National Bank of Serbia

2010

August

INFLATION REPORT

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Introductory note

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

Since one of the underlying principles of inflation targeting is strengthening the transparency of monetary policy and improving the efficiency of communication with the public, the NBS prepares and publishes quarterly *Inflation Reports* as its main communication tool. The *Inflation Report* provides key economic facts and figures that shape the Executive Board's decisions[1] and underpin activities of the National Bank of Serbia.

The *Inflation Report* aims to cover information on the current and expected inflation movements and to provide analysis of underlying macroeconomic developments. It also seeks to explain the reasoning behind the Executive Board's decisions and to provide an assessment of monetary policy effectiveness during the previous quarter. Also integral to this *Report* is inflation projection for at least four quarters ahead, assumptions on which the projection is based and an analysis of key risks to achieving the target.

The information contained in this *Report* will help raise public understanding of monetary policy implemented by the central bank and awareness of its commitment to achieving the inflation target. It will also play a role in containing inflation expectations, as well as in achieving and maintaining price stability, which is the main task of the NBS.

The August *Inflation Report* was adopted by the NBS Executive Board in its meeting of 5 August 2010.

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

Executive Board of the National Bank of Serbia:

Dejan Šoškić, *Governor*

Ana Gligorijević, *Vice Governor*

Bojan Marković, *Vice Governor*

Mira Erić-Jović, *Vice Governor*

[1] In line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia ("RS Official Gazette", No. 44/2010), the Executive Board has assumed all powers of the Monetary Policy Committee.

Contents

I. Overview

Y-o-y inflation declined in Q2, trending in June below the lower bound of the target for the sixth month in a row.

Y-o-y inflation growth slowed down further, staying in Q2, just as in the quarter before, below the lower bound of the target. In a letter to the Prime Minister dated 12 July, the Executive Board of the National Bank of Serbia cited low aggregate demand and the unexpected decline in food prices as the key reasons behind lower than projected inflation. The Executive Board proposed no additional measures for dealing with this situation as the action taken so far is sufficient to help bring inflation back within the target tolerance band in H2 2010 (see Appendix 1).

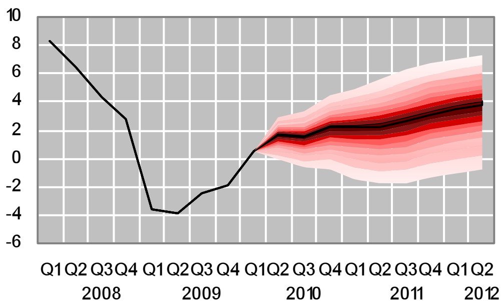
Consumer price growth was driven primarily by the seasonal increase in agricultural product prices and the rise in petroleum product prices.

Q2 inflation was somewhat higher than in Q1 and measured 2.5%. The key boost to its growth came from the seasonal increase in agricultural product prices that turned out slightly higher than anticipated. Of regulated prices, petroleum products gave an impetus to inflation owing less to hikes in world oil prices than to the strengthening of the dollar.

Economic recovery, begun in Q1, continued at a somewhat brisker pace.

The healing of the economy continued in Q2 – GDP rose by an estimated 0.9%, driven primarily by the increase in foreign demand. The contribution of domestic demand remained negative as higher household consumption and private investment were fully offset by the drop in government spending and public investment. The strongest contribution to the growth in economic activity came from industrial production, notably manufacturing industry.

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



Economic activity is poised for moderate growth in the coming period. Foreign demand is expected to remain the key contributory factor of economic growth, while domestic demand is likely to stay weak, making our economic recovery in 2010 relatively slow (around 1.5% GDP growth). Only from 2011 onwards is domestic demand, notably investment, expected to increase which should, together with the continued rise in foreign demand, accelerate GDP growth to 3.0%.

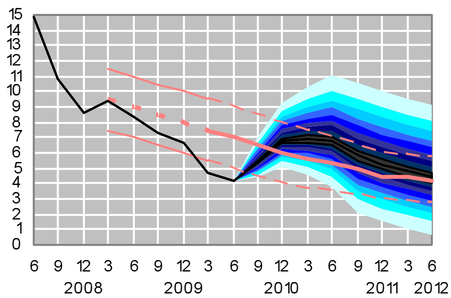
The labour market continues to display negative trends.

Economic recovery has still not translated into jobs. It remains to be seen whether the decline in employment actually bottomed out in Q2 and whether continued economic recovery will trigger a gradual recovery in the labour market. According to the results of the last Labour Force Survey, the jobless rate rose to 19.2% and unemployment structure by the length of job seeking worsened.

The degree of monetary policy expansiveness increased in Q2.

Further lowering of real money market interest rates and widening of the depreciation gap of the real exchange rate gave the monetary policy in Q2 an even more expansionary edge. The expansionary character of monetary policy is further reinforced by the continued depreciation pressures in July and rising inflation expectations. What sent new pressures on the dinar was the increase in risk premium begun in early May due to investors' negative perception about the fallout of the Greek crisis and its spill-over to the rest of the region, as well as due to economic tensions in the eurozone and some East European countries. The rise in risk premium fed through into higher money market interest rates.

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



The past depreciation of the dinar and halted decline in food prices will lead to a moderate inflation growth, despite persistently low demand. In Q3, inflation will retreat within the target tolerance band. For most of the coming year, inflation is expected to move closer to the upper bound of the target.

The key risks to the current projection relate to food prices, pass-through of dinar's depreciation to prices, risk premium, premature and excessive rise in public sector wages and pensions, and the speed of the eurozone economic recovery.

The key risks to inflation projection originate from uncertainties regarding food prices, exchange rate pass-through to prices, risk premium, premature or excessive rise in public sector wages and pensions, and the speed of the eurozone economic recovery. On balance, the risks to the outlook for inflation are tilted to the upside due to the possibly higher pass-through of dinar's depreciation to prices.

Should inflationary pressures accelerate, a further hike in the key policy rate remains a possibility.

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia does not exclude the possibility of a further increase in the key policy rate in the event of major strengthening of inflationary pressures.

II. Monetary policy since the May *Report*

Further lowering of real money market interest rates and widening of the depreciation gap of the real exchange rate gave the monetary policy in Q2 an even more expansionary edge.

The key policy rate was cut twice in Q2, in April and early May, each time by 50 basis points. Though the NBS Executive Board estimated in the May *Report* that the key policy rate was more likely to be lowered in the coming period than kept on hold, no further lowering took place.

The Executive Board's decision not to continue lowering the key policy rate in May despite strong disinflationary pressures from aggregate demand and further decline in food prices was based primarily on the rise in country risk premium and strengthening of depreciation pressures. Namely, fears about the sustainability of some eurozone members' public finance pushed the risk premium higher and boosted depreciation-induced inflationary pressures throughout the region, causing a rise in imported inflation. Considering medium-term uncertainties, especially with regard to the pace of the eurozone's economic recovery and domestic demand, the Executive Board assessed that further monetary easing could lead to the overshooting of the inflation target in 2011.

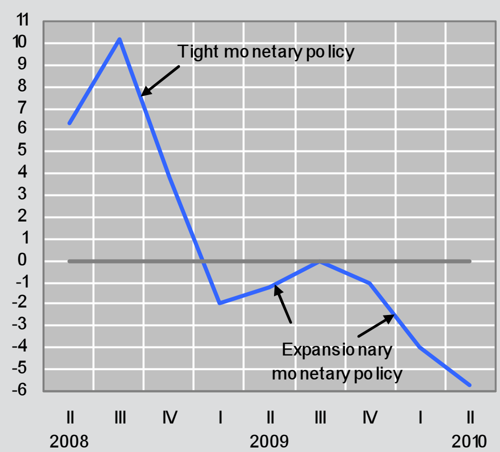
Besides, amendments to the decision on reserve requirements, that entered into force on 18 March and the effects of which will manifest throughout the year, have enabled an ongoing release of dinar liquidity, which makes the monetary policy stance more expansionary.

That the degree of monetary expansion has increased in Q2 is also confirmed by movements in the real MCI[2].

Depreciation gap of the real exchange rate – one of the two MCI components – that opened in late 2009, widened further in Q2 2010 as a result of 2.4% average nominal depreciation of the dinar and smaller than expected exchange rate pass-through to inflation.

The second MCI component – real interest rate on two-week BELIBOR – continued below the neutral level. This was caused by the trend rise in the real interest rate and continued decrease in the rate itself, making the monetary policy stance more expansionary than in the previous quarter. In Q2, the real interest rate was below the neutral level by around 200 basis points on average. The trend

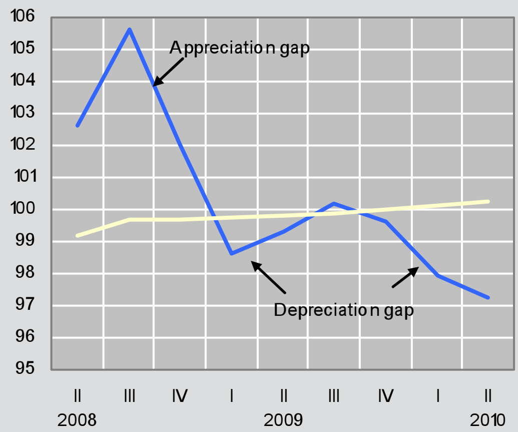
Chart II.0.1 **Monetary Conditions Index**



The degree of monetary policy expansiveness increased in Q2.

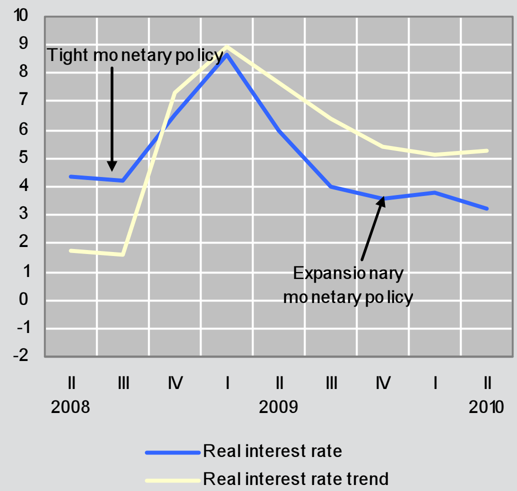
[1] Real Monetary Conditions Index.

Chart II.0.2 **Real exchange rate and its trend**
(base index)



Depreciation gap of the real exchange rate widened further in Q2.

Chart II.0.3 **Real interest rate and its trend**
(in %)



Real interest rate had a stronger inflationary effect than a quarter earlier.

rise was aided by the growth in country risk premium, but also by the mild increase in interest rates across international money markets. On the other hand, as inflation expectations remained almost unchanged from the previous quarter, the 100 basis point cut in the key policy rate triggered a real decline in two-week BELIBOR.

Considering July depreciation pressures, the monetary policy stance is likely to be even more expansionary in Q3 despite the upward revision of the key policy rate in early August to 8.5%.

III. Inflation developments

Y-o-y inflation was on a downward trajectory in Q2, moving in June, for the sixth month in a row, below the lower bound of the target. Quarterly inflation was somewhat higher than anticipated due to faster growth in agricultural prices.

The slowdown in y-o-y inflation growth rates is expected to end in Q3, wherefore inflation will retreat within the target tolerance band.

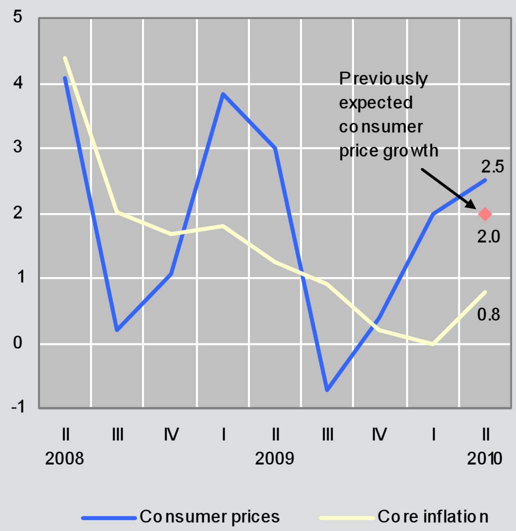
Inflation developments in Q2

Higher than expected growth in agricultural prices lent the strongest boost to consumer price growth.

Growth in y-o-y inflation continued to decelerate, trending below the lower bound of the target for six months in a row. Such an outturn was occasioned by slackening growth in y-o-y core inflation, sustained by a further decline in food prices (most notably meat).

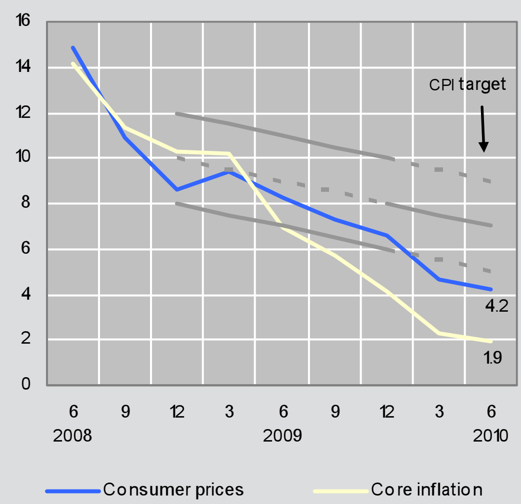
Headline inflation in Q2 (2.5%) outpaced that from Q1. The strongest contribution to faster quarterly consumer price growth came from higher than expected growth in agricultural prices. Of regulated prices, petroleum products gave an impetus to inflation owing less to hikes in world oil prices (until early May) than to strengthening of the dollar. Core inflation followed an upward path relative to Q1.

Chart III.0.1 **Price movements**
(quarterly growth, in %)



Both headline and core inflation picked up in Q2. Growth in headline inflation was mainly due to a rise in agricultural prices.

Chart III.0.2 **Price movements**
(y-o-y growth, in %)



Y-o-y growth in headline and core inflation continued decelerating. Core inflation was at a much lower level than headline inflation.

Table III.0.1 **Price indicators**
(growth rates, in %)

	IX 2009 / IX 2008	XII 2009 / XII 2008	III 2010 / III 2009	VI 2010 / VI 2009
Consumer prices	7.3	6.6	4.7	4.2
Core inflation	5.7	4.1	2.3	1.9
Retail prices	9.5	10.4	7.4	6.4
Cost of living	7.1	6.6	4.4	3.7
Industrial producer prices	5.3	7.4	11.7	11.3
Agricultural producer prices	-8.9	-4.8	-7.3	-9.2*

* May on May.

Core inflation (excluding regulated and agricultural prices) gained 0.8%. Inflationary pressures were backed up by dinar's depreciation, whilst receding aggregate demand and falling processed food prices generated a disinflationary effect. In monthly terms, core inflation accelerated in both April and June (0.4% and 0.5%), but quite unexpectedly turned negative in May due to plummeting meat prices. The strongest contribution to quarterly core inflation growth was provided by prices of non-food products (0.9 pp), mainly technical appliances, cars, household chemical products, clothes and footwear, alcoholic beverages, flat rentals and university fees. Nonetheless, a decline in food prices (included in core inflation) was softer than in Q1, in response to rising prices of sunflower oil, partly offset by falling prices of fresh meat.

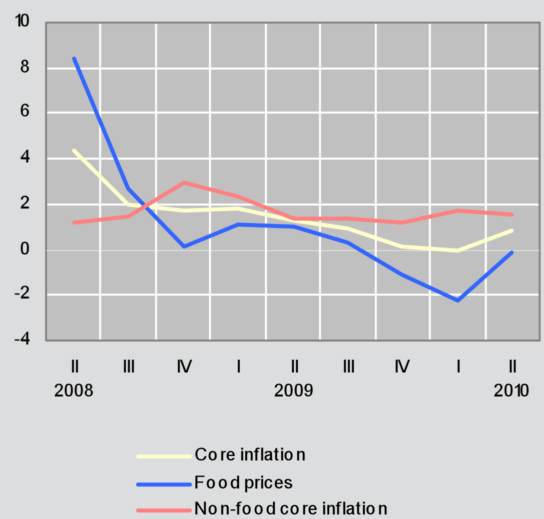
In line with our expectations, regulated price growth slowed from 5.5% in Q1 to 2.3% in Q2. Still, a rise in regulated prices was bolstered by price hikes in petroleum products, medicaments, TV subscription fees and utility-housing service charges. The anticipated drop in petroleum product prices in June did not take place as the effect of falling crude oil prices in May and June was counterbalanced by dinar's weakening against the dollar. In H1 2010, regulated price growth touched 8.0%. Expectations place regulated price growth for 2010 at the upper bound of the planned framework, while the majority of planned adjustments have already been introduced. Y-o-y regulated price growth reached 9.6% in June.

Prices of agricultural-food products had the decisive impact on inflation developments in Q2. Due to bad weather conditions and lower agricultural yield, a rise of 0.2% in agricultural prices was recorded in June instead of the anticipated seasonal drop. Hence on the overall, growth in agricultural prices was higher than expected (17.0%), coming to 4.7% at end of quarter in y-o-y terms.

Table III.0.2 **Consumer price growth by component**
(by quarter, in %)

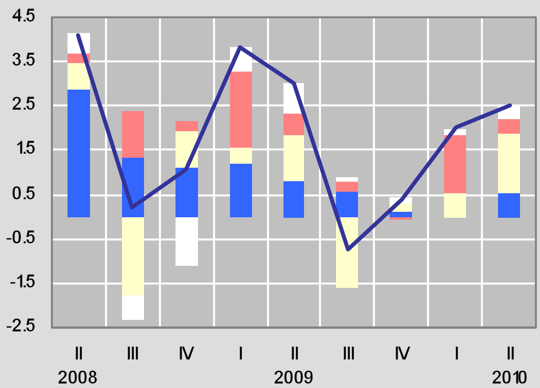
	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2
Consumer prices	3.0	-0.7	0.4	2.0	2.5
Core inflation	1.2	0.9	0.2	0.0	0.8
Agricultural product prices	13.1	-18.5	2.7	7.0	17.0
Regulated prices	4.4	1.1	0.5	5.5	2.3
Electricity	0.0	0.0	0.0	11.5	0.0
Petroleum products	17.9	2.3	3.5	3.0	6.8
Gas for households	0.1	0.0	0.2	0.0	0.0
Utility-housing services	3.1	6.0	1.0	4.2	1.3
Social welfare services	1.8	3.3	8.7	3.7	0.3
Transport services (regulated)	0.4	0.0	0.1	2.3	0.2
Postal and telecommunications services	0.0	1.9	0.0	0.0	0.5
Bread of wheat flour T-850	-4.1	0.6	-2.8	-0.8	0.2
Cigarettes	0.0	0.0	0.0	10.2	0.0
Medications	10.3	-1.3	-2.7	0.2	5.0
Other	9.7	0.1	0.0	0.6	12.6

Chart III.0.3 **Core inflation by component**
(quarterly growth, in %)



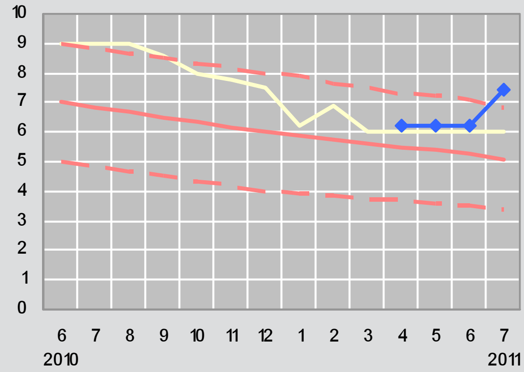
Core inflation growth in Q2 was driven by rising prices of non-food products and services.

Chart III.0.4 **Contribution to quarterly consumer price growth**
(in percentage points)



Agricultural prices lent the strongest boost to consumer price growth.

Chart III.0.5 **One-year ahead expected and targeted inflation**
(in %)



In Q2, one-year ahead inflation expectations of the financial sector remained unchanged from Q1, though they edged up in July.

Inflation expectations

One-year ahead financial sector expectations were stable throughout Q2, but went up in July.

As indicated by the Medium Gallup survey, one-year ahead financial sector inflation expectations remained unchanged at 6.2% throughout Q2. By contrast, the corporate, trade union and household sectors reported a mild edge-up.

Data collected by the Reuters agency also signal stable financial sector expectations moving somewhat above one-year ahead targeted inflation.

However, the July Medium Gallup agency shows that one-year ahead financial sector expectations are higher than in Q2 (7.4%), trending above the upper bound of the target tolerance band (July 2011 target: 5.1±1.7%).

The MRI[3] survey conducted in June and covering a large number of entrepreneurs shows that more than a half of respondents expect higher input costs over the next quarter, with the majority of them also expecting a rise in prices of their final products.

Expectations for Q3

Q3 inflation is expected to move within the target tolerance band.

We estimate that agricultural prices will be the key to movements in inflation in the coming months. Regardless of a seasonal drop expected in Q3, this group of products is most prone to risks to the projection arising from unfavourable weather conditions.

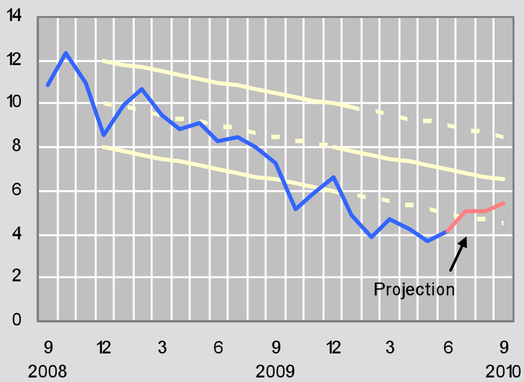
Despite depressed domestic demand, inflationary pressures are likely to rise somewhat in the coming period on the back of rising food prices and in light of dinar's depreciation and its lag effect on domestic prices. Weakening of the dinar and uncertainties regarding the duration of current depreciation pressures pushed up imported inflation. The exchange rate depreciation gap that deepened further due to dinar's depreciation in excess

[3] Market Research Institute.

Table III.0.3 **Major revisions of regulated prices expected in Q3**

	Growth rate (in %)	Contribution to consumer price growth (p.p.)
Utilities and housing services	6.1	0.2
Cigarettes	4.0	0.2
Medications	2.0	0.1

Chart III.0.6 **Short-term inflation projection**
(y-o-y growth, in %)



Y-o-y inflation will retreat within the target tolerance band in Q3.

of the difference between domestic and eurozone inflation points to reduced net importers' marginal profit and stronger pressure on a future rise in import prices.

Y-o-y consumer price growth at end-Q3 is expected to outstrip that from end-Q2 and equal around 5.4%. The y-o-y growth rate will stay within the target tolerance band throughout Q3.

In quarterly terms, consumer prices are likely to rise somewhat (c. 0.5%) in response to growth in market determined prices and some categories of regulated prices, as well as the expected smaller than the usual seasonal drop in agricultural prices.

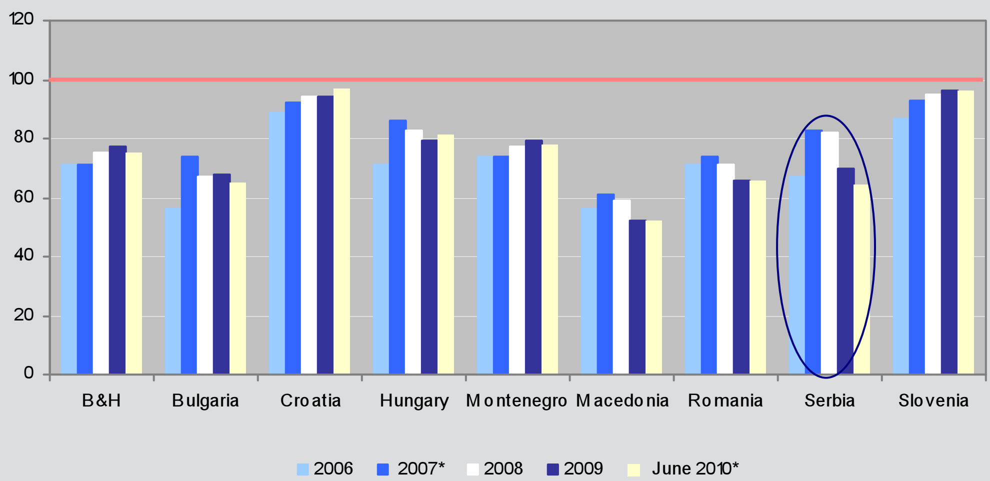
Quarterly growth in core inflation is likely to speed up further in view of the lagged pass-through of May and June depreciation and rising input prices in processed food production (wheat, maize). In this regard, food price hikes are expected with vegetable oil, flour, dairy products, confectionery and beverages, whereas prices of non-food products, and notably costs of services, will probably be somewhat higher than in the previous quarter.

Quarterly regulated price growth is projected to slow further (1.7%). The strongest rise is likely with cigarettes (higher excises), utility-housing service charges (water consumption and waste collection) and medicaments (harmonisation with the new Law on Medications and Medical Substances). Petroleum product prices will most likely remain unchanged in Q3.

Box 1: Comparative price levels for food in Serbia and countries in the region

After the publication of findings of the Eurostat survey on comparative price levels in 37 European countries for 2009 and in view of the impact of food prices on the disinflation process over the last two years, there is an ongoing discussion in Serbia whether its food prices are really the lowest in the region. A comparative analysis of price levels for food and non-alcoholic beverages in Serbia and other countries in the region was made without taking into account the purchasing power or other relevant factors impacting on the standard of living.

Price levels for food and non-alcoholic beverages
(EU-27 = 100)



Source: Eurostat and NBS.

* NBS estimate based on relative changes in retail prices and exchange rates of national currencies against the euro.

Based on 2009 data, the prices of food and non-alcoholic beverages in Serbia were 70% of the EU-27 average, down relative to 2008 and 2007, but up from 2006. Lower prices of food and non-alcoholic beverages were observed only in Bulgaria, Romania and Macedonia. In terms of food subgroups, the greatest downward deviation of price level indices in Serbia compared to the EU-27 average was recorded with bread and cereals, meat, fruit and vegetables (see Table).

Price levels for food and non-alcoholic beverages in 2009, EU-27 = 100

	Food and non-alcoholic beverages	Food	Bread and cereals	Meat	Fish	Milk, cheese and eggs	Oils and fats	Fruits and vegetables	Other food	Non-alcoholic beverages
Slovenia	96	96	101	91	100	101	122	92	103	93
Croatia	94	93	99	87	101	96	102	84	109	112
Hungary	79	78	71	72	93	89	98	75	89	89
Montenegro	79	78	69	76	79	82	98	83	86	83
Bosnia and Herzegovina	77	75	68	77	75	79	81	73	87	90
Romania	66	65	61	58	72	93	79	58	77	75
Serbia	70	69	61	66	85	81	87	62	89	80
Bulgaria	68	67	52	59	72	92	89	65	84	80
Macedonia	52	52	48	51	57	60	62	43	70	63

Source: Eurostat.

However, from early 2006 until end-2009, Serbia showed the highest cumulative growth in prices of food and non-alcoholic beverages in the region (38.2%), whereas the lowest growth was recorded in Croatia (12.8%). High growth in food prices in Serbia was induced by rising prices of meat (45%), milk, cheese and eggs (47.9%), bread and cereals (52.6%) and vegetables (62%).

Though price levels for food and non-alcoholic beverages in Serbia continued down in 2009 relative to the EU-27 average, they rose in CPI terms (growth was also observed in Hungary, Romania and Montenegro). Furthermore, food prices fell by 0.1% while prices of non-alcoholic beverages were up 0.9%. The major contribution to declining food prices came from prices of bread and cereals, milk, cheese and eggs, oils and fats. Albeit on a rise in the last four years, price levels for food and non-alcoholic beverages in Serbia are much lower than in the majority of countries in the region or EU member states.

The estimate of comparative price levels for food and non-alcoholic beverages in countries in the region relative to the EU-27 average in June 2010 was made based on the actual price growth in the first six months of the year vs. the 2009 average, relative price changes vs. price movements in EU-27 and exchange rates of national currencies against the euro in the same period. The results obtained show that food and non-alcoholic beverages in Serbia are priced at 64% of the EU average, which implies a decline from 2009. Lower prices were observed only in Bulgaria, Bosnia and Herzegovina, Montenegro and Romania. Despite small growth recorded in the first half of the year, Macedonia remains the least expensive country in the region. It is followed by Serbia that has become, according to estimates, even cheaper than Romania and Bulgaria.

IV. Inflation determinants

1. Money market developments

Interest rates

Money market interest rates declined in quarterly terms, but recorded a substantial rise at the end of the period. Lending rates fell more sharply than deposit rates, feeding through into lower bank spreads.

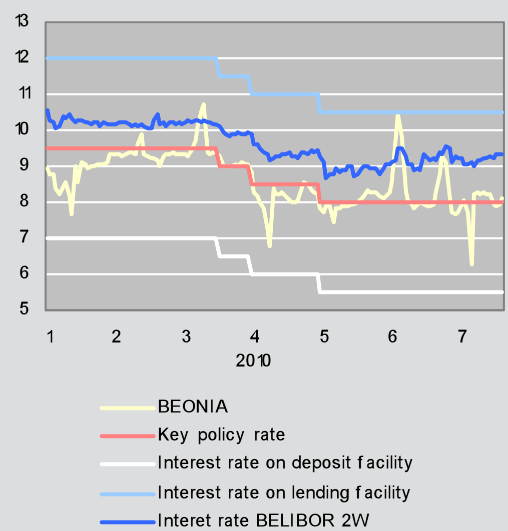
Monetary easing continued into Q2 – in addition to a gradual release of bank dinar funds made possible under amendments to the Decision on Required Reserves of Banks with the National Bank of Serbia, the key policy rate was cut twice to 8.0% (each time by 50 bp). However, due to heightened uncertainties regarding public finance sustainability in some EU countries, the risk premium went up, which, together with cuts in the key policy rate, led to a decline in expected real return[4] on repo securities. The reduction in the stock of repo securities sold was also prompted by NBS interventions in the foreign exchange market. At end-June, the stock of sold NBS securities was by RSD 33.9 bln lower than at end-March. In July, the stock contracted further by RSD 28.7 bln, reaching RSD 77.0 bln at the month-end.

Developments in the interbank money market featured distinct fluctuation in BEONIA (Belgrade OverNight Index Average), particularly at the close of a required reserves maintenance period. Though moving below the key policy rate in early Q2, BEONIA picked up slightly in June, averaging 8.4%. The average daily turnover climbed by 5.4% from Q1 to RSD 8.2 bln in Q2.

BELIBOR (Belgrade Interbank Offered Rate) of all maturities mirrored early-Q2 cuts in the key policy rate and declined in quarterly terms. However, by end of the forecast period, BELIBOR rates went up, notably those for 3- and 6-month maturities. In June, average BELIBOR rates moved between 8.9% for the shortest and 9.7% for 6-month maturity. In July, longer-maturity BELIBOR continued up, resulting in a greater slope of the yield curve (8.9% – 10.7%). Such movements in the money market may signal that the financial sector expects no further lowering of interest rates.

By the mid-quarter, effective rates on government securities displayed a shift in the trend. Since the start of the monetary easing cycle, effective rates on T-bills were on the decline, only to hit an upward trajectory from mid-May. In quarterly terms, 6-month and one-year maturity bills grew by 1.1 pp and 0.9 pp respectively. Investor

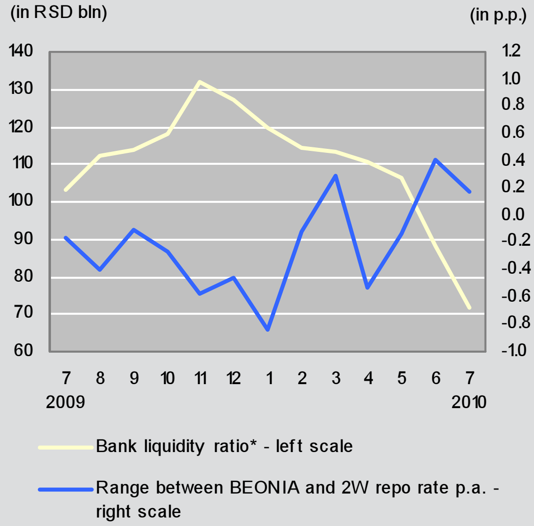
Chart IV.1.1 **Interest rate movements**
(daily data, p.a, in %)



Distinct fluctuation in BEONIA was triggered by volatile banking sector liquidity.

[4] Given a rise in expected one-year ahead depreciation of the dinar, a fall in real return would be much larger if the key policy rate was deflated by the euro exchange rate.

Chart IV.1.2 **Bank liquidity and range between BEONIA and the key policy rate**



* Bank liquidity is calculated as the ratio of bank average liquid assets (free reserves, repo stock with the NBS and net purchase of T-bills in the current month) and transaction deposits.

Reduced excess dinar liquidity of the banking sector was partly due to NBS interventions in the interbank foreign exchange market.

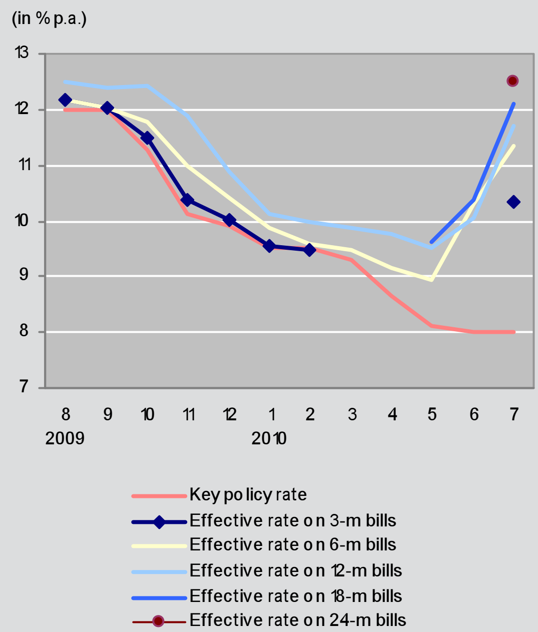
demand for higher return at T-bill auctions and the ensuing rise in effective rates may be linked to rising risk premium. However, despite an increase in effective rates, T-bills were not sold out at the majority of auctions.

The auction programme was changed in July – the value of longer-maturity bill issues was reduced in favour of short-term ones, including issuing of new 3-month bills. Still, effective rates continued up, quite evenly for all maturities (rates gained 1 pp relative to the previous month). By end-July, effective rates ranged from 10.4% for 3-month to 12.5% for 2-year maturity.

Overall trading in the secondary securities market totalled RSD 5.7 bln, with discount securities accounting for 62%. In June, weighted average interest rates on discount securities (traded until maturity) ranged between 9.3% for six-month and 9.9% for 18-month maturity. In July, turnover amounted to RSD 2.4 bln, of which RSD 1.1 bln related to 2-year bonds (the rate of return came to 12.5%).

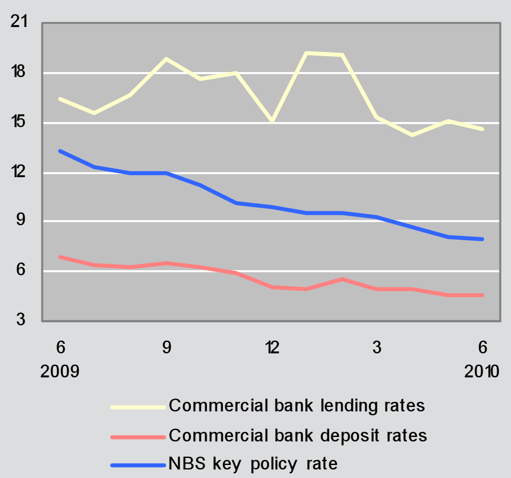
In June, the weighted average bank rate on corporate and household lending equalled 14.4%, down by 0.7 pp from March. A reduction in lending rates is ascribed entirely to lowered rates on corporate loans, with a larger fall recorded with shorter-maturity lending. In terms of household lending, quite perceptible was

Chart IV.1.3 **Effective rates on T-bills**



Effective rates on T-bills rose sharply in Q2.

Chart IV.1.4 **NBS key policy rate and commercial bank interest rates***
(weighted average, p.a, in %)



* Lending interest rates refer to both foreign currency-indexed and dinar loans.

Cuts in the key policy rate in Q2 were accompanied with a mild slump in lending and deposit interest rates.

growth in consumer loan rates (0.7 pp), whilst housing rates remained almost flat. A mild increase in Euribor shows that the drop in lending rates was also driven by the decrease in rates on dinar loans due to a larger share of subsidised loans.

Judging by preliminary data, a decline in dinar loan rates stepped up in Q2, which is correlated mainly with intensification of activity in the subsidised segment of the market.

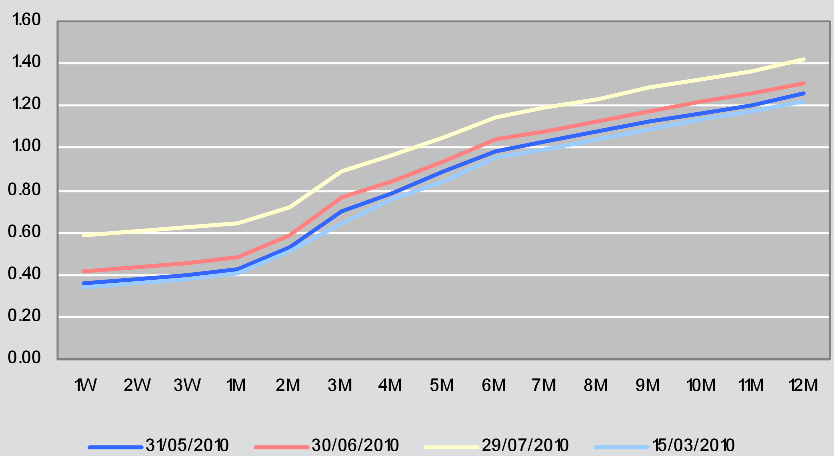
The average deposit rate equalled 4.6% at end-Q2, down by 0.3 pp from end-Q1. Dinar deposit rates continued down as well.

Box 2: Expected interest rate movements in the European interbank market

Ranging between 0.34% for one-week and 1.22% for one-year loans, Euribor was record low by mid-March 2010, but the downward trend in European interbank market interest rates stopped in early Q2. This shift in Euribor coincided with escalation of the Greek debt crisis. The danger of spillover of the fiscal crisis on other EU member states running excessive deficits contributed to soaring risk premium in the interbank market. However, even after the EU adopted its stabilisation package, Euribor continued slightly up for all maturities.

Further upward pressure on interest rates came from one-year ECB loans (worth EUR 442 bln) falling due on 1 July. Note that the preceding decline in interest rates was mainly the result of ECB's expansionary measures. After cutting its key interest rate to 1%, in June 2009, the ECB launched measures to create additional liquidity by implementing extraordinary auctions of one-year bills (selling to banks EUR 614 bln) and by purchasing bonds, whereby it accepted an increasing array of eligible collaterals. To mitigate a potential disruptive effect of maturing long-term investments, monetary authorities embarked on extraordinary open market operations to sell bills with up to three month maturity. However, as bank interest in additional borrowing was waning (EUR 131.9 bln were sold to banks at the 1 July auction) a substantial amount of excess liquidity was withdrawn from the market. This impacted on a further rise in Euribor for all maturities – on 27 July, the rates ranged between 0.58% and 1.41%, with Euribor for there-month loans at 0.89%.

Yield curve in the European interbank market



Financial market participants expect a moderate rise in interest rates to continue over the medium term and to pick-up slightly in the short run. According to a June survey, the financial sector expects the three-month Euribor to move between 0.8% and 0.9% at end-July and between 1.1% and 1.2%[1] in July 2011. Futures on the three-month Euribor only confirm such forecasts. End-July quotations in futures trading came at 0.97% in September and 1.08% December 2010, as well as 1.17% in March and 1.27% June 2011[2].

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[1] Source: Consensus Forecast, July 2010.
[2] Source: London International Financial Futures and Options Exchange.

Publication of stress-test results has not yet contributed to restoring trust of interbank market participants which lay at the heart of interest rate hikes in the prior period. The other driver behind rising interest rates was not entirely neutralised either – banking sector liabilities to the ECB, worth EUR 571.6 bln (of which EUR 172.2 bln relating to one-year auctions), will mature by end of this year.

Interest rate movements in the interbank market are determined by the character of ECB’s monetary policy, degree of financial system liquidity and risk perception within the banking system. Euribor rates are likely to follow a moderate upward trend in the coming period given the expected gradual dismantling of ECB’s non-standard monetary policy measures, a rise in the ECB’s key interest rate in 2011 and expectations of financial market participants.

Monetary aggregates

The second quarter brought in a moderate rise in money demand, sustained by a mild pick-up in economic activity.

Reserve money continued down in Q2, contracting by 14.8% in real terms. The foreign exchange channel was dominant in reserve money withdrawal, though the dinar channel played a role as well.

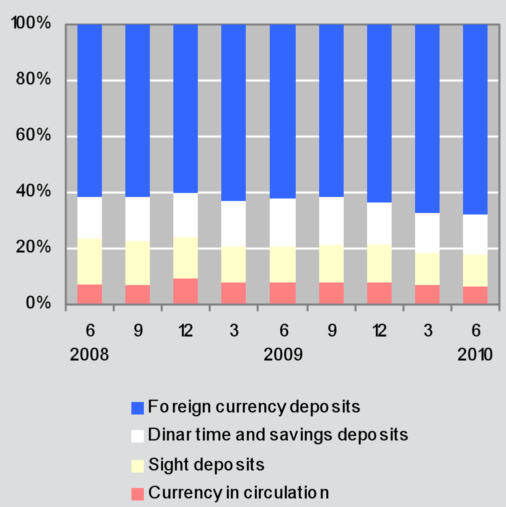
NBS interventions in the foreign exchange market had the strongest impact on reserve money withdrawal. Inflows from budget support loans[5] extended by local banks to the government, the European Investment Bank loan and the partial drawdown of two IMF loan tranches did not suffice to cover the outflows occasioned by NBS interventions in the interbank foreign exchange market and the redemption of maturing frozen foreign currency savings bonds. As a result, EUR 49 mln flowed out of gross foreign exchange reserves in Q2. Despite NBS interventions, net foreign assets, at the programme exchange rate, outstripped the IMF criteria by EUR 542 mln.

Exchange rate gains were neutralised by an increase in reserve money driven by lower bank investment in repo securities and spending of funds held in government accounts, so that total dinar transactions also contributed to reserve money withdrawal.

A gradual release of funds, under amendments to the Decision on Required Reserves of Banks with the National Bank of Serbia, started in April and continued in May and June. A portion of released funds was used by banks to finance lending activity, purchase T-bills and long-term RS bonds from the NBS portfolio, as well as to purchase foreign currency because of the scheduled phasing out of dinar allocations against FX reserve requirements under the above Decision.

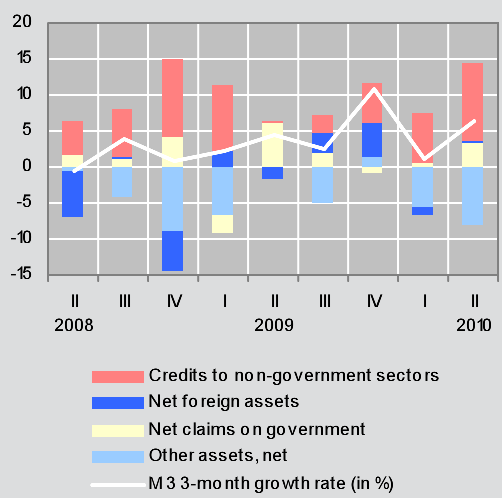
By contrast to the prior quarter, all three monetary aggregates recorded an increase in Q2. Relative to March 2010, M1, M2 and M3 were up 1.5%, 1% and 3.8% in real terms respectively. Growth in all deposit categories, in both dinars and foreign currency, together with a small rise in currency in circulation, caused an expansion of monetary aggregates.

Chart IV.1.5 **M3 Composition**



Relative shares of M3 components remained unchanged from end-Q1.

Chart IV.1.6 **Contribution to M3 growth**
(in p.p.)



Bank lending and government net borrowing gave the strongest impetus to M3 growth.

[5] Used for servicing liabilities due to foreign creditors and payment of frozen foreign currency savings.

A rebound in dinar deposits was spurred by higher balances in accounts of enterprises, primarily privately-owned ones, whereas rising foreign exchange deposits were due largely to an upswing in household and corporate savings.

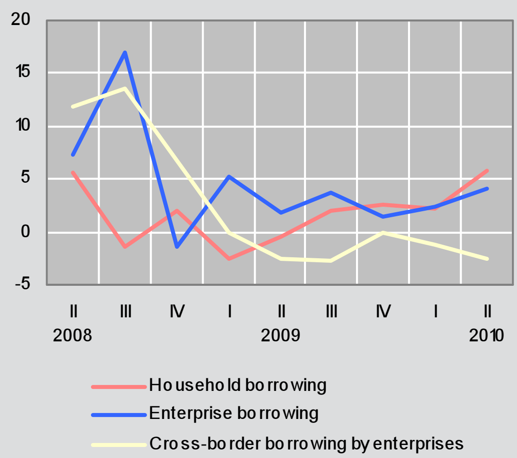
Demand for money rallied on a quarter earlier, signalling positive tendencies in the economy.

Bank lending remained the main driver behind growth in M3 (10.9 pp). Another impetus came from government borrowing via T-bill sales, disbursement of local bank loans and reduction of balances held in accounts with the NBS.

A y-o-y rise in money supply slowed from Q1. Relative to June last year, M1 and M2 remained broadly unchanged in real terms, whilst M3 leapt by 17.2% due to a rise in foreign exchange savings.

Following a six-month slump, reserve money went up in July. Contraction in the repo stock and spending of government deposits with the NBS pushed up reserve money, while the withdrawal was effected through interventions in the foreign exchange market. An upturn in currency in circulation and higher balances in dinar and FX current and savings accounts triggered a further rise in M1, M2 and M3.

Chart IV.1.7 **Real domestic and cross-border borrowing**
(quaterly growth rates in %)



Growth in lending accelerated relative to Q1 and enterprises continued to service their external debt.

Bank lending

Following a moderate rise in Q1, bank lending gathered pace in Q2.

Bank lending gathered pace in Q2 as the real quarterly lending growth rate[6] doubled over a quarter earlier to reach 4.7%. In real terms, corporate and household lending rose by 4.1% and 5.8% respectively.

Lending intensified in y-o-y terms as well, most notably in May. Y-o-y growth in real lending reached 12.5% in Q2, up by 3.9 pp from Q1.

To finance their lending activity in Q2, banks turned primarily to domestic sources (nominal growth in lending came to RSD 131 bln or 9.5%). This growth in lending was fed largely from contracted bank reserves held with the NBS (4.5 pp) and a rise in FX deposits, mainly those of households (4.4 pp). In the period under review, banks did not rely on foreign sources of finance and at the same time reduced their foreign claims.

Furthermore, local banks lent RSD 78.0 bln to enterprises, of which RSD 11.2 bln to public ones. Net of the increase generated by dinar volatility, growth in enterprise lending equalled RSD 47.8 bln. As in the previous period, liquidity loans rose the most. Rather encouraging was an upturn in investment loans (RSD 37.6 bln), in train since Q1 and particularly pronounced in Q2, which may signal heightened investment activity. Most loans were extended to enterprises from the industry, trade and transport sectors.

Enterprises continued to service their external debt – cross-border loans declined by EUR 315 mln net.

Household loans rose by RSD 47.3 bln nominally or RSD 31.1 bln in real terms (excluding the depreciation effect). Housing loans retained the dominant share in household lending. A moderate rise was recorded with loans extended to agricultural producers, as well as consumer and cash loans.

[6] Adjusted by the effects of the exchange rate and inflation.

Lending intensified in the subsidised segment of the market as well. In Q2, banks extended RSD 65 bln of government-subsidised loans. Within the Government Programme of Measures to Ease Negative Effects of the Global Financial Crisis, banks extended around RSD 62 bln and some RSD 3 bln of subsidised housing loans. Liquidity loans (around RSD 42 bln) remained predominant. Since May, banks have been extending only dinar liquidity loans, whilst the extension of foreign currency clause-linked liquidity loans was discontinued. Within only three months since they were launched in April 2010 for the purpose of stimulating domestic demand, dinar cash loans totalled around RSD 12 bln.

The share of foreign currency clause-indexed loans decreased by 2 pp from Q1 to 73% in June. Within newly extended loans, the share of household and enterprise dinar loans was up by 50% and 30% respectively, notably on the back of subsidised dinar loans.

The share of NPLs rose by 0.7 pp from end-Q1, reaching 10% in May[7].

Table IV.1.1. **Subsidised loans**

Programme of Government Measures to Mitigate Negative Effects of the Global Financial Crisis

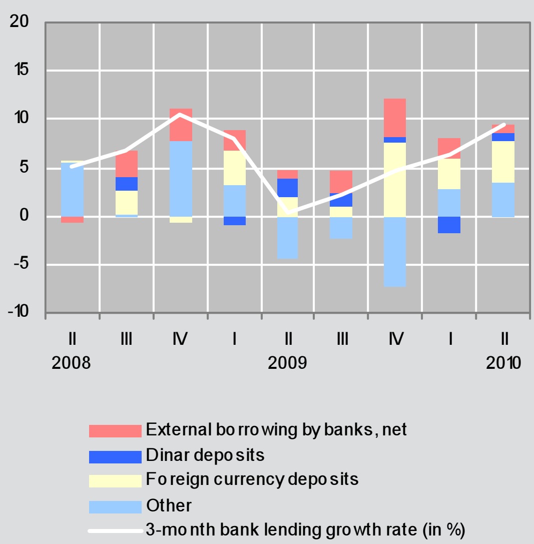
	January - June 2010		
	Approved	Funds earmarked under the Programme	Execution percentage
	(in RSD billion)		(%)
Total approved	87.7	125	70.2
Liquidity	64.2	75	85.6
Investment	5.3	15.0	35.1
Consumer	6.7	25.0	26.7
Dinar cash loans	11.6	10	116.1

Subsidised housing loans

	January - June 2010
	(in RSD billion)
	6.1

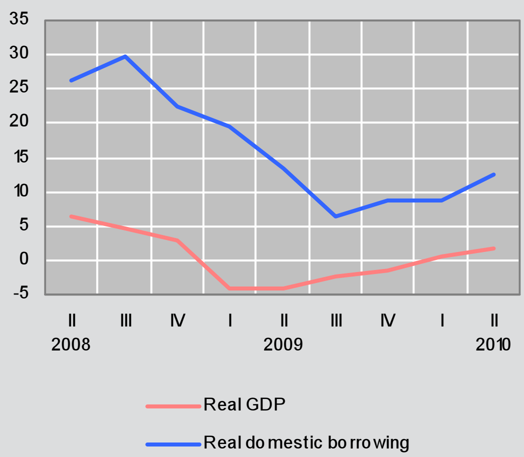
Source: Ministry of Economy and Regional Development and National Mortgage Insurance Corporation.

Chart IV.1.8 **Contribution to bank lending growth**
(in p.p.)



To finance their lending activity in Q2, banks turned primarily to domestic sources.

Chart IV.1.9. **Real domestic borrowing and real GDP**
(y-o-y growth rate in %)



Economic recovery in Q2 was followed by growth in lending activity.

[7] Calculated by the net principle, i.e. after exclusion of value adjustments.

2. Movements in the foreign exchange market and the exchange rate

The dinar's slide against the euro continued in Q2. The strengthening in depreciation pressures is attributable primarily to the impact of regional factors.

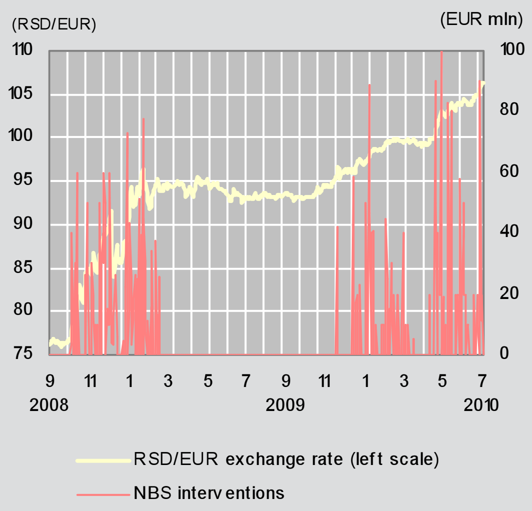
After relative stability of the exchange rate of the dinar in March and April, depreciation pressures started building up in May. Though the NBS intervened heavily in the foreign exchange market throughout May and June, the dinar lost around 5%. On the whole, depreciation in Q2 averaged 2.4% and the exchange rate moved between 99.0 and 104.4 dinars for one euro.

The main reason behind the dinar's decline was the increase in risk premium begun in early May due to investors' negative perception about the fallout of the Greek crisis and its spill-over to the rest of the region, as well as due to economic tensions in the eurozone and concerns over the financial health of Central and East European countries. Depreciation pressures swept across the region, causing in some countries not only the weakening but also marked volatility of the exchange rates.

Risk premium, measured by the Emerging Market Bond Index (EMBI), rose by around 120 basis points in May and June, reaching at the end of June 475 basis points. EMBI increased at a much faster pace in May than in the month that followed. Similar movements were recorded in other transition countries too.

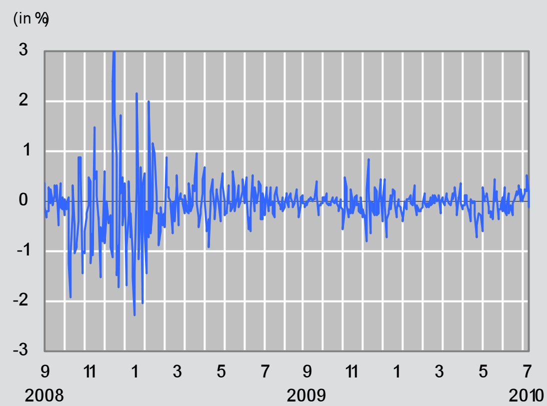
The above movements resulted in a smaller than expected increase in foreign exchange savings in May and a substantial mismatch between bank clients' foreign exchange demand and supply in May and June. Corporate demand for foreign exchange was stronger than before, while nonresidents, usually acting as net sellers, were among buyers of foreign exchange from banks. On the other hand, foreign exchange supply was low due to a rather meagre inflow of FDI and repayment of foreign debt by banks and enterprises.

Chart IV.2.1 **Movements in RSD/EUR exchange rate and NBS FX interventions**



Depreciation pressures building up since May are attributable primarily to the rise in risk premium triggered by economic tensions in the eurozone.

Chart IV.2.2 **Daily changes in RSD/EUR exchange rate***



* Negative rates indicate depreciation and positive rates appreciation of the dinar.

The exchange rate of the dinar weakened, exhibiting greater daily volatility than a quarter earlier.

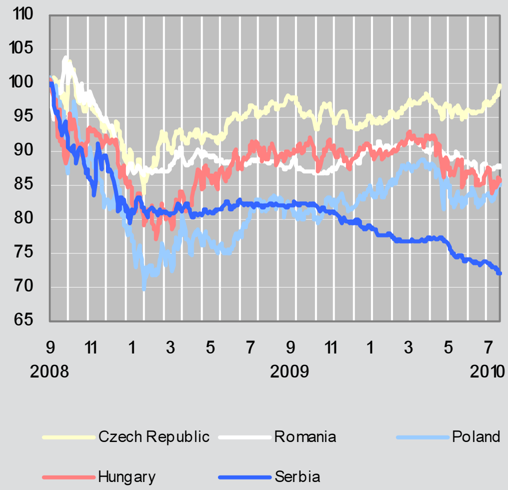
After selling only EUR 5 mln in April in the Interbank Foreign Exchange Market (IFEM), the NBS intervened with EUR 780 mln in May and June mostly in order to ease excessive daily volatility of the exchange rate. To a degree, this contributed to the increase in interbank trading volumes relative to the first quarter. Q2 interbank trading volumes averaged around EUR 48 mln per day.

In the three-month FX swap auctions, organised since April, the NBS bought EUR 142.5 mln and sold EUR 109.2 mln.

As the euro continued down against the dollar so did the dinar – by around 11% in Q2. With 4.4% weakening of the nominal effective exchange rate of the dinar[8] and faster growth in domestic relative to foreign prices, Q2 saw real effective depreciation of the dinar of 2.9% (1.3% against the euro and 8.6% against the dollar).

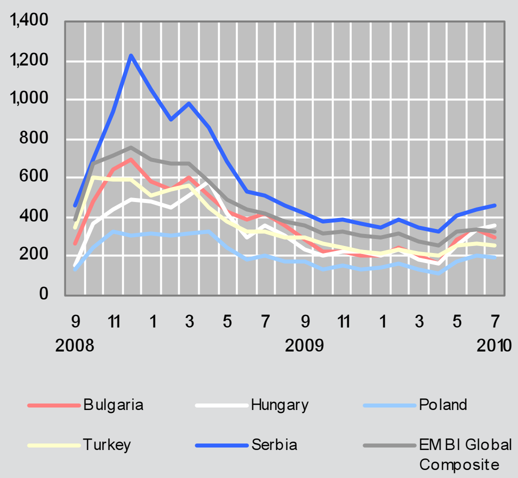
According to the Reuters survey carried out in July, the financial sector expects the exchange rate of the dinar to stabilise over the coming period. Banks expect the end-August exchange rate to be at the same level as at end-June – around 104.3 dinars for one euro.

Chart IV.2.4 **Movements in exchange rates of national currencies against the euro**
(Sep 30, 2008 = 100)



Higher risk premiums triggered depreciation pressures throughout the region.

Chart IV.2.3 **Risk premium indicator – EMBI by country**
(monthly averages, in basis points)



Source: JP Morgan.

All countries observed saw a rise in their risk premiums in May and June. In July, further growth in risk premiums was registered for Serbia and Hungary, while those of other countries recorded a mild decline.

Foreign capital inflow

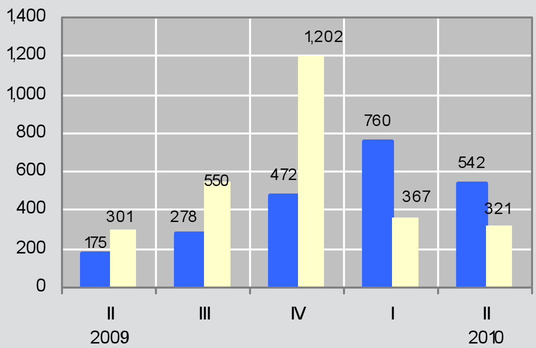
Turbulence in the regional financial markets had a negative impact on capital movements in Q2. In fact, the quarter saw a net capital outflow amid a rather modest inflow of FDI and foreign debt repayment by enterprises and banks.

Net FDI inflow came to EUR 136 mln, more than half of it in April. In May and June, however, FDI inflow measured mere EUR 35 mln and EUR 26 mln, respectively. Net inflow under portfolio investment amounted to EUR 26 mln and is attributable primarily to nonresidents' purchase of RS bonds in April and early May.

Foreign exchange also flowed in thanks to the Stand-By Arrangement with the IMF. Half of the funds approved under the third tranche were disbursed in April, and around 15% of the funds approved under the fourth

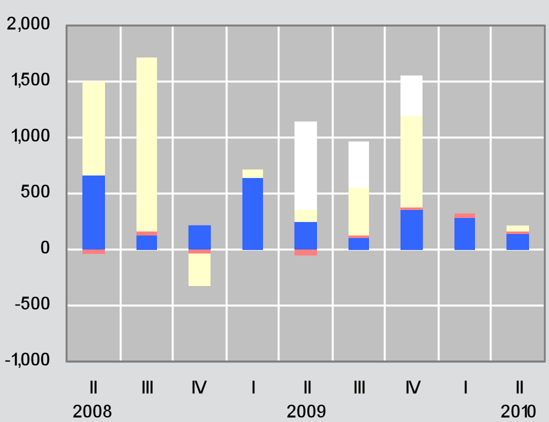
[8] Weights: 0.8 for the euro and 0.2 for the US dollar.

Chart IV.2.5 **Current account deficit and net capital inflow**
(in EUR mln)



As in Q1, capital inflow was insufficient to cover the current account deficit.

Chart IV.2.6 **Structure of the financial account**
(in EUR mln)



Capital inflow was rather modest in Q2.

tranche in June (EUR 180 and 56 mln, respectively).[9] However, intended as support to the country's international reserves, this inflow had no impact on movements in the foreign exchange market.

Banks continued servicing their short-term foreign debt, reducing it in Q2 by around EUR 389 mln. By contrast to the previous quarter, this reduction was not covered by long-term borrowing, which explains why the stock of long-term loans remained practically unchanged.

Like banks, enterprises continued reducing their foreign debt, long-term in particular, and at a much brisker pace than in the first three months of the year. In Q2, enterprise debt was slashed by around 315 mln.

3. Capital market developments

Escalation of the Greek debt crisis and the ensuing stronger investor aversion to risk prompted a fall in stock exchange indices across the region. Tumbling shares on the Belgrade Stock Exchange tallied with further turnover contraction.

In Q2, shares encompassed by both Belgrade Stock Exchange (BSE) indices precipitated down. At end-Q2, Belex 15 came at 634.5 and BELEXline 1,237.9 index points, down by 7.4% and 5.3% respectively. The downward spiral continued in July, with Belex 15 and BELEXline slipping to 630.8 and 1,218.0 index points at the month-end.

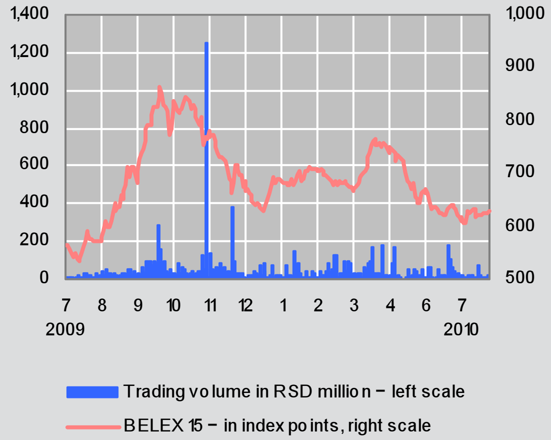
Average daily trading on the BSE shrank by 11.4% from Q1.[10] Investor propensity to less risky financial instruments is mirrored in the BSE trading structure –average daily trading in shares (5.4%) fell more steeply than trading in bonds (12.5%). Continued negative trends in stock market liquidity are illustrated by the fact that over one third of total trading (37%) involved AIK banka shares.

Foreign investors participated with 43.7% in total stock trading, with the net effect of stock purchases of RSD 1.1 bln. April and May saw net stock purchases, whilst June recorded heightened foreign investor sales (RSD 53 mln). In July, foreign investors were once again net stock purchasers (EUR 61 mln) though their interest was rather muted.

[9] In view of Serbia's broadly comfortable reserve position and the need to minimise the costs of the credit arrangement with the IMF, the authorities decided not to draw the tranches in the full amount approved.

[10] Overall trading (RSD 4.7 bln) was down 3.8% from Q1 due to a greater number of working days in Q2.

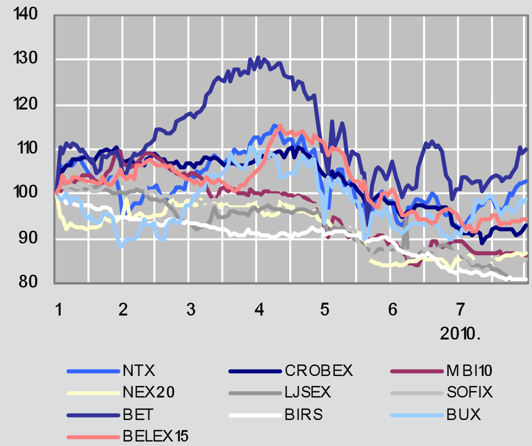
Chart IV.3.1 **Belex 15**



Source: BSE.

Belex 15 tumbled in Q2 and trading in shares included in this index contracted further.

Chart IV.3.2 **Stock exchange indices across the region**
(in index points, normalised, 31. 12. 2009 = 100)



All regional stock exchange indices precipitated down in Q2.

Overall BSE market capitalisation arrived at RSD 853.5 bln on 30 June, down by RSD 18.9 bln from end-March, mainly on account of delisting of A2010 bond series maturing on 31 May.

The bond market experienced slight contraction in return for all maturities, ranging between 3.7% and 3.8% p.a. by end-Q2. Of total turnover, 28.8% related to 2014 bond series.

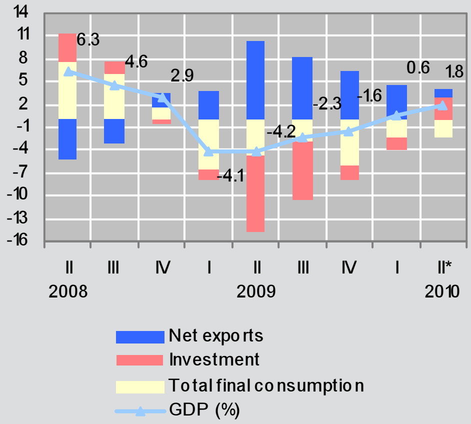
Indices declined on all regional stock exchanges. The sharpest fall, attributed largely to vigorous growth recorded in Q1, was experienced by the Bucharest Stock Exchange (20.5%). After the BSE Belex 15, the Ljubljana Stock Exchange index witnessed the smallest drop (8.8%). July, however, ushered in positive trends on the Bucharest, Budapest and Montenegro stock exchanges, with BET, BUX and MOSTE up by 7.0%, 5.8% and 4.3% respectively.

4. Aggregate demand

Economic growth recorded in Q2 was for its major part attributable to the rise in net exports. As higher household consumption and private investment failed to fully compensate for the effect of government austerity measures, the effect of domestic demand on overall economic activity remained negative.

According to seasonally-adjusted data, domestic demand softened by 0.2% relative to the previous quarter, while GDP rose 0.9%. Key contributions to GDP growth in the quarter under review came from net exports (1.1 pp), private investment (0.8 pp) and household consumption (0.7 pp). Public investment and government consumption were on a steep decline and provided negative contributions. Y-o-y, both GDP and domestic demand rose (1.8% and 0.6%, respectively). Still, it should be noted that such movements are primarily a result of last year's low base.

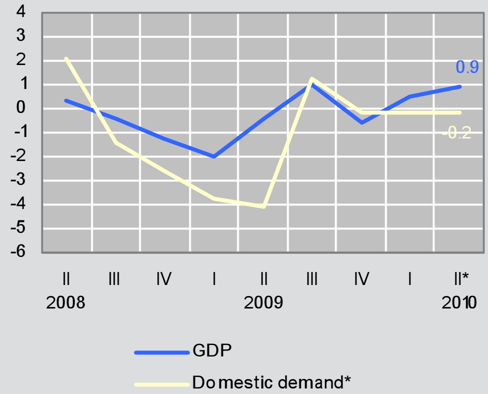
Chart IV.4.1 **Contribution to y-o-y GDP growth***
(in percentage points)



*NBS estimate.

Q2 is expected to see a y-o-y GDP growth owing to the increase in stocks and exports of goods and services.

Chart IV.4.2 **Growth in GDP and domestic demand**
(seasonally-adjusted quarterly growth rates)



*NBS estimate.

GDP recorded an increase in Q2, while domestic demand mildly declined amid a reduction in government consumption and investment.

Positive contributions to the projected 1.5% GDP growth in 2010 are anticipated from net exports (1.3 pp) and investment (1.0 pp) – government and private alike, while total consumption is expected to provide a negative contribution of 0.8 pp.

Domestic demand

Household spending

Quarterly growth in retail trade turnover points to a tepid recovery in household spending relative to Q1.

In seasonally-adjusted terms, household spending[11] picked up somewhat relative to a quarter earlier (1.0%) and gave a positive contribution to quarterly GDP growth (0.7 pp). Y-o-y data signal a slower decline in spending (2.3%).

Overall household income (wages, pensions and social transfers) bounced back from Q1 (1.3%) in seasonally-adjusted terms. This was due to a mild increase in real net wages and social security transfers.

Quarterly growth in real net inflow of remittances slowed down from Q1 (2.9%), whereas the volume of exchange dealers' purchases of foreign currency from households dipped further.

Bank lending, notably to households, is getting stronger by the month. This trend is also confirmed by y-o-y data.

Growth in household savings gained traction in Q2, rising by 3.1% in real terms. Y-o-y figures only confirm such developments.

Judging by seasonally-adjusted data, retail trade turnover rose in Q2. Y-o-y data point to a lessened decline in turnover, implying a softer fall in household spending.

In H1 2010, the decline in household spending was deeper than expected (3.8% y-o-y). This was mainly due to the unexpectedly sharp drop in spending in Q1, driven by a drastic scale-back in the green market trading, plummeting real outlays for personal and natural consumption (as shown by the *Household Consumption Survey*) and a subdued rise in the telecommunications

[11] Including not-for-profit organisations providing services to households.

sector. Still, household spending in 2010 is expected to show a much weaker decline than in the previous year.

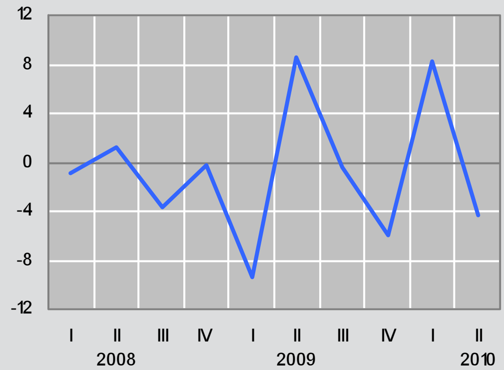
Government spending

Government spending fell substantially from the previous quarter both y-o-y and in seasonally-adjusted terms. Still, it is expected to record moderate real growth in 2010 as whole.

Data on government outlays for the purchase of goods and services and payment of public sector wages point to a cut in government spending by 2.9% y-o-y in real terms relative to the first quarter. Seasonally-adjusted, the reduction comes to 4.3%. Hence, in view of high volatility in public spending from one quarter to the next, it is best to draw conclusions on its character and impact on economic activity at year level.

After last negotiations with the IMF mission, the government decided to keep the freeze on public sector wages until the end of the year, anticipating real decline in this category of government spending of up to 5% at annual level. On the other hand, the planned government budget for 2010 envisages a more than 10% increase in spending for the purchase of goods and services. In view of the respective shares of the above two items in public spending, total public spending should record a real growth of around 2.5% at annual level.

Chart IV.4.3 **Public spending**
(seasonally-adjusted data, quarterly growth, in %)



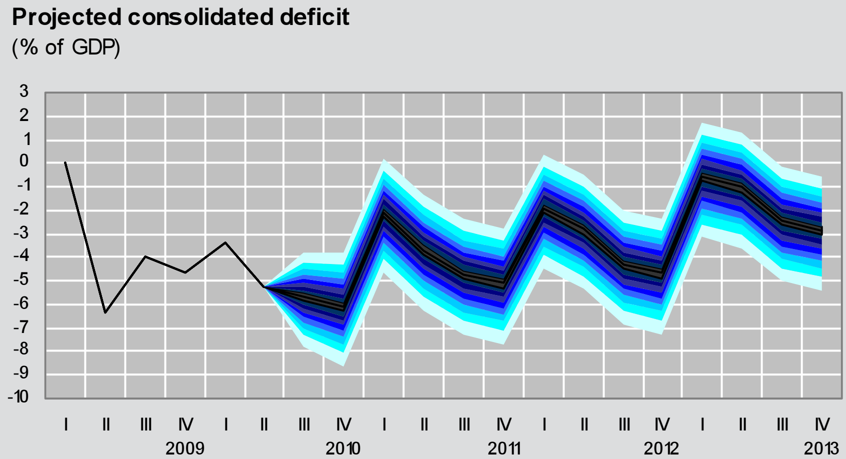
Public spending fell sharply in Q2. This fall, however, is of temporary nature.

Box 3: Fiscal policy in the medium run

With a consolidated budget deficit of RSD 28.8 bln recorded in Q2, total budget deficit in H1 2010 rose to RSD 51.8 bln, and exceeded the amount anticipated in the May Report, primarily due to a shortfall in revenue collection relative to the amount anticipated in the Law on Budget. During the May negotiations with the IMF mission, the expected budget deficit for 2010 was raised from 4% to 4.8%, as a proportion of GDP, to about RSD 140 bln, and the adopted Memorandum on the budget and economic and fiscal policy in 2011, with projections for 2012 and 2013 sets the deficit in 2010 at 4.8% of GDP.

Since the monetary effect of fiscal policy in Q2 was RSD 2.5 bln, the fiscal policy stance in Q2 was almost neutral. This was primarily due to the fact that the financing of a rather substantial deficit was, for its major part, pursued through the issue of treasury bills which managed to drain almost all excess liquidity created. The increase in net reserve money via issue of treasury bills amounted to RSD 21.9 billion in Q2, while the corresponding amount for H1 2010 was RSD 30.8 bln with a somewhat higher monetary effect - RSD 14.3 bln.

We still expect the budget deficit in the years through to 2013 to gradually decline, but the downward adjustment will start from a somewhat higher level than expected early in the year, and based on the adopted Memorandum on the budget and economic and fiscal policy in 2011, with projections for 2012 and 2013 following the 4.8% of GDP in 2010, the deficit is expected to decline to 4% of GDP in 2011, 3.5% of GDP in 2012 and 1.8% of GDP in 2013. The underlying assumption is a real GDP growth of 1.5%, 3%, 5% and 5.5% in 2010, 2011, 2012 and 2013, respectively, and the fiscal system reform designed to cut public expenditure and boost the revenue-generating capacity (through reform of the income tax, profit tax, VAT and excise duties, and amendments to customs regulations). The proposed Law on the Budget System containing provisions on fiscal responsibility will provide further support to the process of fiscal consolidation. The Law is expected to be adopted in September this year. Our estimates, however, suggest the prevalence of downward risks of divergence from the central value (deficit) i.e. they point to the rising deficit (see the chart below[1]). The key risks to the projection lie in the possible underperformance in terms of revenue, tax collection and GDP outturn.



[1] The chart was made based on data stated in the *Memorandum on the budget and economic and fiscal policy in 2011, with projections for 2012 and 2013* and NBS estimates.

Investment activity

In seasonally-adjusted terms, investment stagnated in Q2, while the increase in y-o-y data is due to the low base.

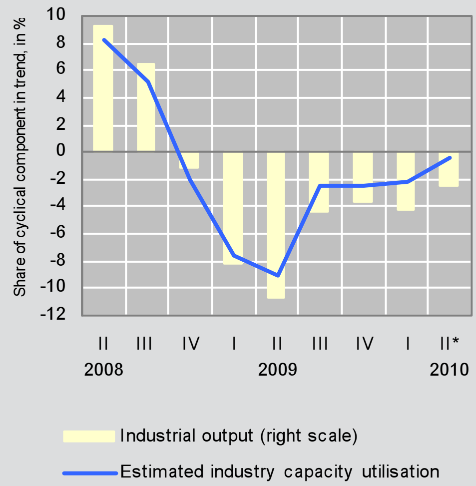
After a temporary recovery in H2 2009 and a resumed decline in Q1 2010, investment stagnated in Q2 from the previous quarter (-0.1%). Private investment provided an appreciable contribution to quarterly GDP growth, but it was offset by the drop in government investment and stocks. Y-o-y, investment recorded quite solid growth (13.8%), which should however be interpreted in the context of a substantial contraction in economic activity in 2009.

Temporary revival in the industrial production of capital goods came to a halt in Q2, when production tumbled down and the stocks of capital goods recorded a strong y-o-y increase. The production and exports of intermediate goods, on the other hand, continued on the path of a steady rebound.

Rising 4.6% on the previous quarter, capital investment showed signs of recovery for the first time in two years, partly due to a slower decline in the value of completed construction works and imports of means of labour.

As indicated by the cyclical component of labour productivity in industry, though still below the trend, industrial capacity utilisation rose on a quarter earlier, possibly heralding a gradual recovery in investment.

Chart IV.4.4 **Industry capacity utilisation**
(seasonally-adjusted data)



Though still below the trend, industry capacity utilisation is estimated to have increased in Q2.

Financial indicators for Q2 point to a rebound in domestic lending, both corporate and household. This rebound was significantly propped up by the government-subsidised

Table IV.4.1 **Investment indicators**
(growth rates in %)

	Q2 2009 / Q2 2008	Q3 2009 / Q3 2008	Q4 2009 / Q4 2008	Q1 2010 / Q1 2009	Q2 2010 / Q2 2009
Real indicators					
Construction	-16.6	-18.4	-19.6	-12.0	-11.8 *
Industrial production of capital goods (physical volume)	-23.4	-22.4	-10.3	4.0	-11.3
Exports of capital goods**	-16.9	-29.2	-19.5	-9.2	6.9
Imports of capital goods**	-35.9	-12.8	-7.7	-15.9	0.3
Stocks of capital goods	-20.3	-18.0	-10.5	4.2	11.7
Industrial production of intermediate goods (physical volume)	-34.2	-18.5	3.0	14.8	21.6
Exports of intermediate goods**	-49.2	-42.8	-3.1	37.1	58.8
Imports of intermediate goods**	-26.5	-10.1	-0.1	9.7	23.0
Stocks of intermediate goods	-4.2	-5.3	-3.4	-1.9	-1.4
Government investment spending**	-19.6	-20.3	-21.3	-31.7	-35.3
	2009			2010	
Financial indicators	Q2	Q3	Q4	Q1	Q2
Medium- and long-term external borrowing by enterprises (net) in EUR million	-226.4	-114.0	-35.4	-77.0	-275.6
Short-term credits to entreprises in RSD billion	2.3	8.8	-1.8	32.5	39.4
Long-term credits to enterprises in RSD billion	3.4	10.7	35.4	16.1	35.8
Long-term credits to households in RSD billion	-5.7	4.2	20.9	23.9	43.8

* NBS estimate.
** Imports are deflated by the index of producer prices of manufactured products in Germany; Exports are deflated by export producer prices of capital goods; Government investment spending is deflated by the index of producer prices of manufactured products.

loan programme for 2010, whose implementation gathered traction in Q2. Enterprises continue to borrow in the domestic market, while at the same time repaying their foreign debt in net terms.

Because of the extremely slow pace of project implementation in 2010, Q2 saw government investment activity slumping by 35.3% y-o-y. Should the budget plan for this year be executed in full (which is very likely), government investment will rise 3.4% on 2009 in real terms. But if the budget for 2010 undergoes an upward revision similar to the one we saw last year, real growth in government investment could reach 13%.

Investment activity, both private and public, is expected to gradually improve over the coming period and, together with increased foreign demand, play the key role in the recovery of our economy in 2010.

Net external demand

As exports grew faster than imports, foreign demand provided a positive contribution to GDP growth in Q2. The rise in imported inflation, in place since Q4 2009, decelerated.

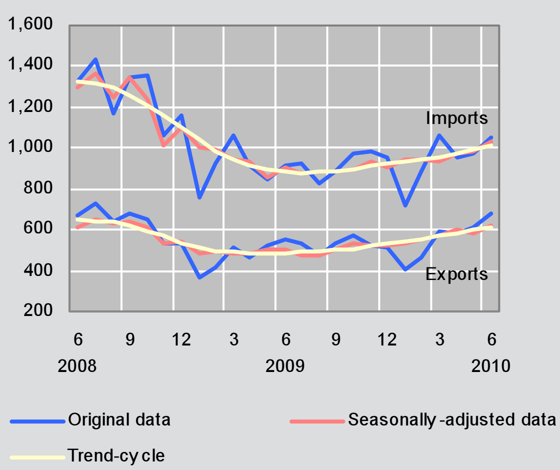
The role of foreign trade in GDP movements was rather significant in Q2. Seasonally-adjusted data indicate that exports rose faster than imports relative to the previous quarter, exerting a decisive impact on GDP growth. Thus, according to our estimates, net exports provided a 1.1 pp contribution to GDP growth.

Y-o-y data also point to a much faster growth in exports than in imports (21.6% compared to 11.3%), suggesting that export growth not only continued but also stepped up relative to Q1, which is partly attributable to the effects of the depreciation of the dinar. As imports recorded their first y-o-y increase since Q3 2008, the deficit on trade in goods fell 2.6% from the same period a year earlier.

Imports of consumer goods continued on a declining path (3.3%), but the fact that the strongest growth within imports was recorded for intermediate goods (34.4% in the last year) is rather encouraging and possibly heralds a step-up in the growth of production. In addition to the real depreciation of the dinar, foreign trade deficit contracted during the last year under the impact of an improvement in terms of trade, i.e. faster growth in export relative to import prices in same currency terms, triggered largely by the surging prices of base metals. As the effects of the most recent bout of dinar's depreciation are yet to unfold, upward trend in exports is likely to persist. This, of course, also depends on the recovery of the global economy, notably eurozone and CEFTA members.

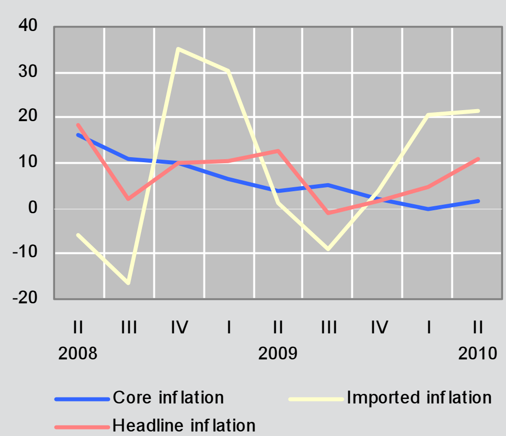
Though still relatively high, imported inflation[12] slowed down considerably from the previous two quarters and measured an annualised 21.6% in Q2. The slowdown was

Chart IV.4.5 **Exports and imports**
(in EUR mln)



Thanks to the growth in exports, the trade deficit contracted from the previous quarter.

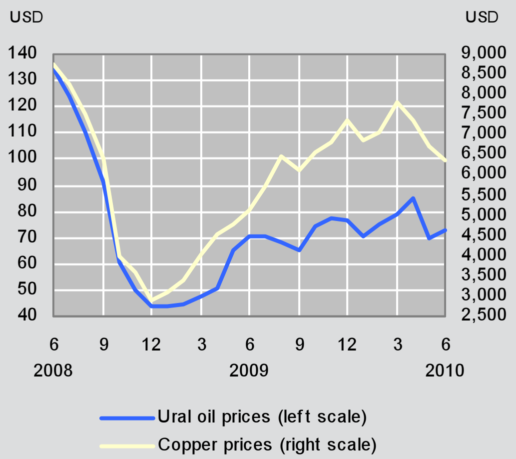
Chart IV.4.6 **Domestic and imported inflation**
(annualised quarterly growth rates)



Source: NBS and Eurostat.

Imported inflation continued rising in Q2, albeit at a much slower pace than in the previous two quarters.

Chart IV.4.7 **Oil and copper price movements**



Source: *Bloomberg.*

Oil prices displayed great volatility in Q2. Copper prices were a downward trend throughout the quarter.

due to a smaller depreciation of the nominal effective exchange rate of the dinar in Q2 compared to Q1. The rise in imported inflation reflected very little on core inflation (annualised 1.8%), but is expected to exert some upward pressure in Q3.

Oil prices displayed great volatility in Q2 2010. Threatening to reach as much as USD 90 pb, they were sustained at a relatively high level throughout April by investors' expectations that the eurozone financial market would stabilise and economic growth step up following adoption of the IMF rescue packages. However, as this failed to come about and the distrust in sustainability of public debt only increased, Ural oil prices spiralled down to USD 68 pb in mid-May. By the end of Q2, the prices edged up in response to the release of better-than-expected macroeconomic data for the eurozone and the easing of tensions in the financial market. They currently stand at around USD 75 pb, and are expected to average USD 75–80 pb until the end of the year. Oil demand is likely to increase mildly in H2 2010, especially in India, China and the Middle East, but also in advanced regions with economic recovery under way.

The price of copper, the most important non-ferrous metal for Serbian exports, hit its 2010 high at the close of Q1 – nearly USD 8,000 per tonne. Already in April, the trend reversed. The decline gathered pace in May, leaving copper prices only slightly over USD 6,000 per tonne in early June. As the prospects for global economic growth improved and the demand for raw commodities picked up, the price of copper recorded a modest increase in the second half of June relative to its annual low touched in the first ten days of the same month.

Late June saw a worldwide surge in the prices of primary agricultural commodities. After the US Department of Agriculture released data on the drop in global crop stocks and the planned cut in acres under wheat next season, the price of wheat soared in July by 34% relative to its June level. Price growth was further aided by crop condition reports on lower yields in the world's major exporters such as Russia, Ukraine and Kazakhstan. Given the role of psychological factors in such a rapid price growth, it would be reasonable to expect that the prices of wheat will retreat to a sustainable level in the foreseeable future.

5. Economic activity

Estimates point to economic recovery in Q2. GDP recorded mild quarterly growth, whereas negative output gap narrowed slightly.

The most recent data released by the Statistical Office for Q1 show a downward revision of the preliminary y-o-y GDP growth figure from 1.0% to 0.6%. Relative to Q4 2009, GDP was up 0.8%, somewhat less than estimated by the Statistical Office.

Based on seasonally-adjusted data, both GDP and non-agricultural value added (NAVA) are estimated to have risen in Q2 – by 0.9% and 1.1% from Q1 respectively. The strongest boost to GDP growth came from industrial output (0.4 pp) and the transport and communications sector (0.2 pp). The construction sector, however, gave a negative contribution (–0.1 pp).

[12] Imported inflation is a result of change in the nominal effective exchange rate of the dinar (weights: 0.8 for the euro and 0.2 for the dollar) and prices in the eurozone and the United States.

Overall industrial output rose by 2.8% in quarterly terms in response to an upturn in manufacturing. The manufacturing sector increased by 3.3% mainly on account of higher growth in the production of basic metals, chemicals and chemical products. The mining and quarrying sector recorded a 1.5% rise. The production of electricity, gas and water was up 1.2% due to higher energy production in April to cover the needs of rising export demand. Bad weather conditions and extended heating season gave further boost to electricity production.

Seasonally-adjusted quarterly data on the volume of retail and wholesale trade point to stagnation (0.1%), while the hotels and restaurants sector witnessed a rise. Growth in the financial intermediation sector is estimated to have slowed to 1.3%.

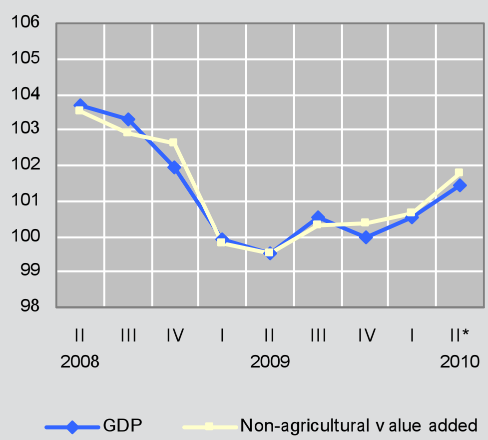
According to our estimates, a decline in the construction sector decelerated as evidenced in rising production of non-metal minerals, whereas on the other hand, government capital expenditure contracted.

Y-o-y GDP growth, attributed to the low 2009 base, is estimated at 1.8%, which is in line with our expectations of a 1.5% rise in GDP in 2010. The strongest contribution to growth was provided by overall industrial output (1.0 pp), with manufacturing and the transport and communications sectors accounting for 0.9 pp and 1.0 pp respectively. On the other hand, the strongest negative contribution came from the construction and trade sectors (–0.3 pp each).

Y-o-y growth, recorded by overall industrial output in Q1 after more than a year, continued into Q2 (6.8%) and was sustained by manufacturing (7.4% y-o-y) owing mainly to the production of basic metals. The mining and quarrying sector grew 11.7% but contributed little to the overall growth in industry. In terms of economic destination, y-o-y growth in industrial output was supported by the production of intermediate goods and energy.

On the other hand, construction is estimated to have declined by 11.8% y-o-y, as indicated by a fall in government investment spending measured by capital

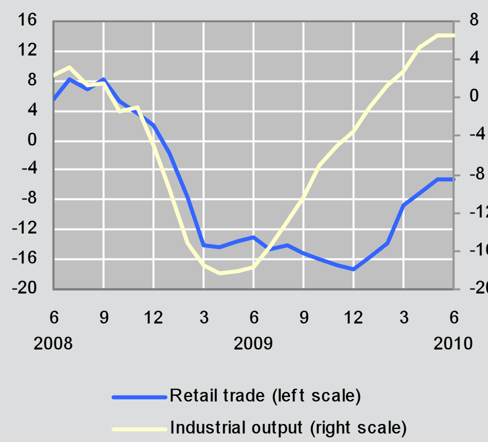
Chart IV.5.1 **Economic activity indicators**
(seasonally-adjusted data, 2009 = 100)



* NBS estimate.

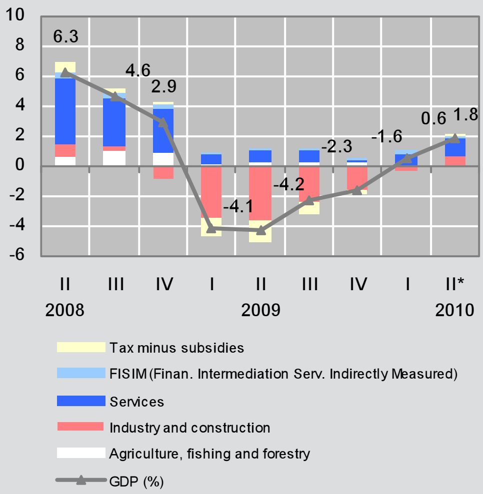
GDP rose in Q2, largely in response to growing industrial output.

Chart IV.5.2 **Quarterly moving averages of industrial output and retail trade**
(y-o-y rates, in %)



Y-o-y decline in retail trade slowed further in Q2, while industrial production rose, partly due to low last year's base.

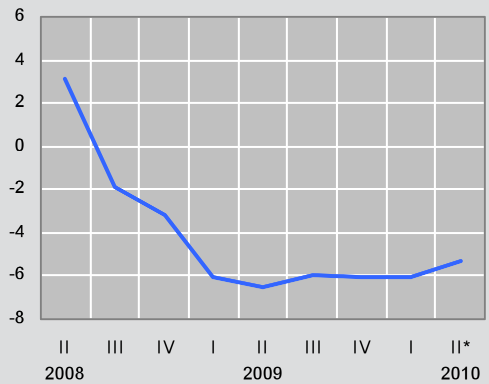
Chart IV.5.3 **Contribution to y-o-y GDP growth**
(in p. p.)



* NBS estimate.

Y-o-y GDP growth is expected in Q2.

Chart IV.5.4 **Output gap***
(percentual deviation from the trend)



* NBS estimate.

Negative output gap narrowed on account of further economic recovery in Q2.

expenditure. The decline in the wholesale and retail sector slowed (2.6% y-o-y), as indicated by a decelerated fall in retail trade turnover. A slower decline was also recorded by the hotels and restaurants sector (6.1% y-o-y) as a result of a smaller drop in the number of tourist overnight stays.

Judging by the condition of crops on 25 May 2010, the Statistical Office estimates that wheat production will fall in 2010 by 8.0% from 2009. On the other hand, according to preliminary data on the spring sowing area, more maize, sunflower, soy and sugar beet were sown in this than in the previous year. The production of cherries, sour cherries and apricots is likely to decline as well.

Negative output gap measured by NAVA narrowed, which implies that the disinflationary pressure of low aggregate demand was weaker than in Q1. However, given the still markedly negative output gap, demand is likely to be the key disinflationary factor in the coming period as well.

6. Labour market developments

Wages

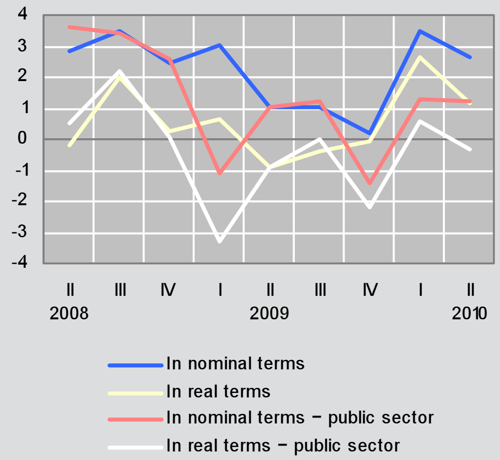
The pace of nominal and real wage growth eased from Q1. Unit labour costs in the industry underwent a slight decline.

The pace of nominal and real wage growth eased in seasonally-adjusted terms. Relative to Q1, wages were up 2.6% and 1.2% in nominal and real terms respectively.

Judging by original data, the average net wage came at EUR 335 (RSD 34,192), up by 4.2% on Q1, mainly on account of acceleration in nominal wage growth (7.1%).

According to seasonally-adjusted data, wage growth was recorded by almost all sectors, most notably electricity production, finance, manufacturing and real estate. Both construction and hotels industries experienced a drop in wages, with a significant degree of slack persisting in the construction activity.

Chart IV.6.1 **Average net wages – total and the public sector**
(seasonally-adjusted data, quarterly growth, in %)



Real public sector real wages rose at a much slower pace than total wages.

Unit labour costs in the industry underwent a slight decline in seasonally-adjusted terms due slower growth in real gross wages in the industry than in production. Nevertheless, manufacturing reported a negligible rise in unit production costs prompted by stronger growth in real gross wages than in productivity.

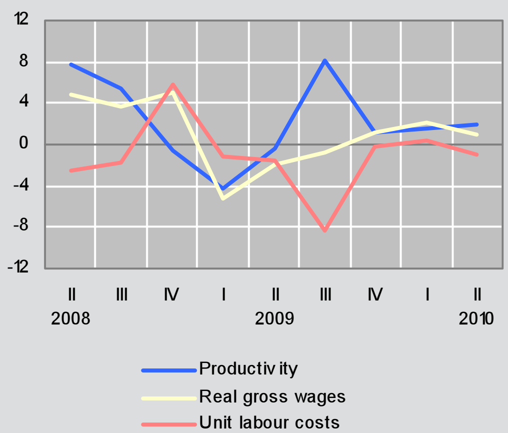
Employment

Economic recovery is still weak to stave off exacerbation in labour market conditions.

Results of the Labour Survey point to a continuing, albeit slower fall in employment. Labour market developments mirror economic activity with a time lag. Economic recovery has so far been too slow and inadequate to hold back negative trends in the labour market. It remains to be seen whether a decline in employment bottomed out in Q2.

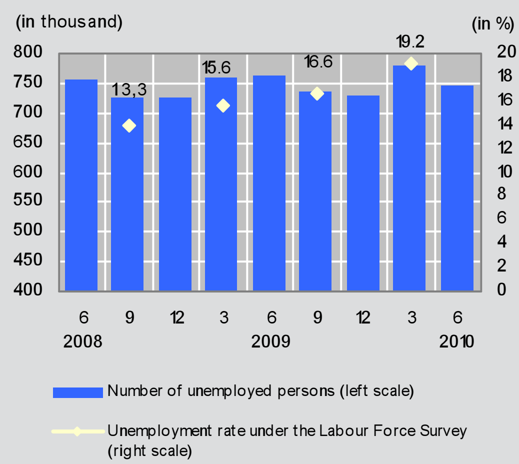
In terms of employment dynamics in the post-crisis period, it should be borne in mind that recessions triggered by financial crises typically give rise to longer-lasting macroeconomic effects than those resulting from other, non-systemic recessions. The effects include longer-lasting increases in unemployment and higher structural unemployment.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in the industry**
(seasonally-adjusted data, quarterly growth, in %)



Recovery of industrial production and a slowdown in real gross wages resulted in a small drop in unit production costs.

Chart IV.6.3 **Unemployment**

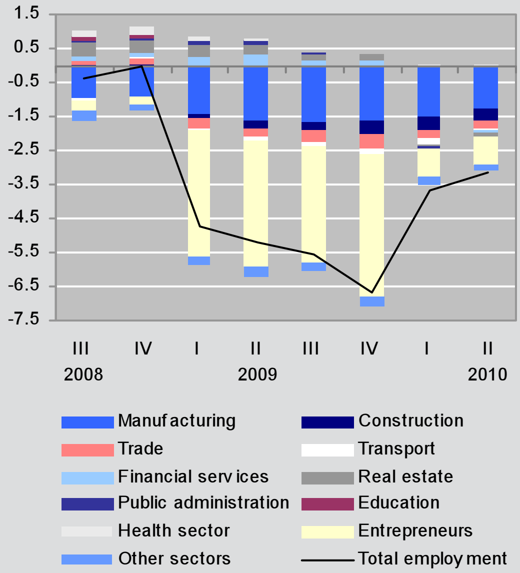


Source: National Employment Service and Serbian Statistical Office.

The number of unemployed persons registered by the National Employment Service contracted in Q2, largely in response to tighter unemployment eligibility criteria.

Public sector wages showed much lower nominal growth (1.2%) and real decline (0.3%) than total wages. A marked rise in wages was noted in public administration and public state-run companies despite the pay freeze measures.

Chart IV.6.4 **Employment by sector**
(contribution to y-o-y growth in employment, in p.p.)



Source: Statistical Office.

The heaviest job losses in Q2 were suffered by manufacturing.

As regards sectoral dimension to the recession, the heaviest job losses were suffered by manufacturing. The hotels industry, finance and real estate sectors followed suit. By contrast, electricity production and transport experienced growth in employment. Likewise, the public sector (administration, public and local enterprises and the health sector) reported an upturn, whilst public state-run enterprises and the educational sector went through a downturn.

The number of unemployed persons registered by the National Employment Service contracted in Q2, largely in response to tighter unemployment eligibility criteria and a lower number of first-time job seekers (stimulated by government measures). June saw around 746,000 unemployed persons, down by around 32,000 or 2.1% relative to March.

Box 4: Labour Force Survey

Though with a time lag, the economic crisis reflected strongly on movements in the labour market. According to the Labour Force Survey conducted in April, the unemployment rate rose from 14.0% in October 2008 to 19.2% in April 2010, its increase being particularly pronounced since October 2009 – 2.6 percentage points.

Between October 2009 and April this year, employment measured around 2,412 thousand persons, while the employment rate declined by around 2.7 pp or 178 thousand to 38.1%, indicating acceleration of the downward trends. This confirms that the impact of the economic crisis on the labour market usually comes with a time lag and that the duration of the decline in employment is significantly longer than that in GDP.

Labour Force Survey

	April 2008	October 2008	April 2009	October 2009	April 2010
Unemployment rate	13.3	14.0	15.6	16.6	19,2
Employment rate	44.7	44.2	41.6	40.8	38.1
Informal employment rate	23.6	23.0	22.2	20.6	19.8

In the same period, the jobless number climbed by around 56,000, which hardly matches the drop in employment. In fact, around 98,000 persons were reclassified into the category *inactive labour force* rather than entered under *unemployed labour force*. Unemployment structure by the length of job seeking also shows deterioration – the share of long-term in total unemployment rose by 1.2 structural points, reaching 66.7%.

The sharpest decline in employment (around 47,000 persons) was registered in the 45–54 age group. At the same time, this group of population recorded an increase in unemployment of around 10,000, which suggests that quite a significant number of people were reclassified to the category *inactive labour force*. The 25–34 age group was the second worst affected by the crisis and its employment losses came to around 41,000. Its unemployment however rose by around 27,000, while the rest spilled over to the category of inactive labour force.

Apart from being low, employment is badly structured – nearly one fifth is attributable to the black market. Informal employment covers persons working in (non)registered companies with no employment contract and pension and disability insurance, as well as unpaid contributing family workers. As in other countries, this type of unemployment bore the brunt of the crisis. From October 2009 to April 2010, informal employment fell from 20.6% to 19.8%.

Employment declined across nearly all industries. The largest losses were observed in agriculture and forestry – around 70,000 persons. The recovery in the manufacturing industry is still not strong enough to halt the downward trend in employment that fell by around 36,000 between two surveys. Since the start of the economic crisis (October 2008 Labour Force Survey), employment in the manufacturing industry was cut by around 20%. A noticeable decrease in employment between two surveys was also recorded in construction and trade.

7. International environment

The global recovery is proceeding, though at varying speed across countries and regions and against the backdrop of heightened risks of another bout of recession. Still-fragile economic growth in Serbia's key trading partners is expected to remain that way in 2011 as well.

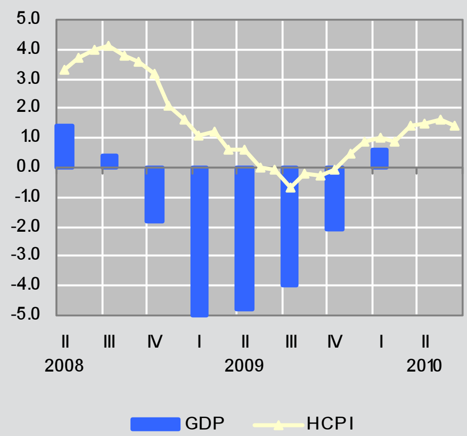
In the first half of the year the global recovery evolved better than anticipated, driven largely by the vigorous expansion of emerging and developing economies that are forecast to grow 6.8% for the year as a whole (IMF). Thanks to them, notably India and China, the global economic outlook has somewhat brightened. Though the world economy is poised for further growth, some downside risks persist, mostly associated with uncertainties about public debt sustainability of some eurozone members. For the time being, these risks are restricted to the eurozone and East European countries, but they could easily spread around the globe, threatening financial stability and further economic recovery.

The recovery is proceeding at an uneven pace across economies and regions. Its pace is weakest in the eurozone, rather strong in Japan and the USA, and solid in emerging economies. Growth in advanced economies is expected to slow in the second half of the year due to a decline in consumer demand. The recovery in East Europe is faster than in the eurozone, but on the whole, sluggish and unevenly distributed, wherefore pre-crisis growth dynamics can not be expected before 2011.

It can be said that the worst consequences of the financial crisis have been eliminated in the USA and that its recovery is now moderately-paced. In addition to extraordinary monetary and fiscal policy measures that yielded visible results, amendments to financial regulations will be enacted to prevent any future irresponsible behaviour of banks and other financial institutions and their bailout at the expense of taxpayers. The Fed is expected to continue implementing accommodative monetary policy until unemployment goes noticeably down. The forecasts of economic growth in the USA for 2010 are higher than for the eurozone.

With greater scope for economic growth and no inflationary pressures, advanced economies are expected to pursue accommodative monetary policies for quite some time. Apart from the Unites States, this refers to the eurozone, Japan, United Kingdom and Switzerland. The eurozone is the region most exposed to the risk of another bout of recession as the situation in some of its members has eroded investor confidence and induced a hefty rise in risk premiums on bonds issued by those countries. It is

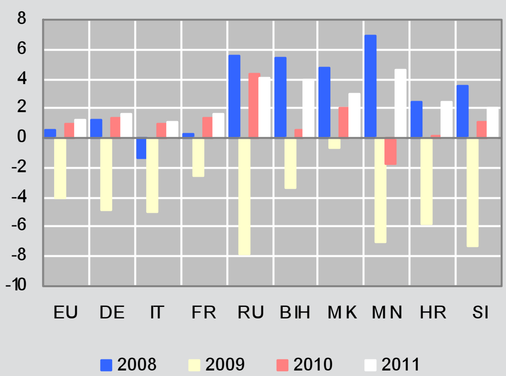
Chart IV.7.1 **Eurozone GDP and inflation**
(y-o-y growth rates)



Source: Eurostat.

After declining for five quarters in a row, eurozone economy recorded growth in Q1 2010. Inflation edged up in April and May, but declined in the month that followed.

Chart IV.7.2 **Serbia's key foreign trade partners - GDP growth rates and their projections**
(in %)



Source: IMF, WEO, July 2010.

The recovery of the above economies in 2010 and 2011 is expected to be sluggish and exposed to various risks. It will not be strong enough to spur major growth in our exports.

expected that governments' stabilisation policies aimed at consolidation of public finance will help restore investor confidence and bring the risk premiums down. As the risks to economic growth prospects are elevated, nobody is considering the withdrawal of unconventional monetary policy measures unlike just several months ago when advanced economies discussed extensively the options for their exit strategies.

Recent financial market developments in the eurozone, Serbia's key trading partner, have dampened the prospects for faster growth in that region. Therefore, the IMF reaffirmed its April forecast for eurozone growth in 2010 (1%) but, at the same time, cut the one for 2011 by 0.2 percentage points.

Estimates of economic growth in Central and East European countries for 2010 have slightly improved. Analysts believe these countries have a potential for moderate growth despite strong impact of movements in the eurozone financial market. The volume of FDI is admittedly much lower and there is a risk that these countries could default on their debt obligations, but that risk is much smaller than in advanced eurozone economies. Central and East European countries are projected to grow 3.2% in 2010. Consistently with forecasts of moderate growth, monetary policies pursued by their central banks are expected to remain accommodative. Though the room for lowering policy rates has been largely exhausted, their increase in the period ahead seems highly unlikely. In fact, it could be delayed until economic growth fully takes hold.

Over the past several months exchange rate movements were overwhelmingly determined by the rise in risk premiums sparked by the mounting concerns over peripheral eurozone countries' public debt sustainability. The euro weakened against the dollar considerably during that period, mostly amid fears that the Greek debt crisis might spread to other eurozone countries whose public finance are in bad shape. Uncertainties about movements in the exchange rate of the euro persisted throughout the second quarter. The steepest decline against the dollar was recorded in April and May, whereas in June the exchange rate stabilised at around 1.23 dollars for one euro. Further movements in the EUR/USD exchange rate could be determined by somewhat higher confidence in the implementation of austerity measures by Greece and other overindebted eurozone countries, by the lowering of the risk premium on their bonds, and smaller difference in the speed of recovery of the US and eurozone economies.

Box 5: EU fiscal consolidation

The eurozone debt crisis has sparked a heated debate in economic circles worldwide about the sustainability of public finance in EU countries, but also about the survival of the eurozone itself. Further out, the crisis has highlighted the weaknesses of existing mechanisms for maintaining macroeconomic stability, coordinating economic policies and ensuring public finance sustainability.

Current regulations require the member states to maintain budget discipline, implying up to 3% budget deficit to GDP ratio and up to 60% public debt to GDP ratio. If these thresholds are exceeded, the so-called excessive deficit procedure is initiated, which involves stricter surveillance of the member state concerned and the issuance of policy recommendations regarding the introduction of corrective measures. If the member state persists in breaching the thresholds, it may be required to make a deposit of a pre-determined size with the European Commission. However, practice has shown that the scope for the implementation of the above described rules is limited, largely due to the complex nature of the sanction mechanism. In the past five years, only 5 of the then EU-25 had a budget deficit to GDP ratio of less than 3%, while 9 countries had a continuously higher than 60% public debt to GDP ratio. Standing particularly out for their continuous breach of budget discipline were two countries – Hungary and Greece, whereas on the other side of the gap, there were Denmark, Luxembourg, Estonia, Finland and Sweden who fully observed the criteria defined. As the global financial crisis has led to a further deterioration in public finance across the EU, only three members are now outside the excessive deficit procedure (Estonia, Luxembourg and Sweden). The EU has issued policy recommendations to budget offenders on an individual basis and laid down the pace and time limits for their fiscal consolidation.

To overcome the shortcomings of the existing framework, in late June 2010 the European Commission unveiled a proposal for stronger EU economic governance that includes a number of measures supporting macroeconomic stability and promoting employment and economic growth. The Commission proposes a mechanism of stronger surveillance of national economic policies, comprising a preventive arm (monitoring of a comprehensive set of indicators revealing members' external and internal position) and a corrective arm (modelled upon the excessive deficit procedure and designed to address the risks identified). The Commission also proposes strengthening of national fiscal frameworks through definition of fiscal rules, harmonisation with EU accounting standards, and switching from one-year to multi-year budgeting. To achieve fiscal sustainability, an overindebted member state must implement the measures designed to reduce its public debt, according to a pre-determined time schedule.

The tightening of the sanctions mechanism in the event of insufficient progress with budgetary consolidation represents a significant improvement on current regulations. Namely, in addition to the obligation of making a deposit with the EC, for countries in long-standing breach of debt and deficit criteria, a conditionality mechanism is proposed for EU support to cohesion policy implementation, including subsidies for agriculture, fishing and regional development. However, this would not abrogate the member state's obligation to pay out subsidies to the end beneficiaries of EU funds. If the member state's noncompliance continues, a part of its appropriations from the EU budget for the next year would be cancelled. Finally, the EC proposes better coordination of national economic policies through the introduction of the European semester, which means that the member states would have to be acquainted with the principles of the common policy before drafting their own budgets and programmes of reform. The cycle of national budget preparation would be completed with the issue of recommendations regarding draft national budgets by the European Council, implementation of these recommendations in the final budget proposals and budget adoption by the national parliaments.

As announced by the European Commission, formal proposals of the above described measures will be finalised and submitted for consideration to the relevant institutions by end-September.

V. Inflation projection

Inflation is expected to retreat within the target tolerance band in Q3 2010, and move closer to its upper bound at end-2010 and throughout 2011. Inflation will moderately rise on the back of the past weakening of the dinar and the anticipated growth in food prices despite persistently low demand. In view of the recovery in foreign demand and the past real depreciation of the dinar, economic activity is expected to grow moderately. Should inflationary pressures accelerate, a further hike in the key policy rate remains a possibility.

The medium-term inflation projection aims to show expected inflation movements (CPI), the main factors behind such movements and the underlying risks. It is expressed both as a range for the CPI and as a central projection rate. This projection presumes an active monetary policy which aims to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Background information

The period since the last Inflation Report has been marked by a major turmoil in the global financial markets caused by the Greek debt crisis and fears of eurozone contagion. The impact on Serbia has manifested through higher risk premium, depreciation pressures and rising money market rates.

In Q2 2010 inflation moved below the lower bound of the target tolerance band. Quarterly consumer price growth was for its major part due to the seasonal increase in agricultural product prices. Regulated prices and core inflation also played a role.

Core inflation (inflation excluding regulated and agricultural product prices) rose on the previous quarter reflecting a much slower decline in processed food prices and dinar's depreciation (i.e. rise in import prices) over the past several months.

By contrast to the prior period, food prices are expected to stop producing disinflationary pressures. The drop in agricultural product prices in June and July was much weaker than seasonally expected, while the rise in wheat and corn prices in the past several months is likely to put pressure on many processed food products such as flour, bread, milk, meat, etc.

In an environment of dampened demand, net importers responded to the weakening of the dinar by lowering their profit margins rather than by raising their prices. The consequent widening in the depreciation gap could develop into a significant inflationary factor over the medium run.

Working in the opposite direction is the still-low aggregate demand. Though output gap narrowed in Q2, demand-side disinflationary pressures remain strong over the medium term.

Economic growth registered in Q2 is attributable primarily to the rise in exports taking place in response to slightly improved foreign demand and real depreciation of the dinar. The eurozone, our main trading partner, is also estimated to have experienced economic growth in Q2, which means that its stable, though sluggish, recovery continues.

The widening of the depreciation gap and lowering of the key policy rate by 100 basis points overall, gave the monetary policy a more expansionary edge in Q2 than a quarter earlier. Considering July depreciation pressures, the monetary policy stance is likely to be even more expansionary in Q3 despite the upward revision of the key policy rate in early August to 8.5%.

Projection assumptions

Based on their increase in H1 and revisions announced for H2, regulated prices are expected to remain within the planned growth range of 9±2%. The projection assumes that the government will adhere to its plan for regulated price growth in 2011 as well (7±2%).

As the agricultural product prices are currently very low, they are likely to grow faster than other prices in the medium term.

With the waning of the crisis, the trend of price convergence to the eurozone (real appreciation of the dinar against the euro) is expected to step up again. The risk premium rose in May and June, but is expected to recede, which should together with the appreciation trend rise induce a gradual decline in the real interest rate trend.

The eurozone economy is set for a modest recovery in the coming period. Despite tight fiscal measures introduced by member states over the past several months, forecasts of its growth have been revised downwards only slightly, reflecting expectations that the weaker euro will bolster eurozone exports. Consistent with tight fiscal policies, the ECB is unlikely to raise its rate earlier than in mid-2011.

Inflation projection

Inflation is expected to retreat within the target tolerance band in Q3 2010. At end-2010 and throughout 2011, it is forecast to move closer to the upper bound of the target (Chart V.0.1).

The second half of 2010 is likely to see a somewhat faster growth in market-determined prices, moderate rise in regulated prices and a seasonal drop in agricultural product prices.

The rise in import prices, triggered by the depreciation of the dinar in Q2, will be the key source of pressures on core inflation until the end of the year. Besides, by contrast to the prior period, processed food prices are expected to edge up in H2 due to higher input costs (higher prices of corn, wheat…). The above two factors are expected to induce a rise in core inflation in the second half of the year despite persistently low aggregate demand.

In all likelihood, agricultural product prices will experience a much weaker seasonal decline than in earlier years, reflecting the impact of unfavourable weather conditions (excessive rainfall) on their supply.

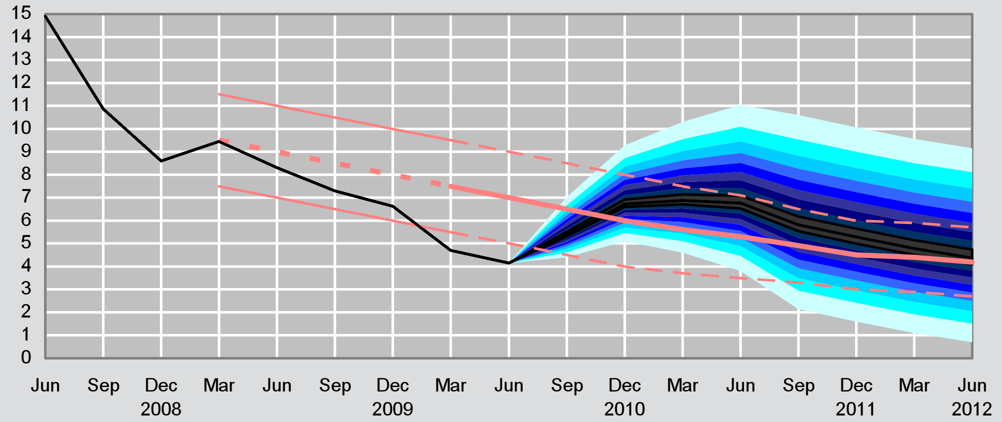
Overall consumer price growth in the second half of the year will be higher than in the same period last year when inflation was very low. This will induce a rise in y-o-y inflation and steer it back within the target tolerance band in Q3. In December 2010, inflation is expected to move slightly above the target rate.

In the medium run, the drop in net importers' profit margins (manufacturers and traders), i.e. widening of the depreciation gap in H1 2010, will be an important factor affecting inflation. To put it in simple terms,

Table V.0.1 **Projection assumptions for 2010 and 2011**

	2010	2011
External assumptions		
EU inflation (Q4 to Q4)	1.6%	1.5%
ECB policy rate (year-end)	1%	1.5%
Euro area GDP growth	1.1%	1.4%
Ural oil price per barrel (year-end, USD)	78	84
Internal assumptions		
Regulated prices excl. petroleum products (Dec to Dec)	11,1%	7.5%
Prices of agricultural products (Dec to Dec)	15.0%	8.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.2%	1.8%
Real interest rate trend (average)	5.4%	4.7%

Chart V.0.1 **Inflation projection**
(y-o-y rates, in %)



Inflation will retreat within the target tolerance band in Q3. In late 2010 and throughout 2011, it is expected to move closer to the upper bound of the target. The risks to the projection are tilted to the upside due to the possibly faster growth in food prices and stronger pass-through of dinar's depreciation to inflation.

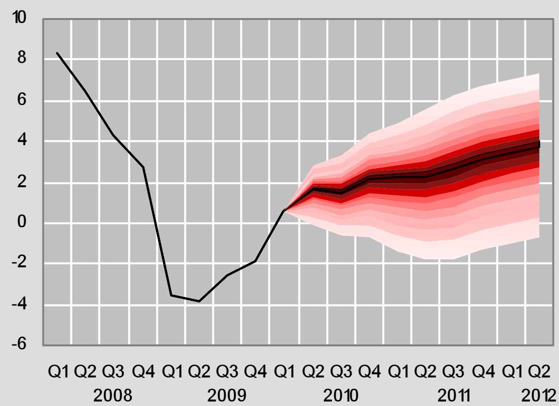
The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. Outturns of inflation are also expected to lie somewhere within the entire fan chart with probability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

these enterprises will seek to compensate for the loss in their profit margins either by raising the prices of their products once the conditions are met, or by not lowering them proportionately to the strengthening of the dinar in case such strengthening takes place some time in the future.

On the other hand, price growth will be held back by depressed demand. But as the economy recovers and the negative output gap (indicative of low demand) gradually closes, demand-side disinflationary pressures will grow weaker. The rise in domestic demand will be aided to a degree by the lifting of the freeze on public sector wages and pensions announced for April 2011.

Inflation is forecast to move near the upper bound of the target for the major part of 2011 due to the rise in monthly inflation rates in H2 2010 (reflecting on y-o-y rates over a one year horizon) and the prevailing of inflationary pressures of the depreciation gap over the disinflationary effects generated by the output gap.

Chart V.0.2 **GDP growth projection**
(y-o-y rates, in %)



GDP growth in 2010 is projected at a modest 1.5%. Stronger economic growth cannot be expected before 2011 (around 3.0%).

Serbian economy is poised for moderate growth in the coming period (Chart V.0.2). As in the previous quarters, net exports will be the key contributory factor.

The healing of demand in our key trading partners (eurozone and CEFTA members) could lead to a rise in Serbian exports given that the dinar depreciated most against the currencies of those countries. Further out, past depreciation of the dinar, which led to an increase in prices of imported goods, will tend to encourage the substitution of imports with domestic (less expensive) products.

On the domestic front, the contribution of demand to economic activity will remain modest for quite some time yet. Slow economic recovery and high unemployment rate tend to keep the final consumption rather low. With spare capacity still available, enterprises shy away from investment, while government investment continues on a rather modest scale.

It is precisely the weakness of domestic demand that will make our economic recovery in 2010 relatively slow (around 1.5% GDP growth). Domestic demand, notably investment, is expected to increase only from 2011 onwards which should, together with the continued rise in exports, accelerate GDP growth to 3.0%.

The above inflation projection is based on information available as at 31 July 2010.

Risks to the projection

The key risks to inflation projection originate from uncertainties regarding food prices, exchange rate pass-through to prices, risk premium, premature or excessive rise in public sector wages and pensions, and the speed of the eurozone economic recovery.

Typically for this time of the year, agricultural product prices generate a significant short-term risk as they tend to be rather volatile during the summer months, and susceptible to various shocks stemming from weather conditions or movements in the relevant international markets.

Besides directly affecting inflation, this year's agricultural season will have a large effect on the rise in processed food prices that hold a significant share in CPI.

Short-term uncertainties are also associated with the extent to which net importers will be able to pass through their increased costs to end consumers in an environment of low demand. This pass-through was fairly small in the prior period and it remains to be seen if it will remain so in the second half of the year too.

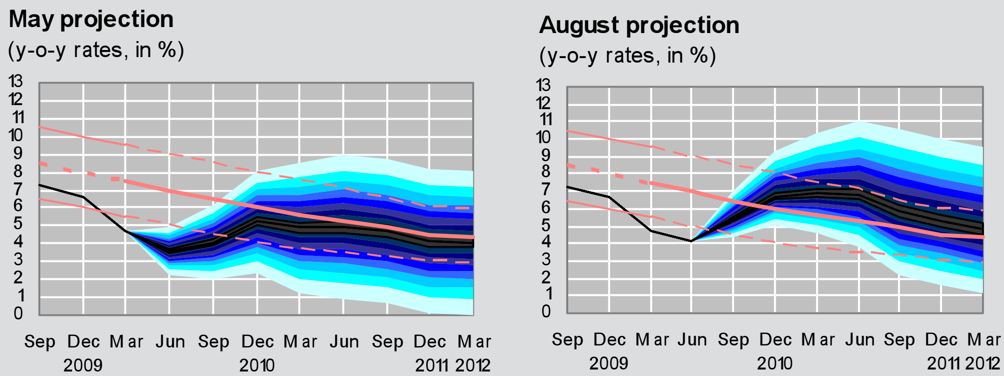
Movements in the risk premium could have a strong impact on the exchange rate of the dinar and local interest rates, and by extension, on the intensity of inflationary pressures. Over the past several months, the risk premium recorded a hefty rise on concerns over the Greek debt crisis. It appears equally possible that the situation on this front will stabilise relatively quickly as that it may take much longer to settle down.

The degree of pass-through of dinar's depreciation to prices will mainly depend on movements in demand. In other words, what happens with public sector wages and pensions in the coming period will largely determine demand-side inflationary pressures. The current projection is based on the assumption that the freeze on public sector wages and pensions will be lifted in April next year and that they will be adjusted by the percentage of inflation or only slightly higher than that. Any earlier or stronger adjustment could greatly increase inflationary pressures.

In addition to wage movements, the strength of demand-side (dis)inflationary pressures will be determined by the pace of global, and in particular the eurozone recovery, which plays an important role in the healing of our own economy. Though the latest forecasts indicate that a moderate eurozone recovery is not under threat, we should not exclude the possibility that exceptionally tight fiscal policy pursued by member states could have a more detrimental effect on their economies than anticipated.

On balance, however, based on our best judgement, the risks to the outlook for inflation are tilted to the upside due to the possibly faster growth in food prices and stronger pass-through of dinar's depreciation to inflation.

Chart V.0.3 **Current vs. previous projection**



The current inflation projection is higher than the one published in the May Report. This is attributable primarily to stronger upward pressures on food prices, but also to the unexpected rise in risk premium and the resulting depreciation pressures in the period May-July. The risks to the current projection are more tilted to the upside due to the possibly faster growth in food prices and stronger pass-through of dinar's depreciation to inflation.

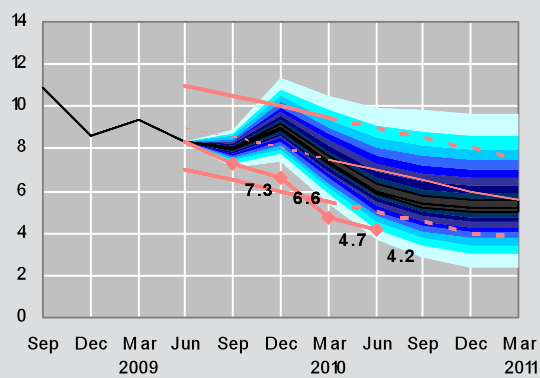
Comparison with the previous projection

The new inflation projection is higher than the one published in the May *Report* (Chart V.0.3) primarily because of stronger upward pressures on food prices, as well as because of the unexpected rise in risk premium triggered by the Greek debt crisis and the ensuing depreciation pressure. The risk of a possibly faster growth in food prices and stronger pass-through of depreciation to inflation makes the overall risks to the current projection more asymmetric to the upside.

The seasonal drop in agricultural product prices in June and July was much weaker than expected due to bad weather conditions. Compared to the previous projection, the pressures on processed food prices also grew stronger under the impact of (unexpected) rise in wheat and corn prices in the past several months.

The increase in import prices driven by the nominal depreciation of the dinar turned out higher than assumed in the previous projection, fuelling short-term inflationary pressures. Due to the same factor, the decrease in net

Chart V.0.4 **Inflation outturn vs. August 2009 inflation projection**
(y-o-y rates, in %)



In the last year inflation moved below the central projection released in August 2009, largely as a result of the unexpected decline in food prices.

importers' profit margins, i.e. widening of the depreciation gap, was sharper than anticipated, wherefore the medium-term inflationary pressures assumed in the current projection are more pronounced.

During the last year inflation moved below the central projection figure released in August 2009, and in late 2009 and early 2010 below the projected band (Chart V.0.4).

Undershooting of the August 2009 projection came about primarily in response to an unexpected decline in food prices that had been gathering pace since September 2009. Good agricultural performance in 2009 led to an immediate drop in prices for agricultural products, followed by a decline in prices for processed food in late 2009 and the first half of 2010. Between June 2009 and June 2010, food prices fell by 1.3%, thereby largely contributing to inflation slipping below the lower bound of the target band.

Outlook for the key policy rate

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia does not exclude the possibility of a further increase in the key policy rate in the event of major strengthening of inflationary pressures.

The National Bank of Serbia will therefore continue to monitor movements in the relevant inflation factors and act promptly in order to keep inflation within the target tolerance band.

Table A
Indicators of Serbia's external position

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010
EXTERNAL LIQUIDITY INDICATORS (in %)											
Forex reserves/imports of goods and services (in months)	3.2	4.1	4.7	3.9	6.2	9.0	7.4	5.5	9.6	9.9	8.9
Forex reserves/short-term debt	114.0	223.5	336.3	425.0	385.9	717.3	729.8	336.4	464.5	475.5	589.2
Forex reserves /GDP	10.3	13.6	16.4	16.4	24.3	38.7	33.5	24.4	34.9	34.3	34.4
Debt repayment/GDP	0.8	1.4	2.0	3.9	4.7	7.0	10.0	10.3	10.9	12.6	11.0
Debt repayment/exports of goods and services	3.8	7.0	9.0	16.5	17.7	23.5	33.9	34.0	39.1	42.8	32.9
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	98.3	67.2	62.7	54.4	64.3	63.9	61.8	65.2	75.0	76,3	78,1
Short-term debt/GDP	9.1	6.1	4.9	3.9	6.3	5.4	4.6	7.3	7.5	7.2	5.8
External debt/exports of goods and services	468.2	344.6	282.2	231.4	245.1	214.2	204.8	214.6	268.8	270.0	264.8
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
Forex reserves/M1	135.9	143.3	195.3	221.0	291.1	356.5	306.9	300.3	393.4	463.2	468.0
Forex reserves/reserve money	136.3	132.0	168.0	166.2	170.3	177.8	173.9	140.6	190.4	201.7	206.8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	60.2	59.3	63.9	73.7	73.6	81.2	84.3	83.9	71.5	75.3	81.3
MEMORANDUM: (in EUR million)											
GDP (in EUR million)	12,821	16,028	17,306	19,026	20,306	23,305	28,785	33,418	30,385	6,841	7,523
External debt	12,609	10,768	10,857	10,355	13,064	14,884	17,789	21,800	22,787	23,278	23,828
External debt servicing	102	218	348	736	945	1,635	2,885	3,453	3,314	859	824
Central bank foreign exchange reserves	1,325	2,186	2,840	3,117	4,935	9,025	9,641	8,160	10,602	10,445	10,493
Short-term debt	1,163	978	844	733	1,279	1,258	1,321	2,426	2,282	2,197	1,781
Current account balance	282	-671	-1,347	-2,620	-1,778	-2,356	-4,615	-6,089	-1,743	-760	-542
				Nov 2004	July 2005	Feb 2006	June 2007	March 2008	Dec 2009		
CREDIT RATING				Standard & Poor's: B+	Standard & Poor's and Fitch: BB-	Standard & Poor's: BB-/positive; Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's and Fitch: BB-/negative	Standard & Poor's & Fitch: BB-/stable		

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. Data are subject to corrections in line with the official data sources.
2. As of October 2006, the IMF publication "International Financial Statistics" features a page on monetary statistics of the Republic of Serbia. This required the NBS to bring its statistical reports in compliance with international statistical standards and methodology harmonised, at the level of the IMF, for all countries. We have adjusted our financial risk exposure indicators accordingly.
3. Trade with Montenegro is registered within relevant transactions as of 2003.
4. Foreign debt repayment does not include early debt repayment.
5. GDP for 2009 and 2010 as estimated by the National Bank of Serbia.
6. In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.

Table B
Key macroeconomic indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009	Q1 2010	Q2 2010
Real GDP growth (in %)	5,6	3,9	2,4	8,3	5,6	5,2	6,9	5,5	-3,0	0,6	1.8[1]
Consumer prices (in %, relative to the same month a year earlier)[2]	40,7	14,8	7,8	13,7	17,7	6,6	11,0	8,6	6,6	4,7	4,2
Core inflation (in %, relative to the same month a year earlier)[2]	20,5	4,4	6,1	11,0	14,5	5,9	7,9	10,3	4,1	2,3	1,9
NBS foreign exchange reserves (in EUR million)	1.325	2.186	2.840	3.117	4.935	9.025	9.641	8.160	10.602	10.444	10.493
Exports (in EUR million)[3]	2.693	3.125	3.847	4.475	5.330	6.949	8.686	10.157	8.478	2.009	2.506
- growth rate in % compared to a year earlier	20,7	16,0	23,1	16,3	19,1	30,4	25,0	16,9	-16,5	8,1	17,3
Imports (in EUR million)[3]	-5.023	-6.387	-7.206	-9.543	-9.613	-11.971	-15.578	-17.878	-13.237	-3.214	-3.611
- growth rate in % compared to a year earlier	32,3	27,2	12,8	32,4	0,7	24,5	30,1	14,8	-26,0	-4,4	10,8
Current account balance[4]											
(in EUR million)	282	-671	-1.347	-2.620	-1.778	-2.356	-4.615	-6.089	-1.743	-760	-542
as % of GDP	2,2	-4,2	-7,8	-13,8	-8,8	-10,1	-16,0	-18,2	-5,7	-11,1	-7,2
Unemployment according to the Survey (in %)[5]	12,2	13,3	14,6	18,5	20,8	20,9	18,1	13,6	16,1	/	19,2
Wages (average for the period, in EUR)	89,9	151,1	176,9	194,6	210,4	259,5	347,6	358,4	337,9	321,5	335
RS budget deficit/surplus (in % of GDP)[6]	-0,2	-4,3	-2,6	-0,3	0,3	-1,9	-1,7	-1,8	-3,4	-3,1	-3,7
Consolidated fiscal result (in % of GDP)	-0,2	-1,8	-2,5	0,8	0,9	-1,9	-2,1	-2,0	-4,0	-3,4	-3,8
RS public debt (external + internal, in % of GDP)[6]	104,8	71,9	63,7	50,9	50,6	40,1	31,4	26,3	32,4	33,6	35,4
RSD/USD exchange rate (average, in the period)	66,71	64,70	57,56	58,44	66,90	67,01	58,39	55,76	67,47	71,38	79,93
RSD/USD exchange rate (end of period)	67,67	58,98	54,64	57,94	72,22	59,98	53,73	62,90	66,73	74,38	75,48
RSD/EUR exchange rate (average, in the period)	59,78	60,66	65,13	72,70	83,00	84,10	79,96	81,44	93,95	98,67	101,37
RSD/EUR exchange rate (end of period)	59,71	61,52	68,31	78,89	85,50	79,00	79,24	88,60	95,89	99,76	104,37
Memorandum											
GDP (in EUR million)	12.821	16.028	17.306	19.026	20.306	23.305	28.785	33.418	30,385[1]	6,841[1]	7,523[1]

[1] NBS estimate.
[2] Retail prices until 2006.
[3] Trade with Montenegro is registered within relevant transactions as of 2003.
[4] In accordance with BPM 5, a portion of estimated remittances was transferred from the financial account to the current account.
[5] Source: Labour Force Survey, Statistical Office.
[6] Source: RS Ministry of Finance Bulletin.
Note: Data are subject to corrections in line with the official data sources.

Table C
IMF's projection for key macroeconomic indicators (July 2010)

	2007	2008	2009 (Estimation)	2010 (Program)	2011 (Projection)
Output, prices and labor market (change in percent)					
Real GDP growth	6,9	5,5	-3,0	1,5	3,0
Real GDP growth excluding agricultural sector	8,8	5,2	-3,4	2,0	3,1
Real domestic demand (absorption)	11,5	6,3	-7,5	-1,8	2,2
Consumer prices (average)	6,5	12,4	8,1	4,6	4,4
Consumer prices (end of period)	11,0	8,6	6,6	6,0	4,5
Nominal gross wage	22,4	16,9	7,4	3,5	6,5
Real net wage	19,9	4,9	-0,7	-1,1	2,0
General government finance (in percent of GDP)					
Revenue	43,5	41,9	39,5	38,6	37,8
Expenditure	45,4	44,5	43,6	43,4	41,6
Fiscal balance	-1,9	-2,6	-4,1	-4,8	-3,9
Public debt	35,2	33,4	35,6	39,1	41,1
Monetary sector (end of period 12-month change, in percent)					
Money (M1)	25,3	-3,8	8,7	14,5	13,8
M3[1)]	44,5	9,6	21,8	10,7	13,5
Domestic credit to non-government	36,9	35,0	15,9	16,0	21,1
Balance of payments (in percent of GDP)					
Current account balance	-15,9	-17,6	-5,6	-8,5	-8,0
Export of goods	22,2	22,2	19,4	20,8	21,3
Import of goods	45,2	45,0	34,9	34,7	34,4
Trade of goods balance	-23,1	-22,8	-15,5	-13,9	-13,1
Capital and financial account balance	18,4	12,7	11,7	4,7	4,8
External debt	61,8	65,2	75,8	77,2	73,3
of which: Private external debt	39,5	46,1	51,6	49,8	46,4
Gross official reserves (in billions of euro)	9,5	8,2	10,6	10,2	9,2
REER (annual average change, in percent; + indicates appreciation)	7,2	6,4	-7,1	-0,9	2,0

[1)] Excluding frozen foreign currency deposits.

Appendix 1. Letter to the Government on reasons why inflation departed from the target

NATIONAL BANK OF SERBIA
Belgrade

12 July 2010

GOVERNMENT OF THE REPUBLIC OF SERBIA
Mr Mirko Cvetković
Prime Minister

Dear Mr Cvetković,

The Statistical Office reported today that CPI inflation for June came at 4.2% y-o-y, which means that for six consecutive months it moved below the target tolerance band projected for H1 (7.8±2% for January and 7±2% for June 2010). As a result, in accordance with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting*, I am writing an open letter to you on behalf of the Executive Board of the National Bank of Serbia in order to explain 1) why inflation has moved away from the target tolerance band, 2) the period within which we expect inflation to return within the target tolerance band and 3) the policy action to be taken to deal with it.

1) Why has inflation moved away from the target tolerance band for six consecutive months?

Y-o-y inflation declined from 6.6% in December 2009 (target: 6–10%) to 4.2% in June this year (target: 7±2%). The Executive Board of the National Bank of Serbia assesses that the decline in inflation reflects the operation of two main factors: low aggregate demand and unexpected drop in food prices.

Contraction in aggregate demand was due to the interplay of several factors. First, economic downturn, prompted by dented external demand in conditions of the global financial crisis, impacted on the private sector financial position, feeding through not only to lower employment and wages, but also to limited investment avenues. Second, a decrease in investment and spending was driven both by reduced foreign capital inflows and lower supply of domestic loans, whilst the volume of cross-border loans even shrank. Third, lower fiscal revenue, induced by weaker economic activity, gave rise to tighter wage policy, manifesting primarily in a freeze on public sector wages and pensions.

The second factor inducing lower than projected inflation were food prices that declined by 1.3% over the June 2009 – June 2010 period. Relatively solid agricultural performance and sufficient supply of agricultural products in the domestic market helped bring down food prices in 2009. Together with low aggregate demand, this provoked a drop in processed food prices by end-2009 and in H1 2010.

The effects of the above factors on the disinflation process were unexpectedly strong, whereas monetary policy also had to allow for continuing uncertainties, most particularly in financial markets. Namely, depressed aggregate demand could not be counterbalanced by increased cuts in the key policy rate against the background of the country's high risk premium and possible negative influences of even stronger depreciation on financial stability.

Room for substantive relaxation of monetary policy opened only after conclusion of the current arrangement with the IMF that contributed to lowering the degree of uncertainties regarding the pursuance of medium-term economic policy and a gradual decline in risk premium. The speed of relaxation was adjusted to the attainment of mid-term objectives, i.e. it was based on estimates that inordinate relaxation would result in marked overshooting of the inflation target in H2 2010, which would have a negative bearing on monetary policy credibility and inflation expectations. However, a relatively substantive relaxation of monetary policy did take place – the key policy rate was cut from 17.75% in January 2009 to 8.0% in May this year.

In our view, the NBS's monetary policy response was adequate bearing in mind the magnitude of the global financial and economic crisis still posing a heavy burden on the economy over the mid- and long-term. Adequacy of the monetary policy response is evidenced in mild economic growth and a relatively small fiscal deficit in H2 2009, which is why Serbia ranks among countries suffering perceptibly weaker impact of the global downturn on economic growth and stability.

2) Over what period do we expect inflation to return within the target tolerance band?

The Executive Board of the National Bank of Serbia expects inflation to return within the target tolerance band in H2 2010 and to move closer to the target by the year-end (6%). In the mid-term, with planned regulated price adjustment (7±2% in 2011, 6±2% in 2012), inflation is expected to move within the target tolerance band: 4.5±1.5% in 2011 and 4.0±1.5% in 2012.

3) What economic policy action should be taken to bring inflation back within the target tolerance band?

In 2010, monetary policy was significantly relaxed through cuts in the key policy rate and reserve requirement ratios. Monetary easing was also made possible via the real exchange rate depreciation gap that deepened on account of nominal depreciation of the dinar and weaker pass-through of depreciation to inflation. Furthermore, lowered reserve requirement ratios will facilitate the release of dinar and foreign exchange liquidity over the coming period. In view of the lagged effect of monetary policy measures on inflation, we believe the economic policy action taken so far will help bring back inflation within the target tolerance band over the medium run.

The Executive Board of the National Bank of Serbia will continue to pursue monetary policy in line with achieving targeted inflation in the medium run. The Board will therefore monitor all relevant inflation factors, assess their effect on inflation, identify the key risks to targeted inflation and try to timely respond to any departures from the target. The achievement of targeted inflation rates and mid-term price stability will give substantial contribution to macroeconomic stability and sustainable economic growth and employment, these being the principal objectives of economic policy of the Government of the Republic of Serbia.

Pursuant to our agreement with the Government of the Republic of Serbia, this letter will be posted on the website of the National Bank of Serbia.

Yours sincerely,

Radovan Jelašić,

Chairman of the Executive Board
of the National Bank of Serbia

Index of charts and tables

Charts

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Sources of data: the National Bank of Serbia and Serbian Statistical Office, unless stated otherwise.

Executive Board Meetings and Changes in the Key Policy Rate in 2010

The Law on Amendments and Supplements to the Law on the National Bank of Serbia (“RS Official Gazette”, No 44/2010) establishes the Executive Board as the National Bank of Serbia’s body that takes over all responsibilities of the Monetary Policy Committee.

Date	Key policy rate (p.a., in %)	Change (in basis points)
Meetings held		
12 January	9.50	0
21 January	9.50	0
4 February	9.50	0
22 February	9.50	0
5 March	9.50	0
23 March	9.00	-50
8 April	8.50	-50
20 April	8.50	0
11 May	8.00	-50
19 May	8.00	0
7 June	8.00	0
22 June	8.00	0
2 July	8.00	0
22 July	8.00	0
Meetings scheduled		
5 August		
19 August		
7 September		
21 September		
7 October		
21 October		
5 November		
19 November		
7 December		
21 December		

Press releases from NBS Executive Board meetings

Press release from the MPC meeting held on 11 May 2010

In its meeting today, the NBS Monetary Policy Committee voted to cut the key policy rate by 0.5 percentage points. As of today, the key policy rate stands at 8 percent.

The MPC noted that inflation is still below the lower bound of the target tolerance band and assessed that such trend is likely to persist in the period ahead. Low domestic demand and sluggish recovery of the global and domestic economies will continue to generate disinflationary effects. Furthermore, recent turmoil in the international financial markets could dampen the prospects for economic recovery, making it significantly weaker than expected. The MPC's best collective judgement is that these factors reinforce downside risks to inflation and that inflation will therefore continue to move below the target in the medium term.

Governor Jelašić will explain the rationale behind current monetary easing and discuss inflation risks that remain in the economy at a press conference, scheduled for Friday, 14 May.

Press release from the MPC meeting held on 19 May 2010

After reviewing current economic developments in its meeting today, the NBS Monetary Policy Committee decided to maintain the key policy rate at 8 percent.

Press release from the MPC meeting held on 7 June 2010

After reviewing current economic developments in its meeting today, the NBS Monetary Policy Committee voted to keep the key policy rate unchanged at 8 percent.

The next MPC meeting is scheduled for 22 June.

Press release from the MPC meeting held on 22 June 2010

After reviewing current economic developments, the NBS Monetary Policy Committee voted to keep the key policy rate unchanged at 8 percent.

The next MPC meeting will take place on 6 July

Press release from the Executive Board meeting held on 2 July 2010

The Executive Board of the National Bank of Serbia held its first meeting today in line with the Law on Amendments and Supplements to the Law on the National Bank of Serbia that entered into force on 1 July.

After reviewing current economic developments, the Executive Board voted to maintain the key policy rate at 8 percent.

The next meeting of the Executive Board is scheduled for 20 July.

Press release from the Executive Board meeting held on 22 July 2010

After reviewing current economic developments, the Executive Board voted to maintain the key policy rate at 8 percent.

The next meeting of the Executive Board is scheduled for 5 August.

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