



National Bank of Serbia

2011
August

INFLATION REPORT

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NATIONAL BANK OF SERBIA

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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 decisions¹ 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 eight quarters ahead, assumptions on which the projection is based and an analysis of key risks to achieving the target.

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

The August *Inflation Report* was adopted by the NBS Executive Board in its meeting of 11 August 2011.

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.

ABBREVIATIONS

bln – billion
bp – basis point
CEFTA – Central European Free Trade Agreement
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
EMU – Economic and Monetary Union of the EU
FDI – foreign direct investment
Fed – Federal Reserve System
FISIM – Financial Intermediation Services Indirectly Measured
GDP – Gross Domestic Product
H – half-year
IFEM – Interbank Foreign Exchange Market
IMF – International Monetary Fund
mln – million
NAVA – non-agricultural value added
NPLs – non-performing loans
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
q-o-q – quarter-on-quarter
s-a – seasonally-adjusted
SDR – Special Drawing Rights
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

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I. Overview

Inflation passed its peak...

After peaking in April 2011, year-on-year inflation started decreasing, moving along the lower edge of the inflation projection band as published in the May Report. At end-June, inflation measured 12.7% compared to the monthly target of $5.3 \pm 1.8\%$.

... and slowed down significantly in the second quarter.

Inflation decelerated significantly in the second quarter (1.2%), even recording a negative growth rate in June (-0.3%). The slowdown came primarily in response to the stabilisation of food prices, and the seasonally unusual drop in prices of vegetables and fruit. Food prices stabilised as the effects of last year's increases in prices of primary agricultural products wore off and the first signs of a better harvest this year cropped up. The largest contribution to inflation in the second quarter came from regulated prices (0.9 pp), whose growth exceeded the limit planned for the year as a whole already in the first half of the year.

Economic activity stagnated, but is expected to reaccelerate from mid-2011.

Economic activity is estimated to have stagnated in the second quarter largely due to the downturn in manufacturing, and the continuing decline in trade turnover. It is expected to gather pace from mid-2011. GDP is projected to grow by around 3.0% this year, mainly on the back of faster growth in industrial production and better harvest yields.

Aggregate demand remains low.

Aggregate demand remains low (the negative output gap widened in the second quarter), and as such, continues to be the key disinflationary factor in the coming period. However, as the economy recovers, the disinflationary effect of this factor is bound to grow weaker.

Economic crisis in some eurozone countries exerted a negative impact on portfolio investment.

The strengthening of the dinar in the second quarter was for its major part attributable to the continuing inflow of portfolio investment. Economic troubles of the eurozone periphery and the rise in the country risk premium, however, heightened the market uncertainty in June and paved the way for depreciation pressures. Investors turned more cautious, which affected national currencies across the region, the dinar being no exception.

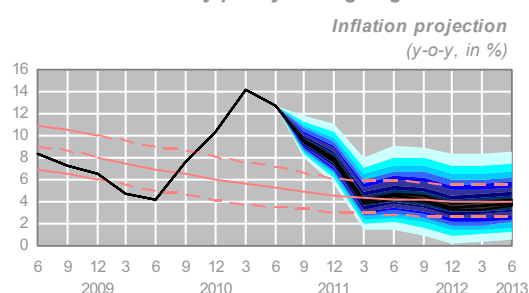
Significant foreign direct investments are expected to flow in by the end of the year.

July saw a substantial increase in capital inflows, thanks mainly to foreign direct investments. Foreign direct investments are expected to be one of the key sources of foreign capital inflows this year, and more importantly, they are expected to be channelled into trade and manufacturing.

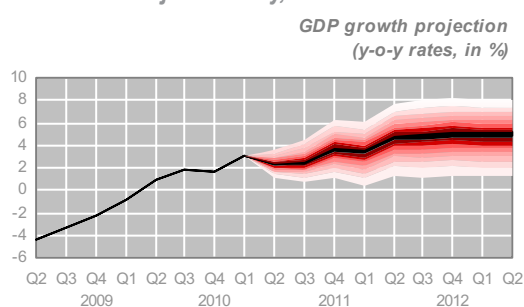
Inflation expectations remain relatively high.

Even though inflation is on a declining path, inflation expectations have not diminished. They are, however, expected to subside in the period ahead.

Monetary policy easing began in June...



... so as to ensure that inflation returns to the target, without major volatility, in the first half of 2012.



The key risks to inflation projection are associated with the country risk premium, fiscal policy and food prices.

Inflation will be on a decline until the end of the year, and will return within the target band in the first half of the next year. The main drivers of such movements will be slower growth in prices of agricultural products, low aggregate demand and lower inflation expectations. Economic recovery is expected to accelerate in 2011 and 2012, led chiefly by the private sector's growing investment demand in the current year, and by the rising net exports in the year after.

The key risks to inflation projection are associated with movements in the country risk premium, possibly looser fiscal policy, and food prices. On balance, the risks to the projected path for inflation are judged to be skewed slightly to the upside, reflecting the possibility of fiscal policy loosening amid forthcoming general and local government elections.

Future path of the key policy rate will depend on the effects which may arise from the materialisation of risks in some advanced countries and currency zones, as well as of the fiscal risks at home.

Based on the current inflation projection and its underlying risks, the Executive Board of the National Bank of Serbia judges that the future path of the key policy rate will depend on the effects which may arise from the materialisation of risks in some advanced countries and currency zones, as well as of the fiscal risks at home.

II. Monetary policy since the May Report

Upward revision of the key policy rate in April marked the end of monetary policy tightening. The cycle of monetary easing began with a key policy rate cut in June.

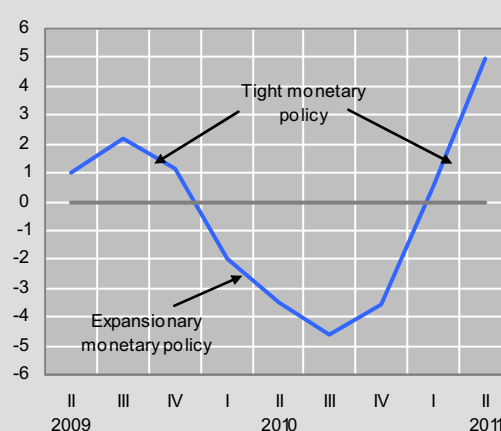
From August 2010 to April 2011, the NBS kept tightening its monetary stance with a view to stabilising inflation around the target in the medium term. The Executive Board raised the key policy rate in April by 25 bp to 12.5% judging that inflation was still under the sway of unexpectedly robust growth in food prices (processed food, fruit and vegetables), caused by global developments, but also by the existing systemic solutions affecting the functioning of the domestic food market. Monetary policy was tightened in order to prevent second-round effects of food price growth, i.e. its spill-over to other prices through higher inflation expectations. The Executive Board also assessed that inflationary pressure from rising processed food prices would subside considerably with the onset of the new agricultural season (from July onwards).

In its meeting in May, the Executive Board voted to maintain the key policy rate on hold. This decision was based on the projection published in the previous *Report*, according to which inflation would peak in April or May, and then start retreating towards the target, within whose bounds it would settle in H1 of the following year. Inflation would fall primarily in response to the waning cost push pressure on food prices in the event of an average agricultural season, as well as in response to low aggregate demand. This projection was consistent with the projected GDP growth of 3.0% in 2011 and 4.5% in 2012. In light of the key risks to the projection – movements in the risk premium, food prices and fiscal policy, the Executive Board judged that the key policy rate was at or close to the peak of its then cycle. The Executive Board also noted the presence of risks calling for a rather cautious reduction of monetary policy restrictiveness, and allowing for the use of all instruments of monetary regulation available.

In early June, the Executive Board voted to lower the key policy rate by 50 bp to 12.0%. As projected, y-o-y inflation peaked in April and started falling back in May. The Executive Board assessed that inflation would continue down, reflecting largely the weakening of the cost push pressure on food prices, low aggregate demand and past monetary policy measures.

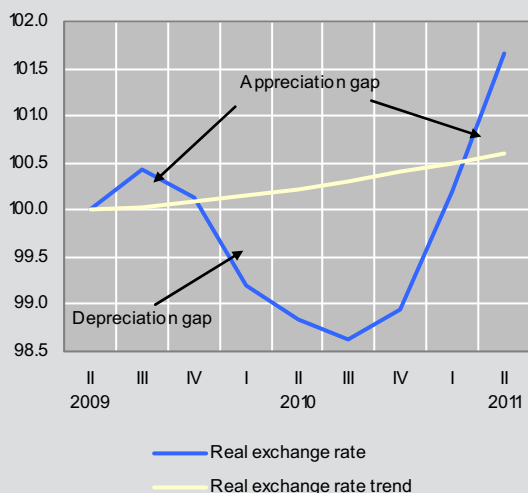
In its July meeting, the Executive Board lowered the key policy rate further by 25 bp to 11.75%, judging that disinflationary pressures would prevail in the coming period. Inflationary pressure from food prices subsided more than anticipated, while the possibility of a reversal in the character of their impact in the new agricultural cycle should not be ruled out either. At the same time, the drop in global wheat and corn prices has still not fully reflected on the domestic market, and once it does, the cost push pressure on food prices will ease. The

Chart II.0.1 Monetary Conditions Index



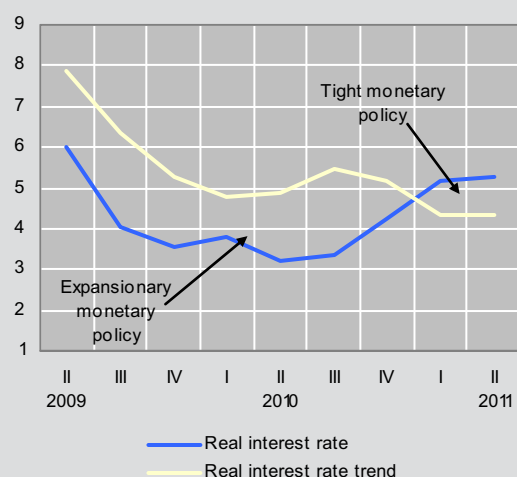
The monetary conditions index shows an increase in the degree of monetary policy restrictiveness in Q2.

Chart II.0.2 Real exchange rate and its trend
(base index, II 2009 = 100)



Monetary policy restrictiveness increased in Q2 due to widening of the real exchange rate appreciation gap.

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



Deviation of the real interest rate from its trend did not change as Q1 levels of the rate and the trend remained the same.

disinflationary effect of aggregate demand remains strong, but is expected to gradually weaken as the economy recovers. A further drop in y-o-y inflation rates should lead to a decline in inflation expectations and the associated inflationary pressure. In H2 2011, inflation will continue down, though probably remaining above the upper bound of the target. Its return within the target band and coming closer to the target midpoint is expected in H1 2012.

Monetary tightening from August 2010 to April 2011 led to an increase in monetary policy restrictiveness in Q2. This is indicated by the real Monetary Conditions Index, which rose as the appreciation gap of the real exchange rate widened and the real interest rate ran above the neutral level (trend), as in Q1.

The appreciation gap of the real exchange rate widened as a result of nominal appreciation of the dinar against the euro and faster growth in domestic relative to eurozone prices.

As the level of the real interest rate and its trend remained unchanged from the previous quarter, real two-week BELIBOR continued above the neutral level by around 100 bp. The level of the real interest rate remained unchanged as its nominal average quarterly growth was accompanied by the rise in inflation expectations. At the same time, there was no change in its trend because the rising trend of real interest rates in foreign money markets neutralised the impact of higher country risk premium.

III. Inflation developments

After reaching its peak in April, y-o-y inflation began to retreat towards the target. Consumer price growth in Q2 was much lower than in Q1 reflecting the stabilisation of food prices and the seasonally unusual drop in fruit and vegetable prices.

According to estimates, y-o-y inflation will continue down towards the target in Q3 2011.

Inflation developments in Q2

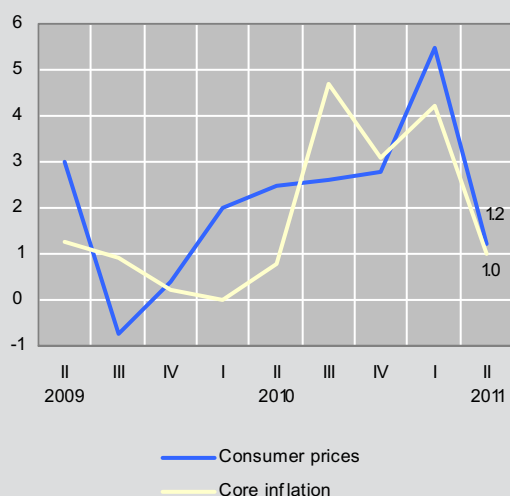
Consumer price growth came at 1.2% in Q2 mainly in response to rising regulated prices. For the first time in a year, food prices generated a disinflationary effect.

As announced in the May Report, y-o-y CPI inflation started to decline in Q2 and hit 12.7% by end-Q2 (June target: $5.3 \pm 1.8\%$). After reaching its peak in April, y-o-y inflation decreased, trending along the lower edge of the inflation projection band published in the previous Report – for the first time since December 2009, deflation was recorded in June (-0.3%).

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

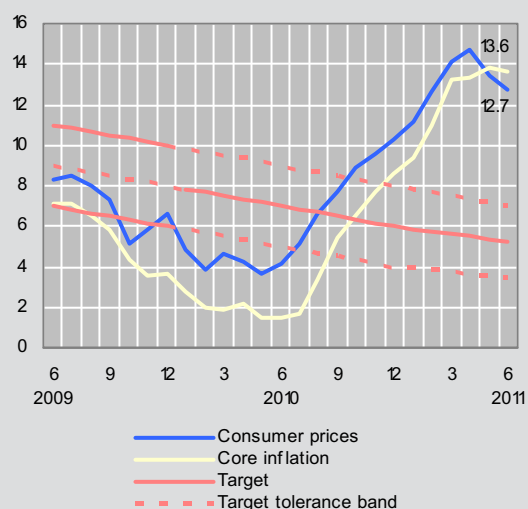
	IX 2010	XII 2010	III 2011	VI 2011
Consumer prices	7.7	10.3	14.1	12.7
Core inflation	5.7	8.8	13.2	13.6
Industrial producer prices	14.0	16.2	17.1	15.8
Agricultural producer prices	22.8	29.3	39.1	28.6

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



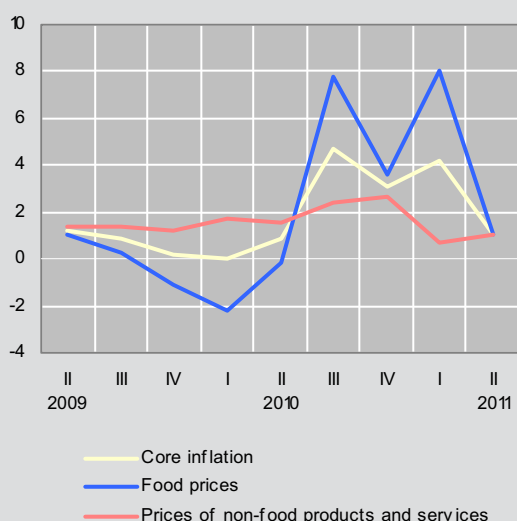
Owing to the stabilisation of food prices, growth in headline and core inflation decelerated sharply in Q2.

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



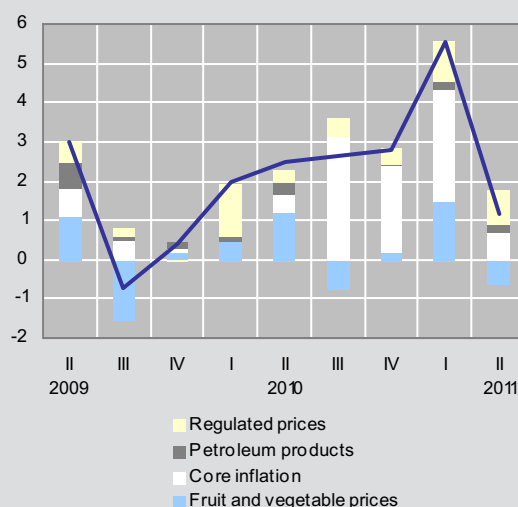
After reaching its peak in April, y-o-y inflation began to retreat towards the target.

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



Food price growth in Q2 was much weaker and on a par with non-food price growth.

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



Consumer price growth was largely determined by rising regulated prices.

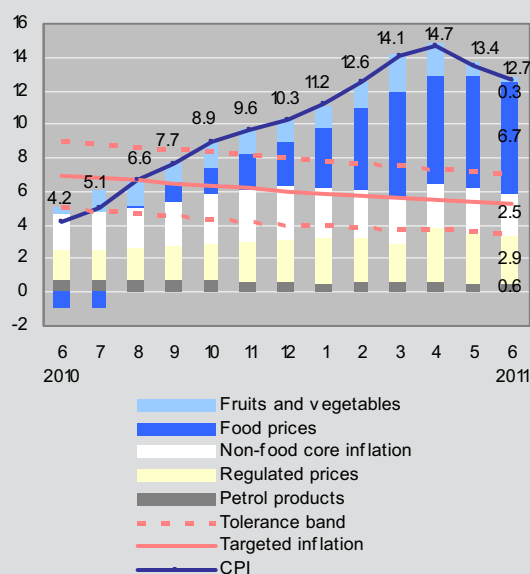
Inflation decelerated sharply in quarterly terms reflecting the stabilisation of food prices and the seasonally unusual drop in fruit and vegetable prices. CPI growth came at 1.2%. After a year, food prices (food, fruits and vegetables) generated a disinflationary effect (-0.3 pp).

Subsequently, **core inflation** (market-determined prices) slowed markedly (1.0%; contribution: 0.7 pp). Food price growth (1%; contribution: 0.3 pp) was much weaker than in Q1 (8%) and on a par with non-food price growth. Some staples even cheapened in Q2 – vegetable oil (-3.9%), meat (-2.5%) and eggs (-1.9%). In contrast, price growth of non-food products and services stayed flat (contribution: 0.4 pp).

Fruit and vegetable prices declined in Q2 (9.1%; contribution: -0.6 pp) for the first time in 20 years.² This was due to high fruit and vegetable prices in the prior period and elevated supply as the new season set in. The new season dragged down global prices of primary agricultural products as well.³ As a result, the cost push on food producers diminished.

Regulated prices rallied 4.1% in Q2 (contribution: 0.9 pp) almost wholly on the back of electricity price hikes in

Chart III.0.5 **Contribution to y-o-y consumer price growth**
(in percentage points)

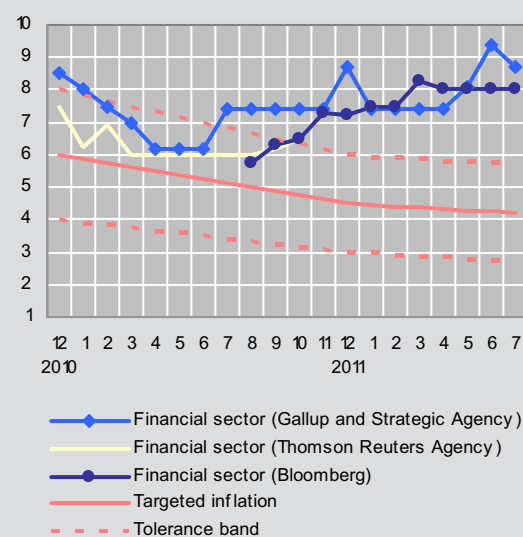


Y-o-y inflation declined in Q2 on the back of falling fruit and vegetable prices.

² CPI data are published since 2007. Before that, agricultural product prices within the retail price index were observed.

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

	2010			2011	
	Q2	Q3	Q4	Q1	Q2
Consumer prices	2.5	2.6	2.8	5.5	1.2
Core inflation	0.7	4.7	3.1	4.2	1.0
Fruits and vegetables	21.4	-11.7	3.7	25.3	-9.1
Regulated prices	1.4	2.2	1.8	4.7	4.1
Electricity	0.0	0.0	0.0	0.0	13.5
Gas for households	0.0	0.0	0.0	0.0	0.0
Utility-housing services	1.3	5.9	9.9	3.3	1.8
Social welfare services	0.3	0.0	2.5	0.0	0.3
Transport services (regulated)	0.2	1.7	0.1	13.1	0.5
Postal and telecommunications services	0.5	0.0	0.0	0.0	0.0
Cigarettes	0.0	5.6	0.0	19.1	-2.6
Medications	5.0	1.8	3.0	3.8	2.5
Other	12.6	0.8	0.2	0.2	0.0
Petroleum products	6.8	0.8	1.3	5.1	5.6

Chart III.0.6 One-year ahead expected and targeted inflation
(in %)

Despite falling prices in Q2, inflation expectations remain relatively high.

April (0.8 pp). In H1 2011, regulated price growth sped up to 9.1%, which is above the limit agreed with the government for 2011 (7±2%).

Petroleum product prices gained 5.6% (0.2 pp) in Q2 as dinar's appreciation could not outweigh the rise in global Ural oil prices. A spike in petroleum product prices was a bit smaller than expected as domestic fuel prices, after the equation of excises on domestic and foreign fuel, did not rise by the entire excise increase.⁴

Inflation expectations

Though on a downward trajectory, inflation expectations remain relatively high.

As indicated by the **Bloomberg** survey, one year-ahead inflation expectations of financial sector analysts remained unchanged on the quarter earlier (from 8.3% at end-Q1 to stable 8.0% in April).

The **Gallup** survey, however, reveals dissimilar expectations – those of the financial sector drifted up from

7.4% in March to 9.4% in June, while the corporate sector lowered its expectations from 12.7% to 11.4%. Trade union expectations hovered at end-Q1 levels (11.4%) and those of households picked up (from 11.4% to 15.4%).

Inflation expectations remain relatively high, trending above the upper limit of the one year-ahead target tolerance band. Though y-o-y inflation is sliding down from the April peak, inflation expectations have not diminished. Their decline, however, is probable in the coming period.

Inflation outlook for Q3

The descent in Q3 inflation will be spurred by the expected drop in fruit and vegetable prices and stabilisation of food prices.

Consumer prices are likely to decline in Q3 on the back of the expected further drop in fruit and vegetable prices. Due to the high last year's base (prompted by steep monthly inflation rates in Q3 2010), y-o-y inflation is expected to continue down towards the target.

³ Global wheat and corn prices lost around 25% and 20% in June. Trading in the new yield of wheat and corn on the local commodity exchange began at prices 25–35% lower than last season.

⁴ Instead of the expected 1.8%, domestic fuel prices rose 1.0%.

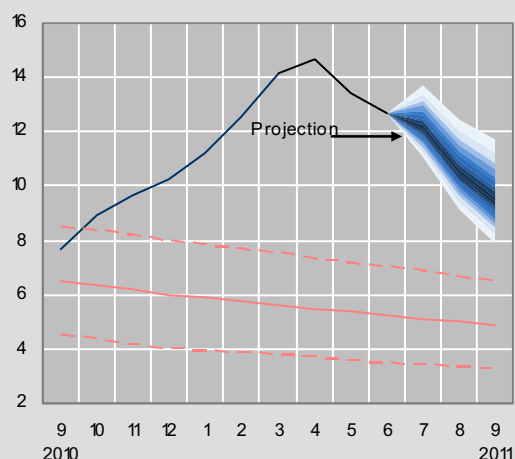
Core inflation will rise less than in Q2 on account of the expected further slowdown in food prices. A decline in primary agricultural product prices, i.e. food industry inputs, set in train in Q2, will enable food producers not only to maintain, but also to lower prices in the period ahead. This is due to the fact that input prices, standing at their peak levels from the earlier period, are factored into the current prices. Moreover, food prices will slow in response to the new government regulation capping, until September, the price of “national bread” – the new maximum price is 15% lower. Movements in non-food products and services within core inflation are likely to mirror the Q2 trends. Dented demand is the key factor behind the continuing low rise in prices from this group.

Consumer prices will probably be affected most by fruit and vegetable prices. These prices are likely to fall vigorously against the backdrop of heightened supply in the new agricultural season.

Regulated price growth is expected to plummet on Q2 as no major adjustments have been announced. Growth will be generally fuelled by landline telephony price hikes. Besides, the regulated price growth agreed with the government for 2011 has already taken place.

Petroleum product prices are estimated to rise further in Q3, though at a weaker pace than in Q2.

Chart III.0.7 Short-term inflation projection
(y-o-y growth, in %)



According to the short-term projection, inflation will continue to retreat towards the target in Q3.

The key risk to the projection is associated with uncertainties regarding fruit and vegetable prices in the new agricultural season. These prices are known for their marked volatility and in case of unfavourable weather conditions may diverge significantly from our projection.

IV. Inflation determinants

1. Money market trends

Interest rates

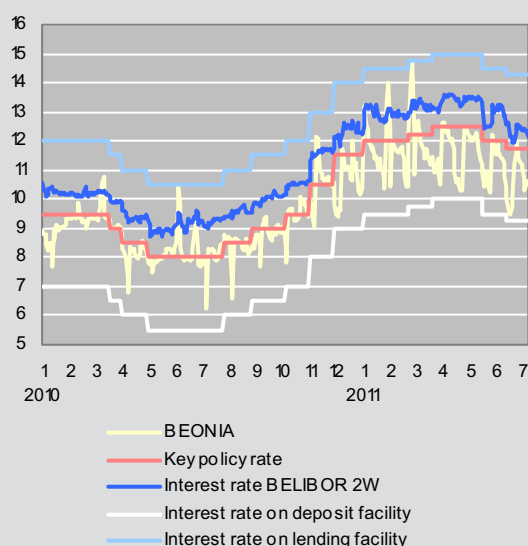
The new cycle of monetary easing initiated in June weighed down on money market interest rates. Given their lag effect, monetary policy measures are likely to bear upon dinar lending rates in the coming period.

BEONIA underperformed the NBS key policy rate in Q2. In quarterly terms, the deviation equalled -0.8 pp and the

two-year average touched -0.2 pp. Such interest rate movements in the overnight money market signal enhanced banking sector liquidity relative to Q1. Improved liquidity is also reflected in the absence of growth in BEONIA by the end of the required reserves maintenance period and a 27.8% slump in overnight trading. These trends unfolded in the setting of banks' heightened interest in repo securities.⁵

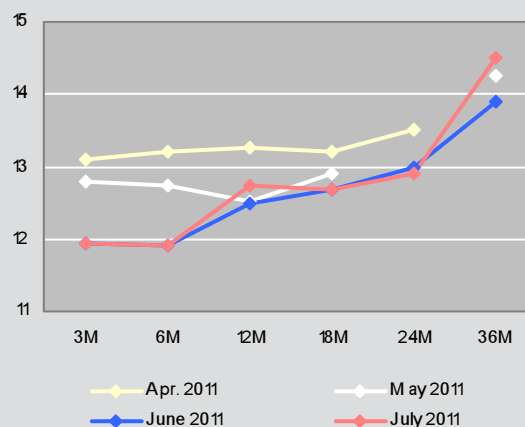
Movements in BELIBOR were determined by the NBS rate. In June, the average one-week to one-month rates declined less than in March, while other maturities lost

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



In Q2, BEONIA trended below the key policy rate due to high banking sector liquidity.

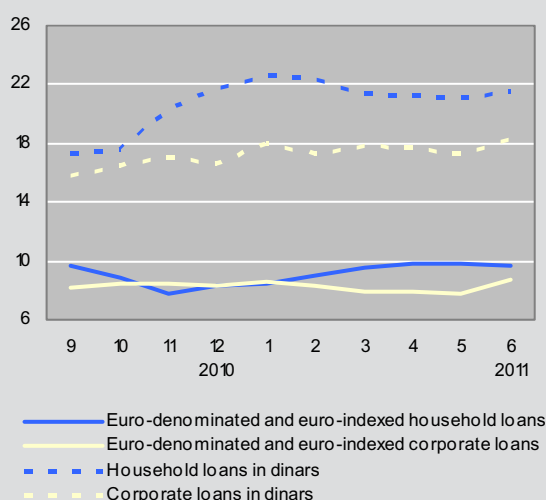
Chart IV.1.2 Yield curve in the primary market
of government securities
(p.a, %)



Shorter-term effective rates declined in response to key policy rate cuts and reduced supply of short-term T-bills. Amplified supply of long-term government securities was not matched with adequate demand, which impacted on movements in effective rates.

⁵ The repo stock augmented in Q2 — its average June value came at RSD 79.8 bln (RSD 49.7 bln in March).

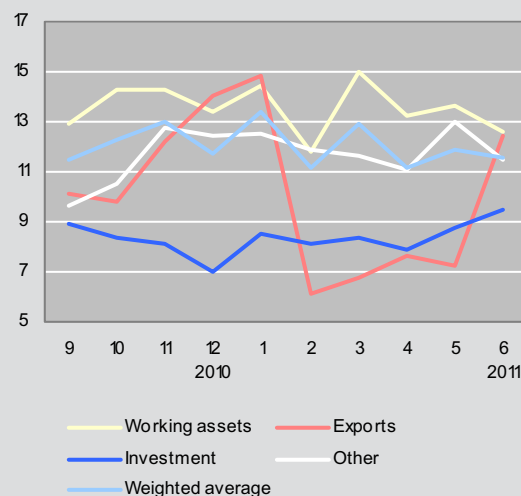
Chart IV.1.3 Bank interest rates on newly extended loans*
(p.a., %)



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

Relative to end-Q1, the rate on dinar and FX household loans remained unchanged, while that on corporate loans picked up.

Chart IV.1.4 Interest rates on dinar corporate loans*
(p.a., %)



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

A decline in rates on dinar corporate loans was spurred by the contraction in interest rates on current assets loans.

around 30 bp. By end-Q2, BELIBOR ranged from 12.4% for the shortest to 13.4% for six-month maturity.

Effective rates on up to one-year T-bills declined as well, notably for 3- and 6-month maturities (105 and 110 bp at their respective quarterly levels), in response to a contraction in the volume of short-term bills to around 20% of the total issue of government securities in Q2. Demand at almost all auctions outstripped supply, resulting in high performance (98%) and bringing 3- and 6-month rates below the key policy rate.

In contrast, effective rates on 18- and 24-month bills rose slightly, which may be partly attributed to end-Q1 developments. At the period-end, heightened foreign investor interest in government securities prompted a rapid decline in rates on over one-year maturities (non-residents are allowed to participate), resulting in an inverse slope of the yield curve. The amplified volume of government securities over one year and almost unchanged performance levels (including smaller foreign

investor participation) did not trigger a further slump in effective rates.

As a result, a rising yield curve was formed, though at a lower level.

Two auctions of euro-denominated government bonds were held in Q2, with semi-annual coupon payment and fixed interest of 5.0% for 3-year and 5.85% for 15-year maturity. Out of total EUR 202.6 mln offered, EUR 105.8 mln nominal worth of bonds were sold.

In early July, RSD 20.1 bln worth euro-indexed, six-month T-bills fell due. The government then issued euro-denominated 18-month bills worth EUR 150 mln – with almost maximum performance, the auction closed at 5.4%.

Secondary trading amounted to RSD 15.5 bln and EUR 32.9 mln. Of total trading in long-term dinar securities, RSD 4.0 bln related to securities sold at the settlement date⁶. By the quarter-end, rates of return until maturity

⁶ Since taking place on the settlement date (two days after the auction for long-term securities), it cannot be considered real secondary trading.

moved between 11.7% for 2-month and 12.4% for one-year maturity.

Rates on household loans remained broadly flat on end-Q1 – they settled at 21.5% for dinar loans, while those on euro-indexed loans picked up by 0.1 pp to 9.7%. A step-up in subsidised loans drove down rates on newly extended consumer and housing loans – in June they touched 14.0% and 5.4% respectively.

The rate on dinar corporate loans rose 50 bp to 18.3%, while that on euro-indexed loans was up 80 bp to 8.7% on the back of higher-priced export and investment loans. The rate on liquidity loans declined.

In both sectors, rates on the costliest forms of borrowing contracted – revolving loans, credit card and current account overdrafts.

Interest on dinar household term deposits fell 10 bp to 10.7%, while that on euro deposits edged up to 4.2% by the period-end. Interest on corporate deposits displayed similar trends – 12.4% for dinar and 3.8% for euro-indexed loans.

Monetary aggregates

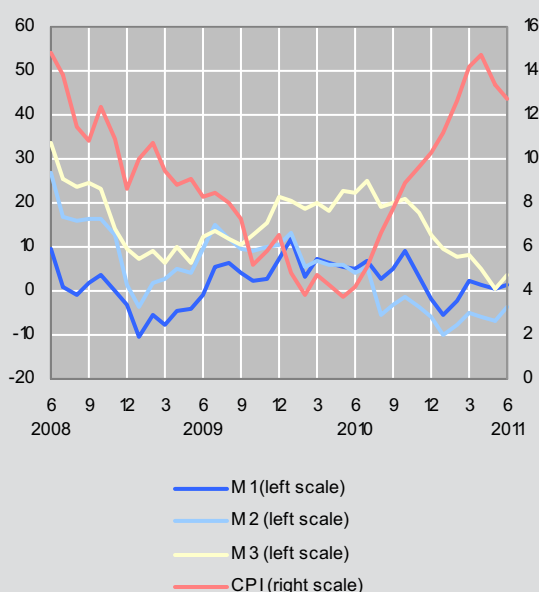
Following a drop in Q1, money supply rose in Q2. As inflation decelerates, a real y-o-y fall in monetary aggregates is slowing as well.

Dinar reserve money gained 6.0% in real terms. Money was issued via FX transactions, while dinar transactions prompted the withdrawal.

Overall NBS FX reserves and NFA swelled by EUR 48 mln and EUR 264 mln respectively. Government FX borrowing with foreign creditors and via the issue of euro-denominated bills shored up NBS FX reserves. They however declined with the release of liquidity under FX required reserve allocations⁷ and the redemption of maturing frozen FX savings bonds.

A part of reserve money issued in FX transactions was largely absorbed via elevated investment in repo

Chart IV.1.5 Monetary aggregates and CPI
(y-o-y rates, in %)



A y-o-y slump in money supply began to decelerate in Q2.

Table IV.1.1 Monetary aggregates
(real y-o-y growth rates, %)

	2010		2011		Share in M3 June 2011 (%)
	Sep.	Dec.	March	June	
M3	11.5	2.3	-5.3	-7.9	100.0
FX deposits	25.1	12.1	0.4	-4.7	70.1
M2	-10.3	-14.8	-17.0	-14.7	29.9
Time and savings dinar deposits	-20.1	-20.1	-25.2	-20.4	12.3
M1	-2.4	-11.1	-10.4	-10.2	17.6
Demand deposits	-4.1	-10.1	-6.3	-7.5	11.3
Currency in circulation	0.7	-12.9	-17.0	-14.7	6.3

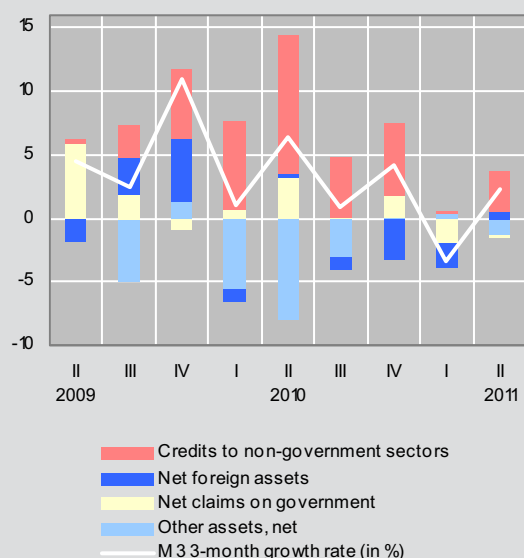
securities. The repo stock advanced by RSD 17.6 bln to RSD 73.9 bln in Q2.⁸

After a contraction typical for Q1, money supply picked up in Q2. Monetary aggregates M1 and M2 rose 1.8% and

⁷ Harmonisation with the new Decision ended with the April required reserves calculation.

⁸ The cycle of key policy rate cuts did not affect the banks' decision to invest in repo securities. Whatsoever, average monthly values of the repo stock show an increase.

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



Growth in lending gave the strongest impetus to M3 growth.

3.8% in real terms respectively, while dinar's appreciation in Q2 pushed down the M3 growth (1.0%) below other aggregates.

A long-term decline in money supply started to decelerate both in nominal and real terms. Relative to June last year, M1, M2 and M3 lost 10.2%, 14.7% and 7.9% in real terms respectively.

The dinar component of money supply was propped up by rising balances on corporate giro-accounts and accounts of other financial organisations and local government authorities. Households continue to save predominantly in foreign currency, whilst their balances in dinar accounts declined marginally. On the other hand, household FX deposits rose more than in Q1, largely due to the redemption of new series of frozen FX savings bonds.

Despite strengthening of the dinar, growth in NFA, notably of banks, buoyed up M3. Corporate and household lending had the strongest impact on M3 growth (3.2 pp). Contracted government borrowing (reduced dinar and higher FX borrowing) had an opposite effect (-0.3 pp).

Monetary multiplier declined slightly relative to Q1 though a moderate upward tendency is discernible in the longer run.

The velocity of money diminished in line with increased money supply and sluggish economic growth.

In July, dinar reserve money expanded by RSD 13.9 bln in response to spending of dinar government deposits, while heightened bank investment in repo securities acted in the opposite direction. All broader monetary aggregates went up, mainly due to an increase in currency in circulation and rising balances in transaction accounts. FX deposits rose in July too by contrast to dinar savings and term deposits which declined.

Bank lending

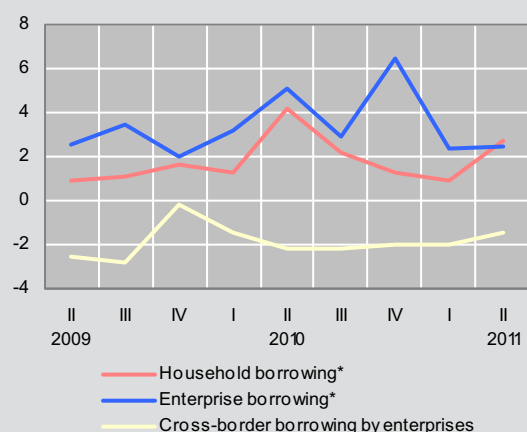
Though more dynamic than in Q1, y-o-y growth in lending remained slow.

Real growth in corporate and household lending amounted to 2.5% in Q2, up by 0.7 pp on Q1. Loans to enterprises and households rose 2.4% and 2.7% respectively. Nominally, total bank lending increased by RSD 42.8 bln. Excluding the exchange rate effect, lending picked up RSD 44.3 bln. Though higher than in Q1, y-o-y lending slackened further – the real y-o-y growth rate came at 12.1% in June, down by 2.5 pp on end-Q1.

In Q2, banks relied on domestic sources of financing the lending activity. They tapped most funds from rising dinar deposits, notably of the corporate sector. As usual, a rise in FX household deposits gave a strong impetus to financing of lending activity. The release of liquidity under lower FX required reserve allocations was partly neutralised by elevated investment in repo securities. Detrimental to lending were banks' mounting external claims and shrinking liabilities.

Corporate lending rose RSD 19.3 bln nominally, or RSD 24.8 bln excluding the exchange rate effect. Majority of bank loans were extended for liquidity purposes. An increase was observed for investment and export loans. A part of the increase in current assets and investment loans was due to a step-up in subsidised lending. Most loans were extended to enterprises from the industrial, trade, transportation and construction sectors.

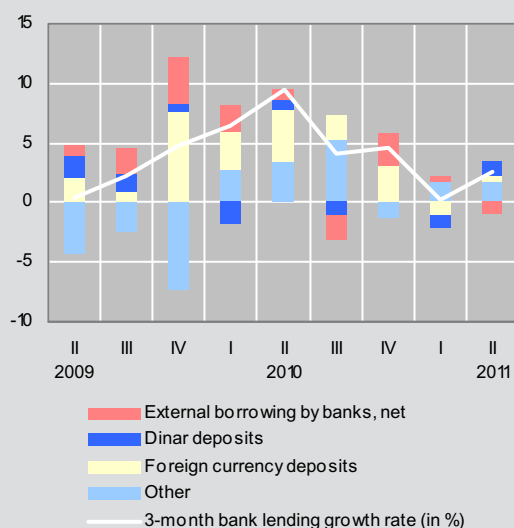
Chart IV.1.7 Bank real loan receivables and corporate cross-border borrowing
(quarterly growth rates, %)



* Deflated by inflation, excluding the effects of valuation changes.

Growth in household lending accelerated on Q1, while remaining flat for corporate loans. Enterprises continued to tap predominantly domestic sources of financing.

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



In Q2, banks relied exclusively on domestic sources for financing the lending activity.

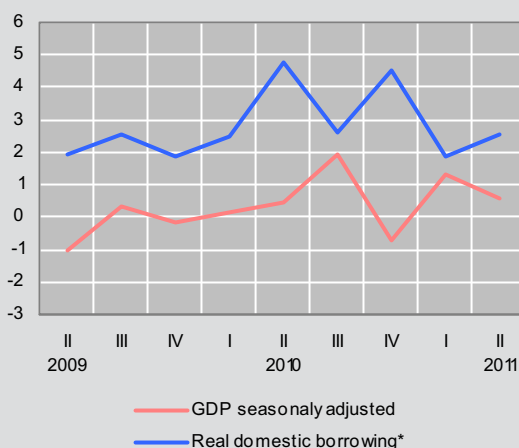
In June, the government adopted a recommendation in an effort to ease the burden of loan repayment and help the economy overcome liquidity problems. Banks are recommended to enable the rescheduling of enterprise obligations by granting a one-year grace period during which only interest will be paid, while the loan repayment period will be extended by one year.

External debt repayment by enterprises continued. External liabilities under financial loans declined by EUR 160 mln in Q2, while trade loans rose EUR 174 mln.

Household lending exceeded the Q1 levels. Nominally, household loans rebounded RSD 18.8 bln, or RSD 14.8 bln excluding the exchange rate effect. Such growth was driven by an upturn in housing loans (with the greatest participation in newly extended loans). Citizens took more consumer loans than in Q1, whilst borrowing under credit card and current account overdrafts remained broadly similar.

To reduce risks in the financial system and urge citizens to borrow in dinars, the NBS adopted a new set of measures in May.⁹ These measures stipulated additional requirements for FX and FX-indexed lending by allowing

Chart IV.1.9 Bank real loan receivables and GDP
(quarterly growth rates in %)

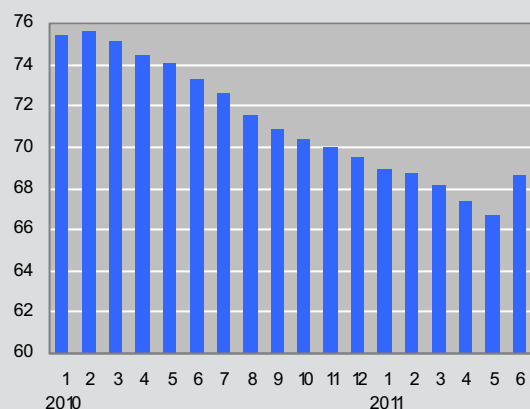


* Deflated by inflation, excluding the effect of valuation changes.

In contrast to economic activity, growth in lending stepped up in Q2.

⁹ NBS's Decision on Measures for Safeguarding and Strengthening Stability of the Financial System came into effect on 30 June 2011.

Chart IV.1.10 Share of indexed and FX receivables in total bank receivables from households and enterprises
(in %)



Dinar's depreciation in June and increased extension of FX and FX-indexed loans put a temporary halt to the upward trend in dinarisation.

Table IV.1.2 Subsidised loans in 2010 and 2011

	2010			2011	
	Q2	Q3	Q4	Q1	Q2
Government Programme of Measures to Ease the Effects of the Global Financial Crisis					
	(in RSD bln)				
Loans approved	65.6	56.3	37.6	27.0	59.0
Liquidity	44.6	34.9	22.7	24.3	50.9
Investment	5.0	9.0	9.8	1.8	6.6
Consumer	4.1	0.6	1.7	0.9	1.5
Dinar cash	11.9	11.8	3.4	-	-
Subsidised housing loans	2.2	2.5	2.0	0.9	1.3
Subsidised military loans	0.1	0.4	0.3	0	0.2
Subsidised farmers' loans	3.1	2.6	2.4	-	-

Source: Ministry of Economy and Regional Development, National Mortgage Insurance Corporation and Ministry of Agriculture, Forestry and Water Management.

only euro indexation, introducing mandatory downpayment – 30% participation for non-housing loans, and placing a cap on mortgage FX and FX-indexed loans to 80% of the property mortgaged.

Activity on the subsidised market intensified in Q2. Subsidised loans worth RSD 60.5 bln were approved, of which most for liquidity purposes (RSD 50.9 bln). As funds earmarked to subsidise interest were spent in May, the activity in this market is likely to abate unless the budget revision provides additional funds for these purposes. In the same period, total RSD 1.3 bln in subsidised housing loans were approved. Activity in this segment is likely to diminish given the amount of funds used up for subsidies in 2011.

After a longer time, the share of dinar in total loans dropped temporarily to 31.4% in June on the back of dinar's depreciation. Excluding the exchange rate effect in June, this share is up to 32.5%. Moreover, attempts to avoid NBS's additional requirements in relation to FX and FX-indexed lending, which came into force on 30 June, triggered a step-up in housing and consumer loans and a sharp rise in FX and FX-indexed household loans in June.

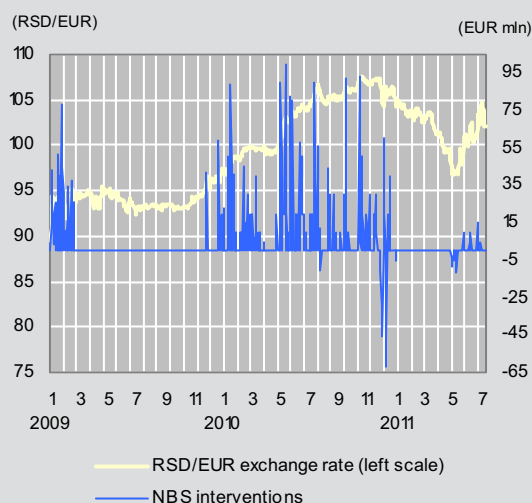
Corporate and household loan repayment capacity measured by the share of NPLs fell relative to Q1. In June, the NPL share amounted to 18.6% under the gross principle (or 11.4% by the net principle). The share of corporate loans in arrears over 90 days was up 1.6 pp to 23.7%, while household arrears rose a tad (by 0.1 pp) to 8.1%.

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

The dinar gained 4.2% on average against the euro in Q2. Economic troubles of the eurozone periphery and the government's decision not to roll over euro-indexed bills led to weakening of the dinar from June onwards. The rise in IFEM trading volumes was accompanied by heightened daily volatility of the exchange rate.

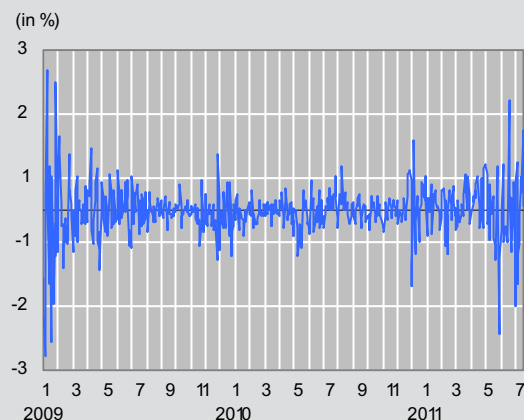
The strengthening of the dinar against the euro, in place since late last year, persisted until early June when

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



After purchasing FX in May, the NBS intervened in June and July by selling FX in the interbank market.

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



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

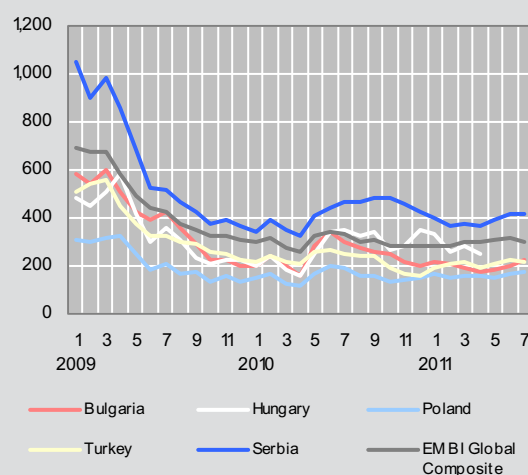
Enhanced liquidity in the interbank FX market was accompanied with higher daily oscillations of the dinar exchange rate in June and July.

depreciation pressures emerged. Overall in Q2, the dinar strengthened 4.2% on average against the euro, while the exchange rate ranged within a relatively wide band, from 96.7 to 103.3 RSD/EUR.

The strengthening of the dinar in Q2 was for its major part attributable to continuing capital inflow from portfolio investment. Domestic enterprises' demand for foreign exchange was stable throughout the quarter, while banks recorded somewhat higher inflow of foreign exchange resulting from net purchases from exchange offices and higher household FX savings relative to Q1. However, economic troubles of the eurozone periphery, the rise in country risk premium, and the government's decision not to roll over six-month euro-indexed bills (around EUR 200 mln) while announcing the issue of euro-denominated securities, heightened the market uncertainty in June and paved the way for depreciation pressures. The dinar lost on average 1.6% against the euro in June and 2.5% in July.

The volume of interbank trading in IFEM has been on a steady increase since May. It averaged EUR 94 mln per day in June, and EUR 117 mln in July (NBS excluded).¹⁰ The increase in interbank foreign exchange market depth

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

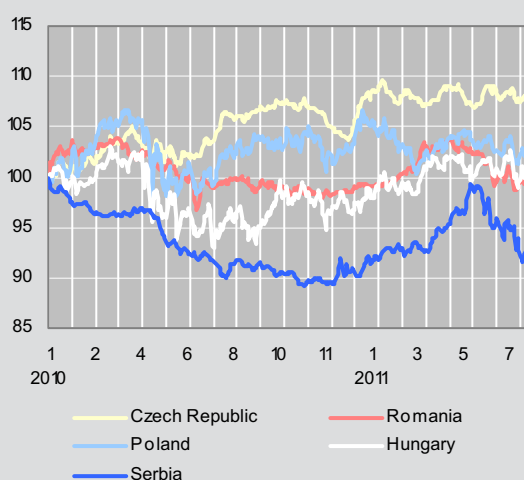


Source: JP Morgan.

Since May, all countries observed have been recording a rise in risk premia.

¹⁰ Average daily trading volume equalled EUR 78 mln in Q2, up by 46% on Q1 or 86% on 2010.

Chart IV.2.4 Movements in exchange rates of national currencies against the euro
(Jan 4, 2010 = 100)



Volatility of domestic currencies against the euro in June and July was also recorded in other countries running flexible exchange rate regimes.

was accompanied by stronger daily volatility of the exchange rate of the dinar. Still, this year again, the dinar was less volatile than other currencies with a market-based exchange rate, such as the Polish zloty, Hungarian forint and Turkish lira. Somewhat greater fluctuations of the exchange rate of the dinar should encourage the use of FX hedging instruments and assist the process of dinarisation.

During Q2, the NBS intervened in the IFEM by buying EUR 40 mln and by selling EUR 30 mln. In July, the NBS sold to banks EUR 20 mln. In the three-month FX swap auctions, reinstated in March¹¹, the NBS sold/bought a total of EUR 4.0 mln/44.0 mln to/from banks. In July, the NBS swap sold EUR 5.0 mln and bought 6.0 mln.

As in the same period last year, resurgent debt crises in peripheral eurozone countries pushed Serbia's risk premium, measured by EMBI, up by around 60 bp from May to 439 bp at end-July. The economic problems of the eurozone periphery reflected on the rise in EMBI for other transition countries too, though to a slightly lesser degree.

As the dinar strengthened against the euro and the euro against the dollar¹² in Q2, the dinar gained an average 9.4% vis-à-vis the dollar.

With a 5.4% appreciation of the nominal effective exchange rate of the dinar¹³ and a faster growth in domestic relative to foreign prices, Q2 saw a 7.3% real effective appreciation of the dinar (6.1% against the euro and 11.4% against the dollar).

Foreign capital inflow

The sovereign debt crisis in peripheral eurozone countries impacted negatively on capital inflows from portfolio investment in Q2. Capital inflow picked up in July mostly thanks to FDI.

Attractive interest rate spreads, Standard & Poor's upgrade of Serbia's credit rating in March, and investment firms' recommendations to invest in the dinar and dinar securities resulted in the continuing inflow of foreign portfolio investment in Q2. However, due to uncertainty surrounding the eurozone periphery debt crisis and the rise in country risk premium, this inflow (EUR 243 mln) was much lower than in Q1.

FDI remained modest – EUR 271 mln net, of which EUR 113 mln in April alone. Most FDI was channelled into manufacturing (iron and steel, food and beverages, non-metal minerals, textile), trade and the financial sector.

Both banks and enterprises continued net foreign debt repayment in Q2 – by EUR 131 mln and EUR 160 mln, respectively.

In April this year, the Republic of Serbia borrowed around EUR 290 mln in the global financial market. The credit was taken from *Société Générale* against guarantee issued by the World Bank. The credit proceeds are intended for budget deficit financing and debt refinancing.

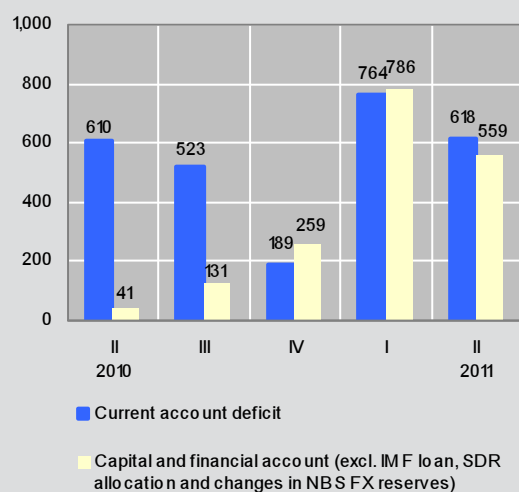
Foreign exchange also flowed in through the recently completed Stand-By Arrangement with the IMF. Around 15% of the funds made available under the last seventh

¹¹ The auctions are organised once a week to bolster interbank swap trading and the development of FX hedging instruments.

¹² Average USD/EUR exchange rate in Q2 relative to average exchange rate in Q1.

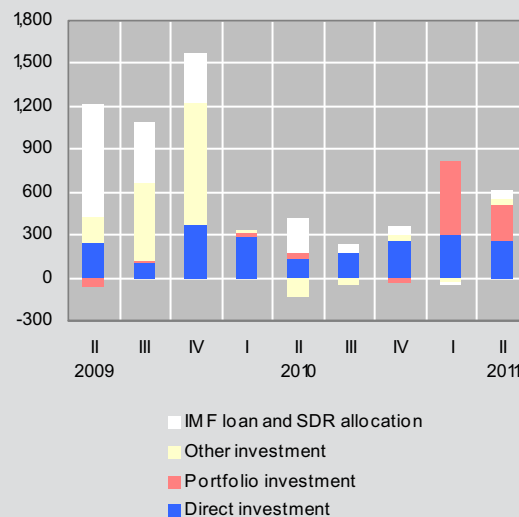
¹³ Weights used: 0.8 for the euro and 0.2 for the dollar.

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



Capital inflow in Q2 was somewhat smaller than the current account deficit.

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



Q2 saw smaller capital inflow under portfolio investment than in Q1.

tranche were drawn in April, strengthening the country's foreign exchange reserves by EUR 51.7 mln.¹⁴

According to preliminary data, FDI inflow increased in July to around EUR 465 mln thanks to the sale of Delta

Maxi, and inflow from portfolio investment amounted to around EUR 85 mln. Banks continued net repaying their foreign debts (EUR 91 mln), while enterprises net borrowed EUR 97 mln, primarily through the credit disbursed by Fiat Automobiles Serbia (EUR 250 mln).

¹⁴ 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 full. Of the total EUR 2.9 bln available under the SBA, Serbia disbursed around EUR 1.5 bln.

Text Box 1: Foreign direct investment in Serbia

Global foreign direct investment (FDI) has yet to rebound to its pre-crisis level. The bounce-back appears likely this year, and 2013 offers a promise of reaching the 2007 high.¹ Reviving investor enthusiasm poses possibilities and challenges to economic policy makers across the world, particularly in emerging countries, where growth and development targets hinge on the ability to attract investment.

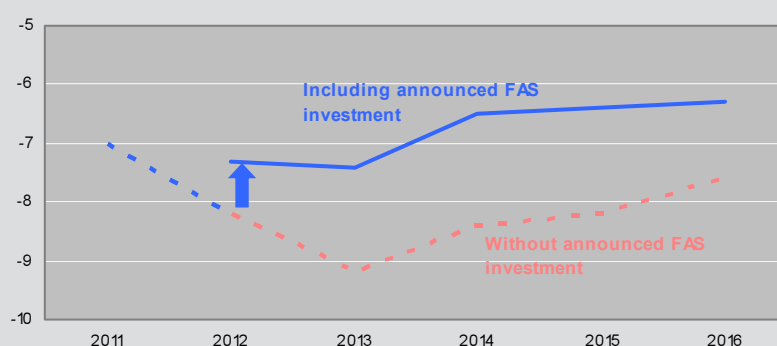
With its planned economic and foreign trade growth rates conditioned on FDI, Serbia is no exception. And despite a still only modest FDI inflow in the post-crisis period, Serbia takes the lead in the region. The United Nations Conference on Trade and Development (UNCTAD)¹ places Serbia, with USD 1.3 bln in 2010, ahead of Albania (1.1 bln), Slovenia (834 mln) and Croatia (583 mln). Although the crisis-induced drop in FDI went across the board, Serbia was less affected than, for example, Croatia or Bulgaria.

The NBS balance of payments projections set 2011 FDI at around USD 2 bln, among the most significant foreign inflows. More importantly, these inflows are projected to pour into trade and manufacturing – mainly base metals, textile and motor vehicles production.

Apart from what Delhaize Group has already invested in the Delta Maxi trade chain, additional investment from this group is expected into trade chains C market, Srbija, Pekabeta and Zvezda. In addition, Merkator announced more investment for 2011.

In the past three years Serbia saw buoyant investment in the base metals production (Smederevo steel producer US Steel, Kikinda Foundry), and H1 data and announcements for the coming period bear out the assumption that the trend will continue. Textile production attracted Italian Benetton, whose inaugural investments into Serbian textile industry this year will be followed by new ones, according to announcements. Other sectors awaiting foreign investments are finance (banks, but also insurance companies), telecommunications, construction and energy.

Chart O.1.1. Current account deficit in GDP* (%)



* NBS estimate based on announced foreign investment in the FAS project.

¹ *World Investment Report 2011*, United Nations Conference on Trade and Development (UNCTAD), July 2011.

The most significant announced FDI in Serbia is the project of Fiat Automobiles Serbia, with the launch of production of new automobile models set for 2012, almost entirely export-oriented and targeting predominantly the EU market.²

Owing to a positive influence on export growth rates of 1.8 pp on an annual basis, this investment alone should slash the share of current account deficit in GDP by 1.5 pp annually. The share of current account deficit in GDP would thus decline from 7.0% in 2011 to 6.3% in 2016, instead of going up to 7.6%.

In terms of effects on Serbia's economic activity, it is estimated that the growth in net exports of Fiat Automobiles Serbia from 2012 to 2016 would add around 0.4 pp to GDP growth on average per year, i.e. 2 pp on a cumulative basis during the period observed.

² Even greater effects could be expected in case of additional production and export into two large potential markets: the USA and Russia .

3. Capital market trends

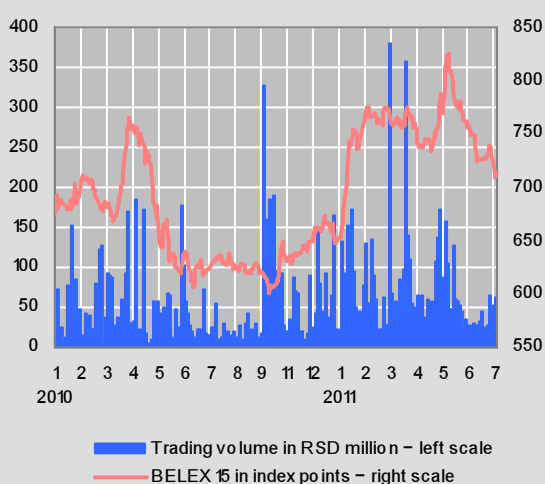
Serbia's expected progress in the European integration process reflected on the Belgrade Stock Exchange in May, though June experienced negative movements due to economic turmoil in the eurozone periphery. Mirroring trends on most regional stock exchanges, Belgrade indices edged down.

Following a rise in May, indices on the Belgrade Stock Exchange (BSE) plummeted in June – BELEX 15 and BELEXline shed 1.4% and 2.6% relative to Q1. The May increase was driven by Serbia's expected progress in the European integration process and demand for shares of the Serbian Oil Industry (NIS). However, due to elevated market uncertainties, triggered by economic turmoil in eurozone peripheral countries, shares tumbled in June. The downward trend continued in July, though at a slower pace.

Relative to Q1, total trading volumes dropped by 16.0% to RSD 7.9 bln. Shares accounted for almost 95% of total trading. Foreign investor participation in overall stock trading went up on a quarter earlier (46.3% vs. 42.2%), resulting in net share purchases of RSD 2.1 bln.

Trading in frozen FX savings bonds amounted to mere RSD 0.4 bln, coming up to a third of the average recorded

Chart IV.3.1 **Belex 15**

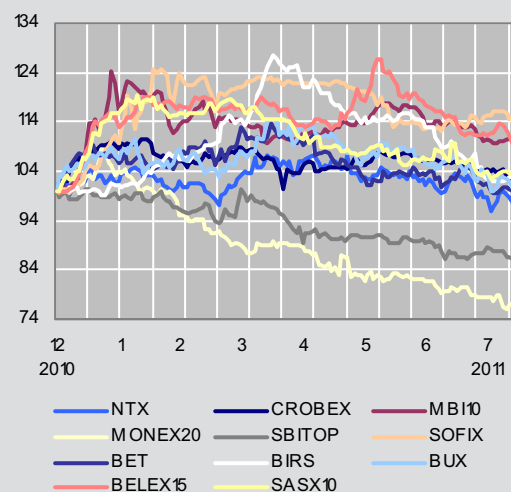


Source: BSE.

After positive May developments on the BSE, shares and trading plummeted.

Chart IV.3.2 **Stock exchange indices across the region**

(in index points, normalised, 31. 12. 2010 = 100)



In Q2, almost all regional stock indices lost ground.

in earlier quarters. A2011-series bonds maturing by end-May were doubtless a driver behind low trading volumes. By end-Q2, rates of return until maturity came at 5.2% for all bond series (2012–2016).

BSE market capitalisation contracted by RSD 71.8 bln to RSD 899.1 bln at the period-end. This was due to the delisting of Hypo-Alpe Adria shares in April as the bank became a close-end joint-stock company.

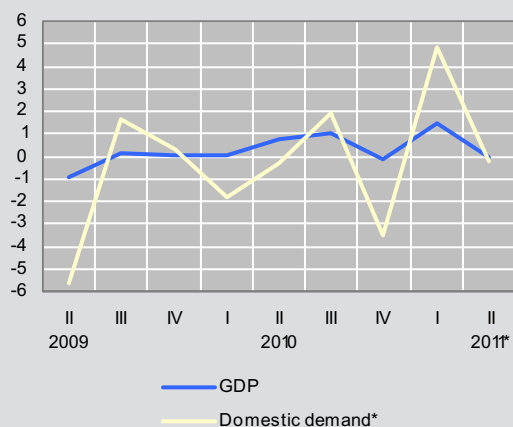
Indices on most regional stock exchanges nose-dived on the previous quarter. Ljubljana's SBITOP index plunged the deepest (10.8%). A step-up was noted only for the Skopje MB10 index (0.7%).

4. Aggregate demand

Following the last quarter's growth, estimates show that aggregate demand went into stagnation in Q2.

Domestic demand is estimated to have recorded a slight decrease (0.2%) in Q2, due mainly to the contraction in final consumption. On the other hand, a faster decline in domestic demand for imported goods and services relative to exports led to a slight pick-up in net exports (1.6%).

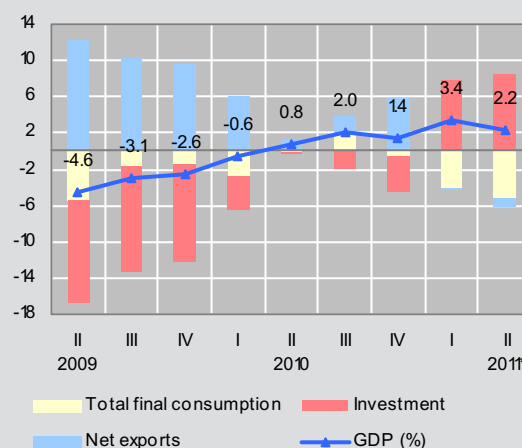
Chart IV.4.1 Growth in GDP and domestic demand
(seasonally-adjusted, quarterly growth, in %)



*NBS estimate.

Domestic demand declined somewhat in Q2, while GDP stagnated.

Chart IV.4.2 Contribution to y-o-y GDP growth
(in percentage points)



*NBS estimate.

Y-o-y GDP growth in Q2 was prompted by rising investment.

In terms of effects on Q2 GDP movements (0.0%), a positive contribution of net external demand (0.2 pp) was offset by a negative contribution from domestic demand (-0.2 pp). Within domestic demand, household spending, government final consumption and fixed-asset investment contracted, while current-asset investment went up.

According to the revised Statistical Office assessment, GDP grew by 1.0% in 2010.¹⁵ A positive contributing factor was net export growth (3.7 pp), while final consumption and investment pushed in the opposite direction (-0.2 pp and -2.6 pp, respectively). The expected acceleration in GDP growth by 3% this year should primarily be fuelled by investment activity and to a lesser extent by net exports and final consumption.

Domestic demand

Household spending

The drop in household spending, begun in H2 2010, continued in Q2 2011.

Household spending is estimated to have weakened q-o-q by 1.1% s-a, providing a negative contribution of 0.8 pp to GDP growth.

This estimate is based on the estimated real drop in turnover in retail and wholesale trade and in the green markets. Nonetheless, the drop in household spending could be overestimated on account of two reasons: increased consumer propensity to buy at discount prices and increased natural consumption, both reflecting low purchasing power and attempts to obtain more consumer goods for less money.

Real household income (wages, pensions and social transfers), as the main source of spending, recorded a negligible increase in Q2.

This increase is attributable primarily to the real growth in social insurance transfers. Net inflow of remittances rose in Q2, and so did the volume of consumer and other household loans intended for consumption financing.

Faster growth in the sources of spending than in spending itself could signal an increase in household spending in the coming period or an increase in the volume of nonregistered payments in prior period.

After stagnating last year, household spending is expected to recover in 2011 and to grow by a modest 0.8%, led chiefly by the real growth in public sector wages.

¹⁵ See Box 2, p. 27.

Government spending

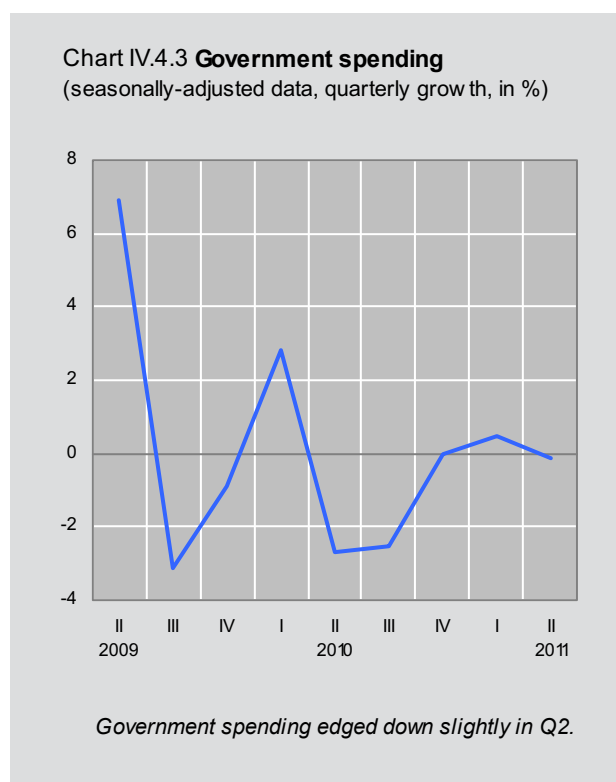
Government spending declined slightly relative to the previous quarter.

Seasonally adjusted data on government outlays for the purchase of goods and services and payment of public sector wages in Q2 point to a 0.1% real decrease in government spending relative to the previous quarter. Compared to the same period a year earlier, government spending declined by 1.8% in real terms.

Looking further ahead, public spending will be predominantly determined by two factors pushing in the opposite direction. The first one, republic budget deficit, swelled over projections in H1, up to 60% of what the 2011 Budget Law set out. H2 therefore calls for cuts in public spending, lest the fiscal framework is abandoned. The second factor is the nearing of general and local government elections, which often entails the risk of fiscal expansion.

Investment activity

As private investment declined in Q2, overall investment activity slowed down, its growth being reliant mainly on investment into current assets.



Investment activity is estimated to have slowed down in Q2, dragged mainly by falling private investment. Namely, private sector fixed investments went down by

Table IV.4.1 Investment indicators

	2005-2008 (average)	2010			2011	
		II	III	IV	I	II
Real indicators						
<i>(seasonally-adjusted, quarterly, growth, in %)</i>						
Construction	2.2	-3.0	0.5	0.4	-0.8	0.0 *
Industrial production of capital goods (physical volume)	-6.5	5.4	-8.2	12.4	22.2	-22.4
Exports of capital goods**	29.3	14.3	0.7	14.7	-16.7	-4.9
Imports of capital goods**	11.2	9.5	15.7	-2.4	10.4	-12.8
Stocks of capital goods	-1.6	12.9	-7.9	-9.9	53.0	2.5
Industrial production of intermediate goods (physical volume)	3.9	8.2	1.3	-4.1	7.7	-1.0
Exports of intermediate goods**	17.6	6.0	-1.5	11.2	9.5	-7.7
Imports of intermediate goods**	15.4	13.5	6.1	4.6	4.2	-2.5
Stocks of intermediate goods	0.5	-1.6	-0.4	-2.7	3.2	-2.6
Government investment**	16.2	-2.5	2.2	0.1	-3.4	0.2
Financial indicators						
Medium- and long-term external borrowing by enterprises (net, in EUR mln)	528.8	-270.0	-150.0	-228.4	-213.2	-169.0
Short-term credits to enterprises (in RSD bln)	51.8	38.9	19.3	33.0	-2.7	-25.8
Long-term credits to enterprises (in RSD bln)	43.3	35.3	13.5	27.1	8.9	43.6
Long-term credits to households (in RSD bln)	78.9	44.3	21.6	12.8	-9.1	19.9

* 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.

9.4% s-a, while capital expenditure movements indicate a marginal increase in government investment (0.2% s-a).

The downturn in fixed investment is signalled by the steeper drop in imports than in exports of capital goods against the backdrop of their reduced domestic production. Consequently, private sector fixed investment contributed -1.7 pp to GDP growth in Q2.

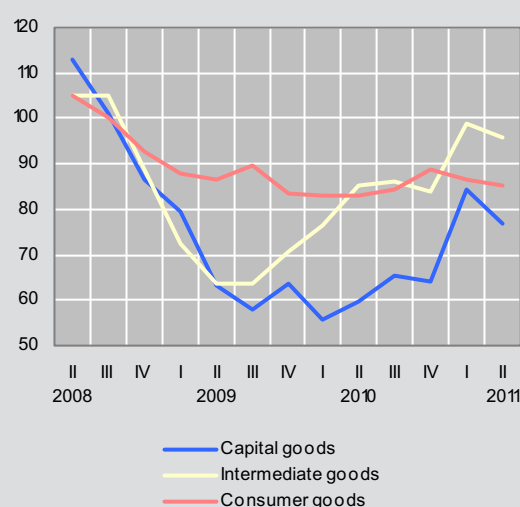
On the other hand, investment into current assets, i.e. stock-building, gained considerable ground. Within final industrial products, the strongest real increase in stocks was registered for durable consumer goods and capital goods.

In line with earlier announcements of new investment projects, Q2 saw more investment loans approved relative to Q1. Looking ahead, private sector investment is expected to pick up faster, turning into a major contributor to economic activity in 2011.

Net external demand

A somewhat faster drop in imports relative to exports had a positive impact on overall economic activity in Q2.

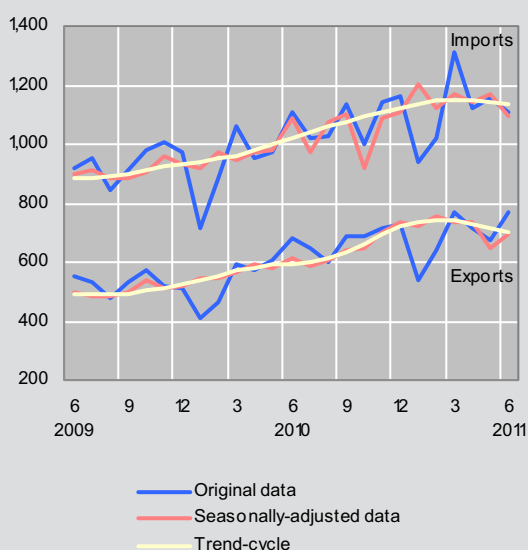
Chart IV.4.5. Imports by key components
(seasonally-adjusted, 2008 = 100)



Q2 experienced a drop in imports of both producer and consumer goods.

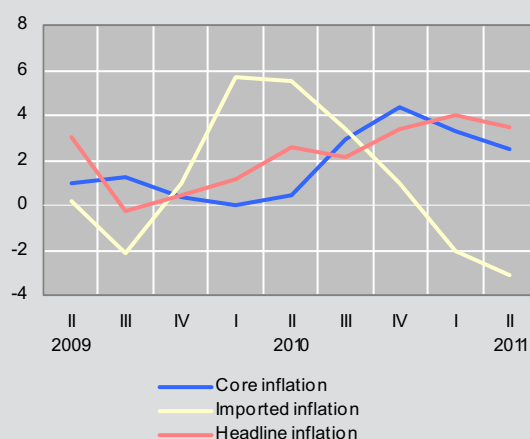
As s-a imports fell at a faster pace than exports, foreign trade provided a positive contribution to GDP growth in Q2 (0.2 pp contribution of net exports).

Chart IV.4.4 Exports and imports
(in EUR mln)



Net exports rose from Q1 due to a faster decline in imports than exports.

Chart IV.4.6 Domestic and imported inflation*
(quarterly growth rates, in %)

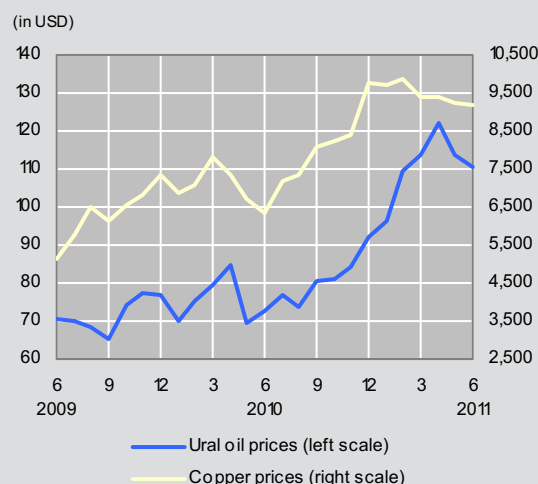


Source: NBS and Eurostat.

* Ratio of averages for two consecutive quarters.

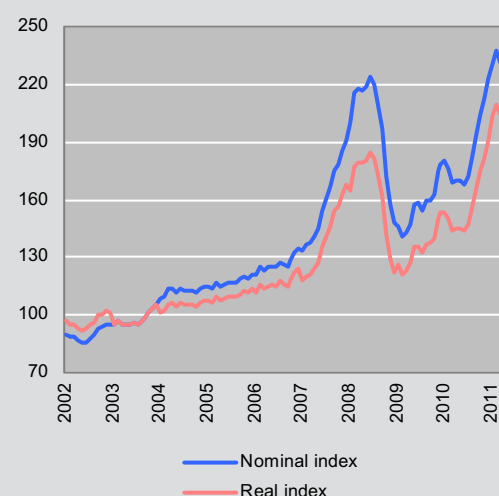
Imported deflation in Q2 was driven by the nominal effective appreciation of the dinar.

Chart IV.4.7 Oil and copper price movements



Source: Bloomberg.

Oil prices plummeted on Q1, particularly in June, while copper prices displayed a moderate decline. In July, they rose anew.

Chart IV.4.8 Index of global food prices
(2002 - 2004 = 100)

Source: FAO, UN.

Global food prices stabilised in Q2.

Y-o-y, however, foreign trade gave a negative contribution (-1.1 pp), even though the growth in exports surpassed that in imports (16% vs. 12% y-o-y).¹⁶

The fall in exports was driven by base metals (iron and steel) and food (grains, fruit and vegetables, and sugar). Exports of agricultural products decreased, in part, due to a ban on wheat exports from mid-March to mid-June. The drop in imports, on the other hand, was occasioned primarily by the weaker imports of capital and intermediate goods (notably the latter). Imports of consumer goods continued down (by around 2%).

In late Q2, s-a exports were by around 9% higher and imports by around 21% lower than pre crisis¹⁷.

Imported inflation declined for the second quarter in a row. Its negative outturn in Q2 (-3.1%)¹⁸ was a result of significant appreciation of the nominal effective exchange rate of the dinar (4.7%), given that the average price growth in the EU and USA in the same period (1.6%) was higher than in the quarter before. Such movements in import prices contributed to the slowing of both core and headline inflation in Q2.

Exhibiting a large degree of volatility, oil prices plunged by around 10% in Q2. Sustained at relatively lofty levels throughout April, oil prices tumbled down in early May as it became clear that the recovery of the global economy in 2011 would be slower than expected. They resurged from mid-May until the second half of June when the International Energy Agency announced a release of emergency oil stockpiles. In the first half of July, oil prices spiked once again due to lower US oil stocks and increased demand, only to decline mildly thereafter amid fears of eurozone debt crisis contagion and concerns over the outcome of the US debt ceiling debate.

Copper prices continued down, though at a slower pace than in Q1. After levelling off at record USD 10,148 per tonne in mid-February 2011, the red metal prices fell back by around 8% until end-Q1. In Q2, copper prices lost 2.4%. The continuing drop in prices was mainly due to reduced demand from China, the world's largest copper importer, as a result of the government's economy cooling measures.

As indicated by the *FAO Food Price Index*, global food prices stabilised in Q2. Namely, following eight

¹⁶ The reason behind the negative contribution is that the share of imports in GDP is significantly higher than that of exports.

¹⁷ January–September 2008.

¹⁸ Ratio of averages for two consecutive quarters.

consecutive months of relentless growth (July 2010–February 2011), food prices have been steady since March. The market of primary agricultural products is expected to be calmer in the coming period.

5. Economic activity

According to NBS estimates, economic activity measured by GDP stagnated in Q2, while slackening measured by NAVA. As a result, the negative output gap widened.

In Q1 2011, GDP growth was slightly higher than expected (May Report) – it arrived at 1.4% s-a (3.4% y-o-y)¹⁹. This was chiefly due to growth in industrial output sectors (mainly manufacturing), agricultural output, transportation and storage. NAVA rose 1.1% s-a and sped up by 3.0% y-o-y.

The economy is estimated to have stagnated in Q2 (GDP growth of 0.0% s-a²⁰), while NAVA dropped by 0.6%. Y-o-y, GDP growth slowed to 2.2% and growth in NAVA

came at 1.4%. As a result, economic activity remains below its pre-crisis levels.²¹

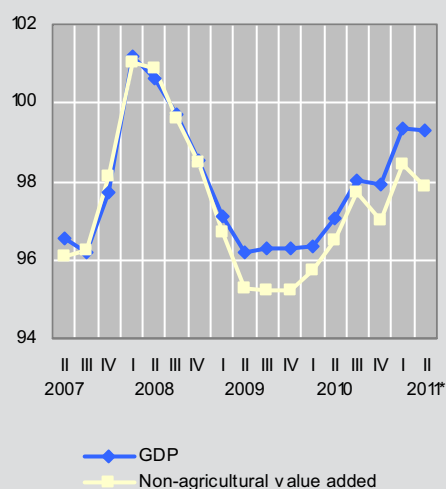
Economic stagnation in Q2 was driven by falling manufacturing (-0.2 pp) and a further slump in trade.

Y-o-y GDP growth in Q2 was based on an upturn in agricultural output (0.5 pp), transportation and storage, and information and communication (0.4 pp each).

Reflecting a drop in manufacturing, the overall industrial output declined (0.9% s-a). However, growth in the remaining two sectors – electricity, gas and steam supply²² and mining, recorded mainly in May, was the reason preventing a steeper downturn in industrial output.

Manufacturing contracted in response to sagging production of motor vehicles and trailers, as well as food. Production of base metals dwindled as one blast furnace in Smederevo US Steel was shut in early May. In contrast, the sharpest increase was noted for the production of coke, petroleum products, and basic pharmaceutical products and preparations.

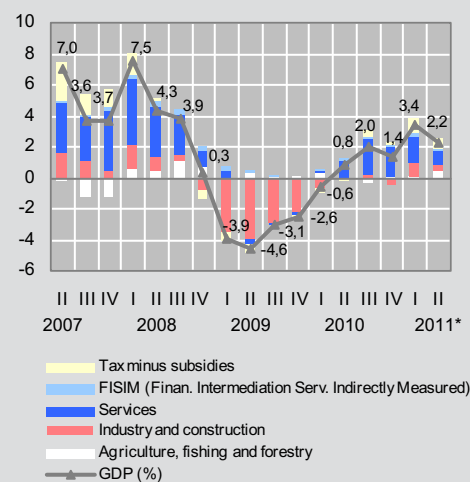
Chart IV.5.1 Economic activity indicators
(seasonally-adjusted data, 2008 = 100)



* NBS estimate.

According to estimates, GDP stagnated and NAVA declined in Q2 as a consequence of depressed industrial production.

Chart IV.5.2 Contribution to y-o-y GDP growth
(in p. p.)



* NBS estimate.

Q2 is likely to see a slowdown in y-o-y economic growth.

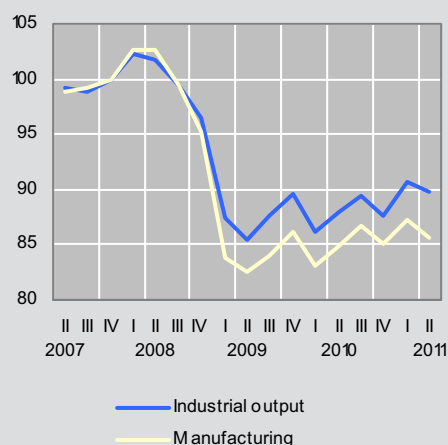
¹⁹ At previous year's prices, under the new classification of activities (2010).

²⁰ Based on the Statistical Office flash estimate of y-o-y GDP growth in Q2 (2.2%).

²¹ Pre-crisis period: H1 2008.

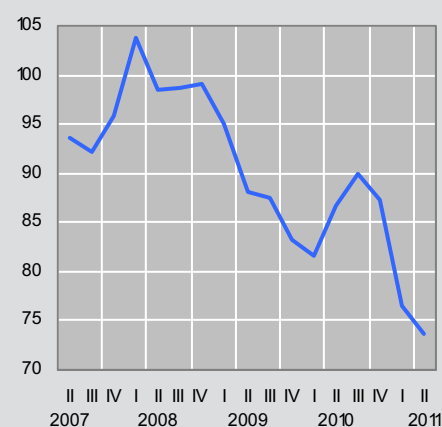
²² According to the new classification of activities (2010) – Sector E: electricity, gas, steam and air-conditioning supply.

Chart IV.5.3 Industrial output
(seasonally-adjusted data, 2008 = 100)



A drop in industrial output in Q2 was caused by dented manufacturing.

Chart IV.5.4 Retail trade
(seasonally-adjusted data, 2008 = 100)



Retail trade contracted further in Q2.

Retail and wholesale trade continued down in Q2 in response to the persistently low aggregate demand that will generate further disinflationary pressures in the period ahead.

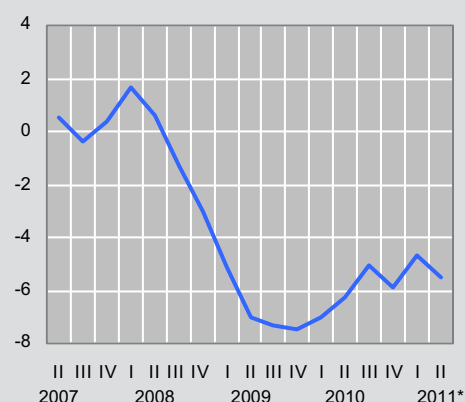
Following a slump in Q1, construction is assumed to have recovered in Q2. This is indicated by rising production of other non-metallic mineral products – cement, roof tiles, tiles and glass.

An upswing was recorded with agricultural output, transportation and storage, information and communication, and financial intermediation. The accommodation and food service activities sector is recovering as confirmed by a rising number of tourist overnight stays (c. 10% q-o-q).

According to the revised Statistical Office estimate, GDP growth equalled 1.0%²³ in 2010. Under the NBS estimate, GDP growth will reach c. 3.0% in 2011, mainly on the back of faster growth in industrial production and a better agricultural performance.

The expected economic slowdown in Q2 signals widening of the negative output gap and strengthening of disinflationary pressures on that account.

Chart IV.5.5 Output gap*
(percentual deviation from the trend)



* NBS estimate.

The negative output gap deepened in Q2 due to economic stagnation.

²³ At previous year's prices.

Text Box 2: Revision of quarterly GDP data

Following the revision of Annual National Accounts¹, the Statistical Office published by end-June revised rates of real GDP growth for Q1 2001–Q1 2011. Calculation was made under the new classification of activities (2010) at previous year's constant prices. The shift from fixed base constant prices to previous year's prices prompted the revision of the earlier published quarterly rates of real growth (Chart 1).

The estimate of real quarterly GDP growth for 2010 was revised in line with the new methodology. Instead of 1.8% under the old methodology (Chart 2), real GDP growth for 2010 equals 1.0%.

Chart O.2.1 Real quarterly GDP growth
(y-o-y rates, %)

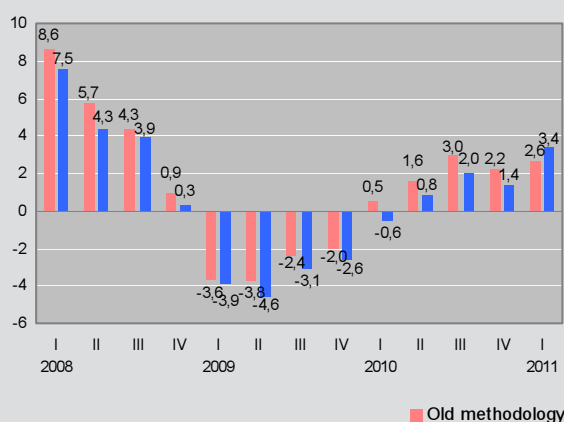
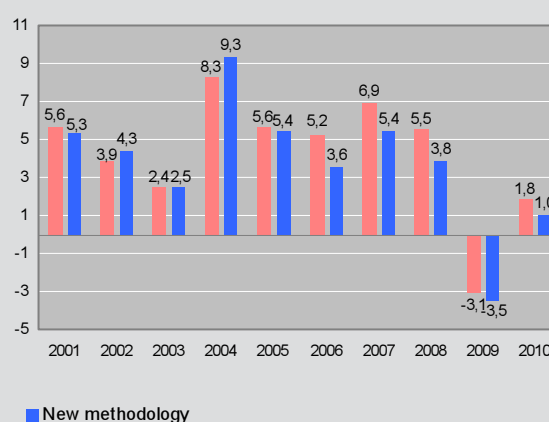
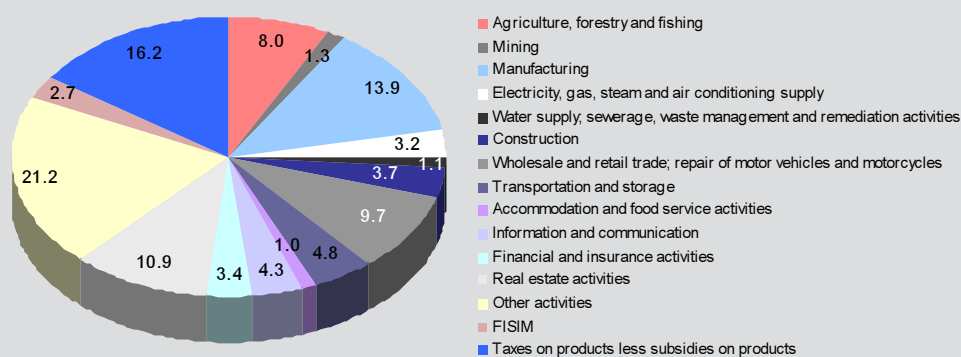


Chart O.2.2 Real GDP growth
(y-o-y rates, %)



Furthermore, the Statistical Office published for the first time data on quarterly nominal GDP – in total and by activity, for the Q1 2001–Q1 2011 period.

Chart O.2.3. Structure of nominal GDP in 2010*
(%)



* Nominal GDP for 2010 is the sum of 4 quarters.

¹ See Box 3 of the May Inflation Report, p. 29.

Introduction of the new classification of activities and revision of annual GDP data² changed the GDP structure by sector. An important change relates to the ‘other services’ sector – its share rising by c. 6 pp – from 15% to 21% of GDP.³ The real estate sector reduced its share from 16% to 11% of GDP, while a reduction of c. 1 pp was recorded with agriculture, industrial output, construction and trade. The water supply, sewerage, waste management and remediation activities sector is now separate, making up 1% of GDP. The transport, storage and communications sector was split in two (transportation and storage; information and communication) accounting for 9%, instead of 8% of GDP.

² Ibid.

³ The ‘other services’ sector was split into the following sectors: professional, scientific and technical activities; administrative and support service activities; public administration and defence, compulsory social security; education; human health and social work activities; arts, entertainment and recreation; other service services; and activities of households as employers.

6. Labour market developments

Wages

Net wages rose in nominal, while stagnating in real terms in Q2. The drop in industrial unit labour costs decelerated.

According to seasonally-adjusted data, Q2 saw a 2.9% rise in nominal wages relative to the previous quarter. Both private and public sector recorded nominal wage growth (by 1.9 and 4.6%, respectively). Nevertheless, real wages stagnated, held down by the real wage decline in the private sector (0.6%) on the one hand, and their increase in the public sector (2.2%) on the other.

Growth in public sector wages was due to the unfreezing of wages, as well as to the payment of quarterly bonuses, vacation bonuses and wage arrears.

Nominal net wage growth was registered in most industries. However, observed in real terms, net wages shrank across

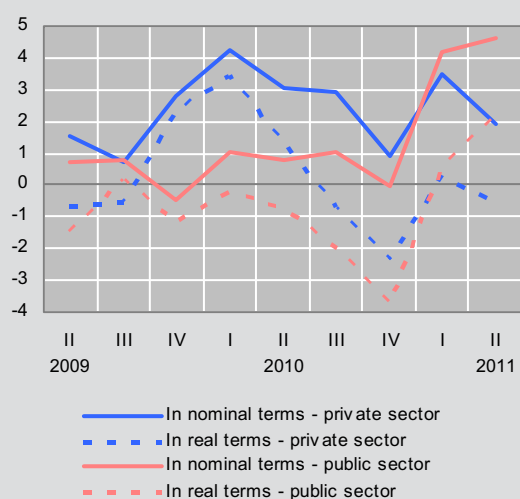
most industries, most notably in mining, professional, scientific and technical activities, as well as in trade.

Y-o-y, nominal wages stepped up their growth slightly (11.1%), while real wages slowed down their decline (2.1%) in Q2. The public sector experienced more robust nominal wage growth (10.2% y-o-y), while that of the private sector decelerated to a certain extent (9.7% y-o-y). The drop in real wages lost some pace in the public sector (3.0% y-o-y), while accelerating in the private sector (3.4% y-o-y).

The average net wage paid out in Serbia in Q2 equalled RSD 37,994.

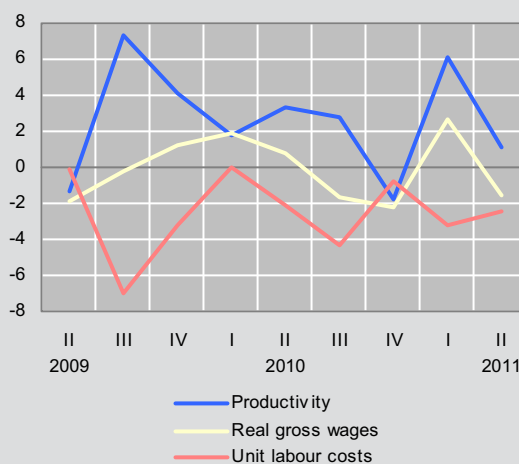
Industrial unit labour costs continued to fall in Q2, the downward pressure coming mainly from a decrease in gross real wages. However, with labour productivity growth lagging behind that in the previous quarter, the fall in industrial unit labour costs decelerated relative to Q1. On the other hand, manufacturing experienced a slight increase in labour costs, triggered by a moderate rise in gross real wages.

Chart IV.6.1 Average net wages
(seasonally-adjusted data, quarterly growth, in %)



In Q2, real wages rose in the public and declined in the private sector.

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



Unit labour costs continued down in Q2 chiefly in response to falling gross real wages.

Employment

Employment numbers remained stagnant in Q2. According to the Labour Force Survey, unemployment rate rose to 22.2% in April.

With only small changes in the number of employees in nearly all sectors, employment practically stagnated relative to Q1 (only 547 newly employed persons in Q2). Employment slumped most in arts, entertainment and recreation, education and manufacturing (1,791 persons, -0.1 pp contribution to overall employment). However, this fall was compensated for by the rising employment numbers in construction and services (primarily information and communication).

Relative to the same period last year, the drop in employment slowed down from 3.4% to 3.1% in Q2. Greatest contributors to the deceleration were manufacturing, and transportation and storage.

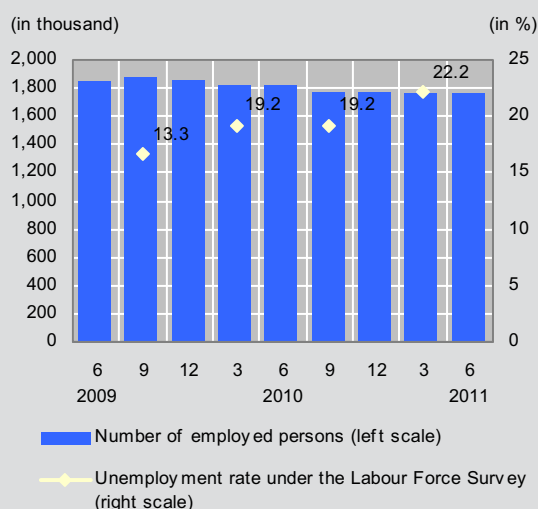
The April **Labour Force Survey** reported a rise in the unemployment rate, from 19.2% in October 2010 to

22.2% in April this year. The unemployment figure went up by around 84,000. The structure of the unemployed by job search duration also deteriorated, with the share of long-term unemployed (for one year or longer) in total unemployed active job seekers rising by 2.5 pp (from 13.8% to 16.3%).

The same survey reported a 1.5 pp decrease in the employment rate (share of the employed in total population aged 15 and above) down to 36.2% relative to October 2010. This marks a continuation of a downward tendency dating back to October 2008. The 45-54 age group recorded the sharpest drop-off (by around 53,000 persons).

Low employment is coupled with a relatively unfavourable structure of the employed, nearly one fifth of whom are informally employed, i.e. undeclared.²⁴ Since October 2010, the share of informal employment in total employment rose negligibly (from 19.6% to 19.9%).

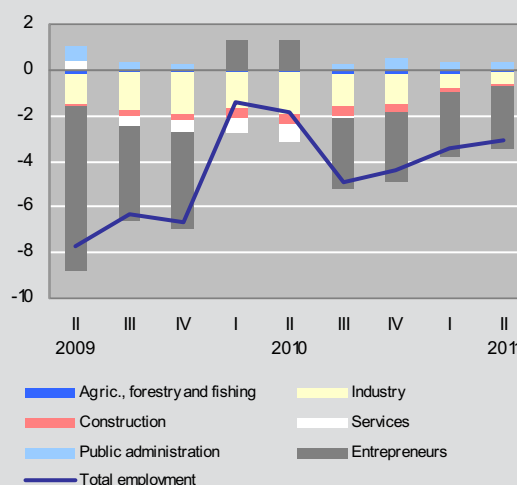
Chart IV.6.3 Unemployment



Source: Serbian Statistical Office.

According to the April Labour Force Survey, the unemployment rate rose to 22.2%.

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



Source: Serbian Statistical Office.

A y-o-y decline in employment continued to decelerate in Q2.

²⁴ It covers persons working in (non)registered companies, persons in registered companies with no employment contract and pension and disability insurance, as well as unpaid contributing family members.

7. International environment

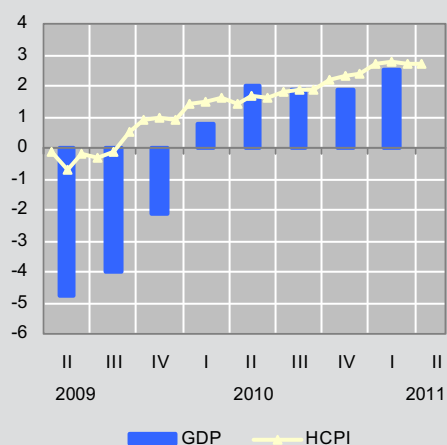
Global economic recovery slowed down in Q2. Crisis in the eurozone continues, and the monetary policy stance is tightening.

According to preliminary estimates, global growth slowed down in Q2 and is expected to reaccelerate in the second half of the year. However, the recovery will remain unbalanced amid elevated downside risks. The greatest risk is associated with the deepening of economic crisis in some peripheral eurozone countries and concerns over their default. Investor confidence is further dampened by the fiscal deficits of advanced economies, notably the United States, wherefore these economies are expected to recover at a slower pace than their emerging counterparts. The latter are, on the other hand, faced with strong inflationary pressures and the risk of overheating sparked by buoyant inflow of foreign capital and investment (Asian and Latin American countries above all).

Financial and debt crisis in the eurozone periphery continues unabated. The EU and the IMF approved a new bailout package to Greece in the amount of EUR 159 bln. The deal involves some participation of private sector investors (around EUR 50 bln). Cooperation of the three parties is considered to be a positive signal in terms of resolving the debt crisis of some peripheral eurozone countries. Nonetheless, the effectiveness of fiscal consolidation remains uncertain. This is evidenced by the latest downgrade of the country's rating by Fitch – from B+ to CCC. This downgrade was preceded by a similar move by Standard & Poor's and Moody's. Thus, Greece has become one of the lowest-rated countries in the world.

In the meantime, fears of the crisis spreading to the eurozone core fed through into higher yields on ten-year Italian and Spanish sovereign bonds. These yields are currently at their highest level since the establishment of the EMU. The Italian parliament recently adopted a stringent public sector austerity plan, but this has had a limited effect in terms of appeasing the stressed financial markets.

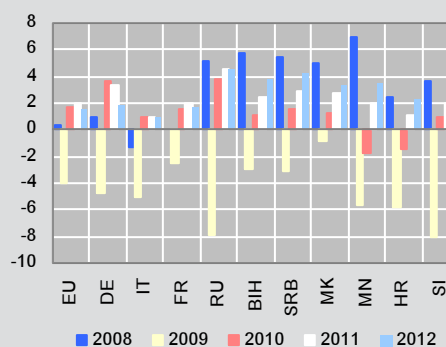
Chart IV.7.1 Eurozone GDP and inflation (y-o-y growth rates)



Source: Eurostat.

Inflation pressures diminished somewhat in Q2. Economic growth accelerated in Q1, while Q2 is likely to see a slowdown.

Chart IV.7.2 Serbia's key foreign trade partners - GDP growth rates and their projections



Source: Consensus Forecast, July 2011, apart from Montenegro (IMF WEO, April 2011)

Germany and Russia are likely to experience high economic growth in 2011, while foreign trade partners in the region will probably see more moderate growth.

After picking up in Q1 in response to robust investment in Germany and France, eurozone economy is estimated to have decelerated slightly in Q2. The reasons lie in ECB's monetary tightening and in the worsening of investment prospects for some eurozone members. Though weaker than a quarter earlier, the German economy is estimated to have grown by a solid 2.9% in Q2 (*Consensus Forecast*).

As regards Serbia's regional trade partners, BiH and Montenegro are headed for moderate and Macedonia for somewhat stronger growth in 2011. Turning to Central and East Europe, the most vigorous economic growth is projected for Russia, Poland, Ukraine and Estonia (4–5%).

A hefty rise in food and energy prices, begun in July 2010 and halted in March 2011, and the resulting inflationary pressure are the main reason behind monetary tightening in the eurozone. The ECB raised the policy rate by 25 bp in both April and early July.

Faced with heightened inflationary pressure, the central banks of Central and East European countries also tightened their monetary policy stance. Perhaps the fastest shift to tightening was that of the National Bank of Poland, which lifted the policy rate in early June by 25 bp for the fourth time this year to counter higher inflation, elevated inflation expectations and the risk of mounting pressure from growth in wages.

After slowing considerably in Q1, the US economy is estimated to have gathered some pace in Q2, though not sufficient to foster employment growth. High public debt, yawning budget deficit and lack of adequate fiscal consolidation measures remain the key problems facing the US economy. Nonetheless, the authorities managed to strike an agreement on raising the public debt ceiling by USD 2,400 bln (from USD 14,300 bln) and cutting spending over the next ten years by approximately the same amount. In early August, Standard & Poor's lowered the US credit rating for the first time, from AAA to AA+, with the possibility of a further downgrade (negative outlook).

Notwithstanding elevated inflationary pressure, core inflation, on which the Fed focuses most, remains low. The Fed announced that the second round of quantitative easing (QE 2) will be concluded as previously planned – at the end of June. The decision not to extend the QE program may be regarded as the first step towards the ending of a markedly accommodative monetary policy implemented by the Fed in the prior period.

The exchange rate of the dollar against the euro was rather volatile in Q2 – after weakening in April, the dollar rallied in May (reflecting uncertainty over peripheral eurozone debt and fears of eurozone contagion), only to dip yet another time in June in response to ECB's announcement of monetary tightening. Investor risk aversion continuing, the Swiss franc and the Japanese yen preserved their safe haven appeal, remaining high against the dollar.

V. Inflation projection

Inflation will continue to fall in H2 2011, though remaining probably above the upper bound of the target. Its return within the target band and coming closer to the target midpoint is expected in H1 2012. The factors shaping the inflation path will be slower growth in food prices, low aggregate demand and the decline in inflation expectations. Economic recovery is expected to accelerate in 2011 and 2012, primarily as a result of increased private sector investment this year and stronger net exports next year.

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 assumes an active monetary policy which seeks to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

Initial conditions

After peaking in April, y-o-y inflation entered a decline, confirming our expectations from the May Report. Inflation slowed down from a quarter earlier (5.5%) to 1.2% in Q2 reflecting stabilisation of food prices and the drop in prices of vegetables and fruit.

Food prices stabilised as the effects of last year's increases in prices of primary agricultural products faded away and the first signs of a better harvest cropped up. Though to a lesser degree, the rise in food prices also slowed down under the impact of the strengthening of the dinar.

Most other primary commodities also recorded a decrease in prices. At end-Q2, crude oil prices plummeted by around 10% relative to the quarter before due to the slackening of global economic growth and the International Energy Agency's intervention on the supply side. The prices of base metals (copper, aluminium, iron and zinc) slumped from the previous quarter, while the prices of industrial raw materials took varying paths (cotton and rubber – downward, leather and wool – upward).

Appreciation pressures, present since early 2011, ended in June and July. Economic troubles of the eurozone, which contributed to the rise in the country risk premium, and the government's decision not to roll over the euro-indexed bills weighed down on the dinar. The recovery of

IFEM trading volumes was accompanied by increased daily volatility of the dinar exchange rate.

Nevertheless, the dinar recorded nominal appreciation against the euro at quarterly level, which together with higher domestic relative to eurozone inflation led to the widening of the appreciation gap of the real exchange rate that opened early in the year. Appreciation gap of the real exchange rate is an indicator of the drop in net importers' real marginal costs and weaker upward pressure on their domestic prices in the medium run.

One year ahead inflation expectations of the financial sector are running above the upper bound of the target tolerance band. However, they are expected to edge down in the coming period in the wake of falling y-o-y inflation rates.

Aggregate demand remains low (negative output gap widened in Q2), and as such continues to be the key disinflationary factor in the period ahead.

Following 3.4% y-o-y growth in Q1, economic activity is estimated to have slowed down in Q2 (2.2% y-o-y). This is consistent with the expectation that, at quarterly level, economic activity would stagnate in Q2 (0.0% s-a growth).

The eurozone economy grew strongly in Q1, but is likely to slow down in the coming period amid uncertainties caused by the economic troubles of some member

countries. This could also weigh down on Serbia's export demand, considering that eurozone members, above all Germany and Italy, are Serbia's most important trade partners.

Monetary policy stance tightened significantly relative to Q1, largely due to the widening of the appreciation gap of the real exchange rate. As inflationary pressures subsided, a cycle of monetary easing began in June.

Projection assumptions

Regulated price growth exceeded the limit planned for the year as a whole already in H1. Clearly, any further increases in these prices would slow down inflation's return within the target band. In 2012, we expect to see lower growth in prices under government regulation.

Despite falling in Q2, relative prices of vegetables and fruit remain above their medium-term averages, and their further drop in seasonally-adjusted terms is therefore quite likely. Judging by the prices of futures in global stock exchanges and the start of domestic trade in the new crop, similar trends will most probably be displayed by the prices of primary agricultural products (corn, wheat).

The projection assumes continuing moderate convergence of prices in Serbia to those in the eurozone, i.e. appreciation trend of the real exchange rate. The projection also assumes that following growth in Q3, the risk premium will gradually decline in the medium term. The appreciation trend of the real exchange rate and lower risk premium should bring about a decline in the real interest rate trend.

Eurozone inflation is above the official target of just below 2%, and is likely to stay there throughout 2011.

The ECB therefore embarked on a monetary policy tightening cycle, raising its policy rate by 25 bp first in April and then in July. Similar moves are expected in the coming period.

Inflation projection

Inflation will continue to fall in H2 2011, though remaining probably above the upper bound of the target. Its return within the target band and coming closer to the target midpoint is expected in H1 2012.

Consumer prices are likely to decrease in Q3, driven primarily by the expectedly lower prices of vegetables and fruit. Other CPI components are likely to work in the opposite direction.

Following a seasonally unusual drop in Q2, prices of vegetables and fruit will probably continue down in Q3, in line with their seasonal pattern.

Core inflation is likely to decelerate in Q3 amid stabilisation of its food component resulting from the drop in prices of food production inputs. Movements in non-food core inflation will be similar to those recorded in Q2. It is estimated that depressed aggregate demand will be the key factor holding the growth in non-food core inflation at bay.

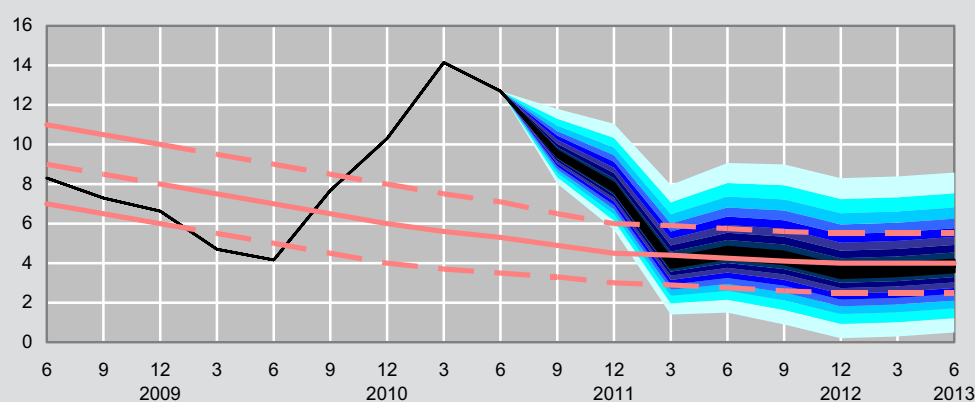
Regulated prices will experience a much lower growth in Q3 than in Q2, most of it being attributable to the increase in prices of landline telephony services. Petroleum product prices also appear likely to go up, but their rise will be smaller than a quarter earlier.

Aggregate demand remains rather low, and as such, continues to generate disinflationary pressure. Its

Table V.0.1 Projection assumptions

	2011	2012
External assumptions		
EU inflation (Q4 to Q4)	2.6%	1.9%
ECB policy rate (year-end)	1.75%	2.75%
Euro area GDP growth	2.0%	1.7%
Ural oil price per barrel (year-end, USD)	107	107
Internal assumptions		
Regulated prices (Dec to Dec)	11.6%	7.0%
Prices of fruits and vegetables (Dec to Dec)	1.0%	6.0%
Trends		
Appreciation trend of the real exchange rate (average)	1.7%	2.2%
Real interest rate trend (average)	4.5%	4.1%

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



In H2 2011 inflation will continue falling back towards the target. It is expected to return within the target band in H1 2012. Overall, the risks to the projected path for inflation are skewed to the upside, reflecting mainly the possibility of a looser fiscal policy.

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%.

disinflationary effect however is expected to grow weaker as the economy recovers.

The dinar's nominal appreciation and uptrend from Q2 reversed in July. If the dinar continues to weaken in Q3, no disinflationary effect from the drop in import prices should be expected in the coming period. On the other hand, what will continue to produce disinflationary pressure in the medium term is the appreciation gap of the real exchange rate, which indicates that net importers' real marginal costs are still low.

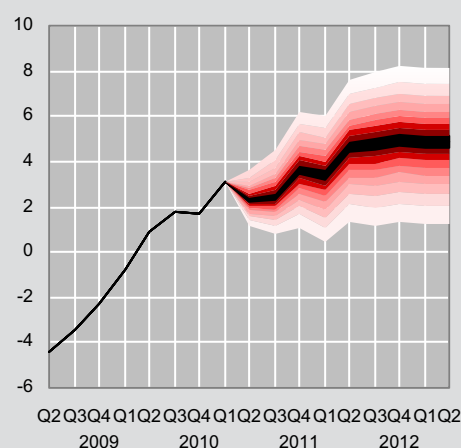
Inflation expectations remain at their end-Q1 levels even though y-o-y inflation rates declined in May and June. As y-o-y inflation rates decline further over H2 2011, inflation expectations are expected to edge down, helping the disinflation process.

A sharp decline in agricultural product prices, dampened aggregate demand, low net importers' marginal costs and the drop in inflation expectations will be the key factors leading to a fall in monthly inflation rates, and, coupled with the high base of last year, to a fall in y-o-y inflation rates too.

Economic activity is expected to gather pace from mid-2011 onwards. Greater disbursement of investment loans in Q2 should have a positive impact on investment demand, which is expected to be the key engine of growth in 2011.

Net exports will continue to provide positive contribution to GDP growth, though much more modest than last year. The contribution of net exports to GDP could be additionally dampened by the growth in imports of equipment and intermediate goods, sparked

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



Economic growth is expected to step up in 2011 and 2012. The key contribution to growth in 2011 will come from investment demand, and in 2012 from net exports.

by the start of announced investment projects and the strengthening of the dinar in H1 2011. Still, as the implementation of the said investment projects will at the same time bolster exports, net trade is expected to provide a substantial contribution to economic growth in 2012.

Besides, after relatively bad agricultural season in 2010, agricultural production will probably record a strong increase in 2011, adding significantly to GDP growth. Furthermore, much higher purchase prices of agricultural products relative to the previous year could also encourage farmers to invest more in production.

Risks to the projection

The key risks to inflation projection are associated with movements in the country risk premium, possible loosening of the fiscal stance, and food prices.

Heightened uncertainty over economic problems of some eurozone countries induced a rise in Serbia's risk premium. Country risk premiums rose across the region, which is quite understandable given its dependence on economic movements in the eurozone. If the crisis comes to a head, Serbia might face rising inflationary pressure from higher risk premium, lower capital inflow, and consequent nominal depreciation of the dinar. If otherwise, Serbia's risk premium could fall back to end-Q1 level, leading to improved investor sentiment, greater capital inflow and stronger dinar.

As many times before, the forthcoming general and local government elections pose a huge challenge in terms of keeping a lid on the planned budget deficit. Apart from leading to higher country risk premium, a larger-than-planned budget deficit could have some implications on price growth. Though these implications depend on the manner of deficit financing (internal or external government borrowing, increasing the tax burden), exceeding the planned budget deficit limit would definitely give rise to inflationary pressure.

Considering that half of the harvest was completed with considerably higher yields relative to the previous season (and forecasts for the rest of the season are similar), it seems rather likely that agricultural product prices will record a relative decline and generate less upward pressure on food prices. This pressure will be even weaker if good weather conditions persist. On the other hand, if the weather worsens, which remains a possibility, the disinflationary effects from food prices might diminish.

On balance, the risks to projected path for inflation are judged to be skewed slightly to the upside, reflecting the possibility of fiscal policy loosening amid forthcoming general and local government elections.

Comparison with the previous projection

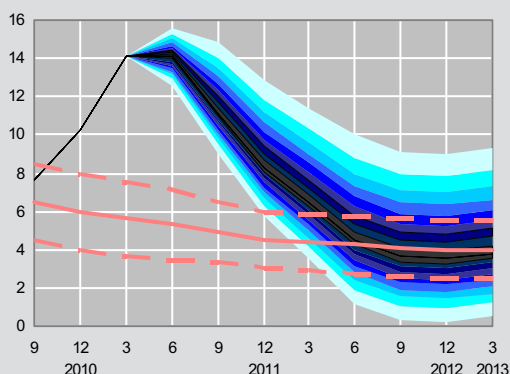
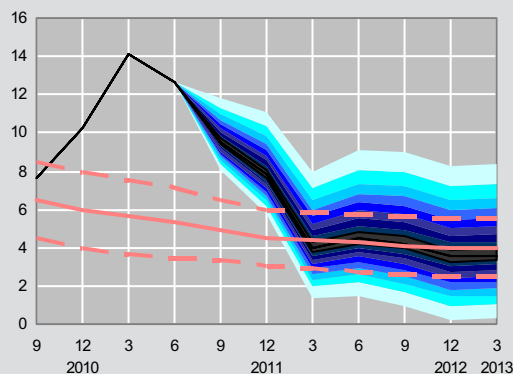
The projected spread of inflation outcomes is lower than in the *May Report* for H2 2011 and H1 2012, but similar further ahead.

Compared to the May projection, the current projection assumes a stronger disinflationary impact of food prices, due to the drop in fruit and vegetable prices, and a stronger inflationary impact of the rise in risk premium.

Good weather conditions in Q2 were conducive to the production of vegetables and fruit. The market being amply supplied, the prices of these products experienced a seasonally unusual drop. Favourable weather conditions led to a fall in international prices of primary agricultural commodities, impacting on the decline in the cost push pressure on food producers to a much greater degree than expected earlier. The first signs that the harvest would be better than last year also had a soothing effect on the cost push pressure.

Debt crisis in some eurozone members caused a worsening in investors' risk perception of the whole region of South East Europe. Due to this, our risk premium unexpectedly headed up and the dinar began weakening.

Chart V.0.3 Current vs. previous projection

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

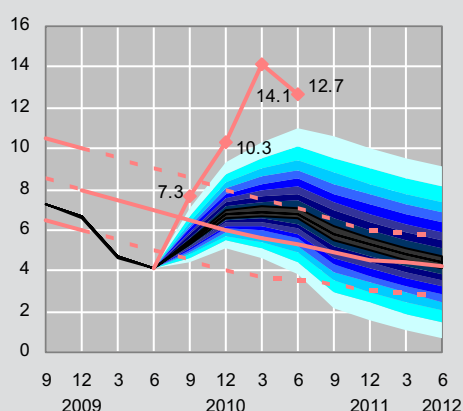
The projected spread of inflation outcomes is lower than in the May Report for H2 2011 and H1 2012, but similar further ahead.

However, as the inflationary pressure generated by nominal depreciation was outweighed by disinflationary pressure from food prices, the profile for inflation in H2 2011 and H1 2012 is lower than in May, whereas in the medium term inflationary pressures are broadly the same.

In late 2010 and H1 2011 inflation moved significantly above the upper bound of the projection band stated in the August 2010 Inflation Report. The main reasons for this deviation were the food price shock of H2 2010 and early 2011 and regulated price growth in H1 2011.

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 judges that the future path of the key policy rate will depend on the effects which may arise from the materialisation of risks in some advanced countries and currency zones, as well as of the fiscal risks at home.

Chart V.0.4 Inflation outturn vs. August 2010 inflation projection
(y-o-y rates, in %)

In late 2010 and H1 2011 inflation moved above the upper bound of the projection band stated in the August 2010 Inflation Report.

Table A
Indicators of Serbia's external position

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011
EXTERNAL LIQUIDITY INDICATORS (in %)											
Forex reserves/imports of goods and services (in months)	4.1	4.7	3.9	6.1	9.0	7.2	5.2	9.4	8.1	7.7	7.5
Forex reserves/short-term debt	360.7	535.6	702.2	519.2	941.7	917.5	380.8	528.8	546.4	889.1	1,031.6
Forex reserves /GDP	13.6	16.4	16.3	24.2	38.7	33.8	25.0	36.7	34.5	33.7	32.8
Debt repayment/GDP	1.4	2.0	3.9	4.7	7.0	10.1	10.6	11.5	11.8	14.6	11.2
Debt repayment/exports of goods and services	7.0	9.0	16.4	17.7	23.5	33.2	34.0	39.1	34.0	40.4	30.9
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	58.7	55.9	49.8	60.1	60.9	60.2	64.6	77.9	82.1	77.0	74.8
Short-term debt/GDP	3.8	3.1	2.3	4.7	4.1	3.7	6.6	6.9	6.3	3.8	3.2
External debt/exports of goods and services	300.9	251.6	211.5	228.9	204.1	197.3	207.6	265.3	236.2	213.0	206.3
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
Forex reserves/M1	143.3	195.1	220.1	290.3	356.1	306.7	300.4	393.4	416.6	446.7	431.1
Forex reserves/reserve money	131.9	167.8	165.5	169.8	179.5	173.8	140.7	190.5	196.4	202.5	209.4
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP											
	59.3	63.9	73.7	73.6	81.2	85.8	86.8	73.6	86.4	91.8	86.9
MEMORANDUM: (in EUR million)											
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,984	7,032	8,032
External debt	9,402	9,678	9,466	12,196	14,182	17,139	21,088	22,487	23,786	22,672	22,734
External debt servicing	218	348	736	945	1,635	2,885	3,453	3,314	3,403	1,026	898
Central bank foreign exchange reserves	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	9,919	9,967
Short-term debt	606	529	442	948	958	1,050	2,143	2,005	1,830	1,116	966
Current account balance	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-764	-618
CREDIT RATING											
		Nov 2004	July 2005	Feb 2006	June 2007	March 2008	Dec 2009		March 2011		
		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: BB-/stable		Standard & Poor's and Fitch: BB-/stable	Standard & Poor's: BB-/stable; Fitch: BB-/stable	Standard & Poor's: BB-/stable; 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 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.

7. As of 01.01.2010 Statistical Office, according to UN recommendations, applies general trade system which is broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using special trade system.

8. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 443.5 mln) used in December 2009, as well as the capitalised interest to the Paris Club Creditors (EUR 86.4 mln). Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 875.4 mln, of which EUR 397 mln related to domestic banks and EUR 478.4 mln to domestic enterprises).

9. Data for April are based on GDP for Q1, and those for May on GDP estimated for Q2.

Table B
Key macroeconomic indicators

	2002	2003	2004	2005	2006	2007	2008	2009	2010	Q1 2011	Q2 2011
Real GDP growth (in %) ⁸⁾	4.3	2.5	9.3	5.4	3.6	5.4	3.8	-3.5	1.0	3.4	2.2
Consumer prices (in %, relative to the same month a year earlier) ²⁾	14.8	7.8	13.7	17.7	6.6	11.0	8.6	6.6	10.3	14.1	12.7
Core inflation (in %, relative to the same month a year earlier) ²⁾	4.4	6.1	11.0	14.5	5.9	7.9	10.8	3.6	8.6	13.2	13.6
NBS foreign exchange reserves (in EUR million)	2,186	2,836	3,104	4,921	9,020	9,634	8,162	10,602	10,002	9,919	9,967
Exports (in EUR million) ³⁾	3,125	3,847	4,475	5,330	6,949	8,686	10,157	8,478	10,070	2,583	2,882
- growth rate in % compared to a year earlier	16.0	23.1	16.3	19.1	30.4	25.0	16.9	-16.5	18.8	28.5	15.5
Imports (in EUR million) ³⁾⁷⁾	-6,387	-7,206	-9,543	-9,613	-11,971	-16,016	-18,843	-13,577	-14,838	-3,873	-4,096
- growth rate in % compared to a year earlier	27.2	12.8	32.4	0.7	24.5	33.8	17.7	-28.0	9.3	20.5	11.9
Current account balance ⁴⁾⁷⁾ (in EUR million)	-671	-1,347	-2,620	-1,778	-2,356	-5,053	-7,054	-2,084	-2,082	-764	-618
as % of GDP	-4.2	-7.8	-13.8	-8.8	-10.1	-17.7	-21.6	-7.2	-7.2	-10.9	-7.7
Unemployment according to the Survey (in %) ⁵⁾	13.3	14.6	18.5	20.8	20.9	18.1	13.6	16.1	19.2	/	22.2
Wages (average for the period, in EUR)	152.1	176.9	194.6	210.4	259.5	347.6	358.4	337.9	330.1	338.3	380.9
RS budget deficit/surplus (in % of GDP) ⁶⁾	-4.3	-2.6	-0.3	0.3	-1.9	-1.7	-1.7	-3.3	-3.6	-4.2	-5.1
Consolidated fiscal result (in % of GDP)	-1.8	-2.4	0.8	0.9	-1.9	-2.0	-2.5	-4.6	-4.6	-2.9	-5.4
RS public debt (external + internal, in % of GDP) ⁶⁾	71.9	63.7	50.9	50.6	40.1	31.8	26.9	34.1	41.9	43.1	43.7
RSD/USD exchange rate (average, in the period)	64.70	57.56	58.44	66.90	67.01	58.39	55.76	67.47	77.91	75.92	69.41
RSD/USD exchange rate (end of period)	58.98	54.64	57.94	72.22	59.98	53.73	62.90	66.73	79.28	73.22	70.64
RSD/EUR exchange rate (average, in the period)	60.66	65.13	72.70	83.00	84.10	79.96	81.44	93.95	103.04	103.95	99.80
RSD/EUR exchange rate (end of period)	61.52	68.31	78.89	85.50	79.00	79.24	88.60	95.89	105.50	103.60	102.46
<i>Memorandum</i>											
GDP (in EUR million)	16,028	17,306	19,026	20,306	23,305	28,468	32,668	28,883	28,984 ¹⁾	7,032 ¹⁾	8,032 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: MoF for public debt and NBS for estimated GDP.

⁷⁾ As of 1 January 2010, the Statistical Office, according to UN recommendations, applies the general trade system which is a broader concept and includes all goods entering/exiting the country's economic territory, apart from goods in transit. The Statistical Office published comparable data for 2007, 2008 and 2009. Previous years are disseminated under a special trade system.

⁸⁾ At constant prices of previous year.

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

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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

2010

Date	Key policy rate (p.a., in %)	Change (in basis points)
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
5 August	8.50	+50
19 August	8.50	0
7 September	9.00	+50
14 October	9.50	+50
11 November	10.50	+100
9 December	11.50	+100

2011

Date	Key policy rate (p.a., in %)	Change (in basis points)
17 January	12.00	+50
10 February	12.00	0
10 March	12.25	+25
7 April	12.50	+25
12 May	12.50	0
9 June	12.00	-50
7 July	11.75	-25
11 August		
8 September		
6 October		
10 November		
8 December		

* 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.

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 12 May 2011

After reviewing current economic developments and the May inflation projection, the NBS Executive Board voted to maintain the key policy rate at 12.5 percent.

Inflation will peak in April or May, and then start retreating towards the target. It is expected to return within the target band in the first half of 2012. Inflation will decline primarily in response to the easing of the cost-push pressure on food prices assuming average agricultural season, as well as in response to low aggregate demand.

The Executive Board judges that the key policy rate has reached or is very near a peak of its current cycle. Nonetheless, as the inflationary pressures continue, the authorities must be rather cautious in reducing the degree of monetary policy restrictiveness, taking into account all instruments of monetary regulation available.

In its meeting today, the Executive Board also adopted the May 2011 Inflation Report, which will be available in print form and officially presented to the public during a press conference on 18 May.

The next rate-setting meeting of the Executive Board is scheduled to take place on 9 June 2011.

Press release from Executive Board meeting held on 9 June 2011

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to lower the key policy rate by 50 basis points to 12 percent.

The Executive Board assesses that inflation has peaked and will decline over the coming period.

Inflation will fall primarily in response to the weakening of the cost-push pressure on food prices assuming average agricultural season, as well as in response to low aggregate demand and past monetary policy measures.

The Executive Board's best collective judgement is that the downward revision of the key policy rate is needed in order to stabilise inflation around the target in the medium term.

The next rate-setting meeting will take place on 7 July 2011.

Press release from Executive Board meeting held on 7 July 2011

After reviewing current economic developments at its meeting today, the NBS Executive Board voted to lower the key policy rate by 0.25 percentage points to 11.75 percent.

The Executive Board assesses that inflationary pressures stemming from food prices are continuing their sharp decline, which is opening up the possibility that once the new agricultural season sets in, food prices will have a negative impact on inflation. A full spillover effect of lower global wheat and corn prices is yet to be felt in the Serbian market and will further lessen the cost-push on food prices domestically.

The disinflationary impact of aggregate demand remains pronounced. Inflation expectations are gradually subsiding, trending over past months within the lower bound of the NBS projection as published in the May Inflation Report. Future dynamics of key policy rate cuts will depend on the actualisation of risks, notably in the fiscal domain.

Judging that disinflationary pressures will persist in the coming period, the Executive Board voted to lower the key policy rate in order to ensure that inflation returns to the target without major volatility in the first half of 2012.

The next rate-setting meeting will take place on 11 August 2011.

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