NATIONAL BANK OF SERBIA

I N F L A T I O N
REPORT
August 2007

Belgrade, August 2007

Introductory Note

Memorandum of the NBS on the Principles of the New Monetary Policy Framework adopted by the Monetary Policy Committee on its session of 30 August 2006 was put together to accomplish the main objective – efficient achievement and maintenance of price stability.

Based on the above monetary policy framework, the NBS has been maintaining price stability within the framework of the defined inflationary corridor using policy rate as its main instrument and other monetary policy measures as supporting instruments. Since the NBS aims to formally adopt inflation targeting in the near future to increase transparency of its monetary policy and efficient communication with the public, it has decided to prepare and publish quarterly inflation reports as its main channel for communicating with the public. This report shall provide the public with information on the main developments in the economy that affect the decisions of the Monetary Policy Committee and the activities of the National Bank of Serbia.

Inflation report contains information on the current and expected inflation, analysis of underlying macroeconomic developments, explanation of the reasoning behind the decisions of the Monetary Policy Committee and an assessment of the monetary policy efficiency as implemented during the previous quarter. Integral parts of this report are inflation projection for at least four quarters in advance, assumptions on which such projection is based and an analysis of the basic risks involved in achievement of target inflation.

Access to such information shall enable the public to have better understanding of monetary policy implemented by the central bank and its commitment to achieving target inflation. Moreover, it shall play a role in curtailing inflationary expectations and maintaining price stability, which is the basic task of the NBS.

August 2007 Inflation Report was adopted by the Monetary Policy Committee on its session of 28 August 2007.

Earlier issues of the Inflation Report are available on the NBS website (http://www.nbs.yu).

Monetary Policy Committee of the National Bank of Serbia:
Radovan Jelašić, *Governor*
Ana Gligorijević, *Vice-Governor*
Diana Dragutinović, *Vice-Governor*
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I. Overview

Inflation recorded an increase in Q2 2007 though declining tendency in its year-on-year rates continued due to high price growth in 2006. At end-Q2, core inflation measured 2.8% year-on-year, which is below the lower bound of the range targeted for 2007 (4%). At the same time, following continuous decline from mid-2006, core inflation rose by 0.9% in Q2 2007 as a result of a surge in oil prices on the world market, May hike in electricity prices and nominal depreciation of the dinar. Disinflationary pressures resulting from the appreciation gap of the real exchange rate continued, though they weakened slightly on Q1 as the gap gradually began to close.

Table I.0.1

Key macroeconomic indicators

	2006	2007					
	Dec	Jan	Feb	Mar	Apr	May	June
Retail prices (y-o-y growth, in %)	6.6	6.54	5.16	5.6	4.6	4.4	5.1
Core inflation (y-o-y growth, in %)	5.9	5.3	4.7	4.0	3.4	2.9	2.8
Belibor (90 days, monthly average, annual level)	16.5	15.0	13.7	12.3	11.4	10.8	10.1
M3 (y-o-y growth, in %)[1)]	39.8	37.2	38.8	42.5	40.4	39.5	37.9
GDP (y-o-y growth)[1)]	5.0	...	...	8.7	...	...	7.0
Consolidated fiscal result (% of GDP)[1)]							
Ministry of Finance methodology	-7.5	...	...	2.3	...	...	3.5
IMF methodology	-7.4	...	...	0.4	...	...	2.8
Balance of goods and services (% GDP)[1)]	-19.8	...	...	-22.9	...	...	-21.3

[1)] Quarterly data.

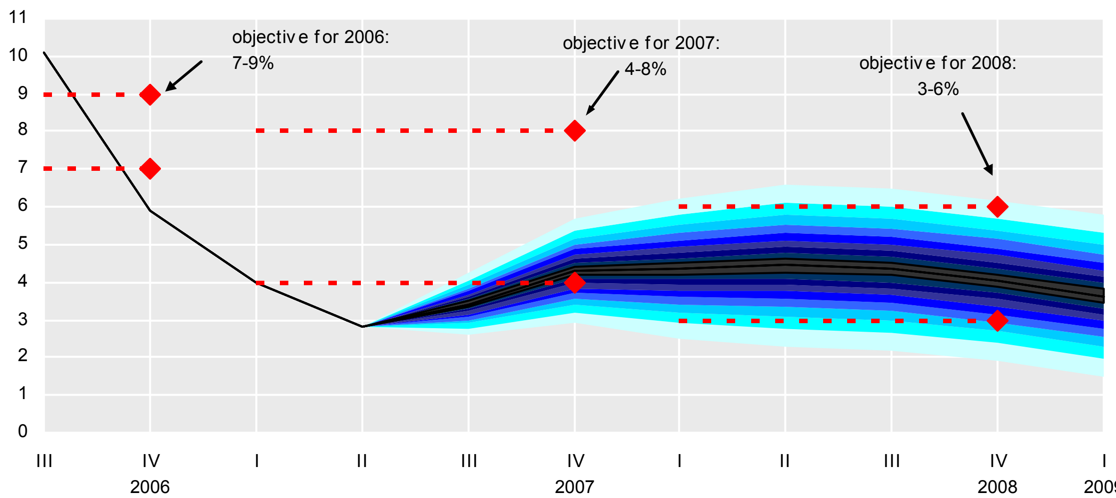
The 2.9% retail price growth in Q2 was mainly determined by movements in regulated prices. Year-on-year, price growth declined from 5.6% at end-Q1 to 5.1% at end-Q2.

A robust year-on-year growth in aggregate demand in Q2 induced an increase in inflation despite a notably higher supply of imported goods and services.

Breakdown of GDP spending in this quarter points to a shift from investment spending to spending for personal consumption.

Estimates are that the particularly pronounced slowdown in government investment spending in the period under review was due mainly to delayed adoption of the 2007 budget and deferral of implementation of projects envisaged by the National Investment Plan.

Core inflation projection
(y-o-y rates, in %)



Economic activity gathered momentum in 2007: its growth rate equalled 8.7% in Q1, and is estimated at around 7% for Q2. Key contribution to economic growth came from the services sector and export-oriented portion of the economy. However, adverse weather conditions will have a negative impact on agricultural production and stability of food prices.

Money market interest rates continued declining, while movements in the foreign exchange market were stable. Cuts in the key policy rate contributed to moderate depreciation of the dinar.

Core inflation rate will run high (1.9–2.4%) in Q3, and will settle between 3.0 and 3.5% year-on-year. Several factors are expected to influence movements in core inflation: announced increase in prices, primarily of industrial foodstuffs; rise in electricity prices resulting in increased production costs; and nominal depreciation of the dinar inducing a rise in import prices. Still open, the appreciation gap of the real exchange rate will continue to produce disinflationary pressures.

In terms of movements in headline inflation in Q3, a significant rise is expected in a number of prices under administrative control, as well as a drought-induced increase in prices of agricultural products (instead of a seasonal decline). Therefore, Q3 retail price growth is expected to amount to 2.4-2.8%, and 7.3-7.6% year-on-year.

Notwithstanding strong inflationary pressures, core inflation in 2007 will most likely settle around the lower bound of the targeted range (4–8%). Central projection places core inflation at 4.3%, up by 1.3 percentage points from the April projection due to unexpectedly robust growth in prices of agricultural products and foodstuffs.

As a result, the inflation gap, i.e. difference between the actual and targeted inflation, will be eliminated in 2007. In early 2008, core inflation will settle within the range targeted for that year (3–6%). As indicated by the July projection of core inflation, a moderate tightening of the monetary policy stance will be needed in the foreseeable future.

Central projection of retail price growth (8.0%) in 2007 is higher than published in the previous issue of *Inflation Report*. It is based on the central projection of core inflation (4.3%) and expectations with regard to non-core inflation (around 12%). The main reason behind such high projection of non-core inflation are surging oil prices in the world markets, increase in electricity prices announced for September and drought-induced rise in prices of agricultural products. Risks to the achievement of this projection are primarily embodied in unpredictable movements of world oil prices and prices of agricultural products.

II. Inflation Developments

At end-Q2, year-on-year retail price growth came to 5.1% and is expected to range from 7.3% to 7.6% in Q3. The Q2 retail price growth of 2.9% was mainly due to movements in regulated prices. At end-Q2, year-on-year core inflation fell back below the lower bound of the target range for 2007 and amounted to 2.8%. It is expected to settle at around 3.0-3.5%., by end-Q3.

Retail prices continued declining in terms of year-on-year growth rates. At end-Q2, such growth measured 5.1% as opposed to 5.6% at end-Q1. Continued disinflation resulted from movements in prices of agricultural products (–13.3% year-on-year growth in June) and market-determined prices – core inflation (2.8%), while regulated prices recorded a notable growth (9.2%) and worked in the opposite direction. Both headline and core inflation figures at end-Q2 (around 5% and 3%, respectively) were in line with expectations as specified in the previous issue of Inflation Report.

Table II.0.1

Indicators of price growth

(growth rates in %)

	XII 2006 / XII 2005	III 2007 / III 2006	IV 2007 / IV 2006
Retail prices	6.6	5.6	5.1
Core inflation	5.9	4.0	2.8
Consumer prices	...	4.1	4.0
Cost of living	6.0	4.2	3.5
Prices of goods	6.1	3.7	3.0
Prices of services	5.2	7.0	6.1
Industrial producer prices	7.3	5.1	4.9
Agricultural producer prices	7.3	3.4	2.7[1)]

[1)] May on May.

Main contribution to retail price growth in Q2 (2.9%[1]) came from the increase in regulated prices (2.4 percentage points), of which the largest contributor were electricity prices (1.1 percentage points) as revised upwards by 15% in May. A notable input also came from prices of oil derivatives (0.6 percentage points), which rose by 7.2%. The 13.9% rise in costs of social services contributed 0.2 percentage points to overall retail price growth in Q2, as much as did the increase in prices of cigarettes. Upward revision in prices of medicaments in the second quarter did not go as far as the announced 7 per cent.

Chart II.0.1

Movements in prices

(quarterly growth, in %)

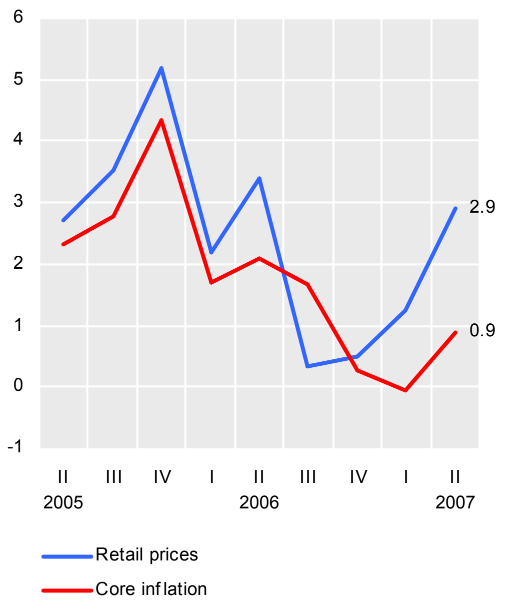
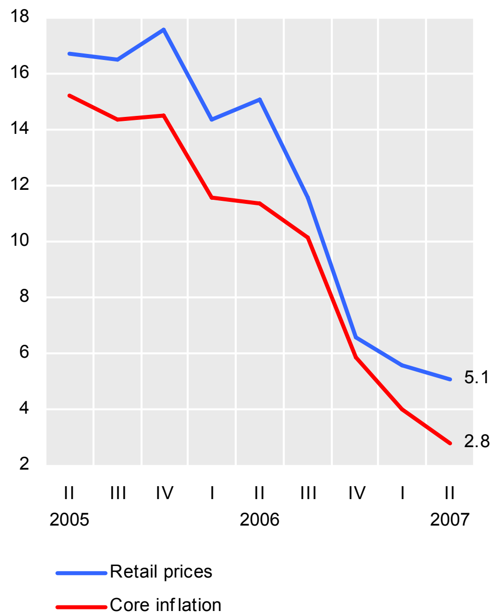


Chart II.0.2

Movements in prices

(y-o-y growth, in %)



[1] Monthly breakdown: April 0.9, May 1.4, June 0.6.

Prices of agricultural products recorded smaller growth (3.0%) than seasonally expected, which may be put down to favourable weather conditions. As mild winter resulted in a season-shift, there was no seasonally-induced growth in prices in the second quarter.

Year-on-year core inflation continued down and settled at 2.8% at end-Q2, which is below the lower bound of the target corridor for 2007 (4%). Following the decline over three consecutive quarters, core inflation rose by 0.9% in Q2 2007 (3.6% p.a.) as a result of surging oil prices in the world market, May hike in electricity prices, and nominal depreciation of the dinar. Disinflationary pressures resulting from the appreciation gap of the real exchange rate continued, though they weakened slightly on Q1 as the gap gradually began to close. In terms of monthly growth rates, core inflation recorded the strongest growth in June (0.5%), when prices of petroleum products went up significantly and effects of the May increase in electricity prices came fully to the fore.

Chart II.0.3

Contribution to retail price growth rate
(in percentage points)

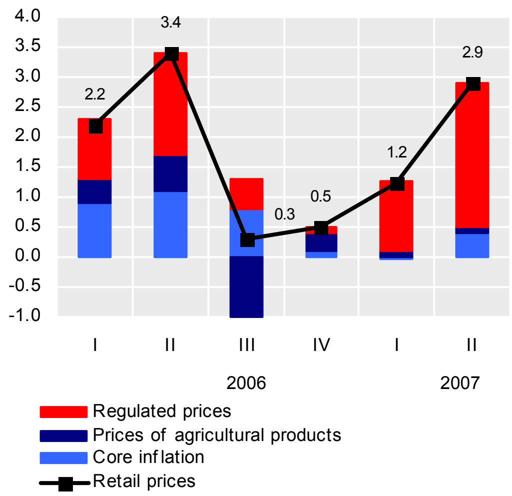


Table II.0.2

Retail price growth by component
(by quarter, in %)

	2006			2007	
	Q2	Q3	Q4	Q1	Q2
Retail prices	3.4	0.3	0.5	1.2	2.9
Core inflation	2.1	1.7	0.3	-0.1	0.9
Prices of agricultural products	16.9	-26.0	10.5	2.9	3.0
Regulated prices	3.8	1.2	0.1	2.6	5.1
Electricity	11.7	0.0	0.0	0.0	15.0
Petroleum products	3.5	-1.6	-8.2	-1.3	7.2
Utilities	0.4	0.6	1.4	7.7	0.7
Social welfare services	0.0	0.1	9.1	0.6	13.9
Transport services (regulated)	-0.6	6.1	1.0	0.0	0.7
Postal and telecommunications services	5.8	0.0	4.2	1.2	-0.1
Cigarettes	5.5	4.7	7.7	11.8	5.6
Medications	1.5	5.6	2.4	0.3	3.9
Other	2.3	3.0	0.8	2.3	0.0

Table II.0.3

Contribution to retail price growth rate
(by quarter, in percentage points)

	2006			2007	
	Q2	Q3	Q4	Q1	Q2
Retail prices	3.4	0.3	0.5	1.2	2.9
Core inflation	1.1	0.8	0.1	0.0	0.4
Prices of agricultural products	0.6	-1.0	0.3	0.1	0.1
Regulated prices	1.7	0.5	0.1	1.2	2.4
Electricity	0.8	0.0	0.0	0.0	1.1
Petroleum products	0.3	-0.2	-0.8	-0.1	0.6
Utilities	0.0	0.1	0.1	0.6	0.1
Social welfare services	0.0	0.0	0.1	0.0	0.2
Transport services (regulated)	0.0	0.2	0.0	0.0	0.0
Postal and telecommunications services	0.2	0.0	0.2	0.1	0.0
Cigarettes	0.2	0.2	0.3	0.4	0.2
Medications	0.0	0.1	0.1	0.0	0.1
Other	0.1	0.2	0.0	0.1	0.0

Inflation Outlook for Q3 2007

The estimates are that core inflation and prices of agricultural products will record higher growth rates in Q3 than in the preceding two quarters.

Table II.0.4

Major revisions of regulated prices expected in Q3 2007

	Growth rate (in %)	Contributions to retail price growth (p.p.)
Bread and flour	26,0	0.6
Social welfare services	8.0	0.2
Transport services	6.9	0.2
Electricity	10.0	0.2
Petroleum products	1.0	0.1
Milk	6.0	0.1
Medications	3.0	0.1

Adjustments in regulated prices are expected to continue in the period ahead. An increase in electricity prices is announced for September: by around 2% for households and 7% for industrial consumers (4.3% on average). The former will be included in the calculation of retail price index with 0.2 percentage points, while increase in the latter is relevant in terms of its cost effects on core inflation. It is expected that electricity prices will contribute 0.1-0.2 percentage points to core inflation, of which around 0.1 percentage points in Q3. Following an unexpected surge in early July, world oil prices gradually subsided by the end of that month. In Q3, they are expected to go up by 1% (0.1 p.p. contribution). Notwithstanding the 14.6% growth recorded in the first half of the year, the costs of social services are expected to rise by 10% in Q3 (0.2 p.p. contribution). In terms of other regulated prices, upward revision is expected for bread and flour (around 0.6 p.p. contribution), transport services (0.2 p.p. contribution), and milk and medicaments each contributing 0.1 p.p. to total price growth in Q3.

Several factors are expected to exert their influence on core inflation in the third quarter: 1) announced increase in prices, primarily of industrial foodstuffs (meat, meat and dairy products); 2) rise in electricity prices resulting in increased production costs; 3) appreciation gap of the real exchange rate that will continue to produce disinflationary pressures, and 4) nominal depreciation of the dinar inducing a rise in import prices. Altogether, quarterly core inflation rate is expected to settle between 1.6% and 2.2%, while year-on-year core inflation is projected to amount to somewhere between 2.8% and 3.4% by the end of Q3.

Due to adverse weather conditions, prices of agricultural products will rise in Q3 rather than fall as would be logical to expect in this period. They are expected to go up by 7-10% thereby contributing around 0.3-0.5 p.p. to retail price growth.

Based on the above, retail price growth is estimated at 2.4-2.8% in Q3, whereas year-on-year, it is expected to amount to around 7.3-7.6% at end-Q3.

Inflation Targeting Regimes

In the early 1990s, a large number of industrial countries (New Zealand, Canada, UK, etc.), later on followed by some transition countries (Czech Republic, Poland, Hungary), abandoned monetary policy regimes based on intermediate or multiple objectives to take up **inflation targeting** and leave all other objectives subordinate to stable inflation.

In literature, we may come across different and contradictory classifications of inflation targeting regimes. Most frequently, however, inflation **targeting regimes** are classified as **full-fledged or explicit and non-full-fledged being either implicit** or **partial**.

Experience of other countries has shown that successful implementation of inflation targeting as a monetary policy strategy is incompatible with fiscal dominance and requires coordination between fiscal and monetary authorities, developed financial system, instrument independence of the central bank, understanding of the effects of different monetary policy transmission mechanism channels, well-developed methodology and technical capacity for inflation forecasting, as well as monetary policy transparency to enable central bank accountability and credibility.

The above list of requirements needs to be complied with if full-fledged IT is to be pursued. In most cases, countries switch to such regime once majority of the above requirements are met, the key requirements, however, being formal announcement of all elements of the new framework and abandoning of the fixed exchange rate policy.

Chile and Israel targeted both inflation and exchange rate (crawling exchange *rate band*). The fact that they kept widening the exchange rate fluctuation band, however, made it clear after a while that they were actually giving priority to inflation targeting.

Despite the fact that announcement of the inflation objective was first made in 1990, full-fledged inflation targeting in Chile began in September 1999 when the fixed exchange rate policy was officially abandoned. Israel announced its inflation objective for the first time in 1991, but did not formally adopt full-fledged IT until June 1997 when the exchange rate fluctuation band was widened to such an extent that conflict between the achievement of objectives for inflation and the exchange rate became negligible.

Given that compliance with criteria and the manner of their interpretation depend above all on the idiosyncrasies of individual economies, and that most often, the criteria are not easily quantifiable or strictly adhered to, it is difficult to draw the line between countries pursuing full-fledged IT and those still going through its interim phases. It is even more difficult to draw this line in case of transition countries. The Czech Republic, for instance, has been known to pursue FFIT from the very start of inflation targeting (1997) although its financial system was underdeveloped at the time, monetary authorities uncertain about the strength and workings of some transmission channels, and most macroeconomic projections were short-term in character.

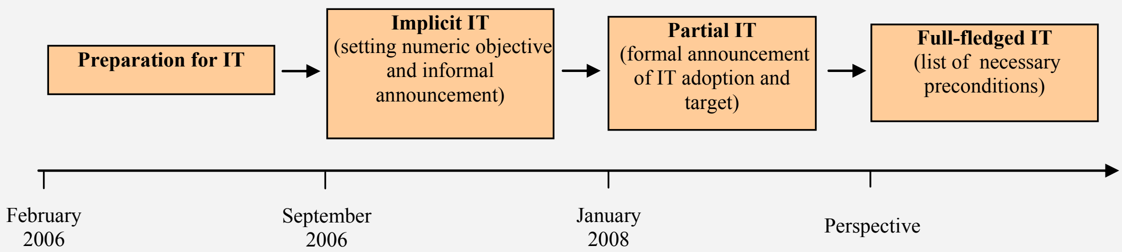
It is also difficult to make a distinction between non-full-fledged IT regimes - implicit and partial inflation targeting. **Implicit inflation targeting** can be defined as a regime under which a country sets its inflation objectives, but does not formally announce inflation targeting regime due to non-compliance with the majority of other requirements. For instance, we may say that Turkey was pursuing an implicit inflation targeting regime prior to 2006. In this period, Turkish monetary authorities set and announced inflation objectives to anchor inflation expectations and convince the public that the period of hyperinflation was over.

Formal announcement of the new monetary policy regime is considered to mark the beginning of transition towards full-fledged inflation targeting. Transition ends once most requirements for switching to full-fledged IT are met and fixed exchange rate policy abandoned or exchange rate fluctuation band significantly widened. There are no rules as to the duration of transition period – it may be very long (Chile, Israel), or very short (Brazil, Czech Republic, Poland, South African Republic).

Partial inflation targeting involves a formal announcement of switching to inflation targeting as a monetary strategy despite non-compliance with all requirements for full-fledged inflation targeting. Given that it does not pursue a flexible exchange rate policy, but a fixed one, Hungary may be classified as a partial inflation targeting country which for the time being has no plans of switching to full-fledged inflation targeting. Many other central banks, such as the National Bank of Poland, practiced partial inflation targeting before shifting to full-fledged inflation targeting regime.

An alternative classification frequently found in literature is that into: **full-fledged IT, eclectic IT and IT lite**. The first two regimes are practised by countries with high credibility, the difference, however, being in the fact that eclectic inflation targeters do not officially declare inflation targeting, as is the case with the European Central Bank. Inflation targeting lite is pursued by central banks with relatively low credibility for whom achieving low inflation is not the principal objective.

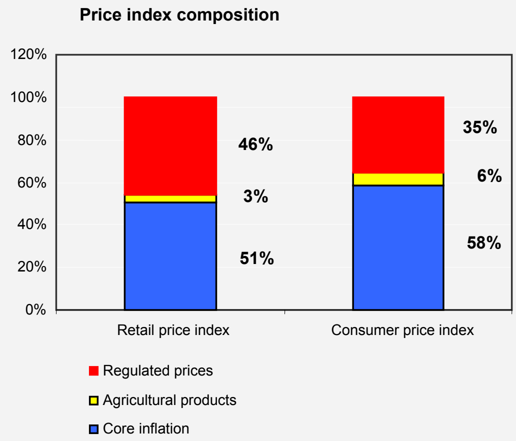
SERBIA



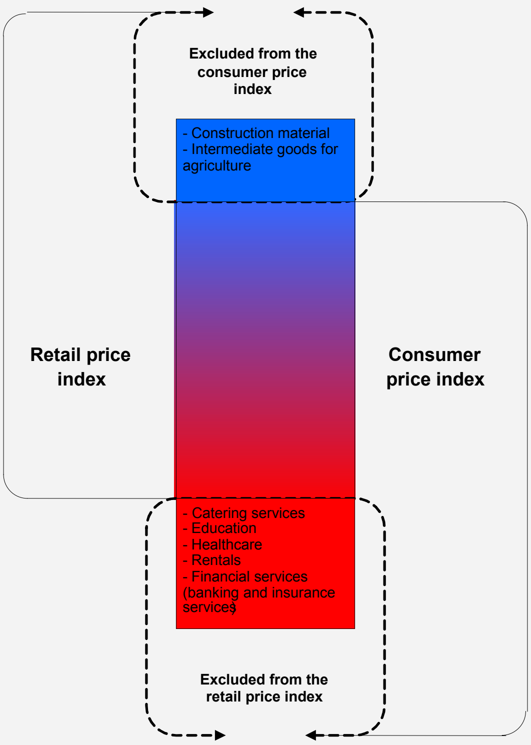
Serbia currently practices implicit IT, but is close to implementing partial IT which entails formal announcement of switching to inflation targeting as a monetary policy strategy.

Retail and Consumer Price Indices

Retail price index is the official measure of inflation in Serbia though it is the **consumer price index** that represents the main indicator of inflation in a large number of countries. The latter index is calculated by applying the methodology of the Harmonized Index of Consumer Prices in the European Union (HICP). The Serbian Bureau of Statistics first published the consumer price index in early 2007.



Methodological differences in calculation of the two indices are reflected in the scope of coverage of products whose prices are analyzed and their relative weights. The retail price index includes prices of construction material and intermediate materials which are excluded from the calculation of the consumer price index (2% of products included in the RPI are excluded from the CPI). The consumer price index, on the other hand, includes prices of a number of services which are not included in the retail price index, such as catering, healthcare, educational and financial services and rentals (7% of products and services included in the CPI are excluded from the RPI). The weights used in the calculation of the retail price index are derived from the structure of retail trade, while the weighting system of the consumer price index derives from the structure of household consumption harmonized with the structure of final household consumption taken from GDP.



A breakdown of prices covered by RPI and CPI into market-formed and regulated prices reveals significant differences between the two indices.

The share of regulated prices in the consumer price index is much smaller than in the retail price index and amounts to 35%. Namely, the share of almost all prices that are under some form of administrative control is lower and amounts to: 4.7% for petroleum products (instead of 9.5% in the RPI); 6.4% for electricity (instead of 7.2% in the RPI); 2.7% for utilities (instead of 8.4% in the RPI), 1.2% for transport services (instead of 3.4% in the RPI). Only the share of prices of medications and coal is higher in CPI relative to RPI. Another significant difference lies in the measure of weights assigned to prices of agricultural products. In the CPI, this group accounts for almost double its share in the retail price index (6.2%).

Hence, the share of core inflation measured in terms of CPI growth is larger (58%) than in terms of the retail price index.

Differences in weighting structure are reflected in a different level of individual product group contribution to the overall price growth, which explains the differences in the level of these indices calculated for the same period.

In Q1 2007, prices went up by 0.7% in terms of CPI, while rising by 1.2% in terms of RPI. However, the smaller rise of CPI was not due to the effect of prices of services covered by the consumer price index (and excluded from the retail price index), but to smaller weights attributed to regulated prices. Namely, prices of utilities, which were the largest contributor to retail price growth, had a substantially lower weight in the CPI and led to lower price growth measured by the CPI in the period under review.

Q2 2007 rise in consumer relative to retail prices was much the same, 3.0% and 2.9%, respectively. It is interesting to note that Q2 core inflation calculated in terms of consumer relative to retail price growth showed similar results (0.8% and 0.9%) as the main differences in contributions to the overall growth came from regulated prices and prices of agricultural products.

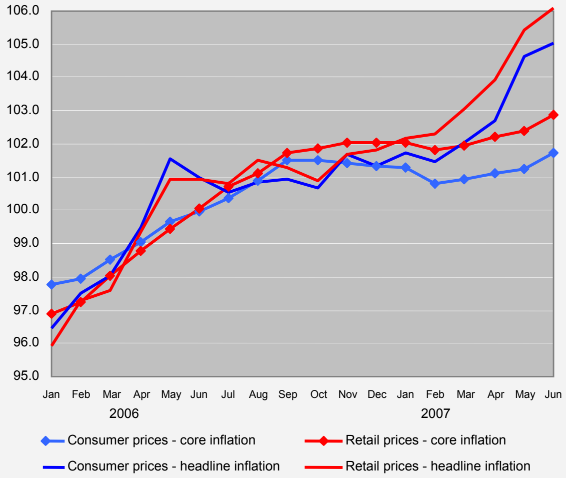
Contributions to price growth
(in % points)

	Jan	Feb	Mar	Apr	May	Jun
Retail prices (monthly growth rate, in %)	**0.4**	**0.1**	**0.7**	**0.9**	**1.4**	**0.6**
Core inflation	0.0	-0.1	0.1	0.1	0.1	0.2
Agricultural products	0.1	0.0	0.0	0.2	0.2	-0.3
Regulated prices	0.3	0.2	0.6	0.5	1.1	0.7
Consumer prices (monthly growth rate, in %)	**0.4**	**-0.3**	**0.6**	**0.7**	**1.9**	**0.4**
Core inflation	0.0	-0.3	0.1	0.1	0.1	0.3
Agricultural products	0.0	0.0	0.1	0.3	0.9	-0.4
Regulated prices	0.4	0.0	0.4	0.2	0.9	0.5

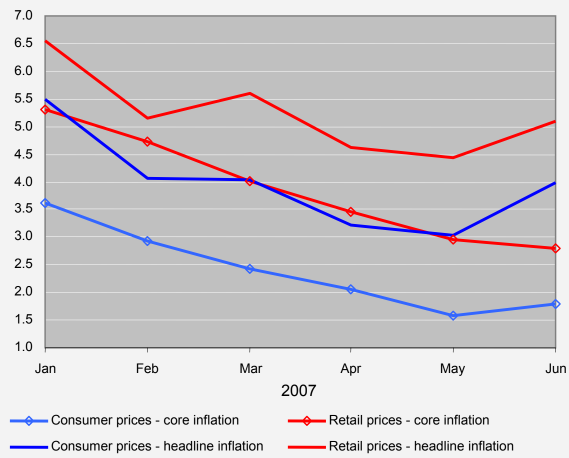
Analysis of price levels and year-on-year growth rates of both headline and core inflation reveals that both retail prices and core inflation are higher if calculated in terms of the retail price index by between 1 and 1.5 p.p.[1]

Historical data on the consumer price index since January 2006 show similarity in movements and the level of volatility of the CPI and RPI in the period observed.

Movements in core indices
(2006 =100)



Movements in year-on-year price indices in 2007
(growth rates in %)



As the consumer price index is a universally recognized measure of inflation calculated by applying a uniform methodology, its application will allow for a higher-quality comparative analysis of movements in Serbia relative to the rest of the world.

Plans have been made to adopt CPI as the official measure of inflation in our country and the similarity in movements of the two indices will certainly facilitate the transition to the new methodology.

[1] Year-on-year price growth as measured by the RPI amounted to 4.4% and 5.1% in May and June, respectively, while year-on-year price growth in the same months as measured by the CPI came to 3.0% and 4.0%, respectively.

III. Determinants of Inflation

1. Monetary Conditions

Though eased from the quarter earlier, monetary policy implemented in Q2 2007 remained tight. Anticipating a decline in year-on-year inflation, the MPC decided to cut the key policy rate twice, by a total of 100 basis points. This led to nominal depreciation of the dinar and closing of the real exchange rate appreciation gap.

As movements in the real repo rate and the level of the real exchange rate gap[2] indicate, monetary policy remained tight in Q2 2007. The restrictive trend goes back to the second half of the prior year, when the key policy rate rose well above the trend and the appreciation gap of the real exchange rate opened as a result of strong nominal appreciation of the dinar on the back of high inflow of foreign capital.

Chart III.0.1
Real interest rate on repo operations and its trend

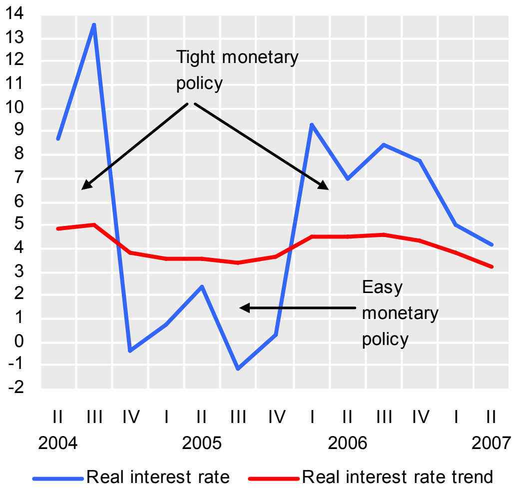
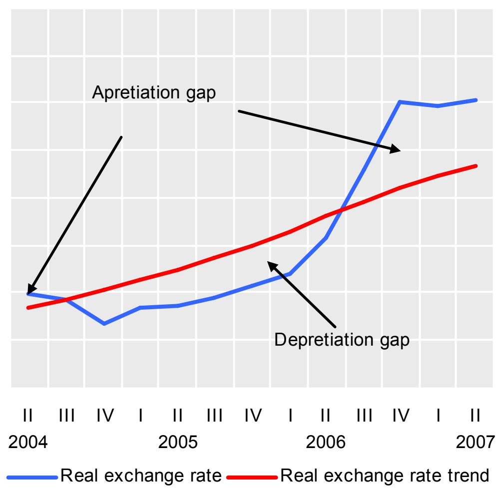


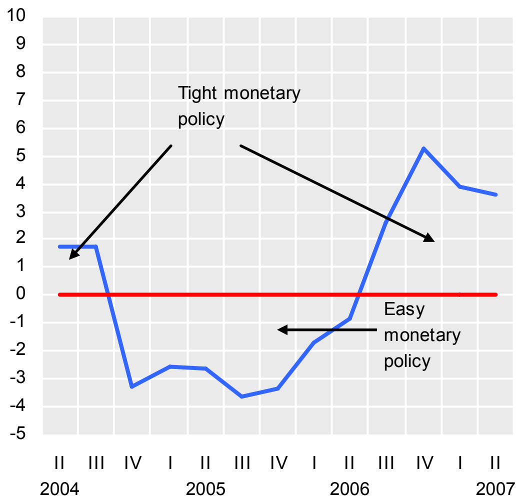
Chart III.0.2
Real exchange rate and its trend



Though convergence of the real key policy rate and the real exchange rate towards the trend level continued from Q1 into Q2, both rates kept running above the trend in Q2 as in Q1. Such movements point to easing of monetary conditions as year-on-year core inflation declined below the lower bound of the target corridor (4%).

In Q2, the MPC decided to cut the key policy rate by a total of 100 basis points, which led to nominal depreciation of the dinar and moderation of the real exchange rate appreciation gap. The monetary conditions index, as an indicator of the combined effect of the real key policy rate and the real exchange rate on price stability and/or aggregate demand, also points to relaxation of monetary

Chart III.0.3
Monetary Conditions Index (MCI)



[2] See text box: *Real Exchange Rate – Trend and Gap,* page. 15.

conditions and easing of the monetary grip in Q2 2007[3].

Average real key policy rate equalled 4.2% in Q2, and was approximately 100 basis points above the trend level. As core inflation expectations of the financial sector equalled 6.2% p.a. according to the latest Gallup Survey, the current key policy rate may be assessed as close to its neutral level.

Relaxation of fiscal policy announced for the second half of 2007, stepped up lending activity of banks as well as other factors that are likely to bring about a rise in inflation pressures will lead to increased monetary policy restrictiveness. In view of the above, a number of measures were enacted in August to limit further expansion in lending to households, particularly in terms of general purpose cash loans.[4]

Price of Stability Equals Sterilization Costs

Macroeconomic flows in countries in transition, especially those that have already adopted or are making preparations to adopt inflation targeting, are very similar. There are also great similarities among the measures taken by central banks of such countries aimed at achieving their primary objective – stability in prices.

Analysis of central bank financial records reveals that they are most often negative, primarily due to sterilization costs and the effect of changes in the exchange rate.

The effects of such costs are particularly pronounced in case of high inflow of foreign capital as it generates appreciation pressures. To prevent high real appreciation and to offset the effects produced by appreciation pressures, central banks engage in purchase of foreign exchange. If they persist in such efforts, no cost effects in respect of exchange rate differentials will materialize. However, such activity builds up costs relating to sterilization as purchase of foreign exchange results in creation of liquidity in the national currency.

If the central bank decides to allow the effects of appreciation pressures to be felt in full or in part, costs of sterilization will be contained, but the exchange rate losses would increase.

In any case, if the objective is to achieve price stability, costs build-up is inevitable, and their level generally depends on the volume of capital inflow from abroad.

Technically speaking, costs of achieving price stability seem to vary depending on the monetary policy measures applied. Essentially, however, long-term sustainability of stability in prices presupposes implementation of adequate (primarily market-based) instruments of monetary policy. It is for this reason that central banks generally choose to adopt open market operations as their main monetary policy instrument. This instrument has a significant effect on macroeconomic stability as it influences investment and savings decisions of all economic agents. On the other hand, it is only the banking sector that responds to changes in the reserve requirement ratio, as the effect of this measure is felt only in terms of limiting credit supply.

In view of the above, it can be concluded that, in the context of high capital inflow, central banks of all countries in transition are faced with increased costs of monetary policy implementation. These costs in fact represent the price to be paid in order to achieve the principal objective of monetary policy, i.e. price stability, in such conditions. All central banks committed to meeting this objective have inevitably sustained high costs.

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[3] The following equation was used for constructing the monetary conditions index: $MCI_t = w_r(r_t - r_{trend}) + w_z(z_t - z_{trend})$, where r_t is the real key policy rate and z_t real exchange rate. Weights for the real key policy rate and the real exchange rate are as follows: $w_r = 0{,}2$, $w_z = 0{,}8$.

[4] Starting from 27 August 2007, repayment period for cash loans will be limited to 24 months. As of 31 December 2007 banks will be required to keep the ratio of end-month gross foreign currency lending to core capital at or below 150% of the value of core capital, instead of 200% as was previously the case. The NBS also enacted a range of, primarily prudential, measures that will have an indirect effect on lending activity. In order to lower the foreign exchange exposure of banks and strengthen the role of foreign exchange risk management, the limit on net open foreign currency position was lowered from 30% down to 20%. Prudential measures relating to risk weights applied in calculating risk-weighted assets and off-balance sheet items were also enacted.

In our case, the reserve requirement ratio proved to be a relatively inefficient instrument of monetary regulation. This is best illustrated by the year 2004/05 when reserve requirement ratio was the main instrument of monetary policy regulation in the context of high inflow of foreign capital and inflation ranging from 10% to 20%. Therefore, in order to create stable economic conditions conducive to long-term sustainable economic growth and development, the National Bank of Serbia has committed to using the repo rate as its main instrument of monetary regulation. Bearing the above in mind, it is assessed that the currently high level of liabilities of the National Bank of Serbia relating to sterilization costs is more than offset by the benefits enjoyed by economic players from the maintenance of low and stable inflation.

Financial results of central banks, movements in the key policy rate and exchange rate

Year	Financial result in EUR mln	Key policy rate	Rate of nominal appreciation (+) depreciation (-) (p.a., in %)	Rate of real appreciation (+) depreciation (-) (p.a., in %)	Financial result in EUR mln	Key policy rate	Rate of nominal appreciation (+) depreciation (-) (p.a., in %)	Rate of real appreciation (+) depreciation (-) (p.a., in %)
	HUNGARY				**ROMANIA**			
1999	138.6	14.50	-4.85	2.24	63.58	35.00	-39.14	-14.23
2000	54.66	11.00	-5.39	0.92	46.35	35.00	-20.57	12.30
2001	14.79	9.75	1.22	7.44	-149.28	35.00	-21.99	1.53
2002	-20.72	8.50	7.06	10.68	-302.89	29.02	-15.42	0.78
2003	664.13	12.50	-0.14	2.24	-235.32	18.84	-13.90	-3.17
2004	-173.9	9.50	2.32	6.90	-515.1	20.27	-6.21	2.60
2005	-84.76	6.00	0.82	2.03	-832.72	9.59	10.78	18.00
	CZECH REPUBLIC				**SLOVAKIA**			
1999	896.15	5.25	-1.27	-1.80	1,001.04	8.80	-9.75	-2.64
2000	71.93	5.25	0.52	1.54	166.97	8.80	0.98	9.70
2001	-879.55	4.50	4.33	6.38	54.40	7.75	-2.30	2.18
2002	-299.62	2.75	11.68	11.57	-595.27	6.50	1.43	2.81
2003	-560.81	2.00	0.21	-1.62	-763.69	6.00	6.30	13.34
2004	-1,763.24	2.50	1.02	1.33	-935.37	4.00	4.63	9.62
2005	688.06	2.00	6.23	5.82	-17.52	3.00	2.56	2.98

Real Exchange Rate, Trend and Gap

The **real exchange rate** is a measure of domestic relative to foreign prices of goods and services, expressed in the same currency. Foreign prices in dinar terms reflect movements in both foreign prices in local currency and the dinar exchange rate against that currency. To illustrate, the real exchange rate applied in trade between Serbia and the EU member countries reflects the ratio between the level of prices in Serbia and prices in the EU expressed in dinar terms:

real exchange rate = prices in Serbia / (prices in EU · RSD/EUR exchange rate)

As price levels are seldom comparable due to differences in the structure and quality of goods and services across different countries, the real exchange rate is most frequently analyzed through its changes, as the difference between domestic and foreign (dinar) inflation:

change in r.e.r. = infl. in Serbia – (infl. in EU + change in RSD/EUR exchange rate)

Real appreciation (depreciation) of the exchange rate means that prices in Serbia grow at a faster (slower) pace than EU prices expressed in dinars (infl. in EU + change in RSD/EUR exchange rate). For instance, high real appreciation in the second half of the preceding year resulted from strong nominal appreciation of the dinar in that period[1], i.e. a decline in EU prices expressed in dinars that was not followed by a corresponding decline in domestic prices.

What is it that affects movements in the real exchange rate? Numerous studies have shown that the long-term **real exchange rate trend** is determined primarily by the level of economic development of the respective countries and/or the differences in productivity of their respective economies, while deviations from the trend, i.e. the **real exchange rate gap,** are determined by comparably shorter-term factors, such as, inter alia, the monetary policy stance.

It is generally recognized that price levels are higher in developed countries. As high productivity growth is typical of countries in transition, the real appreciation rates are inevitably high as well, i.e. there is a clear **appreciation trend** during the transition process[2]**.** Comparative analysis has shown that in the 1996-2006 period countries in transition (with the exception of Croatia) recorded high rates of real appreciation ranging from 3.4 to 5.5%.

Real appreciation in transition economies

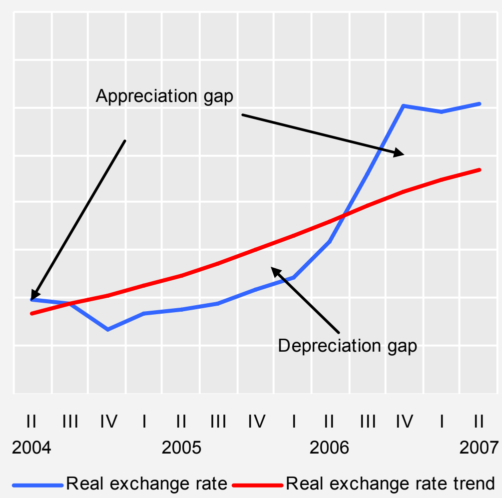
Country	*Average annual real appreciation 1996-2006 (in %)*
Bulgaria	4.9
Czech Republic	4.0
Croatia	0.5
Hungary	3.9
Poland	3.4
Romania	5.5
Slovakia	4.7
Average	**3.8**

This analysis is interesting because it also shows that the real appreciation is inevitable in transition countries over the longer run regardless of the monetary policy stance pursued by a given country (countries included in the sample had different sets of monetary policy priorities). As Serbia has been undergoing transition for several years now, historical data of high real appreciation of the dinar do not come as a surprise and this long-term trend is expected to continue regardless of the country's future monetary policy stance.

[1] Foreign exchange rate of the dinar against the euro moved at around RSD/EUR 87 in June and around RSD/EUR 80 late in the year.
[2] Balassa-Samuelson effect.

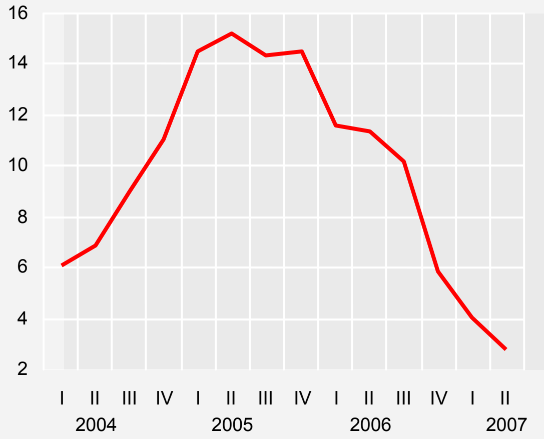
Appreciation gap results from higher than expected domestic prices relative to their long-term trend. If domestic prices are lower than expected, **depreciation gap** will occur**.** If, for instance, a restrictive monetary policy leads to nominal appreciation of the dinar, i.e. decline in foreign prices expressed in dinars, this will not automatically lead to a corresponding decline in domestic prices, which will result in an appreciation gap, i.e. a period during which domestic prices will be higher than expected relative to their long-term trend. In a competitive environment, however, movements in domestic prices will gradually gravitate towards their long-term trend, at least over the longer run, by increasing at a lower rate relative to foreign prices expressed in dinars (adjusted for the trend). Hence, **the appreciation gap always has a disinflationary effect.**

Real exchange rate and its trend



To illustrate, high real appreciation carried over from the second half of 2006 resulted in the creation of an appreciation gap which continues to date to exert disinflationary effect and, prevents faster growth in core inflation which would otherwise have been prompted by high growth in wages, prices of energy and agricultural products, etc. Charts on to the right of this page show an increase in core inflation when there is a depreciation gap, and vice versa.

Core inflation
(y-o-y growth, in %)



Movements in the real exchange rate are relevant for their impact on foreign trade flows as well. Real appreciation stimulates imports and discourages exports, and vice versa. As monetary policy influences movements in the real exchange rate only temporarily, its impact on the foreign trade flows is also limited and short-lived. When appreciation of the real exchange rate is inevitable over a longer run, insistence of the monetary policy on stable real exchange rate or even its depreciation, e.g. in order to stimulate exports, would entail high rates of nominal depreciation of the dinar. This would, over the short run, produce tangible effects on the real exchange rate, but would at the same time trigger a rise in prices which would, sooner or later, completely offset the effects of nominal depreciation. Eventually, this would result in disrupted macroeconomic stability and the need to adjust the real exchange rate to its equilibrium level. Bringing inflation back to its earlier level would, thereafter, involve opening of the appreciation gap.

Change in the Manner of Announcing and Applying the Decision on the Level of the Key Policy Rate

With a view to efficient implementation of monetary policy, the National Bank of Serbia changed the manner of announcing and applying its decisions on the level of the key policy rate. As of 1 June 2007, these decisions are no longer published in the "RS Official Gazette", but on the website of the National Bank of Serbia, on the day they are taken by the Monetary Policy Committee. This will eliminate the time gap between taking and applying a decision on the level of the key policy rate by the NBS, leaving banks and other participants in the financial market no room for arbitrage.

According to the earlier practice applied since September 2006 when the new monetary policy framework was first introduced, the decision on the level of the key policy rate would become applicable after its publication in the "RS Official Gazette". Such arrangement, however, precluded the National Bank of Serbia from responding to market developments in a timely manner by changing the key policy rate. The practice of the Hungarian Central Bank over the last decade provides a good illustration of this principle. In order to respond properly to adverse developments in the foreign exchange market and efficiently implement its monetary policy, it would change the level of its policy rate several times in the course of one day only.

Future implementation of monetary policy may call for a change in the type of auctions (for instance, a switch from the currently used fixed rate auctions to variable rate auctions) in which case it would be impossible to announce an event ex-post. Furthermore, it would be inconsistent if the NBS were to announce the price (interest rate) to be applied in fixed-rate auctions and not to announce the volume in fixed-volume auctions for which the price is not set in advance, the latter being the second type of auctions regularly conducted by the National Bank of Serbia.

It is not in the spirit of best international practice to have the application of the key policy rate pending on its publication in the official herald. In the American Federal Reserves, European Central Bank and other European national central banks, decisions on the level of the policy rate are not regarded as new regulations and their effectiveness is not conditional upon mandatory publication in the official herald. Decisions are, of course, official acts which may be appealed against, but that is quite another matter. Comparative analysis of central bank practice shows that banks resort either to:

1) mandatory publishing of the level of the policy rate in the official central bank herald (ECB, Czech Republic, Poland, or

2) providing information on the level of the policy rate by issuing central bank communications (Slovenia, Romania, Croatia, Hungary).

Such practice stems from the fact that the policy rate is not binding. It, however, represents the central bank's bid rate in open market operations and has a signalling role.

Change in the manner of publishing and application of decision on the level of the key policy rate of the National Bank of Serbia merely represents harmonization with the prevailing central bank practice. Such adjustment will contribute to a more efficient conduct of open market operations and interest rate policy, as well as to the achievement of the principal monetary policy objective – to attain and preserve price stability.

Interest Rates

Cuts in the key policy rate led to a further decline in money market interest rates. Lowering of commercial bank lending and deposit rates also continued.

In the course of Q2, the MPC revised the key policy rate downward on two occasions: from 10.50% to 10% in May, and further down to 9.50% in June.

At the same time, the weighted average interest rate on securities sold by the NBS in repo operations declined. On the last day of June, per annum repo rate stood at 9.50%, down by 190 basis points from end-Q1.

Repo transactions accounted for sterilization of RSD 752.1 billion, which is RSD 135 billion less than in Q1. At the same time, net stock of sold securities declined by RSD 15.9 billion, with two-week securities accounting for 73.1% and six-month securities for 26.9% of the total.

Decline in net stock of sold securities is for its major part attributable to robust demand for dinars amid sale of AIK bank shares, as well as to cuts in the key policy rate.

Interest rate corridor of the National Bank of Serbia (interest rates on **Lombard loans and deposit facility**) remained unchanged. As there were no major liquidity problems, the use of Lombard loans was insignificant.

Chart III.1.1

Weighted average repo rate

nominal and real, deflated by annual price growth
(in percent per annum)

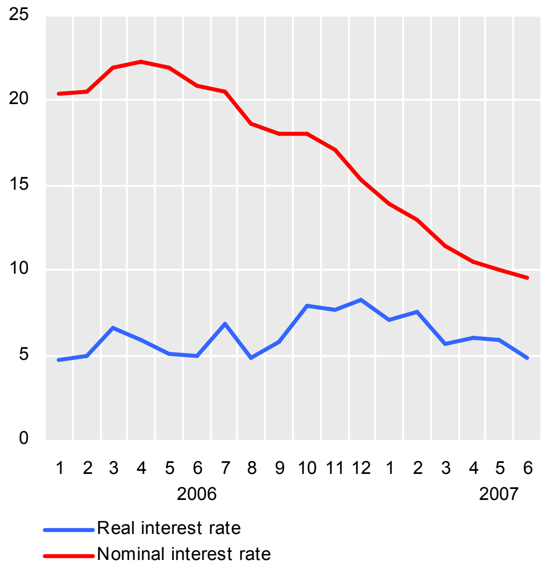
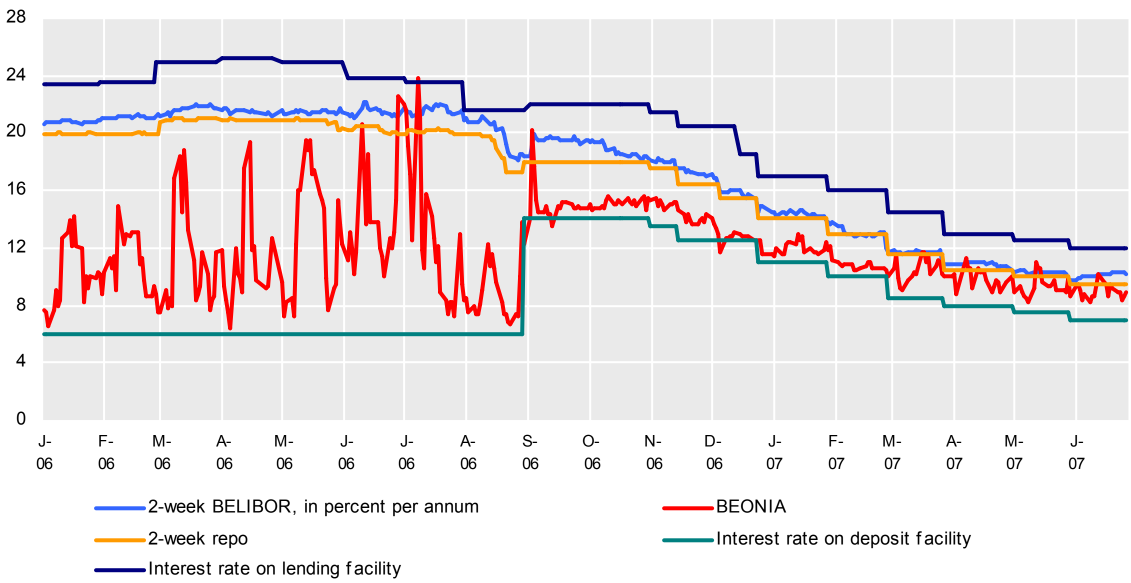


Chart III.1.2

Interest rate movements

(daily data, annual level, in %)



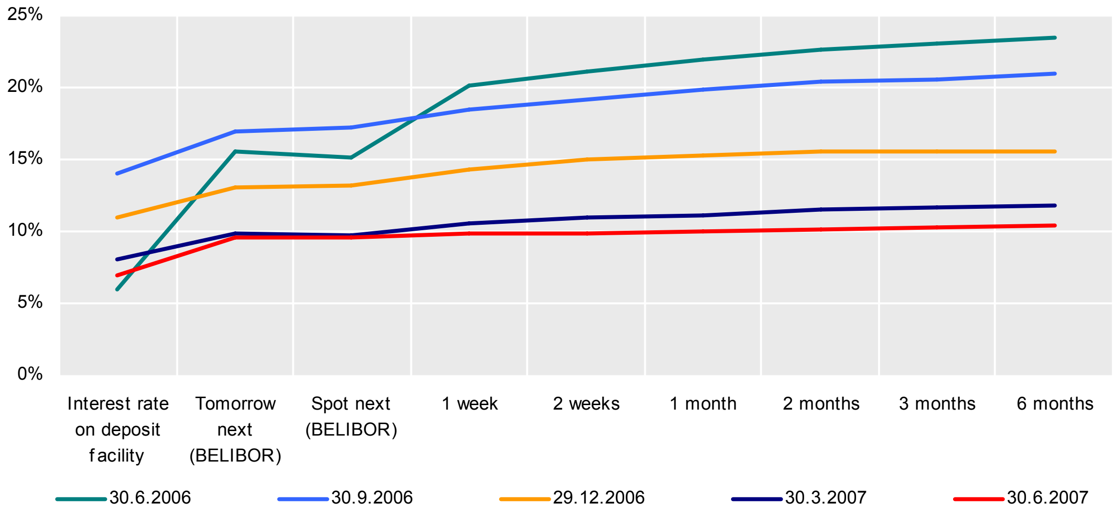
Source: National Bank of Serbia and Reuters.

Interest rates in the money market went down as a result of NBS key policy rate cuts. **Beonia** averaged 8.97% in June (down by 148 basis points from March 2007) and showed no major deviations from the level of the key policy rate. Despite decline in interest rates, average daily volume of deposits came to RSD 2,059 million, up by RSD 511 million on March 2007.

Tomorrow Next and Spot Next, i.e. **Belibor** money market interest rates, also followed changes of the key policy rate and averaged 9.52% and 9.58%, respectively. Average Belibor rates ranged from 9.76% for one-week maturity to 10.28% for six-month maturity.

In line with the downward inflation trends, **money market yield curve** went below its prior quarter level. The yield curve slope declined with the increase of maturity, which is reflective of expectations of further interest rate cuts.

Chart III.1.3
Interbank money market yield curve
(annual data)



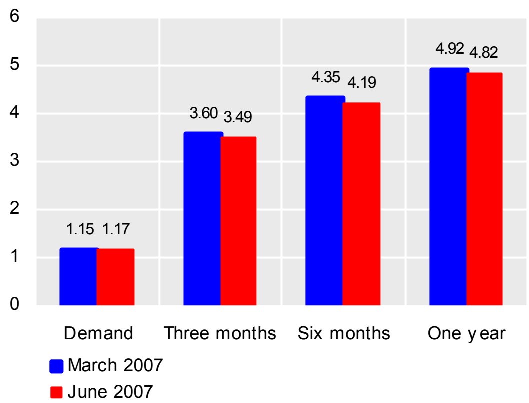
Source: National Bank of Serbia and Reuters.

Weighted average interest rate on **total dinar deposits**[5] trended down in the course of Q1. In June, it came to 0.29% per month or 3.59% per annum. Relative to end-Q1, interest rates on total dinar deposits slid by 110 basis points at annual level.

Analysis of data for eight leading banks in terms of volume of foreign currency savings deposits indicates that there was an increase in June in the weighted average interest rates on demand savings deposits, while interest rates on time deposits with three, six and twelve month maturity, declined.

Commercial bank lending rates[6] fluctuated in the course of Q2 and in June came to 0.96% per month or 12.33% per annum. Compared to end-Q1, lending rates fell by 62 basis points at annual level.

Chart III.1.4
Weighted average interest rate on foreign currency savings deposits*
(in percent per annum)



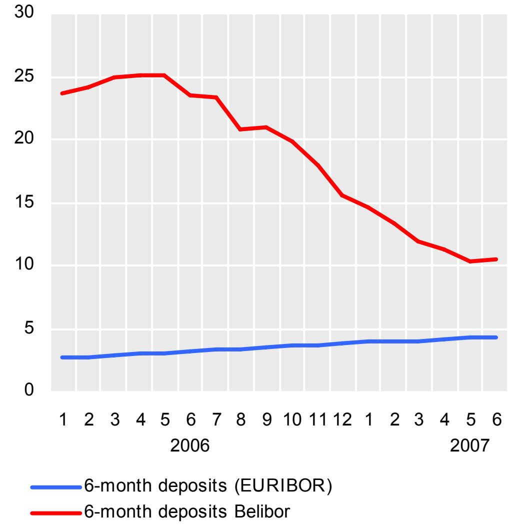
*Analysis captured eight commercial banks with the highest volume of foreign currency savings deposits.

[5] The monetary statistics methodology applied envisages monitoring of interest rates on dinar deposits only.
[6] Monetary statistics methodology does not show loans with foreign currency clause separately but includes them under dinar loans. Hence interest rates on dinar loans are calculated as weighted average of agreed interest rates irrespective of the foreign currency clause.

Chart III.1.5

Interest rate movements in the EU and Serbian money markets

(in percent per annum)

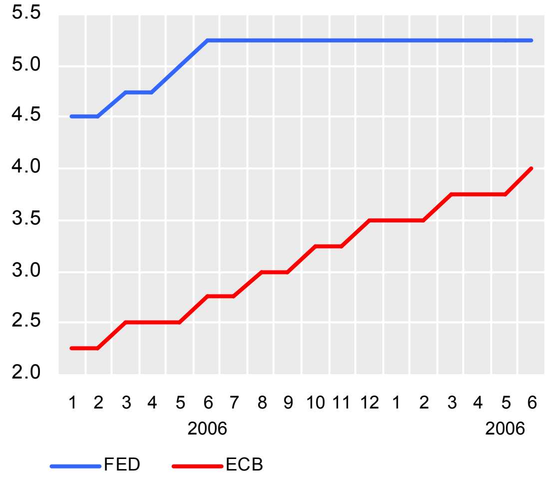


Source: Reuters and ECB, *Monthly Bulletin*.

Chart III.1.6

ECB and FED interest rates

(in percent per annum)



Source: ECB, *Monthly Bulletin* and *Federal Reserve Bulletin*.

Due to stronger decrease of deposit relative to lending rates, interest rate margin rose by 48 basis points on March 2007 and reached 8.74% in June. It is expected that interest rate margin will decline in the coming period due to increased competition among banks. However, one of the factors that could induce an increase in lending rates is a relatively slow restructuring of the economy and the resulting limitations on direct access of economic entities to foreign sources of finance.

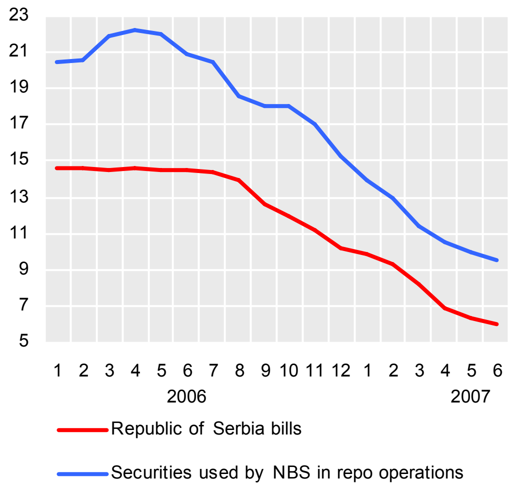
The difference between interest rates in Serbia and those prevailing in the financial markets of the European Union and the USA continued to narrow down in Q2 primarily on account of both falling interest rates in Serbia and interest rate hikes in the EU[7]. Albeit narrowed, interest rate differential continues high, which is the main reason behind the inflow of capital.

In the course of Q2, the Ministry of Finance held five auctions to sell 91-day maturity **government bills.** The overall volume of trade in government bills was modest and amounted to a mere RSD 4.4 billion as a result of the relatively uncompetitive interest rate paid on government bills (6.02% in June) compared to the NBS rates on repo transactions (9.50% in June).

Chart III.1.7

Weighted average interest rates on securities

(in percent per annum)



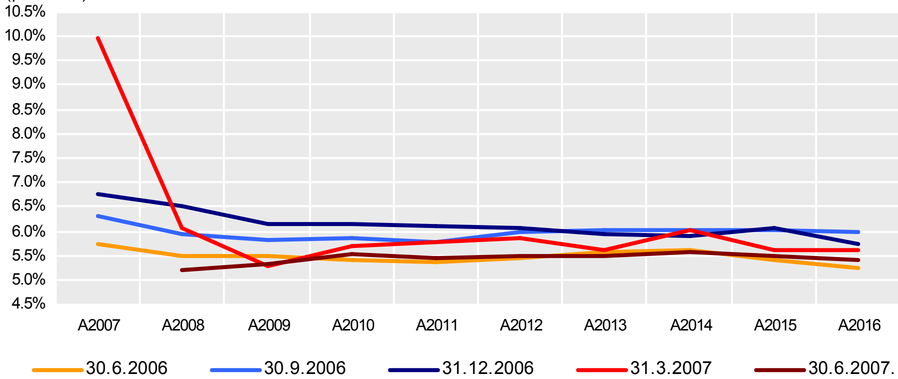
Source: NBS and RS Ministry of Finance.

[7] The European Central Bank raised its policy rate in June to 4.0%, i.e. by 25 basis points, for the second time in 2007. Inflation and economic growth enabled the FED to take a decision in August 2006 to discontinue further growth in its policy rate and keep it at the level of 5.25%, where it also stood in June 2007.

Chart III.1.8

Yield on government bills and frozen foreign currency savings bonds

(per annum)



Source: Belgrade Stock Exchange.

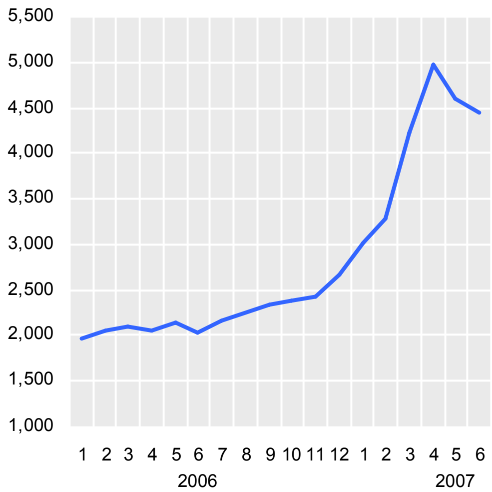
Having increased by EUR 28.1 million from end-March, the volume of trade in government bonds in the Belgrade Stock Exchange reached EUR 44 million in June. Bonds of all series, except A2009 series bonds, recorded a decrease in their annual yield rates. In June, the yield rate on government bonds ranged from 5.19% to 5.55%.

In June 2007, the overall volume of **trade in shares on the Belgrade Stock Exchange** came to RSD 9.3 billion. The RSD 9 billion fall from end-Q1 may be put down to the effects of seasonal factors as investment units in nearly all world stock exchange markets tend to decline in early May and continue down throughout June. In terms of volumes, trade in commercial bank shares remains on top.

Belexline index trended down in Q2. On the last day of June, it reached 4,456.21 index points, down by 235.79 index points from end-Q1.

Chart III.1.9

BELEXline index



Source: Belgrade Stock Exchange.

Dinar Exchange Rate Movements

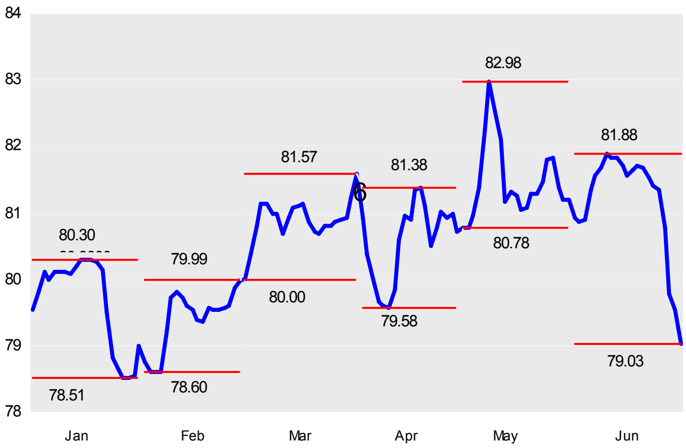
Depreciation of the dinar against the euro, begun late last year, continued into Q2 2007 (1.3%). Save for brief periods of turbulence due to uncertainties with respect to formation of new government in May and capital increase of AIK Bank in June, movements in the foreign exchange market were stable.

Weakening of the dinar against the euro continued in Q2. The dinar lost 1.3% vis-à-vis the euro in nominal terms, while its average exchange rate stood at around 81.1 RSD/EUR. Depreciation of the dinar came as a result of cuts in the key policy rate and increased bank demand for foreign exchange. The main drivers behind high demand for foreign exchange in the IFEM were lower borrowing abroad by banks and intensified demand for foreign exchange by bank clients to settle foreign obligations as they come due. Depreciation pressures also stemmed from political uncertainties surrounding formation of the new government.

Chart III.1.10

Movements in the RSD/EUR exchange rate in 2007

RSD/EUR



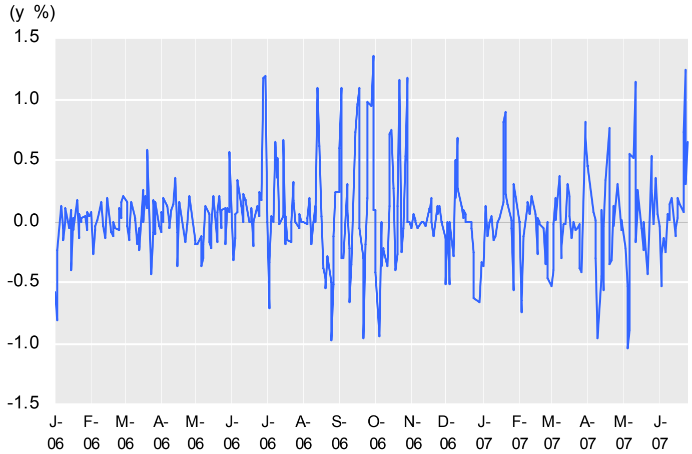
As the ECB raised its policy rate and the FED decided to keep its rate unchanged, the dollar weakened against the euro and induced a 1.5% appreciation of the average RSD/USD exchange rate.

Exchange rate of the dinar against the euro moved within a relatively broad range in Q2 (from 79.0254 to 82.9810 RSD/EUR), although daily fluctuations subsided from the quarter before. The lowest value of the dinar in May came as a consequence of political uncertainties, while the highest rate at end-June was occasioned by robust demand for dinars prompted by capital increase of AIK Bank.

Chart III.1.11

Daily changes in RSD/EUR exchange rate[1)]

(y %)



[1)] Negative rates indicate depreciation and positive rates appreciation of the dinar.

As opposed to Q1, in Q2 the dinar appreciated in nominal terms against the euro by 3.2%. On the last day of June, the exchange rate for the dinar was close to its end-2006[8] level.

At end-Q2, the dinar appreciated in nominal terms against the dollar (4.0%), too.

As dinar strengthened against both currencies constituting the "currency basket", the nominal effective exchange rate index appreciated by 3.4% (end-period).

The real effective exchange rate gained 5.4% by end-Q2 as a result of appreciation of the nominal effective exchange rate and faster growth in domestic compared to foreign prices. In terms of individual currencies, the dinar strengthened in real terms against both the euro and the dollar by approximately the same amount (5.3% and 5.5%, respectively).

[8] On the last day of 2006, the dinar exchange rate stood at 79.0000 RSD/EUR, and on 30 June at 79.0254 RSD/EUR.

In view of the new methodology for setting the official middle exchange rate of the dinar against the euro, in use from 5 March this year, and the fact that the volume of direct interbank trading in the IFEM amounted to nearly EUR 5 billion (which makes up 98% of total IFEM trading), while the NBS participated with mere EUR 94.4 million, it would be right to say that the RSD/EUR exchange rate was fully market determined in Q2.

With the aim to ensure further liberalization of the foreign exchange market, the NBS prescribed new operating terms and procedures to be applied on the foreign exchange market as of 4 June. Pursuant to the new operating terms, IFEM sessions will not be organized on a daily but on as-needed-basis, i.e. when the NBS assesses that its participation is necessary to stabilize the forex market. Since the introduction of the new framework, the NBS organized one IFEM session only in which no trading was recorded. The new regulation also envisages some changes in the manner of NBS participation in the IFEM. The NBS is involved in daily trading in the IFEM through sale of foreign exchange purchased from licensed exchange dealers at the most favourable exchange quote. However, taking into account the new method of setting the official middle RSD/EUR exchange rate, as well as the fact that since the introduction of the new framework, the NBS has been selling in the IFEM around EUR 1 million a day (a total of EUR 19 million between 4 and 30 June), and that the average daily volume of direct interbank trading in the same period came to EUR 88.1 million, it is clear that the NBS leverage on the exchange rate formation in June was negligible.

Q2 data on the EMBI index movements (risk premium indicator) point to a mild improvement in investor mood which went sour in the first three months this year. Improved attitude of investors towards Serbia is expected to produce certain appreciation pressures in the coming period, just as are the movements in the balance of payments. Namely, due to political unease prevailing in the first half of the year, some capital inflows from investment projects were delayed into the year's second half. Furthermore, seasonally induced appreciation pressures are also expected from factors such as inflow of remittances, increased spending by emigrants visiting home, revenue from tourism, etc.

Chart III.1.12

Nominal exchange rate of the dinar

(in dinars, end of period)

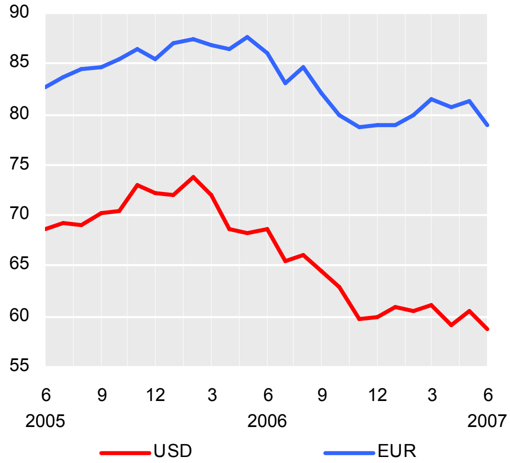


Table II.1.1

Composition of trade in the IFEM in 2007

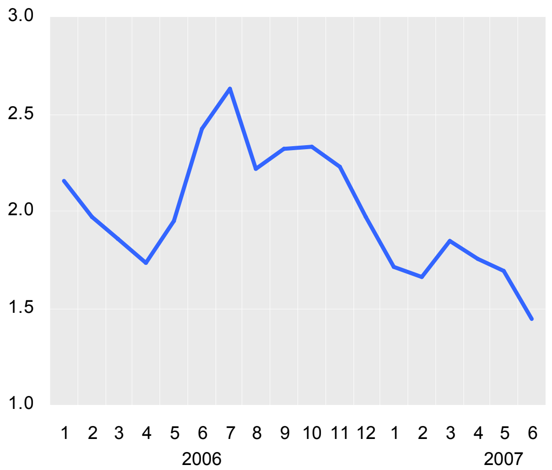
(total trade) EUR

	Q1	Q2	Total 2007
IFEM	**3,141,784,788**	**5,087,608,152**	**8,229,392,940**
NBS - Banks	481,250,000	94,400,000	575,650,000
Bank - bank	2,660,534,788	4,993,208,152	7,653,742,940
Composition of trade in the IFEM in 2007			(in % of total trade)
	Q1	**Q2**	**Total 2007**
IFEM	**100.00**	**100.00**	**100.00**
NBS - Banks	15.32	1.86	7.00
Bank - bank	84.68	98.14	93.00

Chart III.1.13

Risk premium indicator - EMBI

(in %)



2. Import Prices

Appreciation gap of the real exchange rate, opened in mid-2006 and now slowly closing, had a disinflationary effect due to which, as in the preceding quarter, core inflation was lower than imported inflation. Q2 2007 was marked by an increase in world oil prices and a rise in prices of all primary products.

In Q2, import prices picked up by 11.3% (annualized average) as a result of 5.6% nominal depreciation of the dinar against the euro and 5.5% inflation in the Euro zone. Growth in imported inflation was one of the factors that halted decline in core inflation from Q1. However, in this quarter again, core inflation growth rate (2.0% per annum average) was lower than imported inflation.

Although growth in import prices (expressed in dinars) outpaced increase in domestic prices in 2007, thereby inducing gradual closing of the real exchange rate appreciation gap, its disinflationary effects may still be felt.

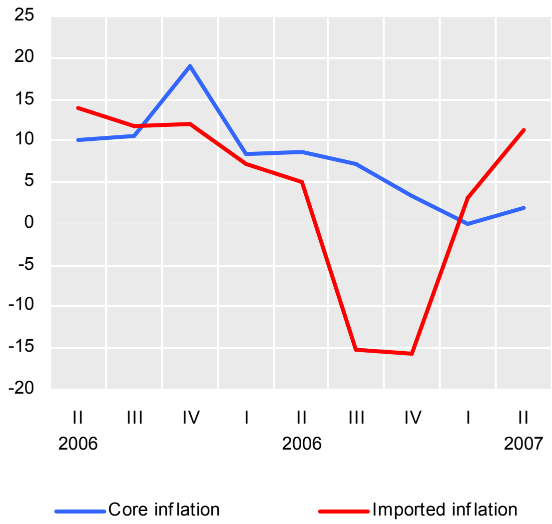
Growth in world oil prices, set in motion at the beginning of the year, continued unabated.[9] Note should be taken that the price of Ural oil remained quite stable throughout April (USD 62 to 65 per barrel). It first rose in the second half of May to USD 68 pb and was kept relatively high, throughout June (USD 66 to 69 pb). The record high of USD 69.52 pb was hit on 18 June. In early Q3, the price of Ural oil spiralled even higher and on 13 July struck an all-time high of USD 76.86 pb. By end-July, it gradually declined to around USD 73 pb.

There are several reasons behind such movements in oil prices. The most important were market concerns whether oil supply would meet demand at the peak of the summer driving season. At the same time, the OPEC cartel countries, which supply around 35% of the world's daily oil consumption, showed no intention of increasing their output. Instead, they tried to appease the market by reiterating that crude oil inventories were sufficient and that the price hike was caused by geopolitical factors and weaker performance of oil refineries. As confirmed by the Goldman Sachs analysis, this was only partly true. According to this American investment firm, oil prices will go up to as much as USD 95 per barrel by the end of the year unless the OPEC cartel countries increase their output.

Chart III.2.1

Core and imported inflation

(average annualized quarterly growth rates)

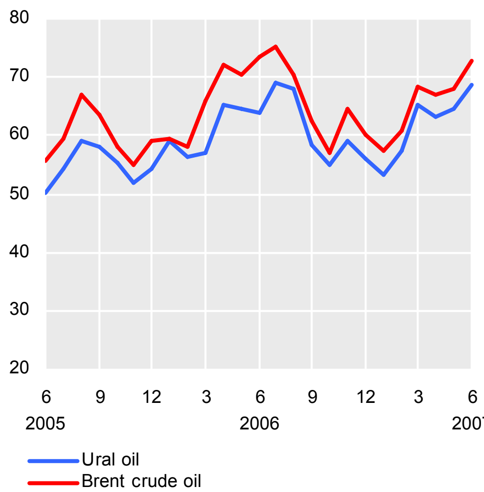


Sourse: NBS and Eurostat.

Chart III.2.2

Oil prices

(in US dollars)



Source: Reuters.

In addition to the abovementioned role of the OPEC countries and concerns over the sufficiency of oil inventories, there were also other equally important factors causing the price of Ural oil to rise to its record level and the price of Brent oil to exceed USD 78 pb and almost hit its historical high from August

[9] As a result, prices of oil derivatives were revised in seven instances in the course of Q2 (total growth came to around 7.2%).

2006 (USD 78.40 pb). These other factors are primarily related to worsening of the geopolitical situation and the record high economic growth of China in the second quarter (11.9%).

As suggested by forecasts of the International Energy Agency, oil supply will be limited in the years to come and its price will remain high as a result of strong world economic growth that will encourage oil consumption and, at the same time, counterbalance the effect of growth in oil prices.

In Q2 2007, prices of primary products recorded a notable growth (7%), too. The highest increase, 13%, was recorded for prices of metals. Such increase came as a result of dynamic economic growth in countries known for their buoyant consumption of raw materials, most notably China which has taken over the U.S.'s role as the leader of world economic growth in 2007.

3. Balance of Payments

Though still high, second-quarter current account deficit narrowed as a result of faster growth in exports relative to imports and recovery in the volume of current transfers. Spending remained strong, prompted by increased foreign investment, government investment and wage growth. Capital and financial accounts show high volume of both foreign investment in the country and domestic investment abroad (purchase of Telekom of the Republic of Srpska), robust portfolio investments and reduced borrowing by the government and banks.

In Q2 2007, **current account deficit narrowed** by 12.5% on the preceding quarter. Deficit on trade in goods recorded a seasonal increase of 6.4% on a quarter earlier, while inflows in respect of current transfers went up by 74.9%. However, the deficit on goods was lower than seasonally expected as exports grew faster (by 18.5%) than imports (by 12.3%).

Inflow from current transfers strengthened notably on a quarter earlier, following a more than twofold increase (by 117%) in net inflow in respect of exchange transactions. This was partly due to the conversion of foreign exchange from remittances received in the preceding quarter (and kept under mattresses because of uncertainties regarding formation of the new government and the future exchange rate policy stance). On the other hand, non-resident deposits declined by USD 137 million as non-residents used their account holdings for portfolio investments (in investment funds) and direct investments (capital increase of banks and enterprises).

Current account deficit more than doubled in Q2 2007 relative to Q2 2006 (it rose by 122%) while the deficit on trade in goods rose much less (by 26.5%) as a consequence of higher growth in exports (38.0%) than in imports (32.3%). Net inflow in respect of current transfers declined by 28.1%, year-on-year.

Though trending down, second-quarter current account deficit remained high as a result of enduring strong demand (consumption) supported by strong foreign investment in both this and the prior quarter, as well as by government investment and real wage growth.

Trade statistics point to continued growth in exports, but also to insufficient slowdown in imports. Relative to Q1 2007, exports and imports rose by 18.5% and 12.3%, respectively. Export to import cover ratio climbed by 2.7 percentage points (from 49.3% to 52%).

Table III.3.1

Balance of payments of the Republic of Serbia

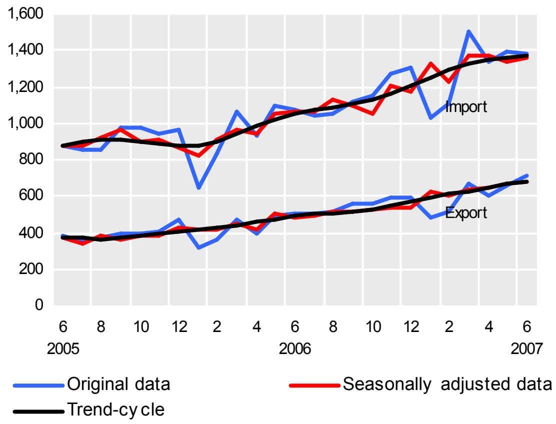
(in USD mln)

	2007		Change
	Q1	Q2	(in %)
I. CURRENT ACCOUNT	-1,500	-1,312	-12.5
Commodity trade, net	-1,874	-1,993	6.4
Exports, f.o.b.	1,820	2,156	18.5
Imports, f.o.b.	-3,694	-4,149	12.3
Services, net	8	12	50
Receipts	640	696	8.8
Payments	-632	-684	8.2
Interest, net	-107	-114	6.5
Current transfers, net	418	731	74.9
Grants	55	51	-7.3
II. CAPITAL AND FINANCIAL ACCOUNT	1,435	1,756	22.4
Capital transfers	-421	1	
Direct investments, net	873	-25	
Portfolio investments, net	353	233	-34.0
Medium- and long-term foreign credits, net	429	1323	208.4
of which: early debt repayment	-232		
Foreign lending, net	3	3	
Short-term credits and deposits, net	-260	134	
Deferred payments for oil and gas	126	-136	
Commercial banks, net (increase -)	2	50	
Other capital, net	329	172	-47.7
III. ERRORS AND OMMISSIONS	-210	92	
IV. OVERALL BALANCE OF PAYMENTS (I + II + III)	-275	536	
V. NBS FOREIGN EXCHANGE RESERVES (increase -)	275	-536	

Chart III.3.1

Exports and imports

(in USD mln)



Note: For the purpose of comparability with the preceding period, data for 2005 and 2006 do not include trade with Montenegro.

In Q2 2007, the volume of exports of goods was primarily affected by new investments from the prior and early this year, and to a smaller extent, by terms of trade, which improved by 5.3% in the first six months this year relative to the same period a year earlier. The unit value of exports rose by 13.2% and the unit value of imports by 7.5%. Imports of goods were primarily influenced by a rise in investment and consumer spending.

Breakdown by SITC section shows that the largest contribution to export growth on a quarter earlier came from seasonal products: fruit and vegetables, sugar and beverages, followed by higher processed goods: electrical machinery, apparatus and appliances, road vehicles, furniture, tobacco products, and capital goods: means of transport and specialized and general machinery. On the imports side, the largest growth was recorded for imports of specialized and industrial machinery, road vehicles, iron and steel, non-ferrous metals, non-metallic mineral manufactures, mineral ores and plastics.

Breakdown by economic region indicates that exports to economies in transition rose most and well exceeded exports to EU member countries, while imports from both EU member countries and transition economies increased, year-on-year.

Services balance improved somewhat relative to Q1, with receipts up by 8.8%, mainly on account of receipts from transport and tourism, and payments up by 8.2%.

Regular interest payments to foreign creditors rose by USD 16 million, while interest receipts rose by USD 9 million, mostly on account of a rise in foreign exchange reserves of the National Bank of Serbia. Hence, net outflow in respect of interest went up by USD 7 million.

The deficit on goods, services and interest rose by USD 122 million on a quarter earlier. **Current transfers offset** 21.2% of this deficit in Q2 2007 against 34.9% in Q1 2007, resulting in a USD 191 million decrease in current account deficit (excluding grants).

Table III.3.2

Commodity trade by economic category
(in USD mln)

	2007 by quarter		Indices
	Q1	Q2	
EXPORTS	1,823	2,145	117.7
capital goods	103	157	152.4
intermediate goods	1,266	1,410	111.4
consumer goods	454	578	127.3
IMPORTS	3,842	4,305	112.1
capital goods	637	744	116.8
intermediate goods	2,389	2,645	110.7
consumer goods	816	916	112.3

Table III.3.3

Commodity trade by economic group
(in USD mln)

	2007 by quarter		Indices
	Q1	Q2	
EXPORTS	1,823	2,145	117.7
EU 25	1,108	1,197	108.0
CEEC	514	732	142.4
CIS	109	130	119.3
EFTA	15	14	93,3
IMPORTS	3,842	4,305	112.1
EU 25	2,060	2,457	119.3
CEEC	267	353	132.2
CIS	783	697	89.0
EFTA	43	42	97.7

Chart III.3.2

Current transfers over deficit on the balance of goods, services and interest

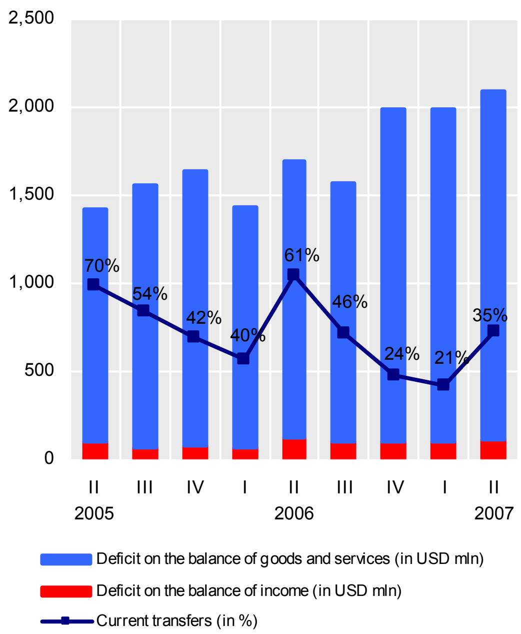


Chart III.3.3

Current account deficit and net inflow of capital
(in USD mln)

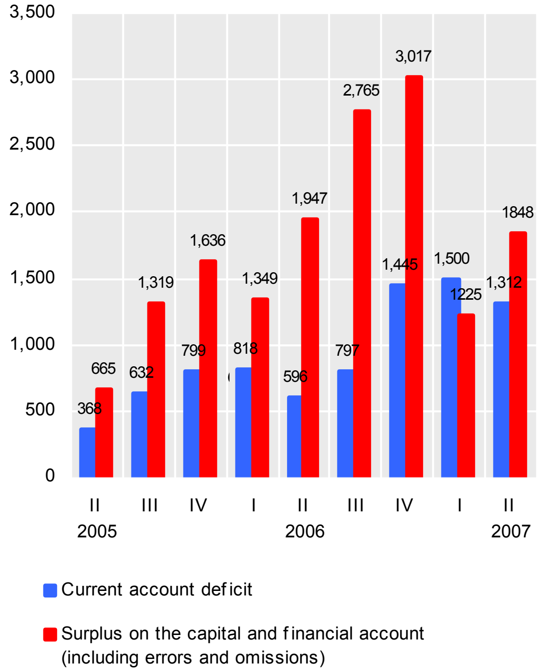
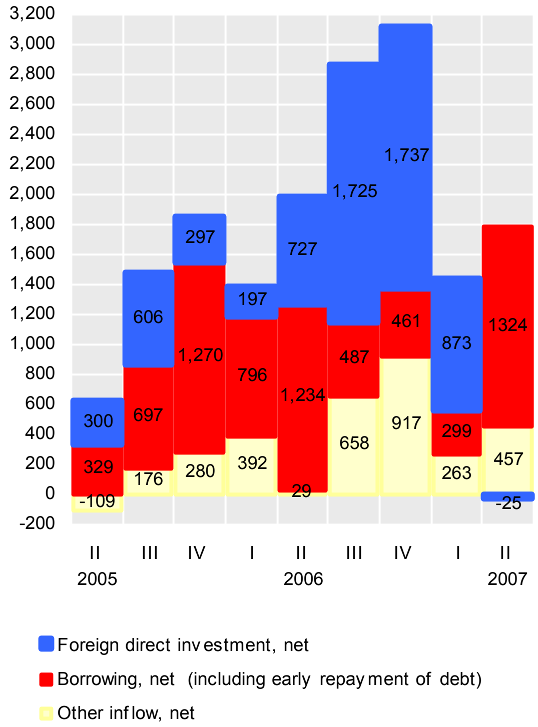


Chart III.3.4

Structure of capital inflow
(in USD mln)



Net capital inflow reached USD 1,756 million, and was 22.4% higher in Q2 2007 than in a quarter earlier.

As **foreign direct investment** in Serbia declined by 6.5% to USD 801 million, and investments abroad came to USD 826 million (purchase of Telekom of the Republic of Srpska), net direct investments were negative in Q2 2007 (USD –25 million).

Significant foreign **portfolio investment** in investment funds and capital increase of banks (USD 233 million) continued in Q2, despite a decline by 34% from Q1.

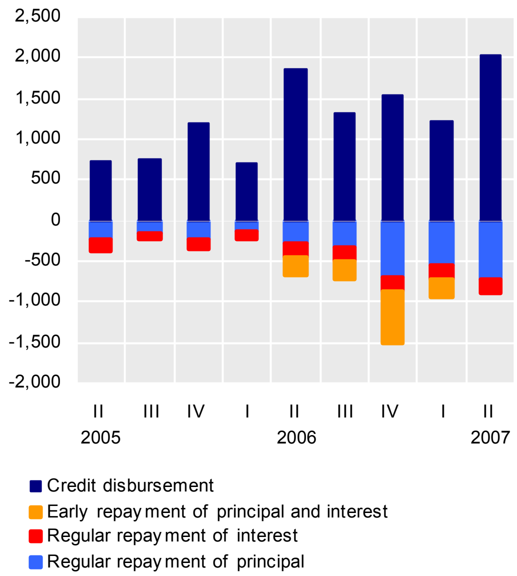
Net **disbursement of long-term foreign credits** increased by USD 894 million or more than tripled on a quarter earlier. However, as the foreign credit for financing the purchase of Telekom of the Republic of Srpska accounted for USD 806 million of this amount, the actual increase in disbursements was USD 88 million or 20.5%. Net long-term borrowing by the private sector declined on a quarter earlier by USD 105 million, with net borrowing by banks down by USD 317 million and borrowing by enterprises up by USD 212 million.

Liabilities in respect of net **short-term credits and deposits** rose by USD 134 million. New foreign currency savings continued to grow, but their Q2 increase was USD 59 million smaller than in Q1.

As a result of such balance of payments flows, capital and financial account balance exceeded the

Chart III.3.5

Medium- and long-term external credit
(in USD mln)



current account deficit by USD 444 million, i.e. foreign exchange reserves of the National Bank of Serbia rose by USD 536 million, excluding exchange rate differentials, and by USD 607 million, including exchange rate differentials.

At the end of Q2, **foreign exchange reserves of the National Bank of Serbia** reached USD 12,337.0 million or EUR 9,176.6 million, which is an increase by 5.2% on Q1. In late Q2, foreign exchange reserves covered 7.7 months of imports of goods and services[10].

During the second quarter, **outlays from foreign exchange reserves** referred primarily to repayment of obligations in respect of bonds issued against frozen foreign currency savings deposits and economic development loan (contributing 1.8pp to the decline in foreign exchange reserves). Net sale of foreign exchange by the National Bank of Serbia in the Interbank Foreign Exchange Market (contributing 1.1pp to a decline in foreign exchange reserves) represented the other major outflow channel from foreign exchange reserves.

Main contribution to **growth in foreign exchange reserves of the National Bank of Serbia** came from inflow of foreign exchange in respect of net purchase of foreign cash from exchange dealers (contributing 4.4pp to growth) and allocation of foreign exchange required reserves by banks (contributing 1.5pp to growth).

At the end of Q2, overall foreign exchange reserves of the Republic of Serbia reached USD 13,042.7 million (EUR 9,701.5 million). Of this, foreign exchange reserves of authorized banks accounted for USD 705.7 million (EUR 524.9 million).

Monetary effects of net foreign exchange transactions hit record high levels in Q2 2007. In the period under review, reserve money rose by EUR 366.1 million in respect of net foreign exchange transactions.

Chart III.3.6

Level and structure of Serbia's external debt

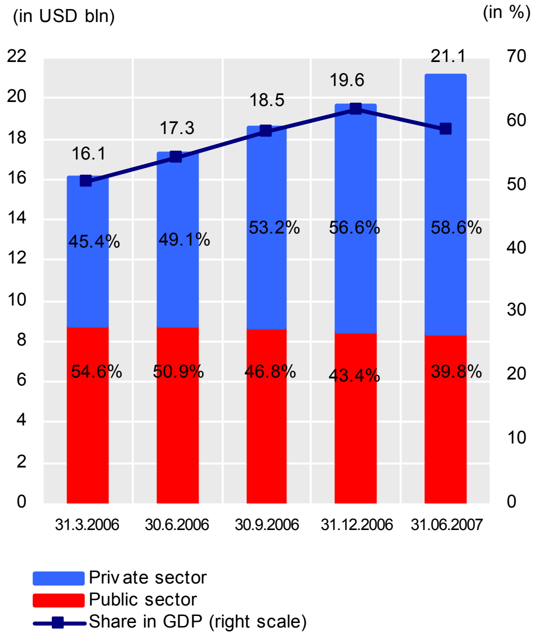
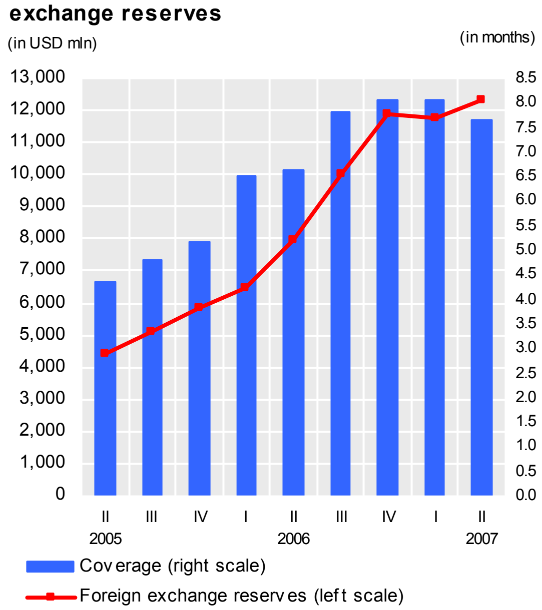


Chart III.3.7

Coverage of imports by foreign exchange reserves



Major contribution to reserve money growth came from net purchases of foreign exchange in exchange transactions (EUR 382.9 million), while the impact of direct foreign exchange transactions was much smaller (EUR 75.6 million). Within direct foreign exchange transactions, reserve money grew on account of other direct transactions and temporary payment transactions with Kosovo and Metohija (EUR 49.0 and 40.3 million, respectively), while money was withdrawn in net foreign exchange transactions with the

[10] The ratio of foreign exchange reserves to imports is calculated as the ratio of NBS foreign exchange reserves to average quarterly value of imports of goods and services.

government (EUR 13.7 million). Reserve money was further withdrawn during Q2 against net sale of NBS foreign exchange in the Interbank Foreign Exchange Market (EUR 92.4 million).

Table III.3.4

Contribution to NBS foreign exchange reserves growth rate
(in percentage points)

	2006				2007	
	I	II	III	IV	I	II
NBS foreign exchange reserves (growth in %)	**10.5**	**23.6**	**25.6**	**18.7**	**-1.3**	**5.2**
Foreign exchange market	2.0	10.4	6.4	10.0	-2.2	3.8
Exchange transactions	*7.3*	*11.0*	*7.0*	*4.8*	*2.7*	*4.4*
NBS's foreign currency net-sale in the IFEM	*-7.6*	*-3.6*	*-1.2*	*5.3*	*-5.3*	*-1.1*
Temporary payment transactions1)	*2.3*	*3.0*	*0.6*	*0.7*	*0.4*	*0.5*
Reserve requirement on foreign currency deposits and credits, and new foreign currency savings deposits	5.6	16.9	4.4	1.1	1.5	1.5
Foreign credits to government	0.8	0.3	0.6	0.3	0.4	0.2
Grants	0.3	0.3	0.2	0.3	0.2	0.1
Frozen foreign currency savings deposits and Economic Development Loan	-0.1	-3.1	-0.8	-0.2	-0.1	-1.8
Other[2)]	1.9	-1.2	14.8	6.6	-1.2	1.4

[1)] Payment transactions with Montenegro (until 26 June) and Kosovo and Metohija.
[2)] Includes privatization receipts, IMF credit, etc.

Table III.3.5

Net foreign exchange transactions of the NBS with an effect on the monetary base in 2007
(in millions)

	Forex market[1)]	Direct transactions[2)]	Exchange offices[1)]	Total net foreign exchange transactions
		Q1		
EUR	-481.2	430.8	242.9	192.4
RSD	-38,628.4	34,347.1	17,687.6	13,406.3
		Q2		
EUR	-92.4	75.6	382.9	366.1
RSD	-7,620.8	6,037.6	32,548.3	30,965.1
		Total		
EUR	-573.6	506.4	625.7	558.5
RSD	-46,249.2	40,384.7	50,235.9	44,371.4

[1)] Includes net inflow/outflow of foreign currency in respect of purchase/sale of foreign currency by the NBS in the interbank foreign exchange market and in respect of exchange transactions.

[2)] Includes net foreign exchange transactions with the government, state authorities, temporary payment transactions with Kosovo and Metohija and other net foreign exchange transactions (e.g. revenue and expenditure of the NBS in respect of transactions with foreign exchange securities, etc.)

4. Monetary Flows and Policy

Second-quarter monetary flows were characterized by accelerated year-on-year growth in reserve money and lending to the private sector as well as by a slowdown in growth of monetary aggregates M1, M2 and M3. Due to the transient nature of the majority of these factors, no strengthening of inflation pressures ensued.

Monetary Aggregates

Reserve money rose by over RSD 19 billion in nominal terms in Q2 2007. The entire increase was recorded in the final days of June, and was primarily due to banks increasing their levels of capital. Although reserve money recorded exceptionally high nominal and real year-on-year growth rates (of 37.2% and 30.4%, respectively), its movements in Q2 were largely determined by factors of transient nature and therefore induced no significant strengthening of inflationary pressures.

In difference to Q1 when reserve money was withdrawn, in Q2 reserve money was created both against net foreign exchange transactions and through the dinar channel. Although the NBS sold foreign currency in the Interbank Foreign Exchange Market throughout Q2, thereby inducing a decline in reserve money, a comparably larger amount of reserve money was created against purchase of foreign cash from licensed exchange dealers. Such developments led to a rise in net foreign exchange reserves of the NBS by around RSD 17.8 billion[11] in Q2, which contributed 17.3 percentage points to reserve money growth.

Decline in net volume of securities sold in repo transactions by over RSD 14 billion contributed 14.3 percentage points to the rise in reserve money. Key policy rate cuts by a total of 100 basis points in Q2 induced a drop in bank demand for NBS securities and an increase in lending to the private sector. Reserve money creation through this channel would have been even higher had there not been a rise in dinar government deposits with the National Bank of Serbia resulting from implementation of a more restrictive fiscal policy in line with the Decree on Temporary Budget Financing.

Breakdown by month of Q2 reveals divergent movements in reserve money. In April and May, money was created against net foreign exchange transactions and withdrawn through the dinar channel

Chart III.4.1

Reserve money creation
(cumulative changes in million dinars)

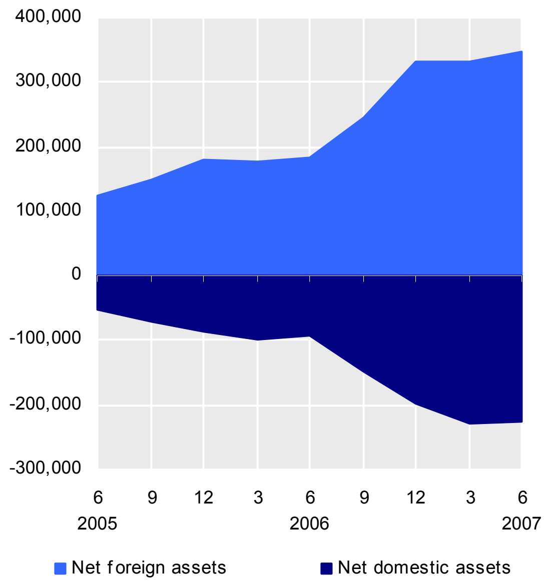
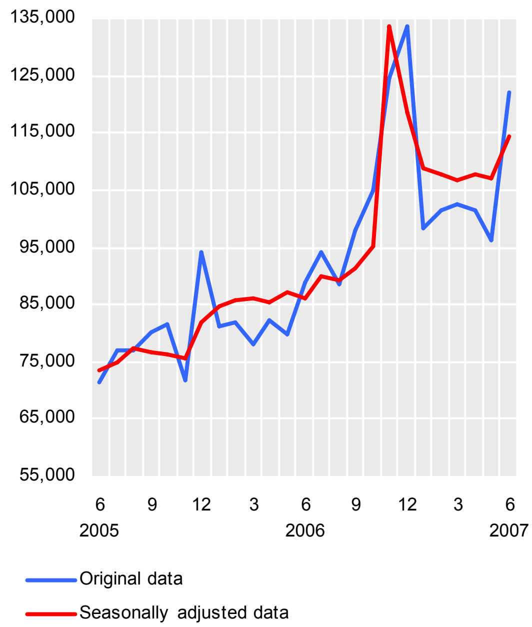


Chart III.4.2

Reserve money
(in RSD mln)



[11] Taking into account net foreign exchange transactions with an effect on the monetary base only (foreign exchange market, direct transactions and exchange dealers), the effect on reserve money increase is even stronger (see: *Net foreign exchange transactions with an effect on the monetary base*, page 28).

(primarily against a rise in dinar government deposits with the NBS). June witnessed an opposite trend: reserve money was withdrawn against net foreign exchange transactions (as a result of nominal appreciation of the dinar in the final days of June) and created through the dinar channel (as a consequence of a decline in the stock of repo securities and dinar government deposits with the NBS). It was the nominal appreciation of the dinar, which stemmed from high demand for dinars occasioned by capital increase of a number of banks (resulting in a decline in net foreign exchange reserves expressed in dinars), that had the decisive effect on end-June balance of reserve money. The decline in the stock of NBS repo securities also led to reserve money growth, which was offset partly by its withdrawal against the rise in dinar government deposits with the NBS. The effect of all these movements, however, was only temporary, as evident from a notable drop in reserve money in July (by around RSD 13 billion).

Table III.4.1

Contribution of selected assets to reserve money growth rate[1)]

(in percentage points)

	2006				2007	
	Q1	Q2	Q3	Q4	Q1	Q2
Net foreign assets	9.7	51.8	21.1	86.7	0.0	17.3
Net domestic assets	-26.8	-38.0	-10.8	-50.6	-23.2	1.6
Domestic credit	-22.7	-45.1	-24.5	-42.1	-35.7	-11.3
Net claims on government	-6.7	-12.6	4.1	28.6	-23.7	-25.1
Net claims on banks	-15.2	-30.4	-28.7	-70.3	-12.2	14.3
Net claims on other sectors	-0.8	-2.1	0.1	-0.3	0.3	-0.5
Other assets (net)	-4.1	7.1	13.7	-8.5	12.5	12.9
Reserve money	-17.1	13.8	10.3	36.1	-23.2	18.9

[1)] Excluding foreign currency government deposits with the NBS.

Within the structure of reserve money, both currency in circulation and overall bank reserves recorded growth since the start of the year, with reserves rising faster because banks placed a portion of their capital increase as excess deposits with the National Bank of Serbia.

Though year-on-year growth rates of money supply M1, M2 and M3 decelerated mildly in Q2, they remained relatively high in both nominal and real terms. Late-June capital increase of banks triggered a decline in dinar transaction deposits of non-monetary sectors and a rise in bank excess reserves, as domestic investors too were interested in buying shares. The decline in transaction deposits induced a slowdown in growth in the dinar component of money supply. Growth in overall liquidity (M3) also slowed down, as the pace of growth in foreign exchange deposits slackened somewhat, due in part to nominal appreciation of the dinar in June. Increase in bank reserves and decline in dinar deposits of non-banking sectors put a stop to acceleration of monetary multiplication in place since end-2006.

Table III.4.2

Contribution of selected assets to M3 growth rate[1)]

(in percentage points)

	2006				2007	
	Q1	Q2	Q3	Q4	Q1	Q2
Net foreign assets	0.4	26.8	11.4	13.2	3.5	3.2
Net domestic assets	1.2	-18.1	-0.7	1	1.3	2.1
Domestic credit	8.7	4.6	2.6	7.8	3.1	5.6
Net claims on government	-2.4	-3.8	0.8	6.1	-5.1	-3.8
Credit to other sectors	10.5	8.5	2.5	1.6	8.8	9.9
Households	3.7	4.6	3.3	3.1	4.3	3.6
Enterprises, in dinars	5.3	4.1	1.2	0.2	4.3	6.8
Enterprises, in foreign currency	1.4	-0.2	-1.8	-1.9	0.2	-0.5
Other	0.1	0	-0.2	0.2	0.0	0
Redeemed frozen foreign currency savings bonds	0.6	-0.1	-1	0.1	-0.6	-0.5
Short-term dinar government credit to banks	0	0	0.3	0	0	0
Other assets, net	-7.5	-22.5	-3.3	-6.8	-1.8	-3.4
Money supply (M3)	1.7	8.9	10.8	14.2	4.7	5.3

[1)] Excluding foreign currency government deposits with the NBS.

Further expansion in lending activity, especially in credits to enterprise and household sectors, was the major contributor (with 9.9 percentage points) to the creation of money supply M3. Net foreign exchange transactions of the banking sector contributed 3.2 percentage points to money supply growth, primarily as a result of net purchase of foreign exchange by the NBS. However, when the effect of net foreign exchange transactions on money supply creation is calculated at the exchange rate valid at the end of the prior year, it becomes clear that the effect of money creation through the foreign exchange channel is much stronger and that moderation in money creation through the foreign exchange channel is for the major part a consequence of nominal appreciation of the dinar in late Q2 relative to end-Q1. On the other hand, main contribution to money withdrawal (around 4 percentage points) came from growth in dinar government deposits with the National Bank resulting primarily from delayed adoption of the budget for this year as well as deferral of implementation of the National Investment Plan.

Chart III.4.3

Movements in monetary aggregates deflated by retail prices

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

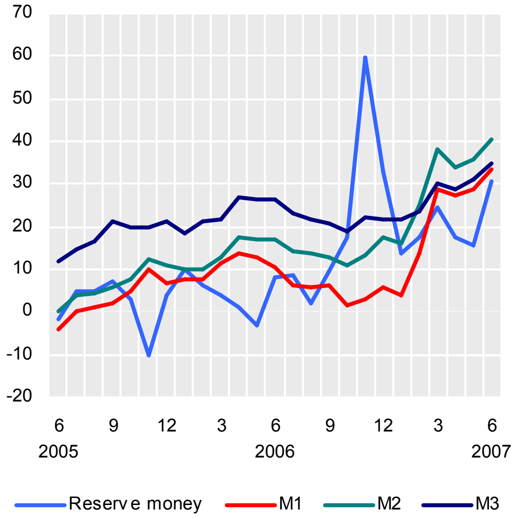
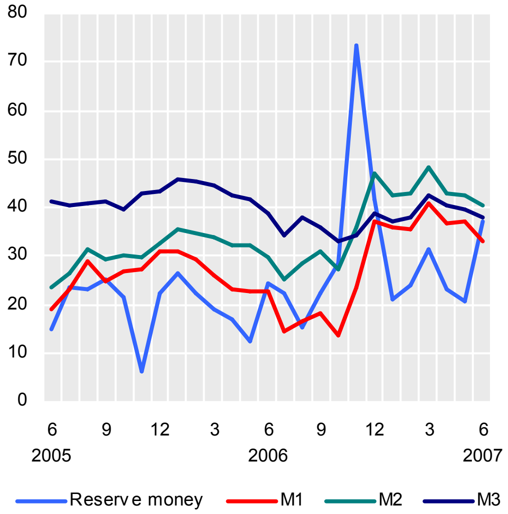


Chart III.4.4

Movements in monetary aggregates

(y-o-y growth, in %)



As banks used most of their excess liquidity for lending to the private sector, purchase of bonds issued against frozen foreign currency savings deposits continued to decline.

Net foreign position of commercial banks improved in Q2 as a result of a notable cut in borrowing abroad and mild growth in foreign exchange reserves. As banks had ample finance from domestic sources at their disposal – enterprise and household deposits, dinars originating from securities redeemed through repo operations and funds from capital increase – they needed not to resort to fresh borrowing abroad and even managed to repay a portion of foreign credits they had previously taken.

Bank Lending

In the first six months this year, bank lending to the private sector grew by over RSD 117 billion, exceeding thus the credit growth recorded in the whole of 2006. Annual growth rate of lending to enterprise and household sectors, which in June reached close to 30% (over 23% in real terms), points to accelerated credit expansion. Household lending, which underwent a mild slowdown, was outpaced by lending to the enterprise sector.

Chart III.4.5

Sources of bank lending growth
(% of balance sheet total of banks)

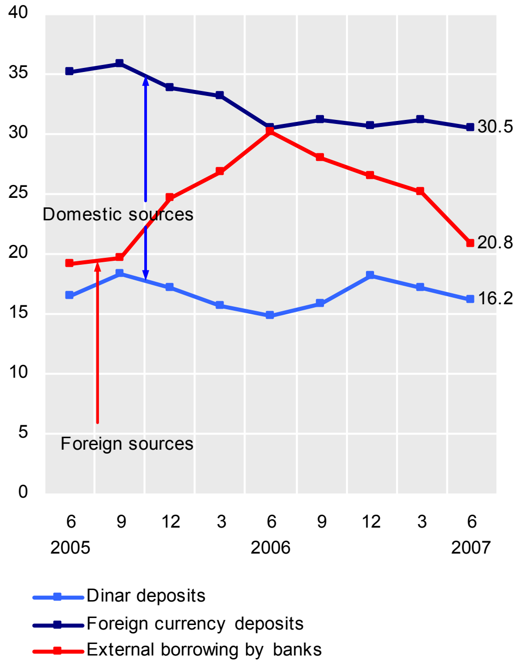
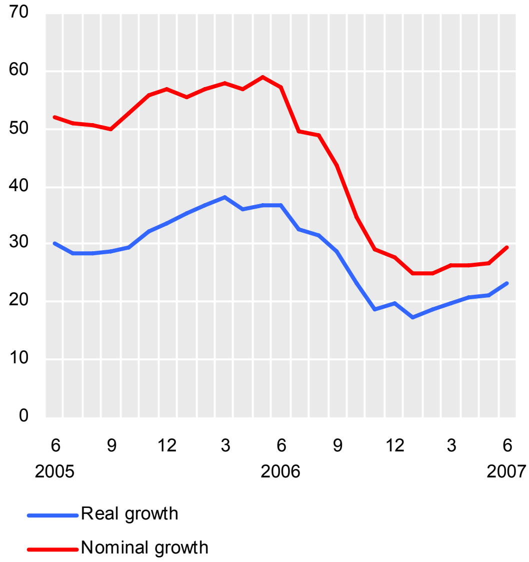


Chart III.4.6

Year-on-year growth in credit to enterprises and households
(in %)



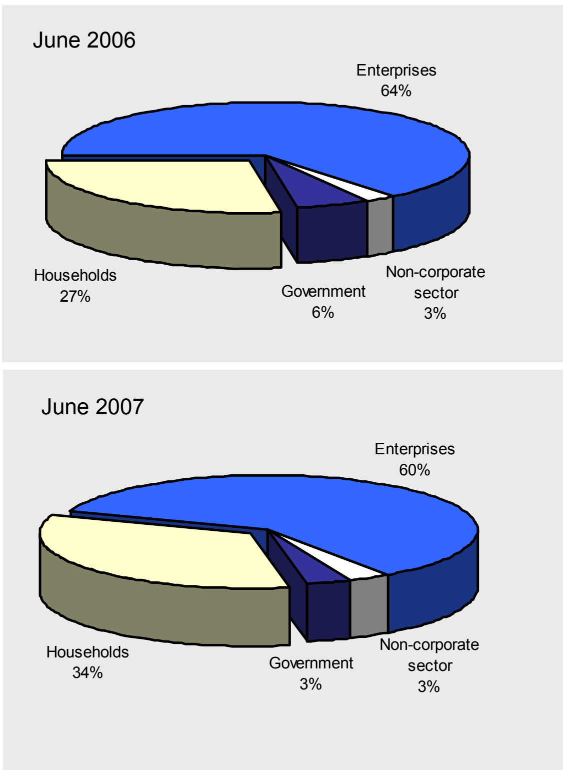
Principal sources of growth in bank lending in the quarter under review were foreign currency deposits of domestic non-banking sectors and dinar payments in respect of prior investment in NBS securities. Core capital increases were another way for banks to finance new lending. In the quarter under review, banks refrained from additional borrowing abroad to back their lending activity, but direct borrowing abroad by the enterprise sector continued.

Sectoral composition of lending in Q2 relative to Q1 reveals an almost unchanged volume of lending to the republican and local governments, a mild decline in lending to public enterprises and a notable increase in credit to the private sector.

In the second quarter, lending to the enterprise sector exceeded household lending. Such stronger growth in lending to the enterprise sector can partly be attributed to the demand for investment finance. Long-term credits to the enterprise sector increased, but so did short-term lending aimed primarily to service obligations as they fall due.

Chart III.4.7

Bank credit by sector



Bank claims on enterprises in respect of short-term corporate securities also increased, while foreign currency credits to enterprises declined, partly as a consequence of exchange rate differentials.

The volume of household lending rose by close to 10% in Q2. Particularly high increase was recorded for long-term lending, especially housing construction and consumer credits. Overdrafts on gyro and current accounts of households accounted for the largest share of short-term credits. Annual growth rate of household lending continues to run above 50%. Although similar trends in household lending prevail in other economies in transition and can partly be attributed to the process of convergence of Serbia's economy to the EU, general purpose cash loans are rising at a worryingly rapid pace and their repayment periods are unreasonably long.

The step-up in lending may yet strengthen inflationary pressures in the period ahead through its impact on growth in aggregate demand. The NBS Monetary Policy Committee will therefore consider a range of prudential and other measures to slow down credit expansion and avert threats to the achievement of target inflation. A number of measures have already been enacted in order to slow down expansion in lending to households (see footnote 4, page 13).

Bank Liquidity

Although the level of bank liquidity fluctuated in Q2, banks generally remained liquid in both dinar and foreign currency terms. Bank liquidity ratio rose in April and May as the volume of NBS securities to be redeemed exceeded the volume of reinvestment in such securities. This ratio, however, recorded a seasonal decline in June.

The average liquidity ratio of banks increased in April and May, primarily on account of a rise in bank holdings in gyro accounts and cash vaults resulting in part from redemption of repo securities and decreased reinvestment in such securities. The decline in bank liquidity in June was brought about by a mostly seasonal rise in government deposits, resulting from VAT payment by large as well as small taxpayers who submit their tax returns on a quarterly basis. Average liquidity ratio, as the ratio of average balance of excess assets to short-term sources of finance, declined by 0.7 percentage points relative to March down to 7.9% in June.

Table III.4.3

Average contribution of excess assets to overall bank liquidity
(in percentage points)

	2006				2007	
	Q1	Q2	Q3	Q4	Q1	Q2
Excess dinar assets	-19.0	10.8	26.0	35.3	-24.9	11.4
Gyro-account balances (net)	-10.5	-3.1	-1.5	0.7	-1.1	6.5
Vault cash	6.7	4.7	11.3	1.1	0.8	9.7
Callable bank deposits in dinars	-15.2	9.2	16.3	33.4	-24.6	-4.8

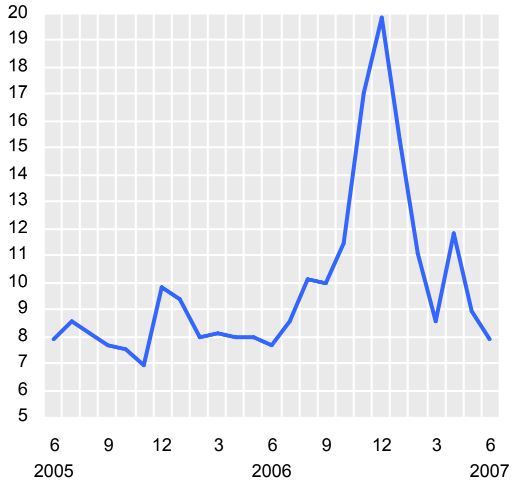
Banks' foreign exchange liquidity levels were satisfactory in Q2. Bank demand for foreign exchange was mostly met through interbank trading. Higher foreign exchange demand resulted from intensified demand by bank clients in order to settle their maturing foreign obligations. Although foreign exchange reserves of banks declined mildly in June compared to March, borrowing abroad fell sharply, as ample funds were available to banks from domestic sources.

Average daily balance of excess reserves of banks[12] stood at around RSD 19 billion. Dinar holdings in cash vaults, which, inter alia, represent a source of cash credits, rose most on a quarter earlier, while the largest decrease was recorded for excess deposits, the movements of which were determined primarily by the inflow and outflow of funds on account of capital increase of individual banks. Banks used excess liquidity to extend credits to the private sector, and, to a smaller degree, to purchase securities in outright and repo transactions. However, in order to settle their clients' obligations to the government, banks cut down notably on investment in NBS securities in late Q2.

Chart III.4.8

Average bank liquidity ratio

(in %)



Household Savings

Household savings continued to increase in Q2 2007. Compared to Q1, overall household savings rose by RSD 15.1 billion, of which foreign currency-denominated savings by RSD 14.6 billion.

As at 30 June dinar savings deposits came to RSD 9,249 million, while foreign currency savings reached EUR 3.9 billion (RSD 307.8 billion). Compared to end-Q1, dinar and foreign currency-denominated savings increased by 5.5% and 5.0%, respectively.

With regard to dinar savings deposits of households, most interest was shown for term savings deposits with the maturity of up to three months, term savings deposits with the maturity of up to one year and for term savings deposits with the maturity of up to six months.

Table III.4.4

Household savings

(in RSD million)

	2006				2007	
	Mar	Jun	Sep	Dec	Mar	Jun
Dinar savings	3,755	5,000	6,828	7,550	8,763	9,249
Foreign currency savings	207,609	222,105	243,422	260,689	293,195	307,783
Total savings	211,364	227,105	250,250	268,239	301,958	317,032

In terms of currency composition of savings deposits, foreign currency savings accounted for 97.1% of total household savings.

Three banks leading in terms of the volume of foreign currency savings deposits accounted for 45.7% of the total. As much as 92.8% of total savings deposits were denominated in euros, 4.5% in US dollars and 2.1% in Swiss francs.

Breakdown of savings deposits by maturity shows that demand deposits account for the highest share of the total (37.2%), followed by term savings deposits with the maturity of up to one year (21.0%) and term savings deposits with the maturity of over one year (16.1%).

In Q2, there were no new issues of NBS savings bills. As at end-June, holdings of NBS bills reached RSD 1,822 million or 19.7% of overall dinar savings of RSD 9,249 million.

[12] Bank excess reserves comprise: vault cash, callable deposits and banks' gyro account balances less calculated required reserves.

5. Supply and Demand

Supply and Sources of Growth

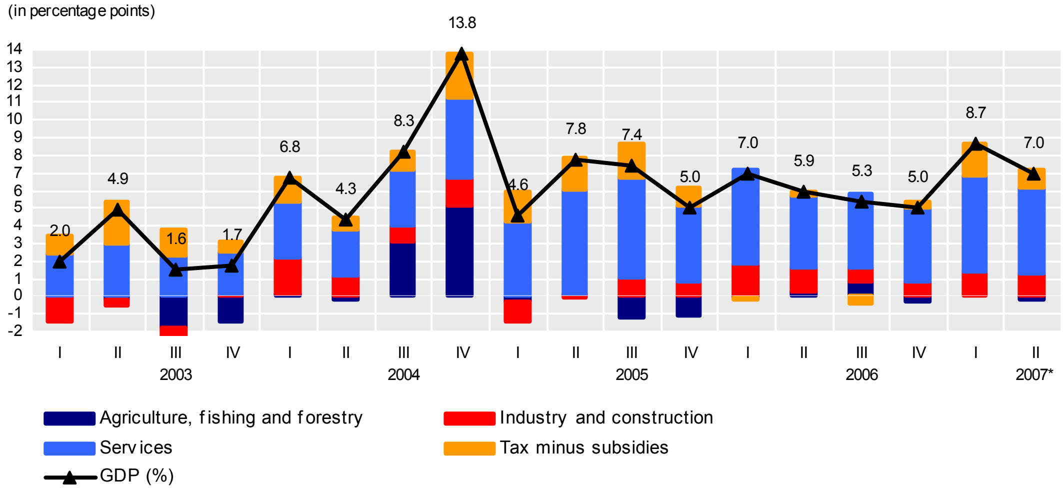
Economic activity gathered momentum in 2007: its growth rate equalled 8.7% in Q1, and is estimated at around 7% for Q2. Key contribution to economic growth came from the services sector and export-oriented portion of economy.

As indicated by available data, acceleration in the year-on-year real GDP growth rate in Q1 was even stronger than estimated in the previous issue of Inflation Report. Namely, according to the latest official data issued by the Serbian Bureau of Statistics, this rate equalled 8.7%. One of the reasons behind the mismatch between the actual and estimated rate (7%) is a significantly higher revenue from taxes (less subsidies) in Q1 (13.7), which contributed 1.9 p.p. to GDP growth.

Chart III.5.1

Contribution to y-o-y GDP growth

(in percentage points)



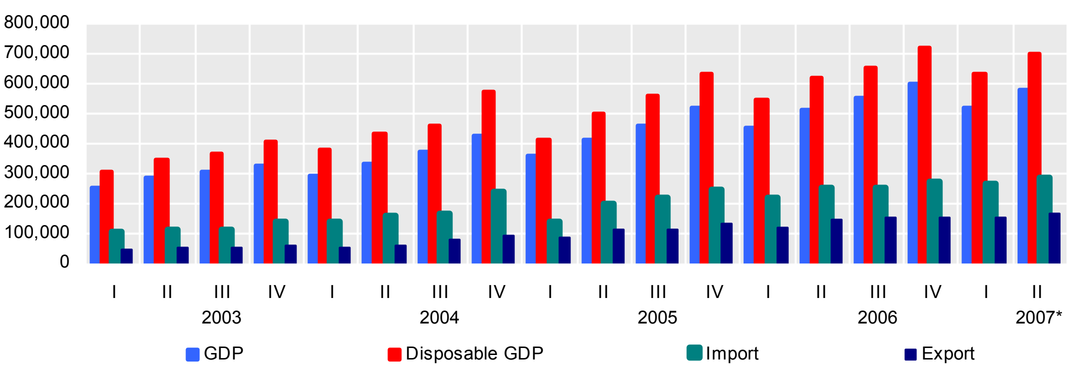
*Estimate of NBS.

In the same period, gross value added contributed 6.8 p.p. to year-on-year GDP growth. Within gross value added, a major contributor to GDP growth was the services sector, and in particular retail and wholesale trade (2.3 p.p.), transport activity (2.1 p.p.) and financial mediation services (1.3 p.p.).

Chart III.5.2

GDP - estimates by quarter

(in RSD mln)



*Estimate of NBS.

Although GDP data for Q2 2007 are still unavailable, data obtained so far and expectations with regard to economic activity in individual sectors point to a slowdown in GDP growth in this quarter to around 7%.

As indicated by the SBS monthly statistics, pace of industrial production growth picked up mildly in Q2 (5.2%). This acceleration was for its major part attributable to high increase in electricity production (8.7% year-on-year) driven by strong consumption (most notably household consumption). In terms of year-on year growth rates, a significant slow down from Q1 was recorded for the manufacturing industry (4.8% and 8.5%, respectively), and a somewhat milder decline for mining and quarrying (1.4% and 2.1%, respectively).

According to our estimates, major contributor to GDP growth in Q2 were retail and wholesale trade (2.3 p.p.). Such estimate is further confirmed by year-on-year real growth in retail trade which remained relatively high despite mild deceleration (25.1% year-on-year).

Construction industry recorded the strongest year-on-year growth (16.2%) from mid-2006 which is in accordance with increased growth rates of its main indicators: production of non-metal minerals (23.4% year-on-year) and government investment spending (68.0% year-on-year). However, measured in effective hours of work, year-on-year growth rate of construction industry shows downward trends (-2.9%), tallying with drop in the production of non-metal minerals. Among the reasons behind the decline in construction industry is also a decelerated growth in government investment spending (16% year-on-year). Although year-on-year growth rate of the value of completed construction works is still positive and at a high level (25.9% in Q2), it displays a markedly downward tendency.

A notable slow down in the year-on-year growth rate of the value of newly contracted construction works in Q2 suggests a downturn in the volume of activity of the construction industry in the coming period. Construction industry is expected to contribute around 0.4 p.p. to GDP growth.

Transport, warehousing and communications recorded strong year-on-year growth rates (19.4%) in Q2, albeit slower than a quarter earlier. High growth in transport was primarily due to the rise in telecommunications services (31.6% year-on-year). Similar trends in the growth of transport activity are expected in Q2 on account of increased number of motor vehicles registered for the first time in Q1. This branch of activity is expected to contribute around 1.9 p.p. to GDP growth.

Due to adverse weather conditions, agricultural production is expected to drop year-on-year in Q2 and provide a negative contribution of 0.2 p.p. to GDP growth.

Estimates of real GDP and price growth indicate that second-quarter GDP could amount to around RSD 580 billion. According to balance of payments data, disposable GDP would stand at around RSD 700 billion (120% of GDP) with exports and imports of goods and services accounting for 29.3% and 49.6% of GDP, respectively. Year-on-year growth in aggregate demand would in such scenario come to around 20.3%, which is 1.7 p.p. up on a quarter earlier.

Demand and GDP Spending

As confirmed by the quarterly data on price growth, robust second-quarter growth in aggregate demand (20.3% year-on-year) induced an acceleration in inflation despite substantially increased supply of imported goods and services. Breakdown of GDP spending in this quarter points to a shift from investment spending to spending for personal consumption.

Estimates are that the particularly pronounced slowdown in government investment spending in the period under review was due mainly to delayed adoption of the 2007 budget and deferral of implementation of projects envisaged by the National Investment Plan. From the aspect of volume and composition of goods in supply chains, the effect of unfavourable hydrometeorological conditions on agricultural production will be of particular concern.

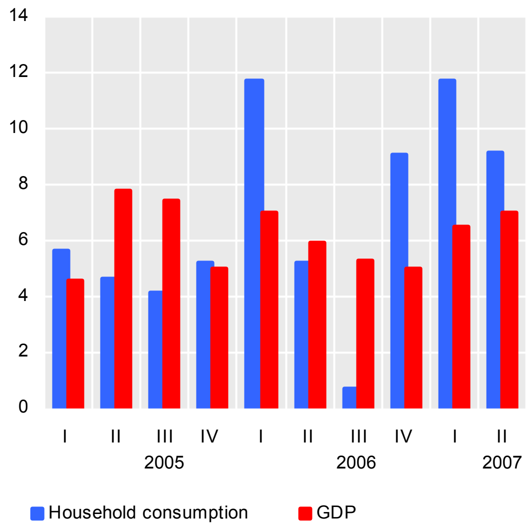
Indicators of Household Spending

Rising household demand, prompted by growth in total wages and increased household lending, generated inflationary pressures.

Chart III.5.3

Household demand and GDP

(y-o-y real growth rates, in %)



Based on selected indicators, the real growth rate of **household demand** is assessed at 9.2% in Q2 2007 relative to the comparable period a year earlier, which is equal to the level recorded in Q1. Such high real rate of growth in household demand resulted primarily from growth in total wages, but expansion in household lending was also a major contributor. Nominal year-on-year growth rate of household demand is assessed at 14.3% in Q2 2007 compared to Q2 2006, which is somewhat lower than the rate recorded in Q1 (15.6%).

Sources of growth in consumer demand are as follows:

Wages. In Q2 2007, the ratio of net wages from the statistical sample to estimated GDP was 13.7%, which is 1.1 structural points more than in the comparable period a year earlier. Assuming that employees not included in the sample earn on average as much as those included in the sample, the ratio of net wages to estimated GDP was 36.6% or 4.6 structural points more than in the comparable period a year earlier.

Social transfers. In Q2 2007, social transfers accounted for 15.3% of the estimated GDP, which is 0.2 structural points more than in the same period in 2006.

Remittances. In Q2 2007, registered remittances accounted for 4.7% of the estimated GDP, the same as in Q2 2006;

Exchange offices. In Q2 2007, household income in respect of net sale of foreign exchange accounted for 5.8% of the estimated GDP, which is a decline by 4.2 structural points on Q2 2006;

Credits. Borrowing provided households with an additional source of financing consumption and amounted to 4.2% of the estimated GDP, thus equalling the share recorded in Q2 2006.

In the period under review, household savings rose by 2.8% of the estimated GDP, which is 0.7 structural points less than in Q2 2006.

Household revenue, less increase in savings and plus increase in credits, accounted for 63.8% of GDP, which is an increase by 1.3 structural points. Therefore, second quarter household consumption generated inflationary pressures.

Public Consumption

Q2 2007 budget, calculated by the IMF methodology, ran a surplus of RSD 16.2 billion. Although this methodology excludes one of the large entries under debt repayment item, i.e. outlays of RSD 13.2 billion in respect of bonds issued against frozen foreign currency savings deposits, fiscal policy pursued by the government in Q2 2007 still came out as fundamentally restrictive and resulted in money withdrawal of around RSD 6 billion.

Total consolidated revenue of the budget of the Republic of Serbia, excluding grants, reached RSD 232.61 billion in Q2 2007 (up by 11.5% in nominal and 6.5% in real terms on a year earlier), while total consolidated expenditure came to RSD 216.44 billion (up by 10.94% in nominal and 5.96% in real terms on a year earlier), resulting in a second-quarter budget surplus of RSD 16.17 billion. The ratio of fiscal surplus to GDP stood at 2.8% in Q2.

The respective shares of fiscal revenue and expenditure in GDP declined as a result of robust GDP growth.

High growth in percentage terms (though less significant in absolute terms) was recorded for revenue in respect of value added tax (88.92% in nominal and 80.44% in real terms). Growing by around 10% in nominal terms, other revenue categories moved broadly in line with expectations, while revenue in respect of income tax underwent an expected decline due to cuts in the income tax rate.

On the expenditure side, by far the largest increase in absolute terms was recorded by net wages (26% in real terms or RSD 13.8 billion up on a year earlier). Another significant item were pensions and unemployment benefits which rose by 9% in real terms or RSD 9.2 billion on a year earlier. Although investments also recorded a notable rise in percentage terms (6% in real terms), their absolute growth was not so impressive (RSD 1.4 billion) as the share of investments in total budget was low. On the positive side, subsidies are the only category of expenditure that recorded a significant 16% decline in real terms, though not so significant in absolute terms.

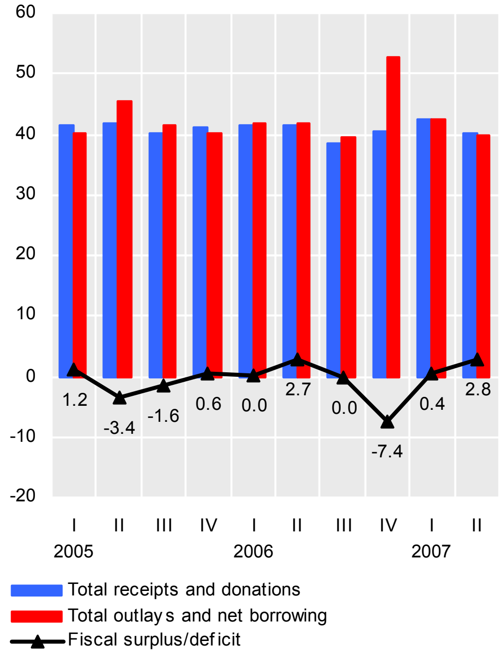
Budget expenditure is still predominantly socially oriented rather than being investment- or development-focussed.

It should also be noted that during almost the entire second quarter (until 22 June) budget expenditures moved in compliance with the *Decree on Temporary Financing of the Republic of Serbia for the Period January-June 2007,* which limited total budget spending in this period to one half of total budget revenue recorded in the same period a year earlier. As the budget adopted on 22 June envisages deficit financing, it is likely that budget spending will

Chart III.5.4

Public revenue and expenditures (IMF methodology)

(as % of GDP)

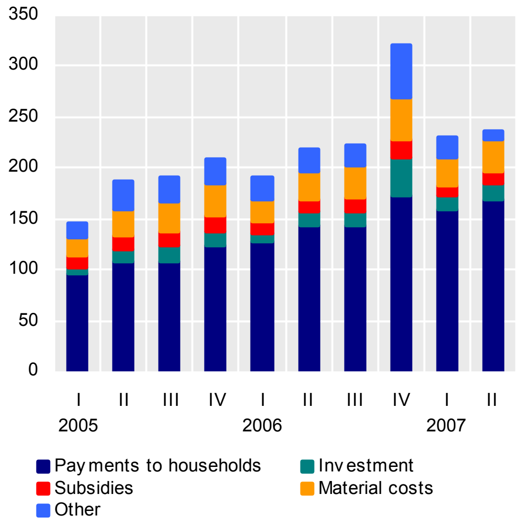


Source: Recalculated based on data provided by the RS Ministry of Finance.

Chart III.5.5

Structure of public expenditures

(in RSD bln)



Source: Recalculated based on data provided by the RS Ministry of Finance.

Table III.5.1

Fiscal balance
(by quarter, in RSD billion)

	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	Indices Q1 2007. / Q1 2006.	Indices, real Q1 2007. / Q1 2006.
I Consolidated revenues and grants	183.2	209.0	209.3	239.2	220.4	232.9	1.11	**1.06**
o/w grants	0.5	0.4	0.3	0.2	0.1	0.3	0.69	**0.65**
II Consolidated expenditures and debt repayments	184.3	210.4	214.7	309.9	219.9	230.1	1.09	**1.04**
o/w foreign debt repayment	1.3	1.2	1.6	12.5	1.3	0.5	0.40	**0.38**
o/w frozen foreign currency savings repayment	0.5	14.0	4.1	1.1	0.6	13.3	0.95	**0.90**
o/w debt pre-payment	0.0	0.0	0.0	13.8	0.0	0.0		
III Consolidated revenues without grants	182.7	208.6	209.0	239.0	220.2	232.6	1.11	**1.06**
IV Consolidated expenditures and debt repayments (excluding foreign debt repayments, pre payments and FFCD repayments)	182.5	195.1	209.0	282.5	218.0	216.3	1.11	**1.06**
Fiscal balance - IMF methodology (III - IV)	**0.2**	**13.5**	**0.0**	**-43.5**	**2.2**	**16.3**	**1.21**	**1.15**
GDP	440.6	504.9	543.4	589.4	518.2	579.4	**1.15**	**1.10**
Fiscal balance - IMF methodology in % of GDP	0.0	2.7	0.0	-7.4	0.4	2.8	**1.05**	**1.00**

Source: Calculation based on RS Ministry of Finance data.

accelerate in the period ahead.

Table III.5.2

Consolidated public expenditure
(by quarter, in RSD billion)

	2006 Q1	2006 Q2	2006 Q3	2006 Q4	2007 Q1	2007 Q2	Indices Q2 2007 / Q2 2006	Indices real Q2 2007 / Q2 2006
Total expenditure and debt repayment	**184.2**	**210.4**	**214.7**	**309.9**	**219.9**	**230.1**	**1.09**	**1.04**
Outlays to households:	**127.9**	**129.7**	**134.6**	**158.4**	**150.5**	**156.5**	**1.21**	**1.15**
Net wages	43.9	43.7	45.1	57.8	53.1	57.5	**1.32**	**1.26**
Employee contributions	7.5	7.9	8.2	9.8	9.4	10.5	**1.33**	**1.27**
Social transfers	76.5	78.2	81.4	90.8	88.0	88.5	**1.13**	**1.08**
Pensions and unemployment benefits	60.7	62.9	65.6	69.8	70.2	72.1	**1.15**	**1.09**
Social benefits	13.1	12.7	13.1	17.9	15.1	13.7	**1.08**	**1.03**
Other transfers to households	2.6	2.5	2.8	3.1	2.7	2.7	**1.07**	**1.02**
Subsidies	**10.1**	**13.4**	**13.1**	**19.0**	**9.5**	**11.8**	**0.88**	**0.84**
Material expenses	**23.4**	**26.6**	**30.4**	**39.6**	**27.1**	**32.8**	**1.23**	**1.18**
Investment	**8.1**	**12.7**	**15.6**	**37.6**	**13.6**	**14.1**	**1.11**	**1.06**
Interest expenses	**5.7**	**4.9**	**5.8**	**18.2**	**5.7**	**3.1**	**0.63**	**0.60**
Debt repayment	**1.8**	**15.3**	**9.7**	**26.5**	**15.3**	**14.2**	**0.93**	**0.89**
Payments in respect of frozen f/cy savings and pension arrears	0.5	14.0	8.1	14.0	9.6	13.3	**0.95**	**0.90**
Foreign debt repayment	1.3	1.2	1.6	12.5	1.3	0.5	**0.40**	**0.38**
Repayment of outstanding internal debt	0.0	0.0	0.0	0.0	4.5	0.4		
Other [1)]	**14.7**	**15.6**	**13.7**	**20.4**	**12.3**	**3.1**	**0.2**	**0.2**

[1)] Item *Other* includes: transfers to Kosovo and Metohija, net borrowing and other current expenses.

Source: Calculation based on RS Ministry of Finance data.

Indicators of Investment Spending

Investment activity growth slowed down in Q2 2007 and was channelled towards investment in working assets.

Medium- and long-term direct borrowing abroad by enterprises, as an indicator of investment in fixed assets, rose by 144%, year-on-year, in Q2 compared to 125% in Q1[13]. On the other hand, growth in the stock of long-term domestic bank net credits to enterprises slowed down relative to a quarter earlier (15.1% compared to 16.3%, year-on-year), as did long-term borrowing by households and small and medium enterprises with domestic banks (49%, year-on-year, compared to 54.5% in Q1).

Foreign direct investment in Serbia slowed down notably in Q2 (year-on-year growth of 11% in Q2 compared to 240% in Q1).

Another indicator of slowdown in investment growth was the sharp reduction in growth of net exports of capital goods in Q2 (35.9%, compared to 67.7% in Q1), which was partly offset by increased demand for domestic capital goods (physical volume of production of capital goods declined less than stocks).

Net exports of intermediary goods recorded a notable increase. On the production side, there was strong growth in industrial output coupled with a mild decline in stocks of intermediary goods, which all together points to a rise in investment in working assets. This is further borne out by data on short-term net bank credits to enterprises, which rose by 7.3%, year-on-year, compared to a 0.6% decline in Q1.

Government investment spending slowed down notably in Q2, which is another indicator of slowdown in overall investment activity (year-on-year growth of 15.8% compared to 68%).

Table III.5.3

Investment indicators

	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q1 2007 / Q1 2006	Q2 2007 / Q2 2006
Real indicators								
Physical volume of industrial production of capital goods, y-o-y indices	107.2	89.4	78	89.7	97.8	99.1	97.8	99.1
Imports of intermediate goods, in USD million	912.3	1164.3	1249.8	1418.2	1343.3	1658.7	147.2	142.5
Exports of intermediate goods, in USD million	636.6	806.3	862.3	957.5	965.3	1123.6	151.6	139.4
Stocks of intermediate goods, y-o-y indices	101.2	102.0	104.7	104.4	100.8	98.4	100.8	98.4
Imports of capital goods, USD million	551.5	776.6	797.1	925.3	929.9	1114.2	168.6	143.5
Exports of capital goods, USD million	130.3	163.2	169.7	214.6	223.6	280.7	171.6	172.0
Stocks of capital goods, y-o-y indices	101.7	115.1	112.7	107.2	95.5	91.2	95.5	91.2
Financial indicators								
Short-term credits to enterprises, RSD billion	201.7	214.0	203.2	188.1	200.4	229.7	99.4	107.3
Medium- and long-term external borrowing by enterprises (net), in USD million	257.0	324.0	637.0	662.0	578.0	1597.4	224.9	493.0
Long-term credits to households, RSD billion	121.5	138.6	152.0	163.7	187.7	206.6	154.5	149.0
Long-term credits to enterprises, RSD billion	162.8	172.3	177.9	174.0	189.4	198.3	116.3	115.1
Government investment spending, RSD billion	8.1	12.7	15.6	37.6	13.6	14.1	168.0	110.9

[13] Credit extended by the *Citigroup* to Telekom Serbia to finance the purchase of Telekom of the Republic of Srpska did not lead to an increase in investment activity in the country, and is therefore excluded from the calculation of long-term foreign borrowing by enterprises.

6. Labour Market Flows

Wage growth slowed down on a quarter earlier, but remains relatively high. The rise in wages spurred demand, but failed to produce stronger inflationary effects as a portion of demand was met from increased imports.

Wages

Average wages slowed down in Q2 on Q1. Year-on-year nominal net wage growth amounted to 28.6%, down by 1.6 p.p. on Q1 2007. Real year-on-year net wage growth equalled 24.4%, up by 0.2 p.p. on Q1 2007.

Chart III.6.1

Average net wages

(y-o-y growth, in %)

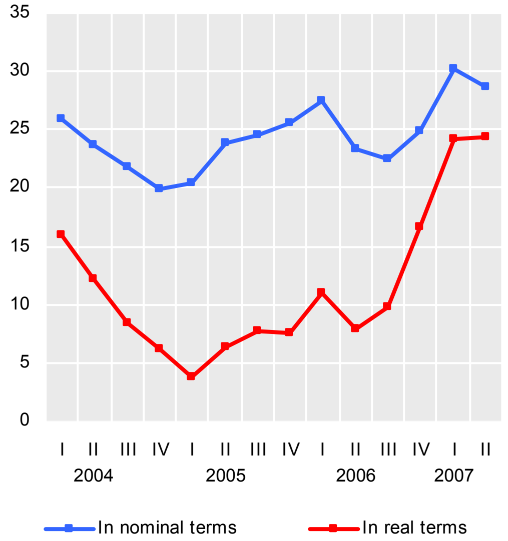
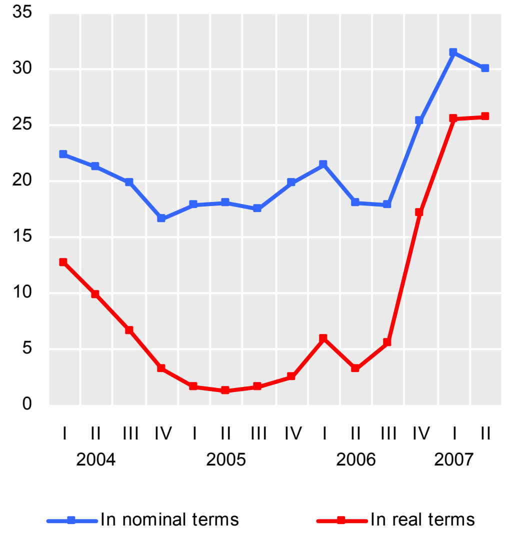


Chart III.6.2

Average net wages in the public sector

(y-o-y growth, in %)



Year-on-year nominal net public sector wage growth came to 30.0% in Q2 2007, which is 1.5 p.p. less than in Q1 2007. Such decline resulted primarily from a slowdown in wage growth of employees in public enterprises and local governments. However, wages in administration, education, culture, health and social work sectors recorded a year-on-year increase relative to Q1. As public sector employees account for 26.3% of the total number of employees, a responsible wage policy is necessary in the public sector in order to maintain the rate of inflation at a low level.

Rising by 0.2 p.p. on Q1 2007, real year-on-year growth in public sector wages amounted to 25.7% in Q2 2007.

Public sector wage bill increased by 28.8% in nominal and 24.5% in real terms, while the number of employees declined.

Seasonally-adjusted data also signal a slowdown of growth in nominal net wages. Hence, in Q2 net wages rose by 2.7% on a quarter earlier, while their growth in Q1 was 10.4%.

Unit labour costs in the industrial sector declined by 0.8% in Q1 on a year earlier, as growth in real gross wages fell behind productivity gains (12.9% and 13.8%, respectively). In the processing industry, unit labour costs increased by 1.2%.

Employment

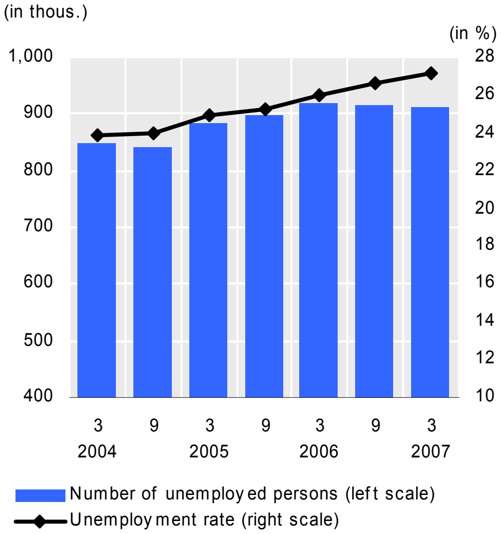
As available data indicate, total employment in June 2007 amounted to 2,444.5 thousand persons, which is 2.7% down on the same month a year earlier. Employment in the public sector also declined from a year earlier.

Total unemployment[14], excluding persons temporarily incapacitated or unwilling to work, amounted to 849.2 thousand in June, which is 6.9% down on the same month a year earlier. The estimated rate of unemployment in June came to 25.8%.

In Q2, new employment grew by 7.8%, year-on-year, to reach 161.7 thousand. This indicator shows a higher level of correlation with movements in GDP. Of the new employment figure, 76.5 thousand persons from the records of the National Employment Service gained new employment (47.3%), while 85.3 thousand persons changed jobs (52.7%).

Chart III.6.3

Unemployment
(in thous.)



Source: Serbian Bureau of Statistics and National Employment Service.

Chart III.6.4

New employment
(in thousand)

Source: National Employment Service.

[14] Serbian Labour Market Bureau.

7. Inflation Expectations

As suggested by the latest July data, inflation expectations continue to fall, but on average still run above the actual inflation performance. However, a rise in inflation expectations is anticipated for August as price increase has been announced for a number of goods and services.

Findings of the July survey, conducted by *TNS Medium Gallup*, point to stable inflation expectations. Expectations of trade unions and households fell significantly from the level recorded in the preceding month.

Inflation expectations of the financial sector more or less imaged the NBS projection, while those of enterprises, trade unions and households remained significantly above the projected levels.

Expectations of the financial sector and enterprises stabilized at 0.5% per month (6.2% per annum) and 0.8% per month (8.7% per annum), respectively. Levelled expectations of the financial sector may be indicative of the fact that banks and other financial institutions are beginning to form their inflation expectations on both realistic grounds and NBS forecasts rather than on the actual inflation performance. Albeit declining and becoming more realistic, household inflation expectations are still the highest. At the moment, they match the level shown by the March survey. Although declining from the beginning of the year, average inflation expectations are still above the actual inflation outturn.

A rise in inflation expectations is seen coming in August on the back of announced price increases.

Reuters survey, conducted in June on the sample of 13 bank dealers and one economist, found that inflation expectations for 2007 averaged 6.2%. The exchange rate at end-2007 is expected to stand at 82.5 RSD/EUR. Using as weights the respective shares of respondent banks in the IFEM SPOT trade, we arrive at the weighted average exchange rate of 82.4 RSD/EUR at end-2007.

Table III.7.1

Inflation expectations over the next 12 months

	2007				
	March	April	May	June	July
Enterprises	12.7	10.0	10.0	8.7	8.7
Financial sector	7.4	6.2	6.2	6.2	6.2
Trade unions	7.4	10.0	10.0	10.0	8.7
Households	12.7	22.4	14.0	14.0	12.7

Source: Survey (TNS Medium Gallup).

Table III.7.2

Expectations of the banking sector[1)] for end-2007 inflation, key policy rate and exchange rate movements

	Retail prices[2)]	Key policy rate	RSD/EUR
March 2007	6.6	10.8	81.5
June 2007	6.2	9.9	82.5

1) Survey includes 13 banks.
2) December 2007/December 2006
Source: Survey (Reuters).

By contrast to the March survey when the banking sector expected the key policy rate at the end of the year to reach 10.8%, June survey reveals that the expected year-end level of the key policy rate is 9.9%. Based on the fact that banking sector expectations with respect to the level of the key policy rate at the end of the year are running above its actual current level, it may be concluded that the banking sector expects a moderate tightening of the monetary policy stance over the coming period.

Expectations with respect to the level of the key policy rate in July

Eleven out of thirteen bank dealers expressed their expectation that the NBS will retain the key policy rate at its present level of 9.5%. One dealer said he expected the rate to be lowered to 9% and the remaining one expected it to be raised to 10%. Assuming that banks have already incorporated their inflation expectations into the exchange rate levels, keeping the key policy rate at its current level of 9.5% would have a neutral effect on the exchange rate.

IV. Inflation Projection

Despite strong underlying inflationary pressures in the economy, core inflation for 2007 is likely to linger around the lower bound of the target corridor (4-8%). Projection for core inflation for 2007 is between 3.0 and 5.6%, and the central projection around 4.3%. Projection for retail price inflation for 2007 has been revised upwards from a quarter earlier to around 8.0% on account of unexpectedly high level of non-core inflation. In 2008, core inflation is expected to move within the target corridor (3-6%), although this will probably call for a more restrictive monetary policy in the immediate future. Central projection places headline inflation for 2008 at around 6%.

Medium-term inflation projection is based on the analysis of different monetary policy scenarios (movements in the key policy rate and nominal exchange rate) in the context of different macroeconomic conditions, and the assessment of their effect on core and headline inflation. Medium-term projection relies on a structural model made up of three basic equations (core inflation equation, nominal exchange rate equation and monetary policy response function), as well as a number of auxiliary equations and identities.

Initial Conditions and Assumptions

Quarterly rate of core inflation increased for the first time in several months. In Q2, it reached 0.9% (3.6% p.a.), edging up to the lower bound of the target corridor for 2007 (4-8%). This was due primarily to indirect effects of rises in energy prices (petroleum products and electricity), nominal depreciation of the dinar in the first half of the year and strong growth in public sector wages. On the other hand, appreciation gap of the real exchange rate15, which opened in the second half of the prior year, had a disinflationary effect and strongly contributed to containing inflationary pressures, though its effects were somewhat weaker than in a quarter earlier.

The abovementioned factors will continue to generate inflationary pressures in the period ahead, especially as, judging by the adopted budget, fiscal policy is expected to be expansionary in the second half of the year. However, the Government has announced its intention to pursue a more restrictive fiscal policy in 2008, which would certainly help rein in inflationary pressures.

Finally, the recent leap in prices of agricultural products caused by drought did not have only a direct effect on headline inflation, but also reflected on prices of foodstuffs included in core inflation calculation. Direct impact of this shock will be only temporary and will wear off before the end of the current year. It could, however, trigger a rise in inflation expectations which may, over a longer run, generate further inflationary pressures.

On the other hand, appreciation gap of the real exchange rate will continue to have a disinflationary effect, but as it narrowed during the year, its disinflationary pressures will be somewhat weaker than in the first half of the year.

Despite a rise in quarterly rates, year-on-year rates of core inflation continued to decline and move away from the lower bound of the target corridor16. Thus, in June, year-on-year core inflation came to 2.8% and is expected to range between 3.0% and 3.5% at end-Q3 (see p. 8).

Medium-term projection of core inflation is based on the assumption that the ECB policy rate will continue rising until the end of the year (from the present level of 4%), as well as on assumptions of moderate inflation growth in the EU and mild decline in oil prices before the end of 2007. The new projection of non-core inflation (regulated prices and prices of agricultural products) incorporates the latest rise in prices of petroleum products, electricity price hike announced for September and drought-induced leap in prices of agricultural products.

[15] See text box: *Real Exchange Rate – Trend and Gap,* p. 15.

[16] Year-on-year rate of core inflation is declining if the current quarterly rates are lower than quarterly rates from the corresponding period a year earlier.

Assumptions used in inflation projection

	2007	2008
External		
EU inflation	2.0	2.0
End-year EU interest rate	4.25	4.25
End-year price of Ural oil per barrel (in USD)	65	70
Internal		
GDP growth	7%	6%
Non-core inflation	12%	7.8%
Republic budget deficit (share in GDP)	-3%	**-1%**

Core Inflation Projection

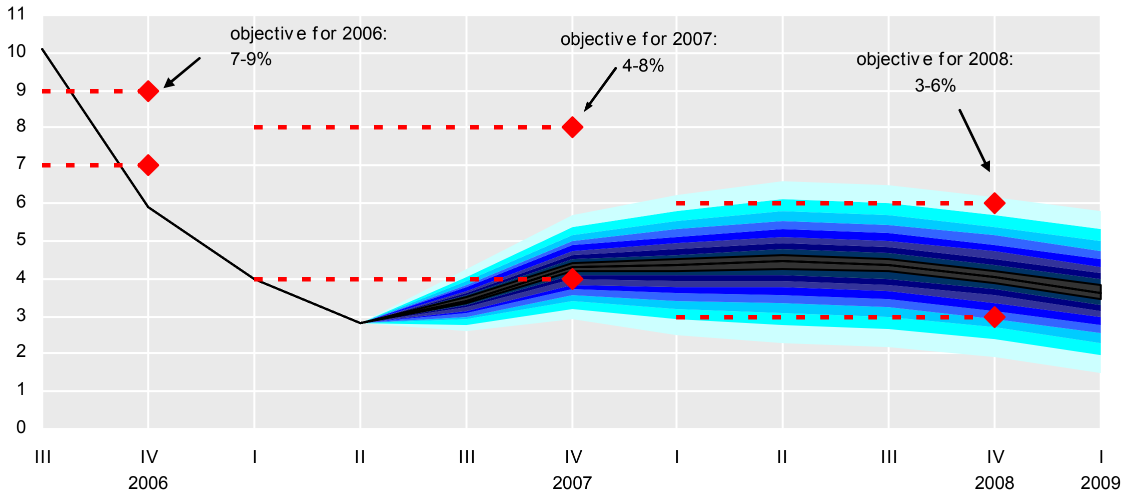
Core inflation for 2007 is likely to hover at the lower bound of the target corridor (4-8%). Projection for core inflation in 2007 is between 3.0 and 5.6%, and around 4.3% in the central projection. In 2008, year-on-year core inflation will move within the target corridor (3-6%).

Strong inflationary pressures generated by leaps in prices of energy and agricultural products, growing demand (spurred by wage growth and fiscal expansion expected in the second half of the year) and a likely rise in inflation expectations will trigger an increase in quarterly rates of core inflation in the second half of the year. This will induce a rise in year-on-year core inflation, which will linger at the lower bound of the target corridor towards the end of the year.

Chart IV.1.1

Core inflation projection

(y-o-y rates, in %)



The fan chart depicts the probability of various core inflation outcomes in the next seven quarters. Central projection is within the darkest central band and the probability that core inflation would lie within it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart with probability of 90%. In other words, the probability that core inflation in the next seven quarters will lie outside the band in the chart is 10%.

In early 2008, year-on-year core inflation will settle within the target corridor for the next year (3-6%) and will remain within this range until the end of 2008. Central projection places core inflation for 2008 at around 4%. Hikes in prices of energy and agricultural products will have a short-term direct effect on core inflation and will not spill over into 2008. In the period ahead, they could trigger a rise in inflation expectations, which in our country represent a very important inflation factor. These pressures are counterbalanced by the appreciation gap, which will most likely continue to have a disinflationary effect in the next year as well.

Moderate tightening of monetary policy is consistent with the core inflation projection and is highly likely in the near future in order to rein in strong inflationary pressures. The projection presupposes that monetary policy decisions will aim at achieving long-term stability, rather than short-term objectives. Therefore, although current-year objective would be met even if monetary authorities proceeded with cuts in the key policy rate, this is unlikely to happen as it would threaten the achievement of core inflation objectives for 2008 as well as long-term price stability.

Projection of Non-core and Headline Inflation

Central projection places retail price growth for 2008 at around **8.0%**. This projection is based on the central projection of core inflation (4.3%) and non-core inflation estimated at around **12%**. The latter still represents a high risk as movements in world prices of oil and agricultural products are highly volatile. Surge in world oil prices, announced electricity price hikes and the most recent drought-induced rise in prices of agricultural products are the main factors behind such high non-core inflation projection for 2007. Projection of the Ministry of Finance[17] places non-core inflation for 2008 at 7.8%, which, together with core inflation projection for the next year, gives headline inflation of around **6%**.

Risks to the Projection

The above projection faces a number of risks. Experience has shown that major risks most often relate to assumptions regarding components of non-core inflation. The largest deviations can be expected in respect of world oil prices, i.e. prices of petroleum products included in non-core inflation, as they can be highly volatile. To illustrate, since our previous projection, world prices of oil have risen by around 20%. Large fluctuations are also possible in respect of prices of agricultural products, which are highly dependent on weather conditions, as illustrated by the drought-induced August leap in prices. These two components of non-core inflation (petroleum products and agricultural products) are the most difficult to predict, as neither monetary authorities nor the government can influence them (or at least not to any significant degree). When it comes to assumptions relating to the EU (inflation and ECB interest rates), there are seldom any significant deviations from the projection.

There are, however, other types of shocks that could also induce deviation from the projection in the period ahead. For instance, sudden inflows or outflows of foreign capital can have a notable effect on the exchange rate, which could result in a departure from the inflation projection and a change in monetary policy stance.

[17] Memorandum on the Budget and Economic and Fiscal Policy for 2008, with projections for 2009 and 2010.

Consequences of Drought and Role of Monetary Policy

The recent rise in prices of agricultural products caused by drought generated strong inflationary pressures on both headline (directly) and core inflation (indirectly). As prices of agricultural products, though not directly included in the calculation of core inflation, influence prices of foodstuffs included in core inflation calculation (meat, edible oil…), we can reasonably expect core inflation to rise in the months ahead. Since maintaining core inflation within the target corridor is the principal objective of monetary policy, the question is **in what way monetary policy should respond to such type of inflationary pressures.**

In order to answer this question, we must first draw the line between short-term (one-off) and longer-term inflationary pressures. Direct cost effects of the rise in prices of agricultural products are short-term and tend to wear off very quickly. For instance, a rise in prices of wheat or flour will lead to an increase in price of bread up to the amount necessary to cover new, higher costs. The effect on inflation will, thereafter, be exhausted and the increase in price of bread will stop at a new level, which means that the effect will be one-off. In that case, monetary policy authorities will choose not to respond since core inflation will very soon return to its pre-shock level even in the absence of such response.

Should, however, this kind of shock trigger a rise in inflation expectations, this could, over a longer run, put upward pressure on all prices. In that case, and in order to rein in such pressures, the NBS would be forced to tighten its monetary policy stance. Therefore, **the NBS will act in response to a rise in prices of agricultural products only to the extent that they trigger a rise in inflation expectations.** The same logic applies to rises in prices of electricity, petroleum products, etc.

As present flows seem to indicate, **current movements in prices of food products do not threaten achievement of core inflation objectives and are in themselves no cause for monetary policy response.** In the period ahead, the NBS will monitor inflation factors and take decisions based on their movements. If the rise in prices of agricultural products is assessed as threatening price stability through a rise in inflation expectations, the NBS will take necessary measures. In any case, the possibility of overshooting the target corridor for core inflation in both this and next year is negligibly low.

Comparison with First-quarter Projection

Central projection of core inflation has been revised notably upwards from that published in the Inflation Report for Q1 2007. This was mainly due to significant changes in assumptions for non-core inflation induced by strong growth in prices of petroleum products, previously unannounced September rise in electricity prices and the most recent drought-induced leap in prices of agricultural products. This has led to an upward revision in core inflation projection as components of non-core inflation – primarily energy and agricultural products – represent cost items in the production of goods included in the calculation of core inflation. In addition, as non-core inflation components are directly included in the calculation of the retail price index, significant revisions were made to the projection of headline inflation so that it now stands at 8.0% against 6% in the first-quarter Inflation Report. Due to notable inflationary pressures, this projection is consistent with a tighter monetary policy stance then assumed in the Inflation Report for Q1 2007.

Chart IV.1.2
Current and previous projecton of core inflation
(y-o-y rates, in %)

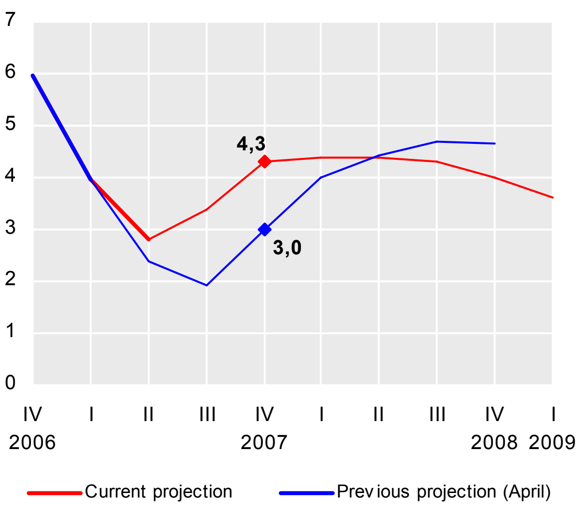


Table A

Indicators of external position of Serbia

	2001	2002	2003	2004	2005	2006	2007 Jan-June
EXTERNAL LIQUIDITY INDICATORS (in %)							
Forex reserves/imports of goods and services (in months)	3.1	4.5	5.3	4.5	5.9	9.6	8.1
Forex reserves/short-term debt	114.1	223.5	336.3	424.9	385.9	717.3	956.4
Forex reserves /GDP	11.0	14.4	17.5	17.3	22.2	37.4	34.3
Debt repayment/GDP	0.9	1.3	2.0	3.8	4.5	6.4	8.9
Debt repayment/exports of goods and services	3.7	7.1	9.1	16.8	17.9	23.5	30.3
EXTERNAL SOLVENCY INDICATORS (in %)							
External debt/GDP	104.8	70.9	66.7	57.5	58.7	61.7	58.6
Short-term debt/GDP	9.7	6.4	5.2	4.1	5.7	5.2	3.6
External debt/exports of goods and services	456.9	379.2	343.0	253.6	234.2	228.1	206.1
FINANCIAL RISK EXPOSURE INDICATORS (in %)							
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	355.0
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	65.3	56.9	59.1	68.6	70.2	73.9	79.8
CREDIT RATING				November Standard & Poor's: B+	July Standard & Poor's and Fitch: BB-	February Standard & Poor's: BB-/positive; Fitch: BB-/stable	June Standard & Poor's: BB-/stable; Fitch: BB-/stable
MEMORANDUM:						(in USD million)	
GDP (in USD million)	10,619	15,840	20,340	24,509	26,355	31,760	18,124
External debt	11,125	11,230	13,575	14,099	15,467	19,606	21,092
External debt servicing	91	211	397	935	1,183	2,021	1,608
Central bank foreign exchange reserves	1,169	2,280	3,550	4,245	5,843	11,888	12,337
Short-term debt	1,026	1,020	1,056	999	1,514	1,657	1,290
Current account balance	-285	-1,247	-1,420	-2,869	-2,224	-3,656	-2,812

Methodological notes:

Foreign exchange reserves/imports of goods and services (in months) - ratio of foreign exchange reserves at end-period to average monthly imports of goods and services.

Foreign exchange reserves/short-term debt (in %) - ratio of foreign exchange reserves to short-term debt at end-period.

Foreign exchange reserves/GDP (in %) - ratio of foreign exchange reserves at end-period to GDP.

Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review.

Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services during period under review.

Debt/GDP (in %) - ratio of outstanding debt at end-period to GDP.

Debt/exports (in %) - ratio of outstanding debt at end-period to annual value of exports of goods and services.

Foreign exchange reserves/M1 (in %) - ratio of foreign exchange reserves to money supply at end-period.

(Exports + imports)/GDP (in %) - ratio of value of exports and imports of goods and services to GDP during period under review.

Notes:

1. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology which apply to all IMF member countries. We have therefore adjusted the financial risk exposure indicator.
2. Trade with Montenegro is registered within relevant transactions as of 2003.
3. Foreign debt repayment does not include early debt repayment.
4. GDP for the period under review as estimated by the National Bank of Serbia.

Table B

Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007 Jan-June
Real GDP growth (in %)	4.8	4.2	2.5	8.4	6.2	5.7	7.8[1)]
Retail prices (in %, relative to the same month a year earlier)	40.7	14.8	7.8	13.7	17.7	6.6	5.1
Core inflation (in %, relative to the same month a year earlier)	20.5	4.4	6.1	11.0	14.5	5.9	2.8
NBS foreign exchange reserves (in USD million)	1,169.1	2,280.1	3,550.1	4,244.5	5,842.8	11,887.5	12,337.0
Exports (in USD million)[2)]	2,435	2,961	4,358	5,559	6,606	8,593	5,311
- growth rate in % compared to a year earlier	17.9	21.6	47.2	27.6	18.8	30.1	39.4
Imports (in USD million)[2)]	-4,499	-6,059	-8,177	-11,853	-11,902	-14,885	-9,158
- growth rate in % compared to a year earlier	28.3	34.7	35.0	45.0	0.4	25.1	37.1
Current account balance (in USD million)	-285	-1,247	-1,420	-2,869	-2,224	-3,656	-2,812
as % of GDP	-2.7	-7.9	-7.0	-11.7	-8.4	-11.5	-15.5
Unemployment, official data (in %)[3)]	21,8	24,5	26,1	23,9	25.3	25.9	25.8
Unemployment according to the Survey (in %)[4)]	12.2	13.3	14.6	18.5	20.8	20.9	…
Wages (average for the period, in EUR)	89.9	151.7	176.7	194.4	210.4	260	323
RS budget deficit/surplus (in % of GDP)	-0.2	-4.3	-1.4	-0.1	1.5	1.4	0.15
Consolidated fiscal result (in % of GDP)							
- Ministry of Finance methodology	0.0	-1.9	-2.0	0.5	3.9	-3.1	4.0
- IMF methodology	-0.5	-2.8	-4.3	-1.4	-3.2	-4.7	1.5
RS public debt (external + internal, in % of GDP)[5)]	106.5	73.7	67.9	53.7	46.2	38.8	32.8
RSD/USD exchange rate (average, in the period)	66.68	64.46	57.56	58.39	66.70	67.10	60.58
RSD/USD exchange rate (end of period)	67.67	58.98	54.64	57.94	72.22	59.98	58.78
RSD/EUR exchange rate (average, in the period)	59.78	60.68	65.05	72.57	82.92	84.16	80.53
RSD/EUR exchange rate (end of period)	59.71	61.52	68.31	78.89	85.50	79.00	79.03
Memorandum							
GDP (in USD million)	10,619	15,840	20,340	24,509	26,355	31,760	18.124[1)]

1) NBS estimate.

2) Trade with Montenegro is registered within relevant transactions as of 2003.

3) Source: Serbian Bureau of Statistics; before 2003, unemployment rate was calculated based on the number of job seekers, while as of 2004 it is calculated based on the number of unemployed persons.

4) Source: Labour Force Survey, Serbian Bureau of Statistics.

5) Source: RS Ministry of Finance Bulletin.

Appendix 1: Decision on Amendments to the Decision on Interest Rates Applied by the National Bank of Serbia in Implementation of Monetary Policy

"RS Official Gazette", No.50/2007 of 1 June 2007

Pursuant to Article 14, item 6 of the Law on the National Bank of Serbia ("RS Official Gazette", Nos. 72/2003 and 55/2004), the NBS Monetary Policy Committee hereby issues the following

D E C I S I O N
ON AMENDMENTS TO THE DECISION ON INTEREST RATES APPLIED BY THE NATIONAL BANK OF SERBIA IN IMPLEMENTATION OF MONETARY POLICY

1. In the Decision on Interest Rates Applied by the National Bank of Serbia in Implementation of Monetary Policy ("RS Official Gazette", Nos. 73/2006, 103/2006, 110/2006 and 31/2007), Section 6 shall be amended to read:

"6.For the purposes hereof, and in line with the decision prescribing guidelines for setting interest rates of the National Bank of Serbia in respect of money market operations, the key policy rate shall be the highest and/or lowest interest rate applied by the National Bank of Serbia in the conduct of two-week (12-16 days) repo operations of sale and/or purchase of securities.

The level of the key policy rate, as well as the commencement of its application, shall be set by the NBS Monetary Policy Committee.

The key policy rate shall be published on the National Bank of Serbia’s website on the day it was set by the NBS Monetary Policy Committee.".

2. This decision shall enter into force on the day of its publication in the "RS Official Gazette", and shall be applied as of 1 June 2007.

NBS MPC No.11
29 May 2007

B e l g r a d e

Chairman at the
NBS Monetary Policy Committee meeting

G o v e r n o r
National Bank of Serbia

Radovan Jelašić

Appendix 2: Changes in Reserve Requirements

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation (dd/mm/yyyy)	Expected effects
1	136/04	Dinar base – unchanged Foreign currency base - extended (inclusion of liabilities arising from foreign currency loans from foreign legal entities with maturity up to 4 years and liabilities arising from foreign loans registered by banks after 31 December 2004)	Unchanged 21% Unchanged 21%	Remunerated Remunerated	10/01/2005	Sterilization of RSD 0.6 billion
2	Guidelines No. 12 of 06/04/2005	Dinar base – extended Foreign currency base - extended (inclusion of liabilities to subordinated and related banks)	21% 21%	Remunerated Remunerated	10/04/2005	Sterilization of RSD 0.5 billion Sterilization of RSD 2.9 billion
3	46/05	Dinar base – unchanged Foreign currency base – unchanged	Reduced from 21% to 20% Increased from 21% to 26%	Remunerated Remuneration cancelled	10/06/2005	Release of RSD 0.1 billion Sterilization of RSD 7.4 billion Net effect: sterilization of RSD 7.3 billion
4	69/05	Dinar base - unchanged Foreign currency base – unchanged	20% Increased from 26% to 29% Minimum foreign currency liquidity against foreign currency savings reduced from 47% to 45%	Remunerated Unremunerated	10/08/2005	Sterilization of RSD 6 billion Release of RSD 0.7 billion
5	77/05	Dinar base - unchanged Foreign currency base - extended (inclusion of all foreign loans with agreed maturity of over 4 years, provided loan contracts and annexes were registered before 31 December 2004).	20% Base extension subject to 7% interest Minimum foreign currency liquidity against foreign currency savings reduced from 45% to 43%	Remunerated Unremunerated	10/09/2005	Sterilization of RSD 5.1 billion Release of RSD 0.5 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
6	80/05	Dinar base – narrowed (deduction of: long-term housing loans insured with the National Housing Loans Insurance Corporation)	20%	Remunerated	10/10/2005	Sterilization of RSD 7.3 billion
		Foreign currency base – narrowed (same as above)	Unchanged except for the base extension introduced by the earlier Decision (increased from 7% to 18%)	Unremunerated		
	86/05	Foreign currency base – extended by inclusion of external liabilities arising from bank operations performed in the name and for the account of third parties				
			Minimum foreign currency liquidity against foreign currency savings reduced from 43% to 42%			Release of RSD 0.6 billion
7	91/05	Dinar base – reduced by time dinar savings deposited in the period from 31 October until 6 November 2005	20%	Remunerated	10/11/2005	
		Foreign currency base - unchanged	Unchanged except for the base extension (increased from 18% to 29%, i.e. equalized)			
			Minimum foreign currency liquidity against foreign currency savings reduced from 42% to 41%	Unremunerated		Release of RSD 0.9 billion
	95/05	Dinar base - unchanged	Reduced from 20% to 18%	Remunerated		Allocation reduced by: RSD 1.7 billion
		Foreign currency base - unchanged	Increased from 29% to 35%	Unremunerated		Sterilization of RSD 20.4 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
8	102/05 109/05	Dinar base – unchanged Dinar base with foreign currency clause - introduced Foreign currency base - unchanged Dinar base - unchanged Dinar base with foreign currency clause Foreign currency base: – extended (inclusion of foreign currency savings deposited after 30 June 2001 which previously had different treatment, with concurrent abolition of minimum foreign currency liquidity requirement) and - reduced by the sum of foreign currency savings deposited with banks in the period from 1-7 November 2004 and 31 October – 6 November 2005	18% 35% Increased from 35% to 38% 38%	Remunerated Remunerated Unremunerated	10/12/2005	Sterilization of RSD 2.0 billion Sterilization of RSD 14.9 billion
9	28/06	Dinar base – unchanged Dinar base with foreign currency clause - changed Foreign currency base - extended (inclusion of the amount of subordinated foreign currency liabilities)	18% Increased from 38% to 40% Increased from 38% to 40%, except for subordinated liabilities (20%), and from 38% to 100% for deposits of leasing companies with banks	Remunerated Unremunerated	10/04/2006	Sterilization of RSD 1.2 billion Sterilization of RSD 18.7 billion
10	39/06	Dinar base – unchanged Foreign currency base - unchanged	18% 40% - for foreign loans with maturity up to 2 years, the ratio was raised from 40% to 60%	Remunerated Unremunerated	10/05/2006	Sterilization of RSD 35.5 billion

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
11	49/06	Dinar base – unchanged Foreign currency base - unchanged	18% For liabilities in dinars arising from deposits and external loans with maturity up to 2 years the ratio was increased from 18% (40%) to 60%, and for liabilities with maturity over 2 years, from 18% (40%) to 40% 40%	Remunerated Unremunerated	10/06/2006	Sterilization of RSD 5 billion
12	73/06	Dinar base – unchanged Foreign currency base - unchanged Obligation of banks to keep their daily balance of allocated dinar or foreign currency reserve requirement at a level of not less than 80% of calculated dinar or foreign currency reserve requirement is reduced to 50% subject to this decision.	Unchanged Unchanged	Remunerated Unremunerated	11/09/2006	The aim is to facilitate liquidity management for banks
13	96/06	Dinar base – unchanged Foreign currency base – unchanged Daily balance of allocated dinar or foreign currency required reserves kept by banks may be higher or lower the calculated level of dinar or foreign currency required reserves, i.e. percentual limitation has been cancelled.	Reduced from 18% to 15% Unchanged	Remunerated Unremunerated	10/11/2006	Release of RSD 3.9 billion The aim is to facilitate liquidity management for banks

At its meeting held on 26 December 2006, the NBS Monetary Policy Committee adopted a new Decision on Required Reserves of Banks with the National Bank of Serbia.

Earlier decision on reserve requirements, issued in April 2004, was amended 17 times. The new decision was issued to amend this complicated method of calculating this classic and frequently changed monetary policy instrument. It is similar to the earlier decision in that the reserving base for the calculation of required reserves includes the book value of average daily dinar and foreign currency balances in the preceding calendar month.

However, pursuant to the new decision, banks do not calculate required reserves against special purpose deposits of enterprises and entrepreneurs in respect of exchange transactions; foreign currency required reserves are calculated and allocated in euros, as is the case with the calculation, payment and collection of interest (by way of exception, foreign currency required reserves may be calculated and allocated in US dollars so as to prevent worsening of open foreign currency positions of banks). Ratio on the dinar reserving base is set at 10%, on household foreign currency deposits on 40% and 45% on foreign currency reserving base (external borrowing). Reserve requirement ratio on short-term external borrowing (60%) has been cancelled. All changes in reserve requirements are presented in Appendix 2.

No.	Legal ref.	Base	Ratio	Interest on allocated required reserves	Initial calculation	Expected effects
14	New Decision 116/06	Dinar base – unchanged Foreign currency base – unchanged *Calculation of foreign currency required reserves is effected in euros.*	10% On foreign currency clause-indexed dinar deposits and dinar obligations arising from deposits and external credits – 45% 45% On foreign currency savings deposited with banks 40%; on foreign currency subordinated obligations 20%; on leasing companies' foreign currency assets 100%	Remunerated Unremunerated	10/01/2007	Release of RSD 5.8 billion Sterilization of RSD 14.6 billion
15	3/07	Dinar base – unchanged Foreign currency base – unchanged *By way of exception, due to foreign exchange risk ratio, banks are allowed to allocate foreign currency required reserves also in US dollars.*	Unchanged Unchanged	Remunerated Unremunerated	10/01/2007	
16	31/07	Dinar base – unchanged Foreign currency base – unchanged *Banks may issue order for allocation, i.e. withdrawal of funds from the foreign currency reserve requirement account.* *Subject to bank authorization, the National Bank of Serbia may credit or debit foreign currency accounts of banks in line with regulations on interbank clearing of payments in foreign exchange.*	Unchanged Unchanged	Remunerated Unremunerated		Applicable as 1 April 2007, just as the Decision on Interbank Clearing of Payments in Foreign Exchange

Appendix 3: Prudential Measures Aimed at Curbing Credit Growth

No.	Legal ref.	Regulation	Description	Previously
1	37/04 86/04 129/04	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	A bank is obligated to classify all claims arising from loans extended to a natural person (with the exception of housing loans) in category E, as top risk-bearing loans, subject to 100% provisioning in cases where total monthly instalment, including previously disbursed loans, exceeds 30% of the borrower's monthly income, and down payment or deposit placed by the borrower is less than 20% of the new loan .	Prior to the amendment to this Decision, loans that failed to meet the criteria were classified in category B subject to 25% provisioning.
2	97/05	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	In cases where the documentation submitted by a natural person applying for a loan does not include a Credit Bureau report on the natural person's liabilities, claims under such loan are classified in category E subject to 100% provisioning.	Prior to the amendment to this Decision, loans that failed to meet the criteria were classified in category B subject to 25% provisioning.
3	51/05	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	The amendment prescribes obligatory inclusion of the analysis of the borrower's dinar exchange rate risk exposure in the credit file in cases where the borrower is a legal entity, and in specific cases where claims on such borrower are to be classified in a category less favourable than they would otherwise have been classified. *(applicable as of 18 June 2005)*	
4	16/06	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	If a loan to a natural person, regardless of its maturity, is collateralized by a mortgage lien, then the base to which provisioning ratio is applied remains unchanged (with the exception of housing loans extended to natural persons, and mortgage backed loans to legal entities, in which case the base is narrowed by 50%, and the mortgage value may not be less than the value of the loan).	Implementation of this amendment to the Decision will prevent banks from evading higher provisioning for mortgage-collateralized cash loans, general purpose loans and consumer loans with longer maturities.
5	49/06	Decision on Criteria for Classification of On-Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations	Amendment to the Decision has supplemented the provision pursuant to which claims on natural persons, excluding claims in respect of housing loans, are classified in category E if monthly instalment for repayment of the loan approved, including monthly payments of existing loans, exceeds 30% of the borrower's net monthly income, or if the borrower has placed a down payment or deposit of less than 20% of the amount of the loan approved. Subject to this amendment, in addition to obligations in respect of existing loans, monthly repayment obligations will also include obligations under revolving credit cards, activated warranties on loans, 50% of the amount of issued warranties on loans and obligations arising from financial lease contracts. *(applicable as of 1 July 2006)*	

No.	Legal ref.	Regulation	Description	Previously
6	11/05 28/05 108/05	Decision on the Uniform Method of Calculating and Disclosing the Level of Effective Interest Rate on Deposits and Loans	This Decision prescribes the uniform method of calculating and disclosing the effective interest rate used in calculation of total cost of a bank loan or deposit received. This Decision came into force on 15 March 2005.,It has, however, been amended on several occasions with a view to providing greater transparency: e.g. a corrective factor to the effective interest rate was introduced for loans under which the loan deposit exceeds 50% of total loan amount (applicable as of 30 March 2005). Also, the banks are required to submit weighted average interest rate for a) foreign currency clause indexed dinar loans separately for all foreign currencies used, as well as for other indexation criteria, b) dinar loans and c) foreign currency loans. *(applicable as of 7 December 2005).*	
7	57/06	Decision on the Uniform Method of Calculating and Disclosing the Level of Effective Interest Rate on Deposits and Loans	This Decision and the accompanying Guidelines were issued with a view to providing comparable and relevant information regarding the method of calculating and disclosing all costs of a loan/deposit. Pursuant to the Guidelines, banks are obligated to prepare and give to clients an Overview of Basic Data on Deposit/Loan, as well as an overview of data not included in the calculation of effective interest rate (revaluation and indexation criteria, Credit Bureau fees, etc.). In addition to quarterly reports, banks will also submit to the National Bank of Serbia monthly reports on their weighted average nominal and effective lending and deposit rates. *(applicable as of 1 October 2006)*	This Decision was issued pursuant to the new Law on Banks (“RS Official Gazette“, No.107/05) With the commencement of its application on 1 October 2006, the earlier Decision on the Uniform Manner of Calculating and Disclosing the Effective Interest Rates on Loans and Deposits (Decision No.6) ceased to be valid.
8	51/05	Decision on the Basic Elements of Procedure for the Approval and Collection of Claims by Bank and Other Financial Organizations	Pursuant to this Decision, banks are obligated to devise methodology for assessment of the borrower’s financial standing (borrower’s creditworthiness), and particularly for analysis of the borrower’s exchange rate risk exposure. In particular, banks are obliged to apply methodology for assessment of the borrower’s financial standing and the effects of exchange rate change by 5%, 10% and 15% on the borrower’s financial standing, as well as classification of the borrower’s obligations in cases where the borrower’s total liabilities amount to more than CSD 10 million. Finally, banks are obligated to apply methodology for assessment of their own credit risk exposure resulting from exchange rate risk movements, as well as to disclose the amount of provisions against potential losses.*(applicable as of 18 June 2005)*	

No.	Legal ref.	Regulation	Description	Previously
9	88/05	Decision Amending and Supplementing the Decision on Detailed Conditions and Manner of Conducting Bank Supervision by the National Bank of Serbia	Amendments to this Decision pertain to the implementation of corrective measures in cases where balance sheet assets and off-balance sheet items are not classified in compliance with supervision findings. *(applicable as of 1 January 2006).*	Valid until 1 October 2006.
10	51/06	Decision on Detailed Conditions and Manner of Conducting Bank Supervision by the National Bank of Serbia	This Decision specifies conditions and manner of conducting supervision, especially with respect to issuing orders and taking measures by the NBS and instituting receivership over banks. Pursuant to this Decision, in the event of any irregularities in the classification of claims, banks are obligated to classify balance sheet assets and off-balance sheet items in line with supervision findings, to enter such data in their ledgers and to disclose the amounts of provisions against potential losses. *(applicable as of 1 October 2006)*	
11	16/06	Decision Amending the Decision on Detailed Requirements with Respect to the Implementation of Articles 26 and 27 of the Law on Banks and Other Financial Organizations	This Decision abolishes two exemptions from calculation of the bank's foreign currency position: a) claims arising from long-term foreign currency loans approved under external loans, which were assumed by the Government and converted into capital, b) foreign currency claims and/or foreign currency clause indexed dinar claims – up to the level of shareholder capital paid up in a different currency. A bank is obligated to adjust its operations in line with this Decision by 31 December 2006 and to achieve a 30% foreign exchange risk ratio. When calculating risk-bearing assets, banks are required to apply a 50% weight only to claims on legal entities and housing loans collateralized by a mortgage equalling not less than the value of the claim.	

No.	Legal ref.	Regulation	Description	Previously
12	49/06	Decision Amending the Decision on Detailed Requirements with Respect to the Implementation of Articles 26 and 27 of the Law on Banks and Other Financial Organizations	When calculating risk-weighted assets, banks are obligated to apply a new 125% weight to “claims in foreign currency or in dinars indexed to a foreign currency clause or any other form of indexation equalling not less than the dinar equivalent of EUR 10,000,000 that have not been protected by the borrower against changes in the exchange rate of the dinar vis-à-vis another currency or any other form of indexation (by securing the claims on such borrower under same conditions that the bank secured itself, i.e. same foreign currency, and/or same foreign currency clause or any other type of indexation, same maturity, payment terms and at least the same amount)”.	
13	39/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Pursuant to this Decision, a bank is obligated to reconcile gross household dinar lending (short-term and long-term, with allowances for loan impairment excluded, and with calculated interest and fees included) against the level of share capital so that, as of 30 September 2006, such lending at the end of each calendar month is lower than or equivalent to 200% of the value of share capital as at 30 September 2006.	New decision issued in May 2006
14	49/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	A bank is obligated to reconcile gross household dinar lending against the level of its share capital so that, at the end of each month, such lending is lower than or equivalent to 200% of such bank’s share capital (instead of 200% of the bank’s share capital as at 30 September 2006).	New provision whereby the level of household lending is reconciled against the amount of share capital at the end of each month was introduced for the purpose of encouraging steady increase in banks’ share capital and curbing growth in lending.

No.	Legal ref.	Regulation	Description	Previously
15	64/06	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Subject to this amendment, lending to be reconciled against the bank's share capital includes not only dinar lending, but also foreign currency lending (pursuant to the new Law on Foreign Exchange Operations, a bank may approve foreign currency loan to resident-legal entity and entrepreneur for the purpose of importing goods and services and to natural person for the purpose of purchasing real estate in the country). Subject to the adopted Decision, gross household lending does not include loans for direct investment in agricultural production, loans for housing construction supported by the RS Government's program and loans approved to entrepreneurs (natural persons independently performing economic activities for the purpose of making profit) for direct investment in production of goods and services within their line of business. *(applicable as of 31 July 2006)*	
16	57/06	Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items	For the purposes of adequate and efficient management of risks that the bank is exposed to in its operations, this Decision sets out the conditions under which a bank classifies its balance sheet assets and off-balance sheet items, as well as the manner of covering the provisions against potential losses on balance sheet assets and off-balance sheet items. Provisions against potential losses on bank balance sheet assets and off-balance sheet items are *special provisions against potential losses and provisions against general banking risks*. The Decision also specifies special criteria for the classification of bank receivables from different categories of borrowers: legal entities, budget beneficiaries, entrepreneurs and natural persons. Banks are obligated to classify all receivables into categories A, B, C, D and E depending on the timeliness of collection, past due status of payment, disputable legal grounds or problems in operation.	This Decision (entered into force on 1 October 2006), practically replaced the preceding Decision on the Classification of Balance Sheet Assets and Off-Balance Sheet Items According to the Level of Collectibility and Level of Special Provisions of Banks and Other Financial Organizations.
17	116/06	Decision on the Classification of Bank Balance Sheet Assets and Off-Balance Sheet Items	Amendment to this Decision prescribes *percentage bands* for the calculation of special provisions against potential losses, whereby banks are given greater independence and responsibility in measuring credit risk. Banks are obligated to define in more detail the criteria and methodology for specifying provisions against potential losses within percentage bands through their internal enactments. The amendment also introduced changes in the manner of classification of receivables from legal and natural persons.	

No.	Legal ref.	Regulation	Description	Previously
18	57/06	Decision on Capital Adequacy of Banks	This Decision sets out the method of calculating a bank's total qualifying capital and capital adequacy ratio. A bank's total qualifying capital is the sum of its core capital elements (minimum 50% of capital) and supplementary capital elements minus deductions. Banks have to ensure that their capital never drops below the dinar equivalent value of EUR 10,000,000 at the official middle exchange rate. The Decision defines risk-weighted assets of the bank, foreign exchange risk (the risk of negative effects on the financial result and capital of the bank caused by changes in exchange rates), and open net foreign currency position. Open net foreign currency position of a bank may be long (if the amount of receivables in a specific foreign currency exceeds the amount of obligations in the same currency) or short (if the amount of receivables in a specific foreign currency is lower than the amount of obligations in the same currency). Open net foreign currency position of a bank is to be shown separately for euro-, US dollar- and Swiss franc-denominated receivables and obligations, while receivables and obligations in other currencies are to be shown in the aggregate, as well as those in gold and other precious metals. Banks will also include in the calculation of open net foreign currency position their foreign currency clause-indexed dinar receivables. Pursuant to the Decision, capital adequacy ratio is the ratio between the bank's capital and risk-weighted assets. For the purposes of running safe and sound business operations, and/or fulfilment of obligations towards the creditors, bank is obligated to keep its capital adequacy ratio above 12%.	This Decision (entered into force on 1 October 2006) practically replaced the preceding Decision on Detailed Requirements for Implementing Articles 26 and 27 of the Law on Banks and Other Financial Organizations, as well as Section 31 of the Decision that regulated foreign exchange risk ratio.
19	116/06	Decision on Capital Adequacy of Banks	This amendment introduces a provision pertaining to the 125% risk weight. Namely, the bank is to include in this category of risk also a portion of receivables that have not been protected by the borrower against changes in the foreign exchange risk. Receivables are considered partly protected against changes in the exchange rate of the dinar or changes in form of indexation, if the borrower can rely on inflow in the same currency, and/or with the same form of indexation for the term of such receivable (inflow from abroad, deposit, wages, etc.).	

No.	Legal ref.	Regulation	Description	Previously
20	31/07	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Subject to this amendment, banks are obligated to pay interest to the National Bank of Serbia on the amount of positive difference between the prescribed and deposited amount of funds, as well as on the amount of positive difference between the correctly calculated and originally calculated amount to be deposited, by applying the interest rate envisaged by the Decision on Interest Rates Applied by the National Bank of Serbia in the Implementation of Monetary Policy ("RS Official Gazette", Nos. 73/2006, 103/2006, 110/2006 and 31/2007).	Beginning of application in the period 25 May – 25 June 2007, according to the level of gross household lending and share capital as at 30 April 2007.
21	56/07	Decision on Capital Adequacy of Banks	This amendment calls for deletion of a clause pursuant to which banks must exclude from the calculation of their foreign currency positions claims on government in line with the Decision on Terms and Conditions of the Regulation of Obligations of the Republic of Serbia towards Authorized Banks from Article 16 of the Law on the Settlement of FR Yugoslavia Public Debt in respect of the Citizens' Frozen Foreign Currency Savings ("RS Official Gazette", No.92/02).	Banks are obligated to bring their foreign exchange risk ratio to the prescribed level by 28 September 2007.
22	77/07	Decision on Reconciliation of Gross Household Dinar Lending against Share Capital of Banks	Subject to this amendment, as of 31 December 2007, at the end of each calendar month the ratio of gross household lending to share capital of banks shall have to be at or below 150%. In addition, banks may not approve cash loans with a repayment period longer than 24 months.	

List of Tables and Charts

Tables

Charts

Source of data: National Bank of Serbia and Serbian Bureau of Statistics, unless otherwise specified.

Meetings of the Monetary Policy Committee of the National Bank of Serbia and key policy rate changes in 2007

Date	Key policy rate	Change (in percentage points)
MPC meetings held		
10 January 2007	14.00	0
29 January 2007	13.00	-1.00
9 February 2007	13.00	0
28 February 2007	11.50	-1.50
13 March 2007	11.50	0
28 March 2007	10.50	-1.00
18 April 2007	10.50	0
27 April 2007	10.00	-0.50
15 May 2007	10.00	0
29 May 2007	9.50	-0.50
11 June 2007	9.50	0
28 June 2007	9.50	0
12 July 2007	9.50	0
27 July 2007	9.50	0
15 August 2007	9.50	0
Scheduled MPC meetings		
28 August 2007		
10 September 2007		
28 September 2007		
10 October 2007		
29 October 2007		
9 November 2007		
28 November 2007		
10 December 2007		
28 December 2007		

Press Releases from the NBS MPC Meetings

Press release from the MPC meeting held on 18 April 2007

After discussing economic developments in the first half of April, the Monetary Policy Committee announced today its decision to retain the key policy rate at the level of 10.5 percent. Although Q1 core inflation movements give scope for further monetary policy relaxation, the MPC decided to keep the policy rate unchanged because information on the risks that could adversely affect inflation expectations in the period ahead is still insufficient.

The above risks refer primarily to core inflation rate yet to be recorded for April and rather relaxed fiscal policy coupled with hazy insight into the state of public finances during extended temporary financing, both with regard to the level of expenditures and spending of additional revenue and the realization of the planned regular budget revenues. Though announced, the annual plan of adjustment in prices under administrative control has not yet been made public. As regards foreign risks, rising oil prices pose the largest threat that could trigger inflation pressures in the period ahead.

The MPC argues that the time since the last significant 1 percentage-point cut in the key policy rate on 28 March is too short to allow for full appreciation of the effects of this reduction, including the response of interbank market interest rates to changed repo rate, which is the main instrument that the NBS uses in maintaining core inflation within the corridor projected for this year.

The MPC also noted that the NBS did not intervene at all in the foreign exchange market in the first half of April, which means that the exchange rate was formed exclusively by balancing supply and demand through interbank trading.

Press release from the MPC meeting held on 27 April 2007

After discussing economic developments and, in particular, the forecast of inflation movements within the defined inflation corridor, the Monetary Policy Committee announced today its decision to cut the key policy rate by 50 basis points from 10.5 down to 10 percent. The MPC based its decision on estimates that 2007 core inflation, including April price movements, is below the lower bound of the target corridor (set between 4 and 8 percent) and that inflation expectations have gone down, leaving scope for further gradual lowering of the key policy rate to the optimum level conducive to maintaining inflation within the range projected for this year.

Another development confirming that the key policy rate is an efficient monetary policy instrument is a fully market-determined exchange rate formed by balancing supply and demand in the entire foreign exchange market, with the NBS not intervening in the foreign exchange market for six weeks already (since 14 March).

However, as the MPC noted, the lowering of the key policy rate should be gradual due to the presence of risks that refer mainly to uncertainty regarding fiscal flows since no budget for

2007 has yet been adopted. In addition, the level and time of adjustments in administered prices, such as the expected rise in electricity prices, are still unknown, as are future movements in world prices of oil.

In view of the abovementioned risks and the need to ensure long-term monetary stability, the MPC today lowered the key policy rate for the eighth time since it was first introduced in September 2006, down to 10 percent. From the beginning of the year, there have been four downward revisions of the key policy rate.

The new key policy rate shall apply as of 4 May 2007.

Press release from the MPC meeting held on 15 May 2007

Following discussion of economic circumstances prevailing in the first half of May, the Monetary Policy Committee has decided to keep the key policy rate unchanged from its present level of 10%. Although the core inflation rate is below the lower bound of the targeted corridor and the money market interest rates declined in April as a result of the key policy rate cut in March, the MPC noted that it currently has insufficient information on which to base additional change in the monetary policy stance.

After not participating for almost two months, in the first ten days of May the NBS intervened in trading in the Interbank Forex Market on two occasions to sell EUR 75.4 million, in order to moderate excessive daily exchange rate oscillations. During the past week, from 7 through 12 May, net purchases of the NBS via exchange offices came to a total of EUR 56.4 million. Although the foreign exchange market stabilized following a short-lived upheaval in the face of uncertainties regarding constitution of the new government, the MPC holds that these events obstruct clear insight into the real effect of the May key policy rate cut on inflationary expectations.

The volume of fiscal spending, which will have a decisive effect on future inflationary expectations and degree of monetary policy tightness, remains unknown. It is yet to be defined by the budget for 2007 that will specify the degree of restrictiveness of the fiscal policy in the remaining months of the current year.

The NBS will keep a close eye on future developments and, once the May inflation rate is revealed later in the month and the new budget is adopted, the MPC will meet again to decide whether monetary policy measures need further adjustment to the core inflation projection for Q2 this year.

Press release from the MPC meeting held on 29 May 2007

The NBS Monetary Policy Committee announced today its decision to lower the key policy rate from 10% to 9.5%. Despite the fact that the May inflation figure will include the effects of the electricity price hike, 2007 headline inflation will in all likelihood not exceed 5 percent. Such development only confirms that the NBS rightly pushed for no delay in revision of electricity prices, assessing that the underlying uncertainties could have far greater adverse effects on inflation expectations than the actual electricity price increase on the general price level.

Annualized measure of core inflation, which is influenced by the NBS monetary policy, continued declining, thereby making room for a further mild relaxation of the monetary policy stance. Following the ninth consecutive lowering of the key policy rate over nine months since it was first introduced as the key instrument of monetary regulation, the NBS key policy rate, moving in line with declining inflation, slid today to a single-digit level.

The NBS wishes to emphasize that maintenance of the declining trend in inflation depends primarily on adoption of a tight economic policy framework for 2007, including the budget for 2007, which should reflect a necessary degree of fiscal policy restrictiveness and assist monetary policy in achieving price stability in an environment of eased monetary conditions.

After discussing the Inflation Report for the first quarter of 2007, the MPC emphasized that the main factors to influence a key policy rate trajectory conducive to the achievement of core inflation objectives set for 2007 are: budget for 2007, as the main determinant of domestic demand, schedule of revisions in regulated prices, investors' attitude towards our country and movements in world prices of oil. In its session today, the MPC also discussed the Memorandum of the NBS on Setting the 2008 Inflation Objective, which specifies the core inflation objective for end-2008. Announcement of the 2008 inflation objective ought to increase transparency and contribute to lowering of inflation expectations in the period ahead. Both documents will be posted on the NBS website as of 4 June.

In its session today, the MPC also adopted amendments to the Decision on Interest Rates Set by the NBS in the Implementation of Monetary Policy, which relates to the manner of announcing the key policy rate. In the future, the key policy rate will be published on the NBS website on the day it is set by the MPC and will be applicable as of that date. As a result, banks and other financial market participants will be informed promptly of a change in the level of the key policy rate and of the National Bank's measures. This change is expected to enhance the efficiency of open market operations and interest rate management aimed at achieving the principal monetary policy objectives.

Press release from the MPC meeting held on 11 June 2007

The NBS Monetary Policy Committee has taken a decision today to keep the key policy rate at its early June level. After discussing current monetary and economic flows, the MPC assessed that money market interest rates have continued declining in June, and that the exchange rate of the dinar, as determined by foreign exchange demand and supply in interbank trading, has been generally stable and showed slight oscillations. As of 4 June, i.e. after regular daily IFEM sessions were abolished, the NBS did not organize a single such session, and the exchange rate has been set entirely by market forces.

The MPC shall continue to monitor closely economic developments, as well as the impact of the May increase in electricity prices on core inflation. Based on the above developments, and following adoption of the budget for this year, the MPC shall in its next session decide on the level of the key policy rate which is conducive to achieving the projected core inflation.

Headline inflation in May was somewhat higher than expected due to the increase in some regulated prices which was not planned in advance, while core inflation expectations were slightly undershot (0.2%). The MPC holds that the unexpected growth of some regulated prices should not have a notable impact on future movements in inflation.

Press release from the MPC meeting held on 28 June 2007

Following discussion of current economic flows, the Monetary Policy Committee announced today its decision to keep the key policy rate unchanged from the level of 9.5 percent, although core inflation remains well below the lower bound of the target corridor set for this year. Strong growth in both headline and core inflation recorded in June compared to earlier months of the year stands out among the reasons against a change in the monetary policy stance.

The main factors behind the rise in headline and core inflation included the indirect effects of the May electricity price hike, the June rise in prices of petroleum products, growth in other regulated prices and uncertainties regarding external pressures that may be generated by rising oil prices in the world market.

The Monetary Policy Committee also took note of the present level of inflation expectations and the fact that the adopted level of fiscal spending for this year, coupled with accumulated effects of high wage growth in the prior months, will only contribute to a further rise in inflation expectations and inflationary pressures. The amount of liquidity in the market, which will increase substantially as of July with implementation of the budget for 2007, is expected to generate significant inflationary pressures in the period ahead.

Even if monetary policy is not relaxed further, all of the above factors are likely to lead to a rise in core inflation, bringing it closer to the lower bound of the target corridor.

The Monetary Policy Committee will closely monitor developments with respect to increased public spending and its impact on aggregate demand and inflation, and will respond by changing the level of the key policy rate in order to retain or even increase the present level of monetary policy restrictiveness.

Press release from the MPC meeting held on 12 July 2007

Following discussion of current economic flows and the outlook for core inflation over the remaining months of 2007, the NBS Monetary Policy Committee has decided to keep the key policy rate unchanged from its present level of 9.5%.

The MPC assessed financial markets flows as stable and conducive to the achievement of core inflation projection, and movements in market interest rates as aligned with the current level of the key policy rate. However, upside risks to inflation and inflation expectations still prevail, such as growth in demand sparked by increased wages and budget spending plans over the coming months.

The MPC has also acknowledged information on the most recent Standard&Poor's decision to downgrade Serbia's credit rating from "BB-/positive" to "BB-/stable" based on the assessment of a likely widening of the current account deficit in the oncoming period due to relaxation in fiscal policy stance.

In view of the positive effects that issuing of savings bills has had and the significant interest that citizens continue to show in this type of investment, the MPC has taken a decision today to release the second issue of savings bills. The new issue in the amount of RSD 1 billion at the discounted interest rate of 11%p.a. will be launched on 17 July 2007 and mature on 11 July 2008. The MPC holds that given the declining inflation trends, they will continue to produce attractive yields.

Reflecting on the successful sale of these securities, the MPC assessed today that the NBS has fully achieved its objectives in this respect. First and foremost, it managed to encourage household dinar savings and to create a stable environment for their growth thereby leading banks to keep raising interest rates on dinar savings deposits. At the same time, positive effects were also felt in terms of improved confidence in the domestic currency. Therefore, the MPC has decided that the new issue, i.e. the second issue in 2007, will be the last issue of NBS savings bills, after which the NBS will withdraw from this segment of the financial market.

Press release from the MPC meeting held on 27 July 2007

Based on the current economic flows and estimated movements in core inflation until the end of the year as well as plans for 2008, the MPC has decided to keep the key policy rate at its current level of 9.5%. As the level of core inflation remains close to the lower bound of the projected range for 2007, the best collective judgement of the MPC is that the current degree of monetary tightness may reasonably be maintained.

The MPC, however, has made a note of the risks currently prevailing in the economy which shall induce acceleration in core inflation in the months ahead and entail a turnaround in the monetary policy stance. The MPC has voiced its concerns primarily about the dangers of future fiscal expansion since, following the period of temporary budget financing during the first half of the year, a notable increase in liquidity shall result from the execution of budget spending plans during the second half of the year. With the impact of increased wages and salaries included in the calculation, a notable increase in aggregate demand, and consequently in inflation pressures, will inevitably result. The MPC has also raised its concerns over the cost-push effects of increases in prices of energy, particularly prices of oil, which has led to eight rounds of price rises of oil derivates from 1 April to date. Mention was also made of the uncertainties with respect to further adjustments in regulated prices which shall have a cumulative effect on future movements in core inflation.

The MPC has assessed that the exchange rate for the dinar has remained stable in the first half of the year and that it was determined almost exclusively by direct inter-bank trading, and at a much increased volume of operations. The volume of direct inter-bank trading in the course of the second quarter of the year came to about EUR 5 billion, which is 98% of the actual turnover in the inter-bank forex market.

Having assessed the movements in core inflation, the MPC is of the opinion that the current level of monetary policy tightness is sustainable, but has also noted that the expected level of inflation pressures in the near future will inevitably bring about tightening in the monetary policy stance. The NBS shall continue to closely monitor current movements and shall promptly react to an increase in inflationary pressures with the aim to achieve the core inflation projection for 2007 as well as for 2008, which has been targeted to grow within a narrower range of 3 to 6%. This means that in the course of this year in which the level of core inflation is expected to stay close to the lower bound of the target range, the NBS shall undertake proactive measures to prevent accumulation of inflationary pressures and their transmission into the next year resulting in the necessity of implementation of a more restrictive monetary policy.

With regard to the accelerated trend in credit expansion recorded since the beginning of the year, the MPC was particularly concerned over the increase in both the volume and lengthening of maturity of cash credits granted to households. The MPC has therefore decided to order reassessment of current regulations related to this segment of credit activity with a view to adopting legislative amendments in full cooperation with commercial banks.

Press release from the MPC meeting held on 15 August 2007

The Monetary Policy Committee of the National Bank of Serbia announced today its decision to keep the key policy rate unchanged from the level of 9.5%.

The next MPC meeting is scheduled for 28 August 2007.