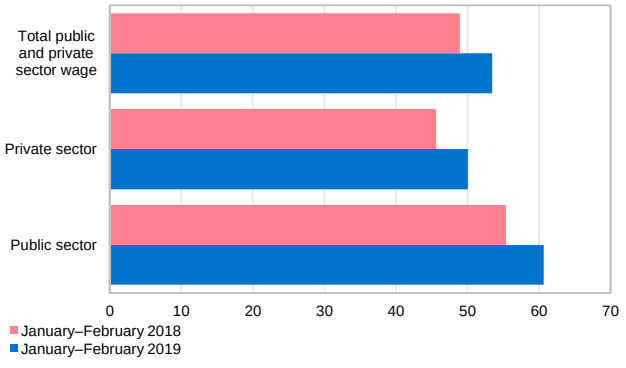
Overall nominal net wage in January and February 2019 went up by 9.3% y-o-y, on the back of further GDP growth. The y-o-y rise in nominal net wage was recorded in both private (9.7%) and public sector (9.5%)[20], the latter reflecting the Government's decision to increase wages (7–12%) starting from January and to adjust the decrease in the wage calculation base to 5% in public funds beneficiaries.[21] The average nominal net wage calculated for January and February amounted to RSD 53,474 or EUR 452.

As the greater part of 2018, January and February also **recorded a y-o-y increase in nominal net wage in all branches of the economy**. In this period wages were the highest and rose most sharply in ICT services, mining and energy and in the financial sector. Wages also rose in public administration, health and social protection and education, largely as a result of the public sector wage increase. The same period saw a rise in wages in agriculture, trade, transportation, construction and manufacturing, which significantly contributed to the strengthening of consumer demand.

The improved labour market performance over the past four years, manifesting as rising wages and employment, also reflected on the increase in the overall nominal net wage bill, which was higher by 14.2% on average in January and February than in the same period the year before. This was a result of a higher nominal net wage bill in both the private and public sector.

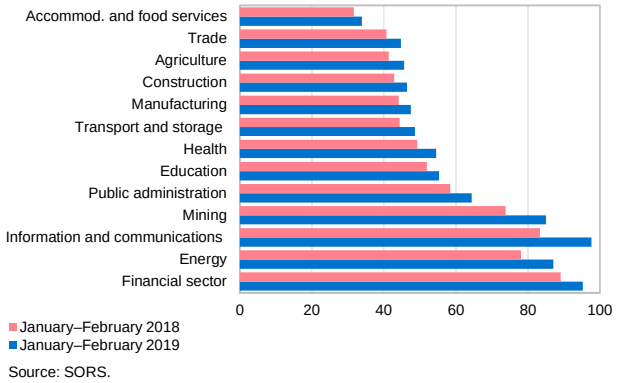
Overall economic productivity picked up last year, while it recorded a mild fall since the beginning of 2019, as the preliminary estimate shows.

Chart IV.6.1 **Average nominal net wage**
(in RSD thousand)



Source: SORS.

Chart IV.6.2 **Nominal net wage by economic sector**
(in RSD thousand)



Source: SORS.

[20] For the purposes of average wage calculation, the Statistical Office classifies the following in the public sector: state-owned enterprises, municipally-owned enterprises, all levels of administration, public institutions engaged in health and social protection, educational and cultural activities.

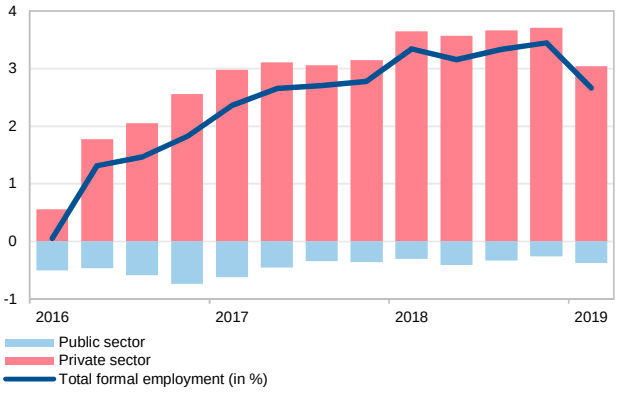
[21] In line with the Law Amending the Law on Temporary Regulation of the Base for the Calculation and Payment of Salaries, and/or Wages and Other Permanent Income in Public Funds Beneficiaries.

Table IV.6.1 **Formal employment and unemployment**
(y-o-y growth rates, period average)

	2018			2019
	Q2	Q3	Q4	Q1
Total number of formally employed	3.2	3.3	3.4	2.7
Employed with legal persons	3.1	3.2	3.4	2.6
Entrepreneurs and their employees	6.2	6.7	6.4	5.3
Individual farmers	-7.7	-8.2	-8.3	-8.3
The unemployed	-10.1	-10.5	-10.8	-9.1
First-time job seekers	-10.8	-10.9	-11.5	-1.6
Used to be employed	-9.7	-10.3	-10.5	-12.7

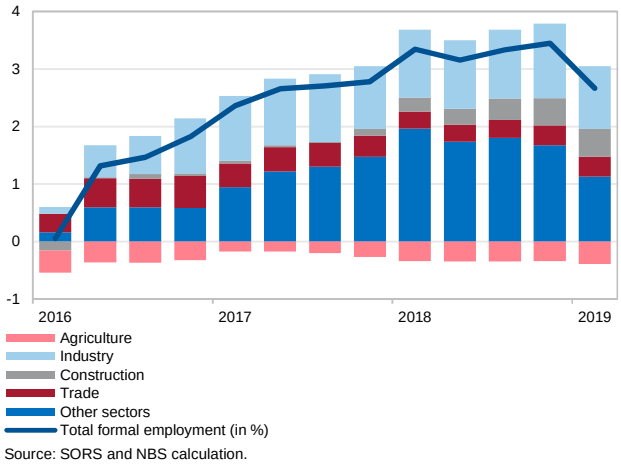
Sources: SORS and National Employment Service.

Chart IV.6.3 **Composition of y-o-y rise in total formal employment**
(in pp, period average)



Sources: SORS and NBS calculation.

Chart IV.6.4 **Contribution to y-o-y growth in total formal employment by economic sector**
(in pp, period average)



Source: SORS and NBS calculation.

Employment

Past unemployment cuts and employment gains accounted for a slightly softer pace of the y-o-y growth rate of overall formal employment in Q1, which averaged 2.7%. This is a result of a further employment growth in legal entities and the increase in the number of entrepreneurs and their employees, while the reduction in the number of individual farmers worked in the opposite direction.[22]

By branch of the economy, **in Q1 employment rose largely on account of** manufacturing, construction and trade, as well as other branches of the services sector which boasts the highest wage growth in the period observed. Lower formal employment in Q1 was recorded in agriculture and energy, as well as public administration and health and social protection, due to continued public sector right-sizing.[23]

Q1 saw the **continuation of the downward trend of registered unemployment** in y-o-y terms, consistent with increasing formal employment. Investment and business climate improvements also drove unemployment down, as well as the implementation of active labour market policies.[24] According to the National Employment Service, **at end-Q1, unemployment headcount stood at 568,514 persons, down by 49,808 persons relative to the same period the year before**. In the past four years, to end-March 2019, unemployment was cut by almost one quarter (around 173,000 people). In addition, in y-o-y terms unemployment declined in all occupational groups, and to the largest extent in those related to manufacturing, trade, catering and tourism, as well as agriculture. Also, more intensified new recruitments brought about a decline in unemployment in Q1 in transportation and construction.

The Labour Force Survey, which captures the informal labour market as well, indicates favourable trends in 2018. This refers primarily to the rising participation rate of the working age population (15–64), which averaged 67.9% in 2018, up by 1.2 pp relative to 2017, and the overall employment rate increase by 0.9 pp, to 47.6% on average. The average unemployment rate also dropped from 2017, by 0.8 pp to 12.7% as did the long-term

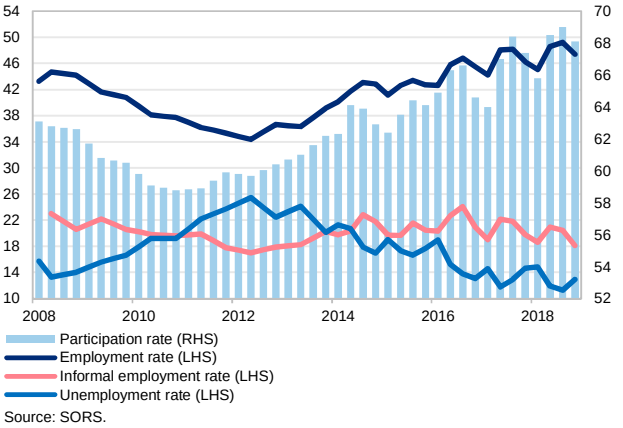
[22] Statistical Office data obtained from the Central Registry of Mandatory Social Insurance.

[23] Pursuant to the Law on Ceilings on the Number of Public Sector Employees.

[24] Active labour market policies entail: job matching services, career guidance and counselling, support to self-employment, further education and training, special programmes for youth in transition from the education system to the labour market, etc.

unemployment rate, by 0.6 pp to 7.6% on average. These are **the lowest unemployment rates since comparable data are available**. In addition, average youth unemployment (15–24) also continued down, by 2.2 pp to 29.7% in 2018. The NEET rate (measuring the share of young people neither in employment nor in education and training in the total youth population) also fell – from 17.2% in 2017 to 16.5% in 2018.[25]

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



Source: SORS.

7. International environment

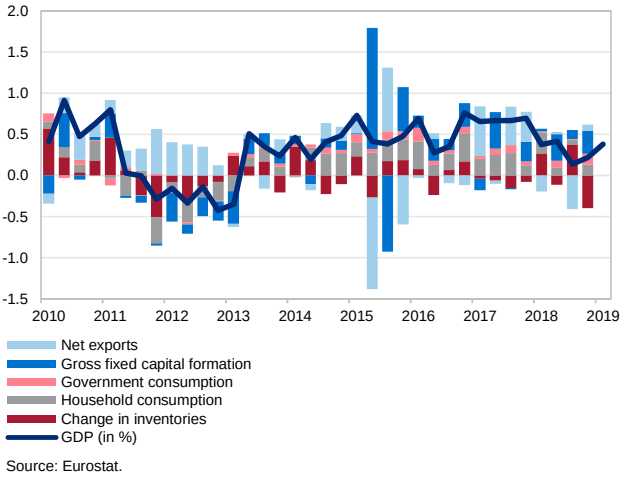
The slowdown in euro area growth, prompted by weaker external demand and subdued activity in some of the countries (notably Germany and Italy), was mirrored by dampened growth prospects in the short-term, whereas the positive impact of macroeconomic fundamentals will prevail in the medium run. In the previous period, countries in Central and Southeast Europe posted stable growth driven by domestic demand, which is forecast for this year as well. Although the US economy decelerated at end-2018 on account of the lower contribution of personal consumption and fixed investments, GDP growth is expected to be sustained in 2019, primarily owing to extremely favourable labour market developments.

Due to the global slowdown and the lack of any major inflationary pressures, monetary policy normalisation of leading central banks is unfolding at a slower pace than previously expected. Such altered character of monetary policies of leading central banks, coupled with indications of a trade agreement between the USA and China, is conducive to more favourable global financial conditions since the beginning of 2019.

Economic activity

Having posted sharp growth in 2017 and early 2018, the **global economy** slowed down in H2 2018, primarily due to the effects of a number of factors in leading global economies (growth slowing down in China and the euro area, trade tensions, etc.). According to the IMF's April estimate, global growth will remain slower in H1 2019 as well, while H2 is expected to see more pronounced growth owing to the slower monetary policy normalisation of leading central banks, stronger fiscal and monetary incentives to the Chinese economy,

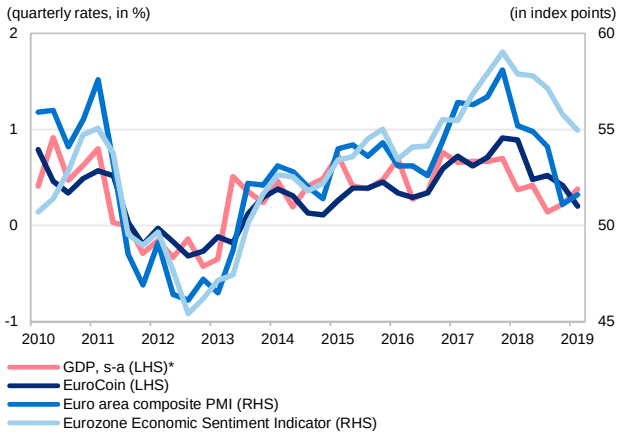
Chart IV.7.1 **Contributions to s-a GDP growth rate of the euro area**
(in pp)



Source: Eurostat.

[25] As also confirmed by the Report: *Western Balkans Labor Market Trends 2019* prepared by the World Bank and the Vienna Institute for International Economic Studies.

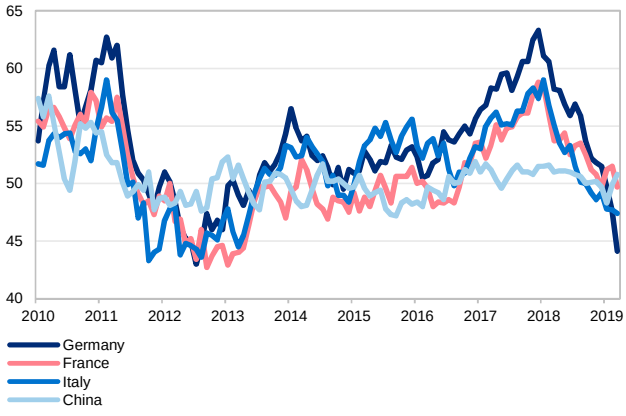
Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**



Sources: Eurostat, Markit Group, Banca d'Italia and European Commission.

* Eurostat's preliminary flash estimate for Q1 2019.
** ESI is standardised relative to PMI.

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



Source: Markit Group.

improved prospects of a resolution to the US-China trade standoff, wearing off of the temporary halts in the euro area, as well as the gradual stabilisation of conditions in some of the emerging countries (Turkey and Argentina). Given that any escalation in trade tensions and the resulting uncertainty in the monetary policy conduct could hamper global growth even more, risks to the projection remain titled to the downside.

Euro area GDP accelerated by 0.2% s-a in Q4 (from 0.1% s-a in Q3), thus posting its lowest growth since Q2 2014. In y-o-y terms, growth slowed down from 1.6% in Q3 to 1.2% in Q4. The weaker results in the euro area in H2 2018 are attributable to dampened external demand resulting from the global slowdown, as well as factors specific to certain economies and sectors. Growth decelerated mainly in Germany, where the contracted exports of the car industry resulted in Q4 GDP lingering at Q3 levels, and in Italy,[26] where economic activity declined for two consecutive quarters, dipping each time by 0.1% s-a.

The dynamics of the leading economic activity indicators – PMI Composite, which averaged 51.5 points[27] in Q1, and the Economic Sentiment Indicator, which equalled 106 points,[28] its lowest level in four years – suggested that euro area growth would not speed up in Q1. Still, according to the Eurostat flash estimate, growth accelerated to 0.4% s-a. Also, according to the available data, Italy is technically no longer in recession and its growth in Q1 measured 0.2% s-a. Favourable developments continued in the labour market – at the start of the year, the unemployment rate dropped to its lowest level since October 2008 and equalled 7.7% in March.

The **ECB forecast** from March suggested that in the short term, a combination of global factors (such as protectionism and Brexit) and factors specific to some euro area countries will most likely act as a drag on economic growth. However, it was estimated that the negative effects of these factors will fade out in the medium term and that macroeconomic fundamentals will continue to sustain euro area growth. These include the very accommodative stance of monetary policy, rising wages, a recovery in external demand and some fiscal loosening. Based on this, the ECB estimated that euro area growth, projected at 1.1% in 2019, will accelerate to 1.6% in 2020 and 1.5% in 2021.

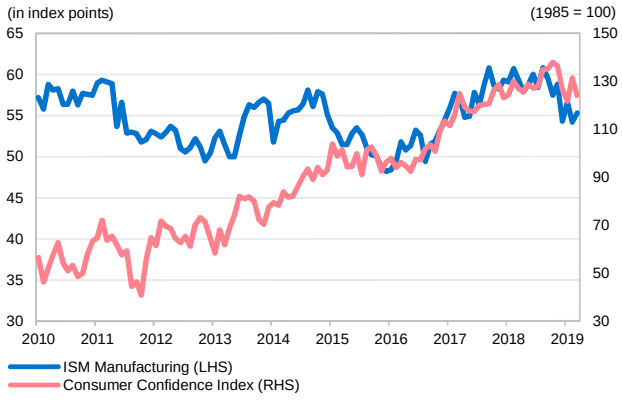
[26] Italy and Germany are Serbia's main foreign trade partners within the euro area.

[27] Index value above 50 points indicates expansion, and below 50 a decline in economic activity.

[28] The index has been designed to indicate long-term average with 100 points.

The US economy slowed down to 0.5% s-a in Q4, i.e. to 2.2% annualised. Though yielding lower contribution than in the prior quarter (2.3 pp cumulatively), personal consumption and fixed investments still provided the main support to GDP growth. In contrast to that, a negative contribution to growth came from government expenditures and net exports (by -0.1 pp each). According to the preliminary estimate of the Bureau of Economic Analysis, GDP growth sped up to 0.8% s-a in Q1 or to 3.2% annualised. In March, **the Fed** came out with its estimate of the US economy's continued stable growth for the remainder of the year, with the medium-term projection slightly revised down relative to December. Compared to its previous forecasts, the IMF revised its US growth projections in April – downward in 2019 (by 0.2 pp to 2.3%) and upward in 2020 (by 0.1 pp to 1.9%).

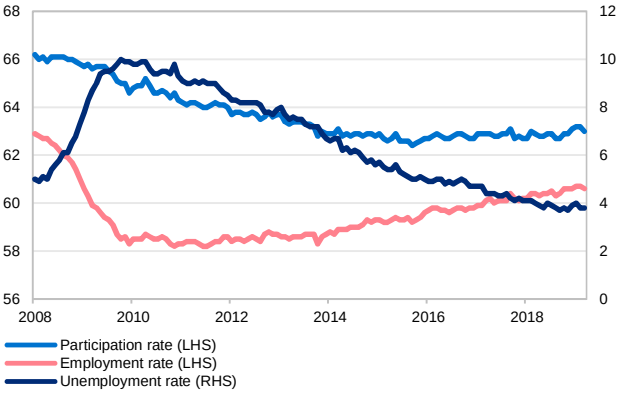
Chart IV.7.4 **Leading economic indicators in the USA**



Source: Institute for Supply Management, Conference Board.

Further growth in the USA will be mostly sustained by favourable labour market developments, considering that the participation rate averaged 63.1% in Q1 and the employment rate equalled 60.7%, thus exceeding their figures from end-2018. In addition, March saw unemployment decline close to its lowest level (3.8%) in almost half a century. The Fed estimated that throughout the year unemployment will continue to trend below the natural rate.

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



Source: Bureau of Labor Statistics.

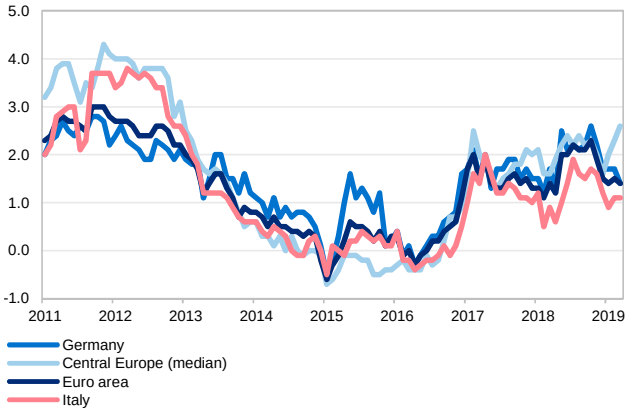
According to the April Consensus Forecast, the **Central European region** recorded growth of 4.5% in 2018, the same as a year earlier. In 2019, growth in the region is expected to remain on a sound footing, driven by private consumption supported by positive developments in the labour market. Fixed investments are also expected to continue up, though the rise could be slower on account of contracted inflows from EU funds. Despite the projected downturn in global economic activity, Poland, the Czech Republic and Hungary, as the leading economies in the region, will continue to post GDP growth propped by strong domestic demand. Relative to the January projection, the Consensus Forecast did not change its estimate of the region's growth in 2019 (3.5%), though the figure for 2020 has been revised slightly up, by 0.1 pp to 3.1%.

Stable macroeconomic fundamentals are still providing support to growth in the **Southeast European region**. Relative to January, the April Consensus Forecast revised the region's growth estimates for 2019 and 2020 slightly down (by 0.1 pp and 0.2 pp, respectively), to 3.1% and

2.8%. Still, the professional forecasters expect Serbia to remain one of the fastest growing countries in the region in 2019 as well, which will be facilitated by strong domestic demand, FDI inflows and positive labour market developments.

In 2018, **Russia's economy** posted the highest growth in six years (2.3%), largely owing to increase in the manufacturing industry and mining, and to the initiated construction projects. The last year's weaker agricultural season worked in the opposite direction. The moderate rise in domestic demand, driven by final consumption, and the mild recovery in external demand are expected to continue to support economic growth in H1 2019. Afterwards, growth is forecast to accelerate based on public investments and the positive effects of the implementation of national projects. In April, the IMF stated it remains with its January estimate of Russia's GDP growth, keeping it at 1.6% and 1.7% in 2019 and 2020, respectively.

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



Source: Eurostat.

China's GDP growth slowed down in H2 2018 in response to the trade standoff with the USA and tighter financial regulations aimed at limiting shadow banking, which resulted in contracted investments in infrastructure projects. The central bank of China then increased banking sector liquidity by alleviating regulatory requirements, while the government continued to provide fiscal incentives in 2019 in order to mitigate the negative effects of the tariffs introduced by the USA. According to the preliminary estimate, in Q1 the Chinese economy recorded growth of 6.4% annualised, the same as in Q4. The IMF forecast an economic slowdown for China for this and the following year (to 6.3% and 6.1%, respectively), primarily if the trade tensions are not dissipated.

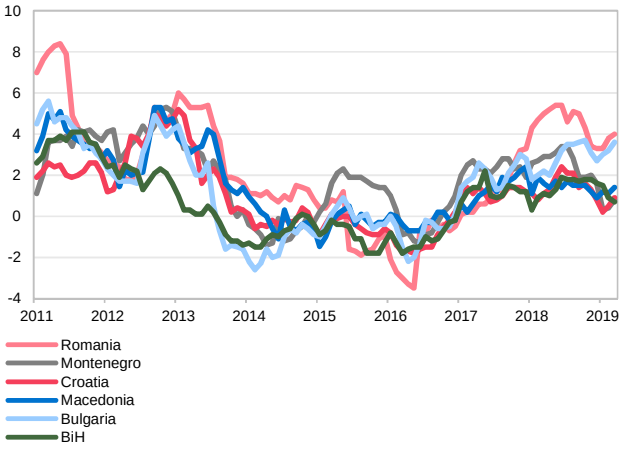
Inflation movements

Average y-o-y inflation in the **euro area** slowed down from 1.9% in Q4 2018 to 1.4% in Q1 2019, mainly owing to the lower contribution of energy prices, while core inflation measured 1%, the same as in 2018. According to the ECB, cost-push pressures are rising amid high capacity utilisation and declining unemployment, though this has not yet spilled over onto core inflation given that corporates are able to absorb the rise in costs by cutting down profit margins in order to stay competitive. An additional factor of low core inflation, notably the price of industrial products excluding energy and especially of durable goods, is the slowdown in import inflation over the past two years due to the nominal effective

appreciation of the euro. Over the medium term, the ECB expects a gradual rise in core inflation, supported by accommodative monetary policy measures and extended, albeit slower economic growth, which should enable corporates to reach their previous profit margins again. According to the Eurostat flash estimate, April saw a rise in the euro area's headline inflation to 1.7% and core inflation to 1.2%.

As for Serbia's main foreign trade partners, average y-o-y inflation, measured by the Harmonised Index of Consumer Prices, declined from 2.2% in Q4 to 1.6% in Q1 in **Germany**, coming to its lowest level in the past year, and from 1.5% to 1.0% in **Italy** in the same period, thus reaching its lowest level in three quarters. On the other hand, average y-o-y inflation in the majority of **Central European** countries either rose or stagnated in Q1. The Czech Republic saw the biggest rise in the average y-o-y inflation, measured by the Harmonised Index of Consumer Prices – by 0.6 pp to 2.3% in Q1, mainly owing to rising wages.

Chart IV.7.7 **Movement in the Consumer Price Index for selected countries**
(y-o-y, in %)



Sources: Statistical offices in several countries.

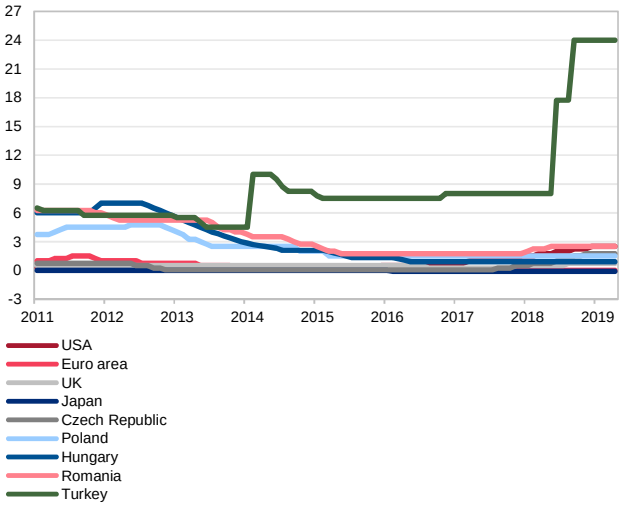
When it comes to **countries in the Southeast European region**, average y-o-y inflation in Q1 was the lowest in Croatia and Montenegro (0.5%), and the highest in Romania (3.7%). In **Russia**, it rose from 3.9% in Q4 to 5.2% in Q1 (its highest level since the start of 2017) in response to rising food prices, the weakening of the rouble in H2 2018 and the VAT increase as of 1 January 2019. Inflation in **Turkey** slowed down from 22.4% in Q4 2018 to 19.9% y-o-y on average in Q1 2019 as a result of past monetary policy tightening.

Measured by the personal consumption expenditure price index, headline inflation in the **USA** edged down from 1.9% y-o-y on average in Q4 to 1.4% y-o-y in Q1 2019, mainly driven by the falling energy prices. Excluding food and energy prices, inflation declined slightly, from 1.9% y-o-y on average in Q4 to 1.7% y-o-y in Q1 2019.

Monetary policy

During Q1 2019, leading central banks took a somewhat more cautious stance towards monetary policy normalisation amid weaker prospects of economic growth and inflation. The **ECB** altered its guidelines and, instead of keeping its interest rates record-low through the summer of 2019, it now expects them to remain unchanged at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term. Also, the

Chart IV.7.8 **Policy rates across selected countries**
(p.a., in %)



Sources: Central banks of selected countries.

* As of June 2018, after a year and a half, the one-week repo rate is again the key policy rate.

ECB will continue reinvesting the principal payments from maturing securities under the asset purchase programme – which was wrapped up in December – past the date when it starts raising its policy rate, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Moreover, the ECB announced in March that from September 2019 until March 2021, it will launch a new series of quarterly targeted longer-term refinancing operations (TLTRO-III), each with a maturity of two years. These operations will aim to preserve favourable bank lending conditions and the smooth transmission of monetary policy.

The **Fed** changed its communications in Q1 with respect to monetary policy going forward, underscoring that it will be patient and flexible in the pursuit of its policy. After raising it in December, the Fed maintained the target range for the federal funds rate at 2.25–2.50% in Q1. Also, unlike in December, when two hikes had been anticipated, most FOMC members no longer expect the target range to be raised until the end of 2019. A more cautious monetary policy is also reflected in the more flexible approach to the normalisation of the Fed's balance sheet. According to the new plan on balance sheet normalisation, published in March, reductions in reinvestments of matured principal payments will be slowed from the current USD 50 bn per month to USD 35 bn as of May, only to be concluded at the end of September 2019, and reinvestments continued primarily in favour of Treasury securities.

Dampened prospects of economic growth and inflation in the euro area, and altered monetary policy guidelines of leading central banks resulted in the majority of central banks in the region opting for a more cautious monetary policy.

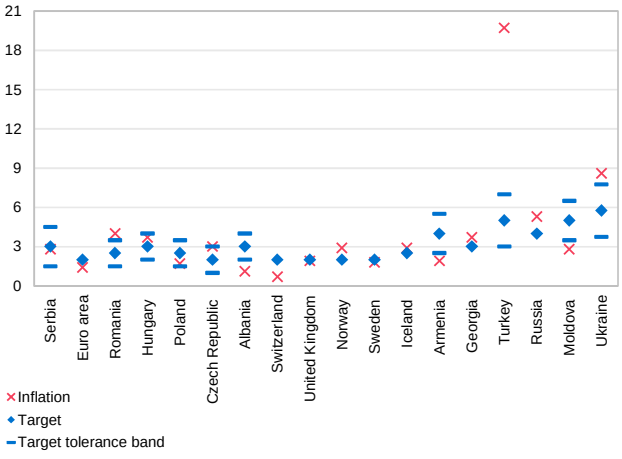
The **Czech** central bank stated that the rise in inflation, which trended in the upper bound of the target tolerance band, was temporary, therefore it kept its key policy rate at 1.75% during Q1. Inflation is expected to return to the 2% target in H2, while risks to the projection are balanced. As in H2 2018, the central bank of **Romania** maintained its key policy rate at 2.5% in Q1 as well, despite the Romanian leu dropping to a historic low and inflation unexpectedly exceeding the target tolerance band. The central bank of **Poland** did not change its key policy rate either (at 1.5% since March 2015). The majority of Executive Board members believe it will remain stable going forward, though some members voiced their view that the announced fiscal expansion could call for an increase in the key policy rate as soon as this year.

Another central bank opting for an unchanged key policy rate in Q1 is that of **Turkey**, which has kept its rate at 24% since end-Q3 2018. Monetary policy measures contributed to a slowdown in inflation, though it is still trending far above the 5±2.0% target. With one-week repo operations temporarily suspended in March, banks turned to credit facilities at the rate of 25.5%, whereby the key policy rate was effectively raised by 150 bp. However, in early April the central bank resumed the implementation of its main instrument, thus offsetting this effect.

Having raised its key policy rate to 7.75% in December, the central bank of **Russia** kept it on hold in Q1, in line with analysts' expectations. Estimates suggest that the December rate hike is most likely sufficient for inflation to return to the 4% target in H1 2020, while a key policy rate cut in 2019 might also be an option.

In March, the central bank of **Hungary** raised its overnight deposit facility rate from -0.15% to -0.05%, which is the first step towards monetary policy normalisation, at the same time retaining the key policy rate at 0.9%. Such decision was made in order to preserve price stability given that headline inflation has hovered close to the 3% target since mid-2018, and that core inflation also reached the target early in 2019. On the other hand, the central bank announced another incentive – the corporate bond purchase programme of HUF 300 bn as of July – to increase the diversity of sources for corporate financing.

Chart IV.7.9 **Inflation and target by country in March 2019**
(p.a., in %)

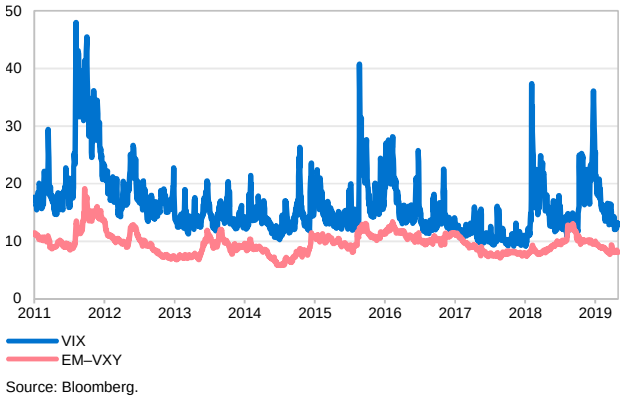


Sources: Eurostat and websites of central banks.

Financial and commodity markets

During Q1, stock markets recovered and the volatility in financial markets was reduced significantly. The implicit measure of **financial market volatility** (VIX) declined in Q1 by 11.7 pp to 13.7%, while volatility measured by the EM–VXY, which tracks volatility of currencies in emerging markets, was reduced by 0.5 pp to 9.2%. Movements in financial markets were stabilised to a significant degree owing to the likelihood of the Fed embarking on much slower monetary policy normalisation than previously announced, which signalled the markets that corporates will still find it relatively easy to settle their liabilities. Also, indications of a trade agreement between the USA and China were mirrored in investors' increased readiness to invest in riskier assets. Favourable developments continued during April when the EM–VXY was lowered by an additional 1.2 pp and VIX by 0.6 pp.

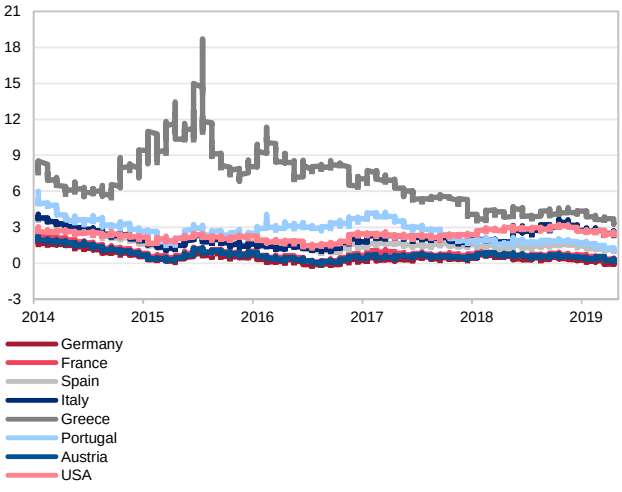
Chart IV.7.10 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

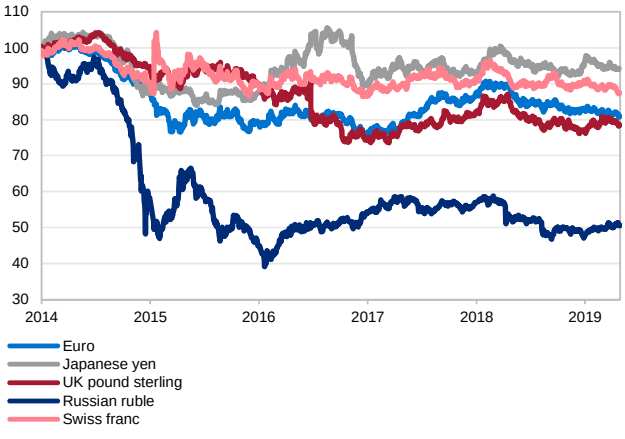
* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.7.11 **Yields on ten-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

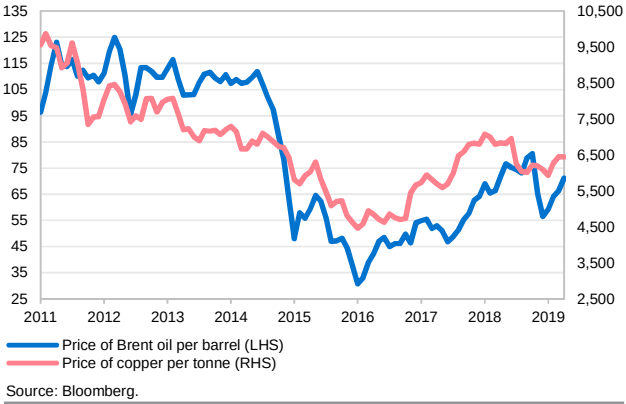
Chart IV.7.12 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



Source: IMF.

* Growth indicates appreciation.

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



Source: Bloomberg.

The Fed officials' announcement that they would exercise more patience and caution in their decisions to change the federal funds rate reflected on the yield of ten-year US Treasuries, which contracted by 0.3 pp in Q1 to 2.4%, their lowest level since end-2017. Apprehension about the global slowdown led to more investments in US Treasuries, which are considered safe assets, thus causing an inversion in one part of the yield curve and sparking additional fears of recession. Yields on ten-year German government bonds, which are considered safe assets, entered the negative territory at end-Q1 for the first time since October 2016, and equalled -0.07%. The drop in the yield is attributable to the slowdown in the Germany's production sector, the recession in Italy in H2 2018 and, on the whole, of dampened prospects of economic growth and inflation in the euro area, as well as the political risk due to Brexit and the renewed fall-out between the Italian government and the European Commission over budget. Yields on benchmark securities of other advanced European countries also declined, ranging at end-Q1 from 0.2% in Austria to 3.7% in Greece. Yields on ten-year German securities edged up slightly in April (by 0.1 pp), thus returning to the positive territory. Given that yields on benchmark US Treasuries climbed by the same figure, the spread between these two securities remained unchanged relative to end-Q1 (2.5 pp).

After weakening in 2018, the leading global currencies that gained on the **dollar** in Q1 were the British pound (3.2%), owing to financial participants' perception that the risk of a no-deal Brexit has decreased, and the Russian rouble (7.4%), partly due to the key policy rate being raised in H2 2018. In contrast, currencies that weakened against the dollar in Q1 were the euro (1.9%), Swiss franc (1.5%) and the Japanese yen (0.1%). The fact that the **euro depreciated against the dollar** can be ascribed to the poorer prospects of the euro area's economic growth and increased investments in the dollar as a safe currency.

Though at a slower pace than in Q4, the **price of gold** continued to edge up in Q1 2019 (1.3%). Uncertainty over the global slowdown and the drop in the yield on other safe assets, which in some cases even turned negative, made gold more attractive and pushed its price up. While the price of gold declined in April (1.0%), it is still higher than at end-2018.

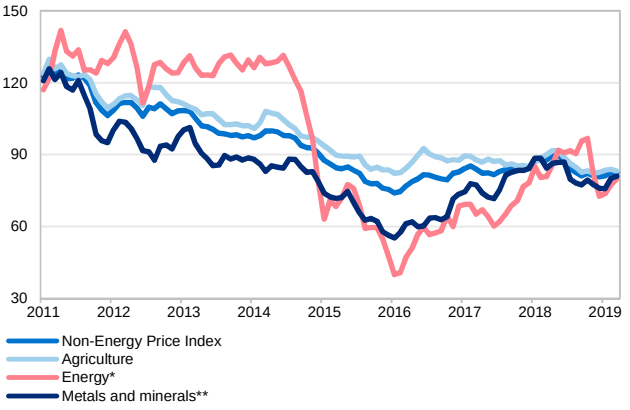
Having fallen to USD 53 per barrel at end-December, **the global oil price** rose again during Q1 2019 and came at USD 68 at the end of the quarter, though it still has not exceeded its four-year maximum from early Q4 (USD 86 per barrel). Despite US production continuing up, the rise

in the price of oil was facilitated to a considerable degree by other factors on the supply side – dampened output in Saudi Arabia and other OPEC members, and the slump in the production in Venezuela and Iran due to US sanctions. On the demand side, the oil price was driven up by the increased prospects of a trade deal between the USA and China, which would reflect positively on global economic growth. During April, the price of oil rose to USD 72 per barrel, in response to the US decision to eliminate sanctions waivers for countries that are still buying Iranian oil, the Saudi Arabia's announcement that a cap on the OPEC members' production might extend beyond June, i.e. by end-2019, and the rising political instability in Venezuela.

Based on the World Bank's primary commodities' price index, the **prices of metals and minerals** recovered during Q1, measuring 6.6% more than at end-2018. Although the economic growth of China, the world's biggest metals and minerals consumer, has slowed down, the rise in their prices was supported by expectations that the Chinese government's fiscal incentives and progress in US-China trade talks will provide support to economic activity. The iron ore price recorded robust growth (14.1% in Q1) in wake of the mining dam failure in Brazil, which could lead to a prolonged halt in operations of several mines and the postponed launch of new projects. The price of copper went up 8.7% in response to subdued supply in the global market.

Measured by the FAO index, **world food prices** recovered in Q1 after dipping in Q4 (1.9%), and ended the quarter 3.4% higher than at the end of 2018. The growth was primarily driven by the rise in the prices of dairy (20.2%), in anticipation of the seasonal contraction in production. The price of vegetable oil also went up (by 1.4%) due to the seasonal decrease in palm oil production by leading global producers and strong demand, as well as the limited global inventories of soy and sunflower oil. The prices of sugar and meat also rose slightly (0.5% and 0.1% respectively), while the prices of cereals declined (-1.8%) due to high inventories, poorer demand and good prospects for this year's wheat harvest, as well as the expectations of a good corn harvest in Argentina.

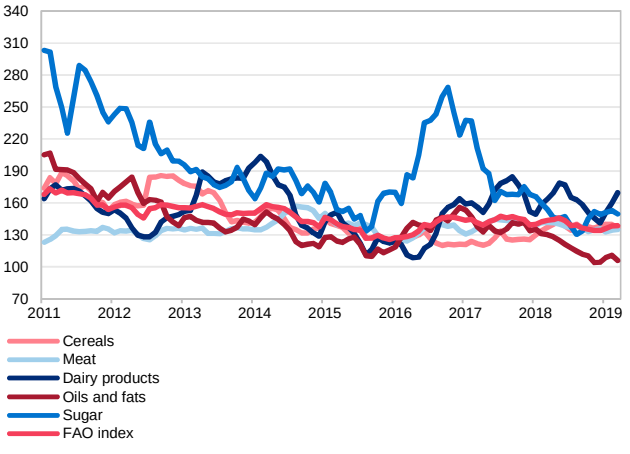
Chart IV.7.14 **Primary Commodity Prices Index**
(2010 = 100)



Source: World Bank.

* Crude oil, natural gas and coal.
** Copper, aluminium, iron ore, lead, nickel, zinc, copper and tin.

Chart IV.7.15 **World Food Price Index**
(in real terms, 2002−2004 = 100)



Source: UN FAO.

V Inflation projection

Under the May central projection, we expect that y-o-y inflation will continue to move within the target tolerance band – most likely in its lower part – until the end of the projection horizon. Also, after reaching the midpoint in April, it will decline, getting close to the lower bound of the target tolerance band in H1 2019, only to start its gradual return to the midpoint thereafter.

To a great extent, such inflation profile will result from the base effect for vegetable prices, while the rise in aggregate demand will work in the opposite direction. In addition, the disinflationary effects of the past appreciation of the dinar should gradually fade out, and administered prices should rise slightly faster than in the previous years. Uncertainties surrounding the inflation projection are associated primarily with developments in the international commodity and financial markets and, to an extent, to administered price growth. On the whole, risks to the projection are judged to be symmetric.

In view of the movements in indicators since the start of the year and expectations going forward, we kept our GDP growth forecast for 2019 at 3.5%, with its structure slightly altered. As in the previous projection, we expect GDP growth to be fully driven by domestic demand, whose positive contribution increased on account of improved movements in short-term indicators of fiscal consumption and investments of the private sector and the government. In contrast, and due to the unfavourable developments in the international arena, the negative contribution of net exports is somewhat higher than in the previous projection. On the production side, we expect growth to continue in the services sectors, industry and construction, while agriculture will most likely exert a negative contribution on account of the base effect. In the medium run, we expect GDP growth to accelerate to around 4%, mainly driven by investment, exports and viable growth in household consumption. Medium-term risks to the GDP projection are judged to be symmetric, while in the short term, i.e. during 2019, those stemming from the international environment are judged to be tilted to the downside and those from the domestic environment to the upside.

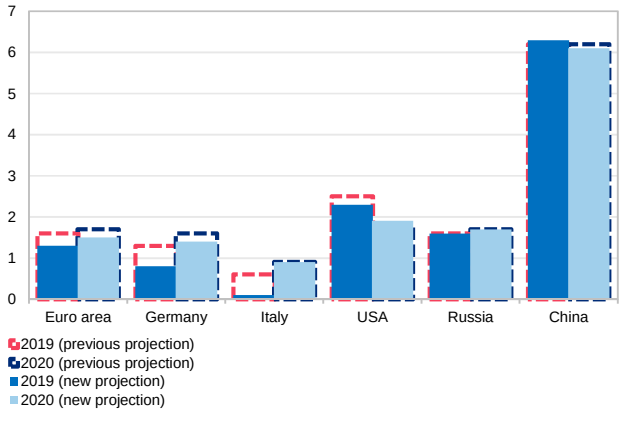
The medium-term inflation projection aims to show expected inflation movements (CPI) in the coming period, the main factors behind such movements and the underlying risks. The projection is set out in the form a range and the central projection. The projection assumes an active monetary policy which 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.

Inflation projection assumptions

External assumptions

Prospects for **global economic growth** during this year have been dampened once again under the impact of several factors having a restrictive effect on growth since H2 2018. The key ones are the trade tensions between the USA and China, recession in Argentina and Turkey, slowdown in the euro area and the stammering production in Germany's automobile industry (due to the introduction of new fuel emission standards), a tighter credit policy in China and the gradual monetary policy normalisation of leading central banks. According to the

Chart V.0.1 **IMF's revised forecast for real GDP growth for 2019 and 2020**
(in %)



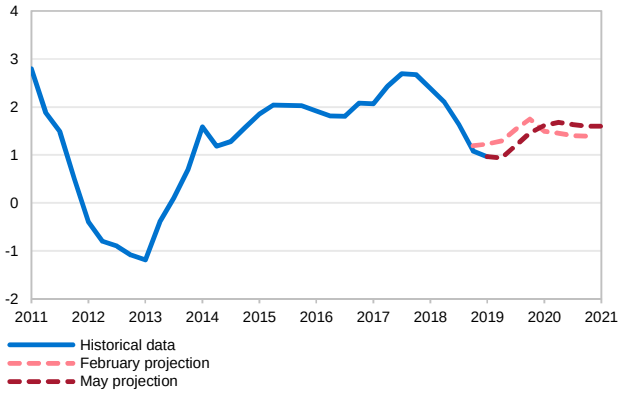
Sources: IMF WEO (January 2019) and IMF WEO Update (January 2019).

Table V.0.1 **Major projection assumptions**

	2019		2020		2021
External assumptions	Feb.	May	Feb.	May	May
Euro area GDP growth	1.5%	1.1%	1.4%	1.6%	1.5%
Euro area inflation (annual average)	1.5%	1.2%	1.5%	1.5%	1.6%
ECB key policy rate (average)*	0.0%	0.0%	0.4%	0.1%	0.37%
International prices of primary agricult. commodities (Q4 to Q4)**	1.6%	-5.8%	-0.9%	2.9%	2.5%
Brent oil price per barrel (december, USD)	61	70	61	66	63
Internal assumptions					
Administered prices (Dec. to Dec.)	4.4%	3.8%	4.0%	4.0%	4.0%
Trends					
Appreciation trend of the real exchange rate (average)	0.3%	0.3%	0.4%	0.4%	0.5%
Real interest rate trend (average)	0.4%	0.4%	0.3%	0.2%	0.1%

* ECB Survey of Professional Forecasters.
** Composite index of soybean, wheat and corn prices.
Sources: NBS, ECB, Euronext, Consensus Forecast, CBOT and Bloomberg.

Chart V.0.2 **Assumption for euro area GDP growth**
(y-o-y growth, in %)



Sources: ECB and NBs calculation.

IMF's April forecast,[29] global growth will abate from the last year's 3.6% to 3.3% this year, which is 0.2 pp below the January forecast. The IMF stated that 70% of the global economy will grow at a slower pace due to the weak start of 2019, while movements in H2 will look brighter as the effect of those factors dissipates. Improved developments in H2 will be facilitated by monetary policy normalisation of leading central banks which will be slower than previously expected. With Argentina and Turkey seeing their economies recover, global growth should pick up to 3.6% in 2020. Relative to January, the IMF expects growth to slow down by 0.2 pp in advanced economies (1.8% instead of 2.0%) and by 0.1 pp (4.4% instead of 4.5%) in emerging countries.

As for **economic growth in the euro area**, Serbia's main trade partner, our current projection has it revised down in accordance with the ECB's March projection, to 1.1% for this year, while growth of 1.6% and 1.5% is forecast for the following two years respectively. The ECB stated that in the short term, economic activity will still be adversely affected by a combination of global uncertainties (notably the possibility of protectionism escalating further and of a no-deal Brexit) and factors specific to some euro area countries. As these factors gradually fade out, the prevailing impact will be that of macroeconomic fundamentals which sustain euro area growth – primarily the impact of the ECB's still highly accommodative monetary policy, recovery in external demand and the fiscal policy changing from neutral to mildly expansionary. The ECB's forecast of euro area GDP growth is somewhat lower in 2021 than in 2020, given that financial conditions will become unfavourable in the second half of the projection horizon, although they will still sustain growth, and that employment will rise at a slightly lower rate in the medium term, mostly on account of labour supply shortages in some euro area countries. Speaking about monetary policy its April session, the ECB underlined that risks to euro area growth are still rather skewed to the downside due to uncertainties over geopolitical factors and protectionism, as well as the vulnerability of emerging countries.

On a similar note, the Consensus Forecast projected a slowdown for the euro area to 1.1% this year, which is an 0.4 pp correction downwards relative to three months ago. For the following year the Consensus Forecast put euro area growth at 1.3%, which is slower than the ECB projection and represents a downward correction of 0.1 pp. As for the IMF, though its 2019 growth projection for the euro area has been trimmed by 0.3 pp, the IMF is

[29] World Economic Outlook, April 2019.

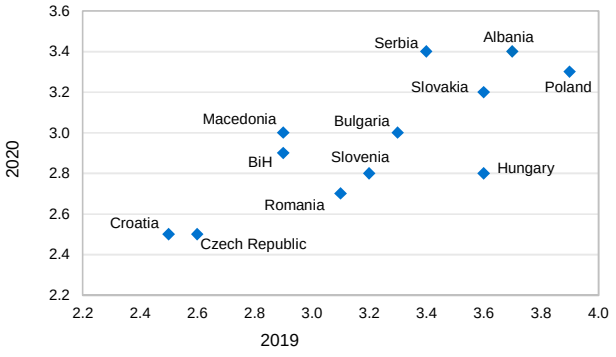
slightly more optimistic and expects growth to reach 1.3%. For 2020 the growth rate has been revised down by 0.2 pp, to 1.5%.

As for **our main trade partners in the euro area**, the Consensus Forecast changed its projection from three months ago, lowering Germany's growth for this year significantly – by 0.6 pp to 0.8%, and for 2020 by 0.1 pp to 1.5%. The reasons for the downward revision are the negative effects of US tariffs on the German economy and production bottlenecks caused by regulatory measures. Italy's growth projection was also revised down considerably, to 0.0% in 2019, from 0.5% three months ago, while the forecast for 2020 was trimmed to 0.5%, from 0.7%. The Consensus Forecast stated that Italy's poorer than anticipated growth is mainly attributable to apprehensions over the programme of fiscal incentives through private investments which is unlikely to resolve structural issues and is bringing into question the sustainability of public finances.

Regarding **growth prospects of countries in the region**, which are also our important trade partners, the expected slowdown in euro area growth was mirrored in the growth outlook for these countries, though to a lesser extent. The rise in these countries' domestic demand is still forecast as solid, propped by rising wages and further improvements in the labour market, while strong growth of fixed investments is likely to continue, albeit at a slower pace, in response to slightly contracted inflows from EU funds. According to the April Consensus Forecast, growth in the **Southeast European region**[30] in 2019 was slightly revised down relative to January, by 0.1 pp to 3.1%, mostly due to decelerating external demand, while estimated growth for 2020 was lowered by 0.2 pp to 2.8%. The 3.5% growth estimate for the **Central European region**[31] for 2019 remained unchanged, while the forecast for 2020 was increased by 0.1 pp to 3.1%. The IMF estimated that growth in some Central and Eastern European countries will exceed expectations, however, owing to the economic slump in Turkey, its growth forecast for this group of countries is a mere 0.8% in 2019. The IMF expects to see a recovery to 2.8% in 2020.

The **inflation outlook in the majority of advanced countries** was revised down. Inflationary pressures have abated, and inflation is still trending below the central banks' target levels, mostly due to the reduction in the global prices of primary commodities, notably oil, in Q4

Chart V.0.3 **Economic growth estimate by country**
(in %)



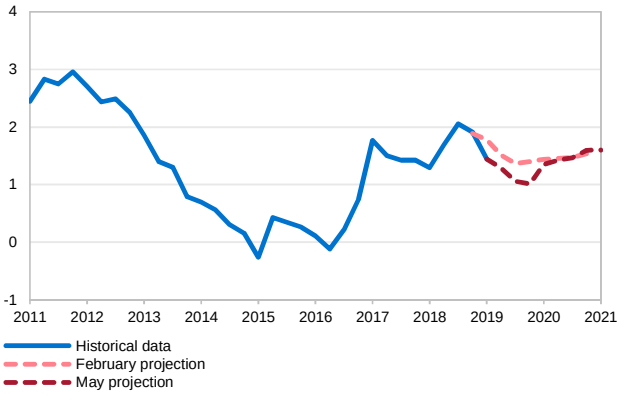
Source: Consensus Forecast, April 2019.

Table V.0.2 **Economic growth estimate by country**
(in %)

	January 2019		April 2019	
	2019	2020	2019	2020
Poland	3.7	3.2	3.9	3.3
Czech Republic	2.8	2.6	2.6	2.5
Hungary	3.4	2.7	3.6	2.8
Albania	3.8	3.5	3.7	3.4
Bulgaria	3.3	3.0	3.3	3.0
Bosnia and Herzegovina	3.1	3.0	2.9	2.9
Macedonia	2.9	2.9	2.9	3.0
Romania	3.2	2.9	3.1	2.7
Slovakia	4.0	3.3	3.6	3.2
Slovenia	3.4	2.8	3.2	2.8
Croatia	2.7	2.5	2.5	2.5

Source: Consensus Forecast.

Chart V.0.4 **Assumption for euro area inflation**
(y-o-y growth, in %)



Sources: ECB, Consensus Forecast and NBS calculation.

[30] Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia.

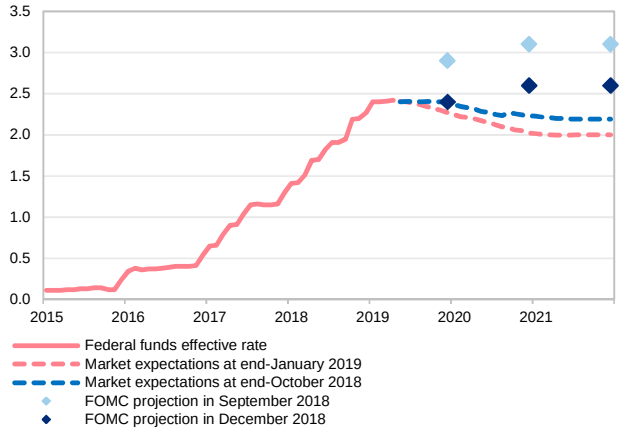
[31] The Czech Republic, Hungary, Poland, Slovakia and Slovenia.

Table V.0.3 **Consumer prices estimate by country**
(annual average, in %)

	January 2019		April 2019	
	2019	2020	2019	2020
Poland	2.0	2.5	1.8	2.5
Czech Republic	2.2	2.0	2.4	2.0
Hungary	3.1	3.1	3.1	3.0
Albania	2.5	2.6	2.2	2.4
Bulgaria	2.8	2.6	2.8	2.6
Bosnia and Herzegovina	1.6	1.8	1.7	1.7
Macedonia	2.0	2.0	1.8	2.1
Romania	3.2	3.1	3.5	3.0
Slovakia	2.5	2.3	2.4	2.3
Slovenia	1.8	1.9	1.6	1.8
Croatia	1.6	1.8	1.2	1.7

Source: Consensus Forecast.

Chart V.0.5 **Expected Fed funds rate***
(p.a., in %)



Sources: Fed and Bloomberg.
* Futures-based market expectations.

2018. Core inflation is also low, despite domestic demand recording a rise in the past two years. Our projection assumes that **inflation in the euro area** will be in accordance with the ECB's March forecast, which sees inflation falling during this year and measuring 1.2% on average, only to gradually edge up afterwards to 1.5% in 2020 and 1.6% in 2021. The projected inflation rates were revised down relative to the ECB's December forecast, when they stood at 1.6%, 1.7% and 1.8% for these three years respectively. As the main reasons for the downward revision, the ECB cited inflation lower than expected, poorer prospects of economic growth and lower assumptions of the global oil price. Core inflation should rise gradually over the projection horizon owing to the continued, albeit slower, growth in the euro area and improvements in the labour market. Professional forecasters[32] also anticipate lower inflation in the euro area in the coming period. According to the ECB's April survey, professional forecasters lowered their expectations again and, relative to January, they anticipate inflation to be 0.1 pp lower in both this and in the following two years – measuring 1.4%, 1.5% and 1.6% respectively. In addition to dampened growth outlook, another factor influencing this was the lower inflation in the euro area at the start of the year. The Consensus Forecast also trimmed its expected inflation for 2019 and 2020 to 1.3% and 1.4%, compared to the January projection of 1.5%.

Major inflationary pressures are not expected in the countries of the region either. Inflation in these countries should be determined mainly by economic growth and rising wages on the one hand, and low imported inflation on the other, though the risk of slightly higher inflationary pressures will persist if the rise in global oil prices exceeds expectations. After lowering it to 2.7% in January, the Consensus Forecast slightly raised its 2019 inflation forecast for the **Southeast European region** – to 2.8% in April, largely in view of the increase in energy prices. Its projected inflation rate for 2020 was trimmed from 2.7% in January to 2.6% in April. As regards inflation in **Central Europe**, the Consensus Forecast January projection for 2019 and 2020 was cut by 0.1 pp for each year, to 2.1% and 2.4%.

In view of the bleak outlook for global economic growth, **leading central banks recently changed their communications on future monetary policy**. The Fed announced patience in terms of monetary policy changes, in accordance with movements in economic indicators, and during 2019 it does not expect an increase in the

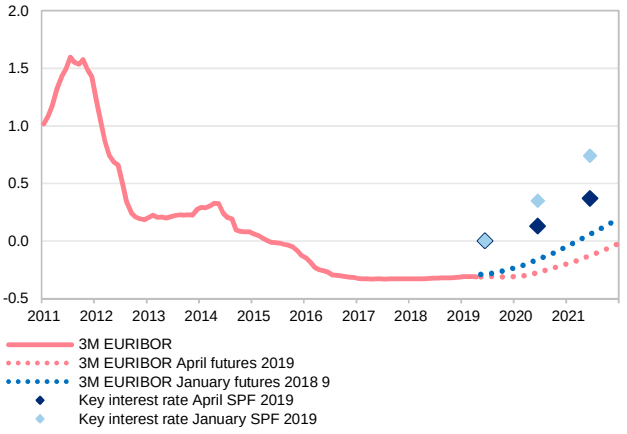
[32] ECB Survey of Professional Forecasters (SPF).

federal funds target range. Looking at end-April futures, market participants also expect no increase in the federal funds rate. Moreover, the likelihood that the rate would be trimmed in December 2019 is greater than the chances for it to remain unchanged (51.0% to 49.0%). China stepped up its fiscal and monetary stimuli to mitigate the negative effects of higher tariffs on exports to the USA. In addition, trade tensions between the USA and China have been moderated. All of this should have a positive impact on conditions in the **international financial market** and hence on capital flows toward emerging countries and their FX market stability.

When it comes to **financial conditions in the euro area**, Serbia's main foreign trade partner, our projection assumptions are aligned with the ECB's announcement that they will be more favourable than what we assumed in the previous projection. In April, the **ECB** kept its monetary policy unchanged, holding the interest rates at their historic minimum and its balance sheet at a relatively high level, due to reinvestments of principal payments from maturing securities. The ECB previously announced in March that it would keep its key rates unchanged until the end of the year. It also announced that a new programme of longer-term financing operations (TLTRO-III), each with a maturity of two years, will be implemented from September 2019 until March 2021, to help bank lending conditions remain favourable. Professional forecasters also expect the ECB's monetary policy normalisation to unfold at a slower pace than the one expected three months ago. According to them, the ECB's key interest rate will remain zero in the short term and will average 0.13% and 0.37% in 2020 and 2021 (unlike 0.35% and 0.74% from three months ago), as we have assumed in our projection as well. The slower pace of normalisation of the ECB's monetary policy is also suggested by end-April futures, according to which three-month EURIBOR should remain negative not only until end-2020, but also throughout the projection horizon, i.e. during Q1 2021 as well. Our projection assumption is that the euro-to-dollar exchange rate will remain unchanged throughout the projection horizon, lingering at the average level from two weeks before the projection was finalised (EUR/USD 1.12).

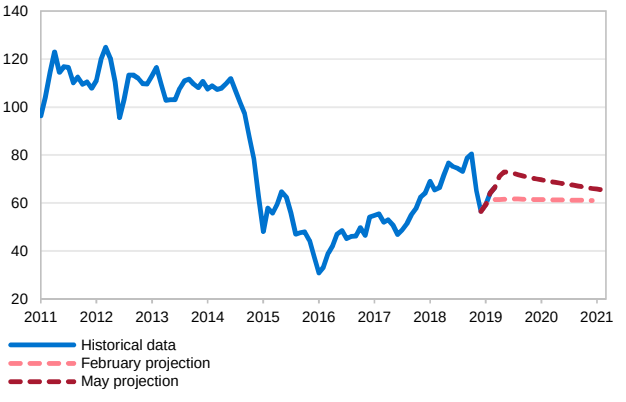
Uncertainty in terms of future trends in the international environment relates to movements in **global primary commodity prices**. This mostly concerns the global **oil price**, which rose by around 30% (to around USD 70 per barrel) since the start of the year, in wake of the leading

Chart V.0.6 **Expected ECB interest rate* and 3M EURIBOR futures**
(p.a., in %)



Sources: ECB and Bloomberg.
* ECB Survey of Professional Forecasters (SPF).

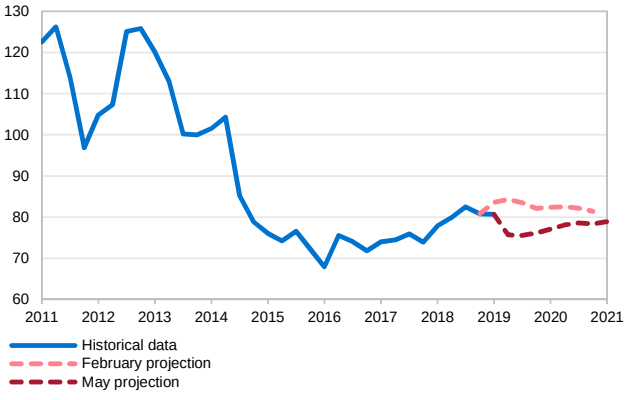
Chart V.0.7 **Assumption for Brent oil prices**
(USD/barrel)



Source: Bloomberg.

world exporters' production cap and geopolitical tensions. Still, the market does not expect it to exhibit any major rise in the coming period. According to estimates, the reduced production by OPEC countries will not be sufficient to trigger a significant rise in the global oil price, bearing in mind the anticipated contraction in oil demand in response to slower global growth, as well as the increase in US oil production. In accordance with oil futures from early May (average for the last two weeks), the new projection operates on the assumption of a global oil price of USD 70 per barrel in December 2019 and then of USD 66 and USD 63 per barrel in December 2020 and 2021, which is slightly higher than what we projected last quarter.

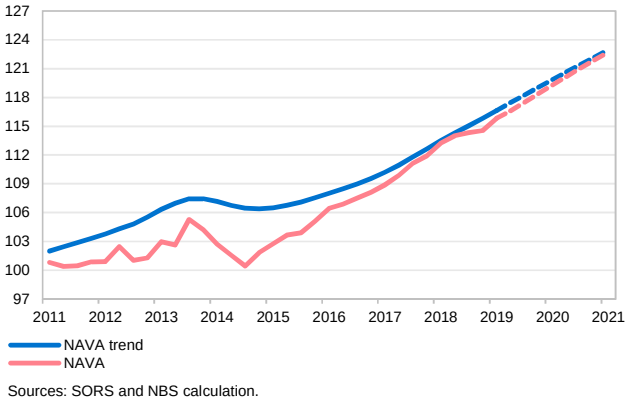
Chart V.0.8 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: CBOT, Euronext and NBS calculation.

There is also uncertainty over movements in the global prices of other primary commodities, notably **metals** and **primary agricultural commodities**. The volatility in these prices reflects the growing influence of supply-side factors, as opposed to subdued global demand. The prices of base metals were trimmed at the end of 2018 in view of the poorer outlook for global growth and the trade tensions; however, they were increased afterwards, under the impact of the anticipated fiscal incentives in China and the improved global market sentiment, as well as supply-side factors, primarily disruptions in the production of several leading global iron ore producers. This year, the IMF expects the prices of base metals to go up 2.4% relative to the 2018 average, only to fall 2.2% in 2020. As the main risks to metals price hike, the IMF cited China's higher demand, if any, and decreased metals supply in wake of stricter environmental regulations in countries which are the main producers of metals. Risks to the reduction in the price of metals are the slower than expected global growth, notably in China, the world's largest metals consumer. Other uncertainties are associated with movements in primary agricultural commodities, which are particularly important for Serbia. Based on the data provided by Euronext Paris and the Chicago Board of Trade, our projection assumed a fall of around 6% in these prices in 2019, followed by a rise of around 3% and 2.5% in 2020 and 2021, respectively. Risks to the projected growth in the global prices of primary agricultural commodities are primarily associated with weather conditions, as they can act in either direction.

Chart V.0.9 **Output gap projection**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Internal assumptions

Primary agricultural commodity prices in the domestic market[33] increased at the start of the year, only

[33] Measured by the composite index of the prices of wheat, corn and soy bean.

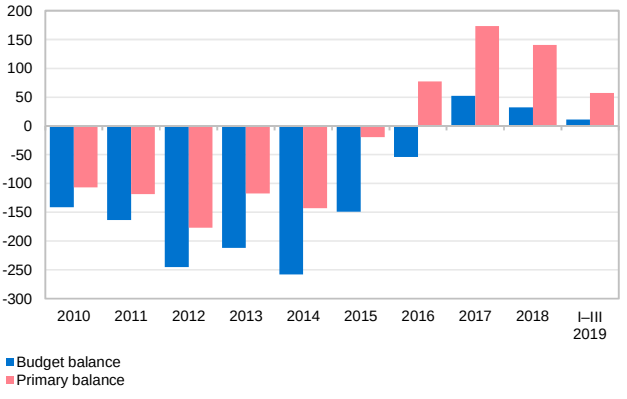
to start declining again as of March. According to our assessment, the costs of raw materials in food production have dropped to the neutral level. Bearing in mind the movements of futures on the Paris and Chicago stock markets, we expect domestic prices of agricultural products in 2019 to be somewhat lower than last year. In the coming period as well, prices in the domestic market are likely to mirror the dynamics of their global counterparts, given their mutual dependence, therefore they are expected to rise slightly over the following two years.

Further growth in **aggregate demand** is a projection assumption. In Q1, NAVA rose faster than potential, hence the negative output gap narrowed. Though the tendency toward the narrowing of the production gap, in place since 2014, has slowed down over the past year, we expect it to continue going forward. Domestic demand will be supported by a further rise in private sector wages and employment, increased public sector wages and pensions, past monetary policy easing by the NBS and the still relatively low interest rates in the euro area. The global downturn, primarily in the euro area, will result in the external demand contribution dropping to lower levels than previously projected.

As for **administered prices**, the anticipated adjustment to the prices of electricity and natural gas did not take place last year, therefore increase in this group of prices was halted at 2.4%. Since the start of the year, there have been no major changes in these prices, except for the increase in cigarette prices in the wake of an excise tax rise, resulting in administered prices rising 2.3% y-o-y in March. We assumed that the prices of natural gas and electricity might also be adjusted by the year-end, hence our administered price growth assumption for 2019 equals 3.7%. Growth assumptions for administered prices in 2020 and 2021 stand at around 4.0%.

Sustained **positive fiscal trends** contributed to overall macroeconomic stability and the country's development outlook. Consolidated budget has been in the surplus since the start of the year (RSD 11.2 bn in Q1 or 0.9% of GDP), and the share of public debt in GDP declined to 50.9% in March. Fiscal policy going forward will most likely be mildly expansionary, without major pressures on inflation growth. Growth in the government's capital expenditures will contribute to investment increase, while rising public sector wages and pensions will be conducive to sustainable consumption growth. This year's deficit is projected at 0.5% of GDP, i.e. the medium-term deficit

Chart V.0.10 **General government fiscal and primary budget balance**
(in RSD bn)



Source: Ministry of Finance.

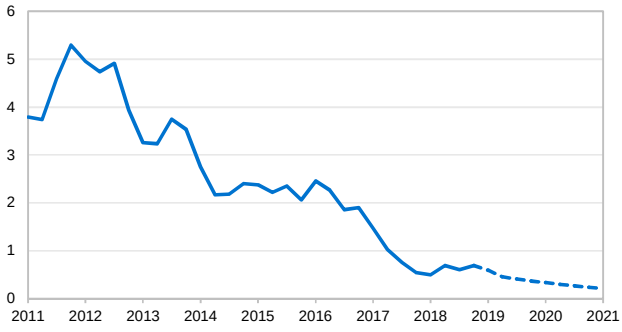
Table V.0.4. **Fiscal Strategy 2019−2021**
(in % of GDP)

	2019	2020	2021
Public revenues	39.9	39.2	38.7
Tax revenues	35.3	35.1	34.9
Non-tax revenues	4.3	3.8	3.6
Public expenditures	40.4	39.7	39.2
Expenditures for employees	9.2	9.2	9.2
Pensions	10.4	10.4	10.4
Interests	2.0	1.8	1.6
Capital expenditures	4.0	4.0	4.1
Total balance	-0.5	-0.5	-0.5
Primary balance	1.4	1.3	1.1

Source: Ministry of Finance.

target, which will ensure that the downward trajectory of public debt is maintained.

Chart V.0.11 **Real interest rate trend**
(in %)

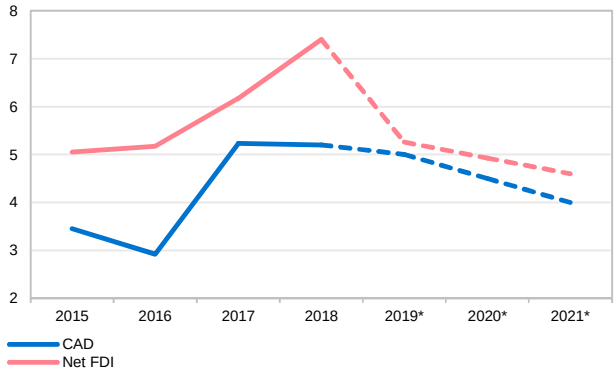


Sources: CBOT, Euronext and NBS calculation.

The balanced public finances and the firm downward trajectory of public debt, along with low sustainable economic growth and low inflation, all form a basis for the further enhancement of macroeconomic indicators. The continued decline of public debt in the coming period should reflect positively on **country risk premium and credit rating**, which will remain conducive to further **relative stability in the FX market and Serbia's increased resilience to risks from the international environment**.

As in previous projections, we expect **inflation expectations** to remain anchored around the central midpoint until the end of the projection horizon. In view of this, as well as the country's lower risk premium, we expect the **real interest rate to continue trending down** throughout the projection horizon.

Chart V.0.12 **Current account deficit and net FDI inflow**
(in % of GDP)



Source: NBS.
* NBS projection.

Exports are expected to maintain a high growth rate in 2019 as well, driven by past investment and growth, albeit slower, of external demand. Imports of equipment and intermediate goods are also expected to rise owing to the continuation of the investment cycle. We estimate that the current account deficit will edge down this year to 5.0% of GDP, from 5.2% of GDP in 2018. The decrease in the current account deficit is anticipated mostly on account of the improved balance of services and more favourable movements in the primary income account, which should offset the effects of the somewhat slower growth in the euro area on the balance of goods exchange. The current account deficit is expected to decrease further over the medium term, given the expectations of a higher impact of the FDI on export growth in the coming years. At the same time, we estimate that the FDI inflow going forward will be stable at around 5% of GDP. As so far, this will be more than sufficient to cover the current account deficit and contribute to its decrease in the medium term.

Projection

Inflation projection

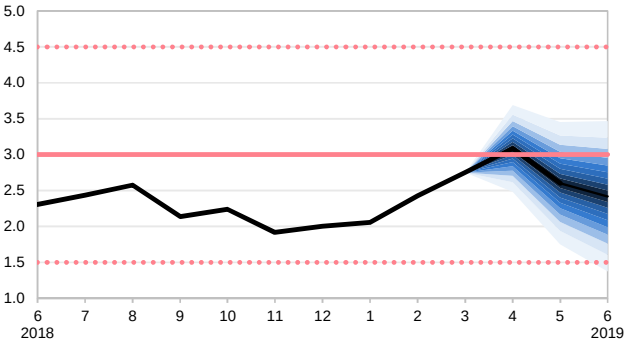
Under our current projection as well, y-o-y inflation is expected to remain low and stable in the next two years. After reaching the midpoint in April, it will continue to move within the target tolerance band until the end of the projection horizon – most probably in the lower part of the target band. Compared to the previous projection, the new projection is slightly higher for this year due to the higher than expected rise in vegetable prices since the start of this

year, and is lower until the end of the projection horizon as a result of the base effect for vegetable prices and somewhat slower than expected closing of the euro area output gap.

Short-term inflation projection

As stated in the previous *Inflation Report*, the short-term profile of y-o-y inflation is likely to reflect the base effect, primarily for the fruit and vegetable group. After getting temporarily around the midpoint in April, in the remainder of Q2 y-o-y inflation is expected to decline. This decline will be prompted primarily by the falling contribution of fresh vegetable prices (the base was high due to last year's hikes in this period of the year). The base effect is also behind the lower contribution of petroleum product prices, which will, however, be milder than expected owing to the global oil price hike since early this year. Owing to low food production costs, the contribution of processed food prices will remain low. Core inflation is expected to remain subdued and stable in the coming period, moving slightly above the current level.

Chart V.0.13 **Short-term inflation projection**
(y-o-y rates, in %)



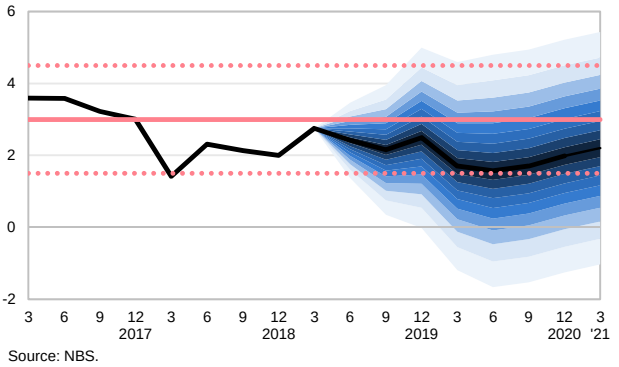
Source: NBS.

The risks to the short-term inflation projection concern primarily the movement of unprocessed food prices in the coming months, and the movement of global oil prices and their spill-over to petroleum product prices at home.

Medium-term inflation projection

Based on projection assumptions, we expect y-o-y inflation to move within the target tolerance band in the next two years, most probably in the lower part of the target band. Its movement in the coming period will be largely determined by the base effect, primarily for the fruit and vegetable group. We expect y-o-y inflation to slide towards the lower bound of the target, reaching it in H1 2020, whereafter it will start its return towards the target.

Chart V.0.14 **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%.

Such inflation profile results from several disinflationary factors. As in the previous projection, the main disinflationary effect will be generated by the high base for vegetable prices, which will in this year and in H1 of the next year outweigh the impact of elevated aggregate demand, the gradual waning of disinflationary pressures from past appreciation of the dinar and administered price growth.

Since early 2019, **fresh vegetable prices** continued vigorously up, coming significantly above their neutral level, which should lead to their strong slowdown in the coming period. Thus, until Q2 2020 their contribution to

inflation is likely to move to the negative zone, and then gradually return to the positive zone.

The **global oil price hike** since the beginning of the year fed through into higher petroleum product prices at home. However, as according to futures, market participants do not expect any significant changes in global oil prices relative to the current level, the contribution of petroleum product prices is likely to decline moderately until October, as last year's price hikes drop out of the y-o-y calculation. Thereafter, the contribution of petroleum product prices will stabilise at a low positive level.

The rise in **aggregate demand**, continuous since late 2014, is likely to persist, i.e. disinflationary pressures from the negative output gap will weaken. Although the downward tendency of the negative output gap slowed in the past year, it is expected to continue in the coming period. Such movement in the output gap will be supported by positive labour market trends and rising public sector wages and pensions, through the positive impact on household disposable income. A positive effect on disposable income also comes from the lower level of interest rates, and thus lower loan repayment costs, achieved owing to past monetary policy easing by the NBS. A positive effect also comes from the still low interest rates on euro-indexed loans, which are likely to remain low longer than expected given the recently announced slower normalisation of ECB's monetary policy. On the other hand, the slowdown in the euro area, notably Germany and Italy, our main trade partners, as well as the capping of steel exports to the EU, will bring about a smaller contribution of external demand to growth than projected earlier.

The past appreciation of the dinar generated disinflationary effects through lower dinar import prices. Working in the same direction was lower euro area inflation. We expect disinflationary pressures on this account for some time yet, though they will gradually wane. However, given the expected relative stability of the **dinar against the euro**, as well as relative stability of the dinar against the dollar assuming unchanged euro-dollar exchange rate, and moderate price growth in the euro area, the rise in dinar import prices is likely to remain relatively low until the end of the projection horizon.

Administered price growth is likely to be 3.8% this year, reflecting mainly the cigarette price adjustment and the potential rise in natural gas and electricity prices, which was absent last year. The contribution of administered price growth to inflation would thus be higher by 0.3 pp

than last year. Similarly to the previous projection, administered price growth is expected at around 4.0% both in 2020 and 2021.

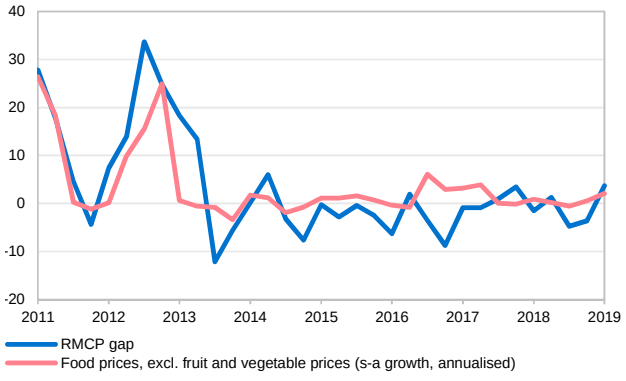
The **costs of raw materials in food production** are estimated at around the neutral level, after the prices of primary agricultural commodities in the domestic market were reduced as of March. We expect these costs to move around the neutral level in the coming period, in accordance with the assumed movement in global primary agricultural commodity prices given that global prices have the major impact on their domestic counterparts.

Given the current fall in prices of important raw materials in processed food production (wheat, corn, soybean), which brought food production costs back to the neutral level, we expect no upward pressures on **food inflation** on these grounds. We believe the rise in food inflation will be modest and led by gradual growth in aggregate demand. A similar trend is expected for **non-food inflation**, after it stays around the current level until the end of this year – namely, its moderate rise will be determined by rising aggregate demand. We expect both food and non-food inflation to continue to move below 3.0% over the projection horizon.

The risks to the inflation projection are associated primarily with movements in international commodity and financial markets, and administered price growth to an extent.

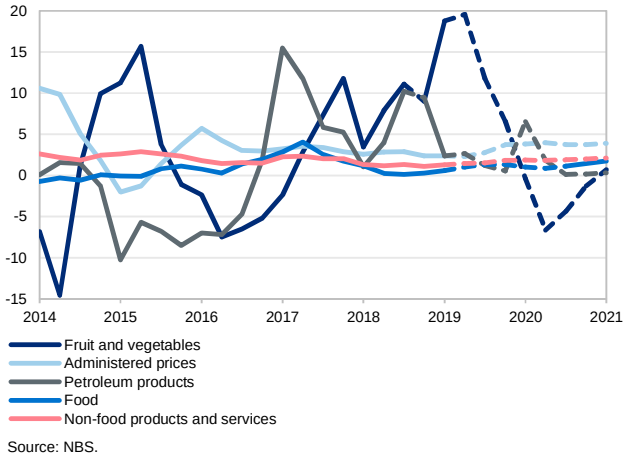
The prices of primary commodities in the **international commodity market** could be both lower and higher than assumed, owing both to demand- and supply-side factors. In terms of demand-side factors, there are risks that the global economic slack could be stronger than estimated, which would diminish demand for primary commodities. Though trade tensions between the leading world economies have been alleviated to a degree, protectionism in international trade and geopolitical tensions remain, which may undermine business confidence and reflect negatively on investment, productivity and economic growth, prompting a decline in demand for primary commodities, notably oil. The greater than expected slowdown of China's growth would reflect particularly on falling demand for primary commodities, given that the Chinese economy has become the main driver of demand for global primary commodities. Although China responded to the slowdown through monetary and fiscal stimuli, economic activity could be lower than expected, particularly in the case of renewed escalation of trade tensions. On the other hand,

Chart V.0.15 **RMCP and food prices**
(in %)



Sources: Novi Sad Mercantile Exchange, SORS and NBS calculation.

Chart V.0.16 **Projection of inflation components**
(average y-o-y rate, in %)



Source: NBS.

an agreement on trade policies of the leading world economies may be reached, and there may not be further negative effects on global growth and demand for primary commodities on these grounds.

Supply-side factors are specific for each primary commodity. Although market participants, according to futures, do not expect any significant changes in **global oil prices** relative to the current level, they are possible in both directions given the unstable balance of global supply and demand. Geopolitical tensions are not waning, primarily due to the US sanctions on oil exports from Iran and Venezuela, as well as developments in Libya. The duration of the current cap on OPEC's oil production is uncertain, as well as the degree to which the member countries will adhere to it. It is also uncertain how the oil processing and transportation industry will respond to the introduction of the new standards of the International Maritime Organization as of early 2020, and what the effect on global oil prices will be, although no significant movements are expected in the market. On the other hand, oil production in the US is dynamic and its growth, as well as a potentially higher rise in production of OPEC members, could additionally reduce global oil prices. Global oil prices will also reflect on the prices of **primary agricultural commodities**, notably cereals, not only through the costs of fuel in agricultural production and fertilisers prices, but also through the impact on biofuel production. Conversely, potential further heightening of trade tensions could lead to a fall in the prices of primary agricultural commodities. In addition, in the past several years the prices of global primary commodity prices increased slightly, or even declined, although futures envisaged growth. Given the uncertainty as to the movement in global oil prices and primary agricultural commodities, the risks to the projection based on global primary commodity prices are assessed to be symmetric.

The risks to the projection are also associated with developments in the **international financial market**, notably the monetary policy stance of the ECB and Fed, and consequently conditions in the international financial market and the euro-dollar exchange rate. Responding to the slowdown in global growth and inflation, the ECB and Fed signalled that the normalisation of their monetary policies would be slower than expected. This means global financial conditions will be favourable for a longer time than expected. However, it is uncertain to what extent the pace of normalisation will be slower, which may give rise to the volatility of global capital flows. Further spread of protectionism in international trade could deepen the instability in the international financial

market, and thus the uncertainty as to capital flows. Working in the opposite direction would be a trade agreement between the leading world economies. Given the said, the risks to the projection from this source are judged to be symmetric.

The projection operates on the assumption of **administered price** growth of 3.8% this year, after the last year's relatively modest growth of 2.4%. The assumed administered price growth for 2020 and 2021 is around 4.0%. Although we have revised downward our administered price growth projections for this year, bearing in mind the modest administered price growth in the past three years, we consider the risks to the projection to be mildly tilted to the downside, given that the adjustments to natural gas and electricity prices could be absent this year as well.

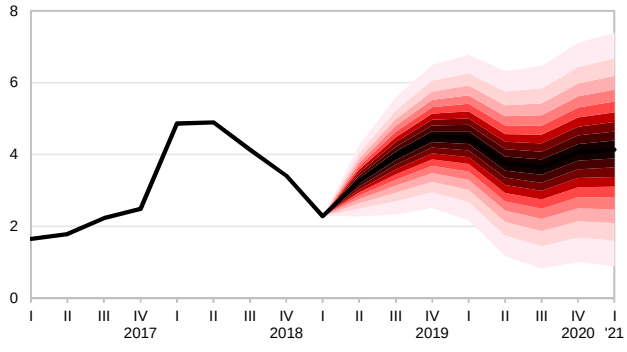
Overall, **the risks to the inflation projection are judged to be symmetric until the end of the projection horizon**.

Monetary policy decisions in the coming period will continue to depend on the assessment of the impact of domestic and external factors on inflation in Serbia. Given that the key risks to the projection emanate from the international environment, the NBS will continue to carefully monitor and analyse trends in the international commodity and financial markets, and assess their impact on domestic economic developments. It should be emphasized that Serbia's resilience to changeable external conditions increased owing to the achieved and preserved low inflation and a stable financial system, the achieved economic growth rates, balanced public finance and the downward path of public and external debt. As so far, monetary policy will be predictable and consistent in delivering low and stable inflation in the medium run, which will, along with the preservation of financial stability, contribute to sustainable economic growth and further strengthening of resilience to external uncertainties.

GDP projection

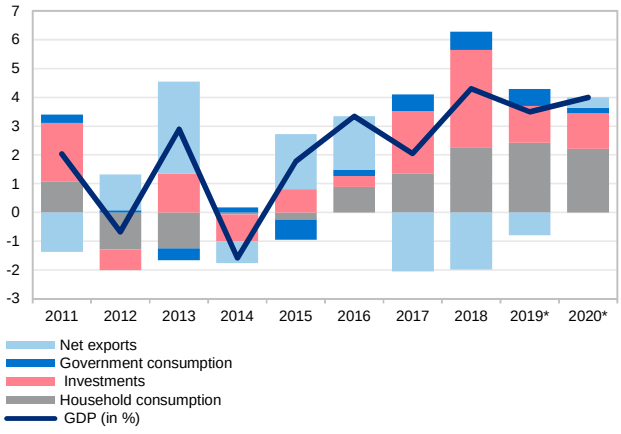
Given the growth recorded in Q1 and expected acceleration in the coming period, we have kept the GDP growth projection for 2019 at 3.5%, with a slightly changed structure. Bearing in mind more favourable than expected movement in short-term indicators of final consumption, we have adjusted upward the contribution of final consumption owing to rising public sector wages and pensions and the continued rise in employment and

Chart V.0.17 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

Chart V.0.18 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS.
* NBS estimate.

wages in the private sector. In addition, we expect fixed investment to continue to positively affect GDP growth in 2019 as well, as indicated, among other things, by the sustained high FDI inflow and higher capital investment since early this year. On the other hand, under the new projection, we expect a somewhat more negative contribution of net exports in 2019, primarily on the back of the euro area slowdown. At the same time, exports are likely to maintain relatively robust growth in real terms – around 7%. Similar growth is expected for imports as well, with the preservation of a favourable structure, i.e. imports will be led by rising procurements of equipment and raw materials for investment and production purposes.

On the production side, the greatest positive contribution to GDP growth should come, in 2019 as well, from elevated activity in service sectors, owing to rising household consumption and gradual recovery of consumer confidence. In addition, we expect continued growth in construction, at the average rate recorded in the past five years (around 8%), as suggested by the envisaged rise in government capital expenditure and favourable trends in the real estate market. A positive contribution to GDP growth is also expected from the continued growth in manufacturing, and the recovery in mining and energy sectors. On the other hand, a negative contribution to GDP in 2019 is expected from falling agricultural production due to the base effect.

According to our estimate, real GDP growth should accelerate to around its potential, i.e. 4% in the medium run. The main underlying factors will be further fixed investment growth, spurred by a favourable business environment and growth prospects, continued EU accession process and stepped-up implementation of infrastructure projects. A positive contribution to GDP growth in the medium run is also expected from net exports, owing primarily to the preservation of a relatively vigorous pace of goods and services exports and a gradual slowdown of import growth. Favourable labour market trends will also contribute to the further growth in household consumption. In the coming period too, household consumption is expected to grow at a slower pace than GDP.

On the production side, gradual acceleration of GDP growth in the medium run is likely to be spurred by more vigorous growth in manufacturing based on investment in new export capacities and the recovery of external demand. In addition, we expect the growth in domestic demand and favourable labour market trends to contribute to gradual acceleration in service sectors. The

construction sector is likely to continue to provide a positive contribution to growth, while agriculture is expected to record multi-year average yields.

Similarly to the previous projection, the risks associated with external demand, most notably the pace of euro area growth, are assessed to be titled to the downside in the short run, i.e. in 2019. On the other hand, the risks which emanate from the domestic environment and concern primarily investment in export-oriented sectors and construction trends are assessed to be titled to the upside in the short run. Thereafter, i.e. in the medium run, all risks to the GDP projection are assessed as symmetric.

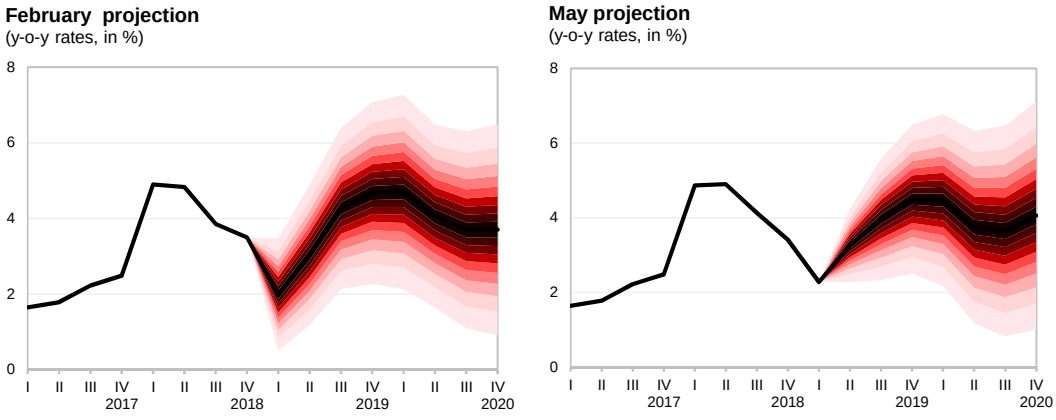
Rising protectionism in international trade, geopolitical risks and country- and sector-specific factors have led to the slowdown in economic activity and the downward adjustment of euro area GDP growth prospects. As the euro area is our most important trade partner, such trends could also reflect on the slowdown in Serbia's exports and, consequently, slower growth in manufacturing. However, the slowdown is still assessed as temporary and related primarily to 2019, whereafter growth is likely to accelerate.

In addition to dented demand in general, trade between Serbia and the euro area is affected by specific factors as well. This concerns primarily the exports of steel from Serbia, which after the privatisation of the domestic steel plant became one of the main export products, exported chiefly to the EU market. The introduction of quotas on the imports of specific steel products by the EU could negatively affect Serbia's exports in the short run.

The uncertainty surrounding GDP growth also concerns the negative effect of the 100% tariffs on Serbian products delivered to Kosovo and Metohija, which takes toll on manufacturing, notably food production. Still, as we expect that these tariffs, as the most blatant form of violation of trade agreements, will be abolished in the coming period, their negative effect is assessed as short-term.

The GDP growth of Serbia, as a small and open economy, is also affected by capital flows and relationships among the main currencies in the international financial market. The uncertainty as to the pace of normalisation of monetary policies of leading central banks still persists, though it is currently somewhat diminished, given that the Fed and ECB announced slower normalisation of their monetary policies. This should help keep the current level of liquidity in the international financial market and mitigate pressures of rising external financing costs,

Chart V.0.19 **Current vs. previous GDP growth projection**



Source: NBS.

primarily in emerging economies. We also wish to emphasize that Serbia – owing to preserved macroeconomic stability, reduced internal and external imbalances, higher domestic demand and lesser needs for external borrowing – reduced its exposure to potential external shocks on these grounds.

The risks to the GDP growth projection are also associated with the prices of primary commodities, notably oil, base metals and cereals. These prices can go in either direction in the global market, which is why we assess the risks on these grounds as symmetric. In addition, a potential oil price hike in the global market could spill over to Serbia as a net importer through lower disposable income and higher costs of operation, while a potential drop would work in the opposite direction. Conversely, a potential rise in the prices of cereals and base metals in the global market could positively impact Serbia as a net exporter of these commodities.

In terms of domestic factors behind GDP growth, their short-term effect could be tilted to the upside. This concerns primarily the favourable effects of faster than expected investment growth, as indicated by the high and project-diversified FDI inflow in 2018, channelled predominantly to tradable sectors, as well as a high y-o-y rise in government capital expenditure. Potentially faster investment growth is also expected based on the start of the new investment cycle in construction, which includes primarily intensive investment in the projects of construction of transportation infrastructure and, to an extent, the continued implementation of a number of projects in the real estate market.

A risk to the GDP growth projection is also associated with the agricultural performance, assumed to be above the multi-year average this year and below last year's record season, and at the level of the multi-year average

in the medium run. Given that agriculture is largely susceptible to the impact of weather, deviations may occur in both directions, which is why the risks on these grounds are judged to be symmetric.

Comparison and outcome of inflation projections

The new medium-term inflation projection is slightly higher for this year and, until the end of the projection horizon, lower compared to the projections published in the February *Inflation Report*. The main reason for somewhat higher projected inflation this year is the higher than expected rise in the prices of vegetables and petroleum products since the start of 2019. This results in higher projected y-o-y inflation rates in the next year. Due to the base effect and slower than expected closing of the negative output gap, in the remainder of 2020 and in early 2021, i.e. until the end of the projection horizon, y-o-y inflation is lower compared to the February projection.

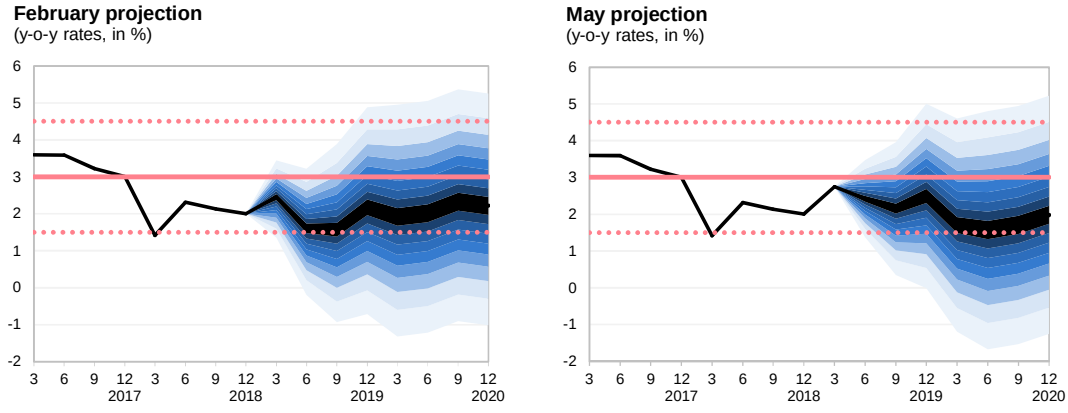
Since early 2019, vegetable prices increased much more than expected. However, as the tendency of these prices is to return to neutral level, their contribution to inflation is projected to move to the negative zone by Q2 2020 and to be more pronounced than in the February projection. To the surprise of most analysts, global oil prices also went up since the beginning of the year, so, based on futures prices, they are now assumed to be higher than in the February projection. This will push up the prices of petroleum products, and thus inflation compared to the February projection, in the next year. Thereafter, a higher base for vegetable prices will generate disinflationary effects until the end of the projection horizon.

A disinflationary effect will also be produced by the negative output gap, which under the new projection is closing more slowly than in the earlier projection, on account of somewhat slower closing of the euro area output gap.

The slower waning of the effects of past appreciation of the dinar also works towards lower projected inflation. Along with slower closing of the negative output gap, this is the main reason why we have projected the rise in non-food product prices at a somewhat lower level than envisaged in the February projection. In addition, smaller growth in the prices of non-food products and services will be supported by lower expected inflation in the euro area, our key trade partner.

At the same time, food prices are at a significantly lower level until the end of the projection horizon because the

Chart V.0.20 **Current vs. previous inflation projection**



Source: NBS.

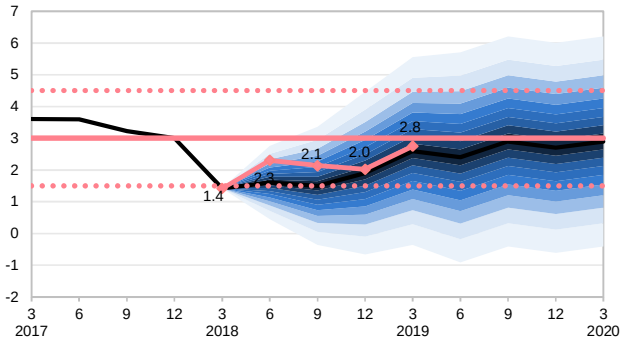
drop in primary agricultural commodity prices as of March brought about lower food production costs.

In the past year inflation moved within the band projected in May 2018. More specifically, inflation hovered around the central projection value – first above, and then below it, only to settle at end-Q1 2019 close to the central value projected in May 2018.

Observed by component, lower end-Q1 2019 growth than projected in May 2018 was recorded for food and administered prices, and the prices of non-food products and services. This reflects lower costs in food production (due to lower prices of primary agricultural commodities in Serbia), slower waning of the effects of past appreciation and the absence of the anticipated hike in natural gas and electricity prices.

On the other hand, higher than expected growth was recorded for prices of vegetables and petroleum products. Vegetable prices rose significantly in the past year and thus made inflation higher than the projected central value (vegetable prices contributed as much as 1.63 pp to headline inflation of 2.8% in March). In addition, a more inflationary impact relative to the May 2018 projection came from the euro's weakening against the dollar and the consequent dinar's depreciation against the dollar, primarily through dinar-denominated prices of primary commodities.

Chart V.0.21 **Achievement of May 2018 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Index of charts and tables

Charts

Tables

Charts in text boxes

Tables in text boxes

Executive Board meetings and changes in the key policy rate

2018

Date	Key policy rate (p.a, in %)	Change (in basis points)
11 January	3.50	0
8 February	3.50	0
8 March	3.25	-25
12 April	3.00	-25
10 May	3.00	0
7 June	3.00	0
12 July	3.00	0
9 August	3.00	0
6 September	3.00	0
8 October	3.00	0
8 November	3.00	0
6 December	3.00	0

2019

Date	Key policy rate (p.a, in %)	Change (in basis points)
10 January	3.00	0
7 February	3.00	0
7 March	3.00	0
09-Apr	3.00	0
9 May	3.00	0
6 June		
11 July		
8 August		
12 September		
10 October		
7 November		
12 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 7 March 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate on hold, at 3.0%.

In making the decision, the Executive Board was guided by the expected movement in inflation and its underlying factors, and the effects of past monetary policy easing.

Inflation has been low and stable for the sixth year in a row. In January it stood at 2.1% y-o-y. Core inflation is also low, at 1.2% y-o-y in January. Subdued inflationary pressures are further indicated by the one-year ahead inflation expectations of the financial and corporate sectors, which stand somewhat below the 3.0% midpoint. The Executive Board expects inflation to continue to move within the target tolerance band (3.0±1.5%) in the coming period.

Caution in monetary policy conduct is still mandated, most notably because of developments in the international environment. As global economic growth slows, the normalisation of monetary policies of leading central banks, the Fed and ECB, is expected to be slower as well. It, however, remains uncertain to what extent the normalisation will be slower and different from market expectations, which may trigger the volatility of global capital flows. After falling in late 2018, global oil prices have regained some ground early this year, but both demand- and supply-side factors make their future movements uncertain. Though trade tensions between the world's leading economies have abated recently, protectionism in international trade, as well as geopolitical tensions, remain, which perpetuates uncertainty regarding the outlook for international commodity and financial markets.

As emphasized by the Executive Board, our economy's resilience to potential adverse effects from the international environment has increased owing to reduced external and internal imbalances and improved macroeconomic prospects. Public finance recorded a surplus for the second year in a row – 0.6% of GDP in 2018. The share of the current account deficit in GDP in 2018 stayed at the 2017 level despite elevated imports for investment purposes, higher oil prices and softening external demand. For the fourth year in a row, the current account deficit was more than fully covered by the FDI inflow that reached EUR 3.2 bn in 2018. The Executive Board expects that GDP growth this year will be powered by domestic demand, i.e. investment and consumption, and that FDI, which contributes to the growth in production and export capacities, will lead to a gradual narrowing of external imbalances in the medium term.

The next rate-setting meeting will be held on 9 April.

Press release from Executive Board meeting held on 9 April 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate on hold, at 3.0%.

In making the decision, the Executive Board was guided primarily by the expected movement of inflation and its underlying factors in the domestic and international environment.

Inflation has been moving in line with the Executive Board's expectations – it has been low and stable for the sixth year in a row, measuring 2.4% y-o-y in February. Core inflation trended similarly, equaling 1.3% y-o-y in February. The Executive Board expects inflation to remain stable within the target tolerance band (3.0±1.5%), while medium-term inflation expectations of the financial and corporate sectors are moving along the same lines.

The NBS Executive Board deems that caution in monetary policy conduct is still mandated, most notably because of developments in the international environment. Due to the slowdown in global economic growth and inflation, the normalisation of monetary policies of leading central banks, the Fed and the ECB, will be slower than expected. It remains uncertain, however, to what extent the normalisation will differ from market expectations, which may trigger the volatility of global capital flows. After falling late last year, global oil prices have been on a rise since the start of this year. Their movement remains uncertain due to a number of factors – both on the supply- and demand-side. Though trade tensions among the leading world economies have eased, protectionism in international trade and geopolitical tensions persist, making the developments in the international commodity and financial markets uncertain.

As emphasised by the Executive Board, our economy's resilience to potential adverse effects from the international environment amplified owing to reduced internal and external imbalances and a favourable macroeconomic outlook. As

in the previous two years, public finance recorded a surplus at the start of this year, while the current account deficit has been more than fully covered by the net FDI inflow for more than four years. The Executive Board expects that this year economic growth will be led by domestic demand, i.e. investment and consumption, while FDI, which boosts production and export capacities, will lead to a gradual reduction in external imbalances in the medium run.

The next rate-setting meeting will be held on 9 May.

Press release from Executive Board meeting held on 9 May 2019

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 3.0%.

In making the decision, the Executive Board was guided primarily by the outlook for inflation and its factors in the domestic and international environment.

Inflation has been moving in line with the Executive Board's expectations – it has been low and stable for the sixth year in a row, measuring 2.8% y-o-y in March. Its temporary approach to the target midpoint in March is judged to be due primarily to the low base for vegetable prices and the fact that they rose more than seasonally usual for this period of the year. Core inflation stayed unchanged from the previous month, equalling 1.3% y-o-y in March. Low inflationary pressures are also indicated by the inflation expectations of the financial and corporate sectors anchored around the 3% target for both one and two years ahead. The Executive Board expects inflation to remain stable within the target tolerance band (3.0±1.5%) in the coming period.

The Board deems that caution in monetary policy conduct is still warranted, chiefly because of persistent uncertainty in the international environment. As recently announced, the normalisation of monetary policies of leading central banks, the Fed and the ECB, will be slower than expected due to the slowdown in global economic growth and inflation. It remains uncertain, however, to what extent the normalisation would diverge from market expectations, which might trigger volatility in global capital flows. Having declined late last year, the global oil price has been on the rise since the beginning of 2019, and its future movements remain unpredictable due to numerous factors on both supply and demand side. While trade tensions between major world economies have loosened, international trade is still hindered by protectionism and geopolitical tensions, fuelling uncertainty in the international commodity and financial markets.

The Executive Board points out that the resilience of our economy to potential adverse effects from the international environment has increased owing to reduced internal and external imbalances and a favourable macroeconomic outlook. As in the previous two years, public finances recorded a surplus early this year and the current account deficit was fully covered by the net inflow of foreign direct investment. The Executive Board expects that economic growth this year will be led by domestic demand, i.e. investment and consumption, and that foreign direct investment, which supports the expansion of our production and export capacities, will lead to the gradual narrowing of external imbalances in the medium term.

At today's meeting, the Executive Board adopted the May Inflation Report, which will be presented to the public on 15 May. On that occasion, the NBS will give a detailed account of monetary policy decisions and the underlying macroeconomic developments.

The next rate-setting meeting will be held on 6 June 2019.

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