National Bank of Serbia

2014
August

INFLATION REPORT

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Introductory note

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

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

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

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

The August *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 7 August 2014.

Earlier issues of the *Inflation Report* are available on the National Bank of Serbia's website (http://www.nbs.rs).

Executive Board of the National Bank of Serbia:

Jorgovanka Tabaković, Governor

Ana Gligorijević, Vice Governor

Veselin Pješčić, Vice Governor

Diana Dragutinović, Vice Governor

Đorđe Jevtić, Director of the Administration for Supervision of Financial Institutions

ABBREVIATIONS

bln – billion
bp – basis point
CPI – Consumer Price Index
ECB – European Central Bank
EIB – European Investment Bank
EMBI – Emerging Markets Bond Index
FAO – UN Food and Agriculture Organization
FDI – **fo**reign 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
LHS – left hand scale
mln – million
NAVA – non-agricultural value added
NBS – National Bank of Serbia
NPLs – non-performing loans
OPEC – Organisation of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
QE – quantitative easing
q-o-q – quarter-on-quarter
RHS – right hand scale
s-a – seasonally-adjusted
SDR – Special Drawing Right
SORS – Statistical Office of the Republic of Serbia
WTO – World Trade Organisation
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

In the second quarter, year-on-year inflation moved below and core inflation around the lower bound of the target tolerance band.

Consistent with the expectations stated in the May *Report*, year-on-year inflation moved below the lower bound of the target tolerance band in the second quarter. In fact, it plunged to 1.3% in June, its lowest level in the past 50 years. The undershooting of the target can be put down to a sharper than anticipated fall in unprocessed food prices over the last year. Low core inflation (the inflation component most responsive to monetary policy measures), which has been moving within the target band since last October and measured 2.5% year-on-year in June, indicates that disinflationary pressures are likely to linger on for quite some time yet.

Subdued inflationary pressures reflect the absence of major cost-push pressures, low aggregate demand, lower inflation expectations and relative stability of the exchange rate.

Persistently low inflationary pressures over the past 18 months reflect the absence of major cost-push pressures, low aggregate demand, lower inflation expectations and relative stability of the exchange rate. Owing to low aggregate demand and a considerable drop in prices of primary agricultural commodities in both domestic and international markets in place since mid-May, the recent flooding has had no major effect on food prices thus far.

The economic recovery of the euro area appears to be sustainable, though there are still downside risks, stemming primarily from the current geopolitical tensions.

In the second quarter, the international environment was marked by the continuing positive trends in the real sector of the euro area, the still present geopolitical tensions over the crisis in Ukraine and the European Central Bank's decision to additionally increase the degree of its monetary accommodation.

Serbia's risk premium declined further during the second quarter.

The risk premia (measured by EMBI) of all countries in the region, Serbia included, declined further during the second quarter. In addition to global factors, the fall in Serbia's risk premium was aided by the announced fiscal consolidation measures. Despite the flooding, our risk premium was on a decline throughout May and the first half of June, when it fell to the level of 220 bp last recorded in early November 2007.

The dinar was under appreciation pressures for most of the second quarter.

In contrast to the previous quarter, the dinar was under appreciation pressures for most of the second quarter. In addition to the falling country risk premium, these pressures were supported by increased non-resident investment in government securities, and to a lesser degree, by the inflow of foreign direct investments and a relatively low current account deficit. In July, however, depreciation pressures emerged on the back of mounting geopolitical tensions, but also unfavourable news regarding the pace and scope of fiscal consolidation in the coming period.

The National Bank of Serbia was cautious in easing its monetary policy stance, mindful primarily of the risks from the international environment, the effects of flooding on economic and foreign trade activity, and the necessary implementation of additional fiscal consolidation measures.

The key policy rate was cut by 100 basis points in the course of the second quarter, to the level of 8.5% in June. Money market and lending rates mirrored its movement. Still, despite low inflationary pressures, the National Bank of Serbia was cautious in its monetary policy decision-making, mindful primarily of the geopolitical and economic risks stemming from the international environment, possibly higher-than-estimated negative effects of flooding on economic and foreign trade activity, and the necessary implementation of additional fiscal consolidation measures.

Agricultural and industrial activity declined because of the flooding.

Relatively favourable trends in economic activity and foreign trade continued into April. Industrial production was by around 2% higher than in the same period last year, while the external imbalance narrowed down further on the back of growing exports and falling imports. However, the positive trends recorded in the first four months of the year have been completely annulled by the large-scale floods that hit Serbia in May. The most severe damage was sustained by electricity production, mining and agriculture.

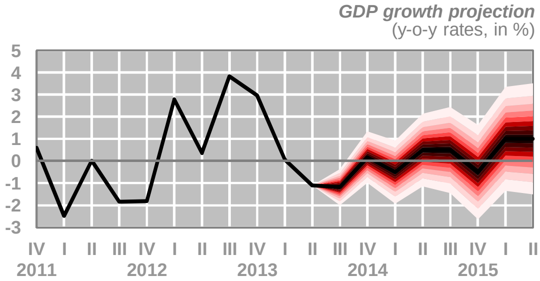
After five consecutive quarters of growth, GDP contracted in the second quarter by 1.1% year-on-year.

After negligible growth in the first quarter (0.1%), GDP fell in the second quarter by 1.1% year-on-year. On the production side, this fall was largely driven by the cutback in electricity production which could not be offset by the continuing positive trends in the oil and automobile industries. Unlike economic activity, the labour market shows an improvement relative to the first quarter. According to the Labour Force Survey, the unemployment rate decreased to 20.3%.

We expect that additional fiscal consolidation measures will be implemented in the second half of the year.

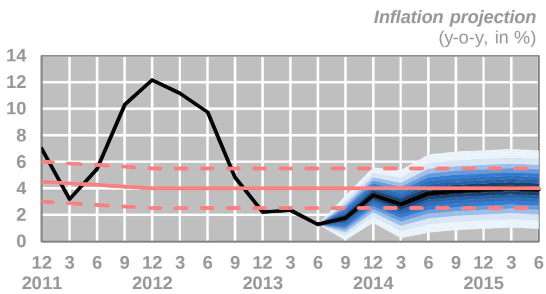
In the circumstances described, the efforts to reduce fiscal imbalance are of critical importance. The consolidated budget deficit reached 6% of GDP in the first six months of the year and will sustain additional cost pressures in the coming period related to flood damage restoration. The budget revision was delayed because of the flooding, but several laws were adopted in the meantime and their application is expected to improve the business environment and attract investment to Serbia. We are of the view that additional fiscal consolidation measures should be implemented without delay in order to ensure not only the sustainability of public finance, but also to increase the resilience of the domestic economy to potential external shocks.

GDP is projected to contract by 0.5% in 2014 and to stagnate in 2015.



The projection of GDP growth for 2014 and 2015 has been revised down from the previous Report due to the effects of flooding and the need for sharper fiscal consolidation measures than expected earlier. Thus, GDP is projected to fall by 0.5% in 2014 and to stagnate in 2015. Though the drop in final consumption on account of the anticipated cut in wages and pensions will also have a negative effect on economic activity in the short term, it is a prerequisite for long-term sustainable economic growth. In the period ahead, we expect the economy to receive positive impulses from the recently launched subsidised loan programme, flood damage restoration works and the expected recovery of our key foreign trade partners. Despite the negative effects of floods on the foreign trade balance, the external imbalance should continue narrowing down. Thus, the current account deficit is estimated to reach around 5.9% of GDP, under the new methodology (BPM6), compared to the 6.5% last year.[1]

Year-on-year inflation is expected to return within the target tolerance band in the fourth quarter and to stay therein until the end of the projection horizon.



Year-on-year inflation is expected to return within the target tolerance band in the fourth quarter and to stay therein throughout 2015. Inflation's return within the target band will be supported by the waning of the disinflationary pressures from food prices, while low aggregate demand remains the key disinflationary factor. The effect of low aggregate demand will be reinforced by the expected fiscal adjustment measures. The stabilisation of inflation expectations within the target tolerance band will also contribute to low and stable inflation, while the relative stability of the exchange rate will underpin low pressure on prices of import products.

The character of monetary policy in the period ahead will depend primarily on developments in the international environment and on the pace and scope of fiscal consolidation at home.

Looking ahead, monetary policy easing will depend primarily on the Executive Board's assessment of the potential inflationary effect of developments in the international environment, as well as on the pace and scope of fiscal consolidation at home.

[1] Under the previous methodology, the current account deficit in 2013 equalled 5.0% of GDP.

II. Monetary policy since the May *Report*

Following a cut to 8.5% in June, the key policy rate was kept on hold in July and August.

In lowering the key policy rate in June, in the wake of flooding that affected Serbia, the Executive Board was guided by the assessment that inflationary pressures would remain low owing primarily to monetary policy measures, weak aggregate demand and the still present disinflationary effect of primary agricultural commodity prices. At the same time, the Board stated that the flooding would exert a negative effect on economic activity, balance of payments and government costs. Mindful of the risks to the Serbian economy in the period ahead, the Executive Board decided in its July and August meetings to keep the key policy rate on hold.

According to the inflation projection published in the May Report and based on the policy rate path the central bank intends to follow over the coming period, after the ongoing undershooting, y-o-y inflation was to return within the target tolerance band in H2 2014 and stay there throughout 2015. It was estimated that in addition to monetary policy measures, such inflation movements would reflect primarily the combined disinflationary effect of low aggregate demand, amplified by additional fiscal consolidation measures and the gradual waning of disinflationary pressures from food prices. The projection of economic activity indicated weaker growth in 2014 than in 2013 due to the exhaustion of the effects of supply-side factors which had led the growth in the previous year (notably agricultural production, oil and automobile industries). A short-term drag on economic activity was also anticipated on account of fiscal consolidation. The risks to the projected inflation and economic growth path were associated primarily with the outcome of this year's agricultural season and developments in the international environment, and to a degree, with fiscal movements at home.

After the Board meeting **in May when the key policy rate was trimmed by 50 bp, to 9.0%**, y-o-y inflation continued to move around the lower bound of the target tolerance band. The risks from the international environment subsided, and the financial market responded positively to the announced fiscal consolidation measures. The risks in the international environment subsided partly in response to increased monetary policy accommodation on the part of the ECB. The Executive Board judged that the ECB's move should have a positive impact on liquidity in the international capital markets in the coming period.

The key policy rate was cut by another 50 bp, to 8.5%, in June, in the wake of flooding that affected Serbia. The Executive Board assessed that inflationary pressures would remain low despite the flooding. In addition to weak aggregate demand, low inflationary pressures would reflect chiefly the lowering and stabilisation of inflation expectations in both short- and medium-term and the relative stability of the exchange rate. It was estimated, however, that the recent flooding would take its toll on economic activity, especially in the sectors of energy, mining and agriculture.[2] The balance of payments trends would also be less favourable than anticipated earlier, while the share of the current account deficit in GDP would again this year be lower than in the year before.

[2] See text box 3, p. 37.

Mindful of the risks to the Serbian economy in the period ahead, **the Executive Board decided in its July and August meetings to keep the key policy rate at 8.5%**. The flood relief and damage restoration efforts are assessed to exert a one-off upward effect on government expenditure. Nonetheless, the Executive Board voiced expectation that the Government will remain committed to the implementation of fiscal consolidation measures and structural reforms. The impetus to economic activity is expected to come from subsidised lending and the flood damage restoration works. The decision to keep the rate unchanged was also underpinned by the Board's awareness of the still present risks from the international environment which could reflect negatively on the country risk premium and international capital flows. Further tightening of geopolitical tensions could slow down the nascent recovery of the euro area economy. The Executive Board expects that consistent implementation of fiscal consolidation measures and structural reforms will help alleviate external risks.

III. Inflation developments

In the course of Q2, headline y-o-y inflation moved below and core inflation around the lower bound of the target tolerance band. Low inflation reflects low food production costs, dented aggregate demand and relative stability of the exchange rate and inflation expectations.

The financial and corporate sectors expect to see inflation within the target band both in the short- and medium-term.

In Q3, y-o-y inflation is likely to continue to move below the lower bound of the target tolerance band. Its growth will be driven mainly by the low base, while a reverse impact is expected from a seasonal drop in unprocessed food prices and low demand slowing a rise in other prices.

Inflation developments in Q2

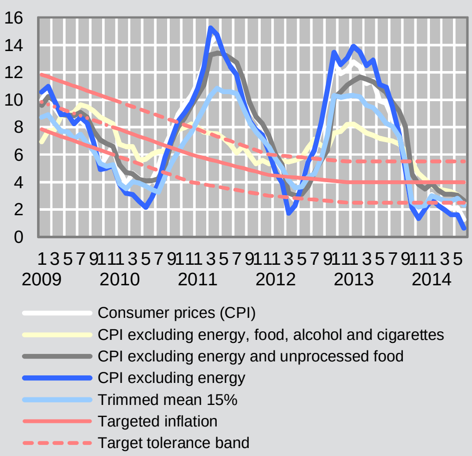
Consistent with expectations presented in the previous Inflation Report, **y-o-y inflation** moved below the lower bound of the target tolerance band in Q2. Still, price growth was lower than expected in Q2, mainly because of a small increase in unprocessed food prices. Low inflationary pressures were the consequence of low cost-push pressures in food production, dented aggregate demand and relative stability of the exchange rate and inflation expectations. In June, y-o-y inflation hit its 50-year low of 1.3%.

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

	2013			2014	
	II	III	IV	I	II
Consumer prices (CPI)	18	-0.5	-0.2	12	0.8
Unprocessed food	10.9	-13.4	-4.3	3.9	4.9
Processed food	-0.4	-0.3	-0.7	0.6	-0.5
Industrial products excluding food and energy	0.9	2.0	10	16	-0.1
Energy	-0.9	5.1	-0.4	0.9	-0.4
Services	18	0.7	12	0.0	16
Core inflation indicators					
CPI excluding energy	2.3	-14	-0.2	13	0.9
CPI excluding energy and unprocessed food	0.7	10	0.5	0.8	0.3
CPI excluding energy, food, alcohol and cigarettes	17	0.7	10	-0.1	0.8
Administered prices	0.7	5.6	0.9	18	0.2

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

In the course of Q2, headline inflation moved below and core inflation around the lower bound of the target tolerance band.

In quarterly terms, **consumer prices** firmed 0.8% in Q2, as a result of an expected seasonal increase in prices of unprocessed food and travel arrangements.

Unprocessed food prices gained 4.9% in Q2. Fruit and fresh meat prices added 0.4 pp and 0.3 pp to headline inflation respectively. At the same time, vegetable prices posted no seasonal hike. Supported by low production costs, **processed food prices** lapsed back in Q2. Apart from milk and dairy products, prices of all product categories declined.

Industrial product prices excluding food and energy did not increase in Q2, indicating muted aggregate demand. No price category from this group gave any significant, either positive or negative contribution to headline inflation.

Neither did **energy prices** record any major changes. They slipped 0.4%, on the back of a 1% drop in petroleum product prices and a decline in solid fuel prices.

Services prices expanded 1.6%. The strongest boost to headline inflation came from travel arrangements where prices rallied over 30% with the onset of the summer season. A comparatively smaller influence was provided by price adjustments of utility-housing (particularly in Belgrade) and handicraft services.

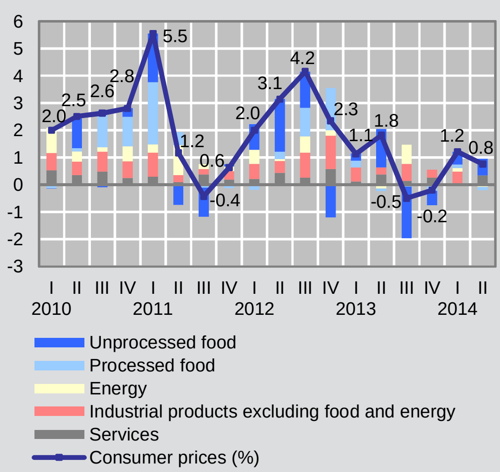
Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) equalled as much as headline inflation in Q2, though it displayed different monthly dynamics. The sharpest rise was observed in June (0.4%), mirroring the seasonal hike in travel arrangement prices. In y-o-y terms, core inflation was on a continuous downward slope since early 2014, arriving at the lower bound of the target tolerance band in June.

Table III.0.2 **Price growth indicators**
(y-o-y rates, in %)

	IX 2013 / IX 2012	XII 2013 / XII 2012	III 2014 / III 2013	VI 2014 / VI 2013
Consumer prices	4.9	2.2	2.3	1.3
Domestic industrial producer prices	1.6	0.8	0.2	1.0
Agricultural producer prices	-26.1	-11.6	-6.1	-3.3*
Prices of elements and materials incorporated in construction	2.5	2.1	3.5	3.9

Sources: SORS and NBS calculation.
* May on May.

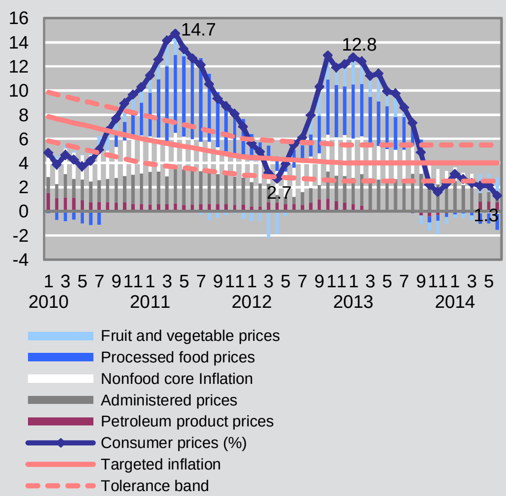
Chart III.0.2 **Contribution to quarterly consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

The largest contribution to inflation in Q2 came from the seasonal rise in prices of unprocessed food and travel arrangements.

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



Sources: SORS and NBS calculation.

In y-o-y terms, food prices continued to have a disinflationary impact.

Administered prices picked up 0.2% in Q2 or 3.2% since early-year. Prices of medicaments and utilities-housing services went up, mainly because of adjustments to the higher VAT rate and an increase in excise taxes. However, H2 is likely to see a more substantial rise in this price group, mainly because of the expected upswing in energy prices. Y-o-y growth in administered prices slowed down from one month to another, coming at 10% in June.

For the time being, the May floods have not largely affected prices. This was due to low demand and the fact that the global market saw a sharp drop in prices of primary agricultural commodities in mid-May, which is why cost-push pressures in food production will remain low through the remainder of the year. Customs-free imports of most agricultural products from the EU, in effect from this year, will also diminish pressures on food price growth against the background of receding supply in the domestic market.

Projection for Q3

In Q3, y-o-y inflation is likely to stagnate and continue to move below the lower bound of the target tolerance band. The fact that lower last year's fruit and vegetable prices will drop out from calculation will generate an inflationary effect. A reverse impact is expected from low food production costs and dampened demand slowing a rise in other prices. No electricity price hike has been anticipated for Q3.

Prices are expected to decline in the category of **food and non-alcoholic beverages**. The decline will be more pronounced for **unprocessed food** because of seasonally lower fruit and vegetable prices. Low costs in **processed food** production and falling prices of primary agricultural commodities will generate disinflationary pressures, as indicated by current prices of agricultural commodity futures in the global market.

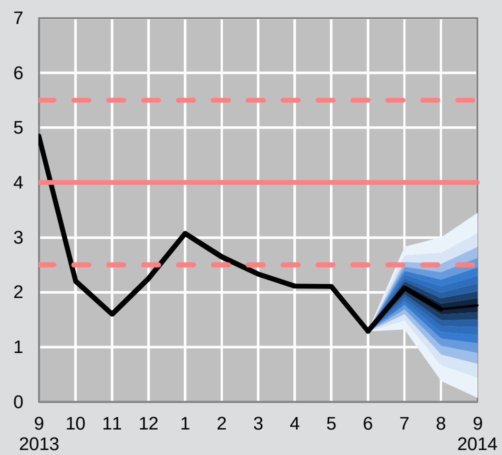
Industrial product prices excluding food and energy will probably outstrip the Q2 levels, mainly due to the cigarette price growth, fuelled by higher minimum excise taxes. However, given the plummeting trading volumes in the tobacco market, it is estimated that the excise tax increase will not fully feed into cigarette prices.

A rise in **energy prices** is expected in Q3, mainly in response to rising petroleum product prices. However, if energy prices are adjusted in September, price growth within this group will be much higher and y-o-y inflation will most probably revert within the target band.

A rise in **services prices** is expected to be lower compared to Q2. An impetus is likely to come from higher prices of travel arrangements in July and August, and the 45% increase in motor third party liability insurance, which has already come into effect.

The major risks to the projection concern whether and to what extent electricity and solid fuel prices will be adjusted. Risks also relate to primary commodity prices that will depend on the performance of this year's agricultural season both at home and abroad, but also on further developments in connection with the current geopolitical tensions.

Chart III.0.4 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

In Q3, y-o-y inflation will most probably remain below the lower bound of the target.

Producer and import prices

Industrial producer prices for the domestic market gained 0.5% in Q2 or 1.0% y-o-y in June. The highest growth in producer prices was registered in the production of food, coke, petroleum products and mining. In contrast, the only substantial drop was observed for the production of paper and paper products.

Up by 5.7%[3] in Q2, the decline in **agricultural producer prices**[4] slowed down to 3.3% y-o-y in May. Prices of farming products edged up, more so in the case of industrial plants than cereals. Still, prices of both categories remained below the y-o-y levels. Producer prices in fruit and vegetable growing fields also went up. The only exception are potato prices that drifted down in Q2. As regards cattle breeding, a rise was recorded for live pigs, which reflected on a surge in retail fresh meat prices. Prices in the production of milk and eggs were lower relative to the previous quarter.

A 1.3% rise in **prices of elements and materials incorporated in construction** in Q2 buoyed up their y-o-y growth as well (3.9% in June).

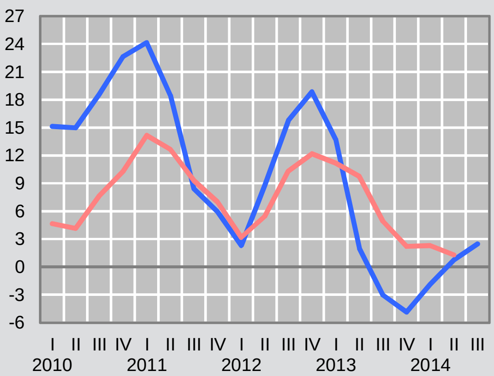
Import prices expressed in dinars[5] upped 0.2%[6] in Q2 as a result of rising global oil prices. Acting in the opposite direction were world food prices – they headed down owing to favourable forecasts of this year's harvest. Import prices of intermediate and consumer goods remained largely at Q1 levels. Exchange rate stability produced a stabilising effect on import prices. In y-o-y terms, import prices accelerated somewhat, reaching 2.5% in June.

Inflation expectations

According to surveys on inflation expectations, the financial and corporate sectors expect to see inflation within the target band both in the short- and medium-term. One-year ahead inflation expectations of these two sectors were lower compared to the first several months of this year, standing significantly below the levels posted last year. The reduction was prompted by falling current inflation and very low expected inflationary pressures. One-year ahead inflation expectations stand high only in the household sector. However, they have never been higher than inflation believed by households to have been achieved in the previous year, which is invariably much higher than actual inflation.

As indicated by the **Bloomberg** survey, **one-year ahead** inflation expectations of the financial sector stabilised at 4.5% from April to August. According to the **Ipsos** survey, they were even lower – following the target midpoint reported in March and onwards (4.0%), they slid to 3.75% in June, where they remained in July. Corporate expectations also matched the midpoint from March up to July when they ticked up to 5.0%. Household expectations stood high at 10.0% from April.

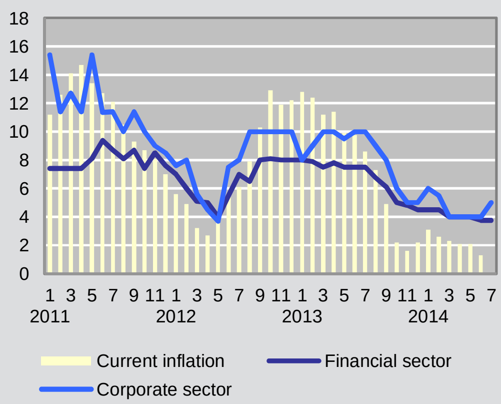
Chart III.0.5 **Domestic and imported inflation**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

Q2 saw further y-o-y growth in import prices, but they remained at the level not generating significant inflationary pressures.

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



Sources: Gallup, Ipsos and NBS.

* Ipsos from November 2011 and Gallup in the earlier period.

Consistent with stabilisation of inflation, inflation expectations of the financial and corporate sectors stabilised within the target band.

[3] April and May.

[4] Producer prices in agricultural and fishing sectors.

[5] As an indicator of import prices, we used the weighted average indices of global oil and food prices and export prices of Germany as our most important foreign trade partner.

[6] The ratio of averages for two consecutive quarters.

However, although household expectations invariably outstrip those of financial and corporate sectors, these two sectors being better informed of macroeconomic developments, a change in the methodology of the household survey should also be borne in mind. Households are no longer presented with data on current inflation, but are required to specify the inflation rate that they believe to have been achieved over the previous year (perceived inflation). As such inflation rate, much higher than actual, is above or equal to the rate expected by households for the next year, movements in household inflation expectations can also be assessed positively. Furthermore, the qualitatively expressed inflation expectations of households point to a rising number of respondents who expect that prices over the next year will remain the same or rise moderately compared to those expecting considerably higher prices.

Medium-term inflation expectations – for two years ahead, have been within the target tolerance band since March when this question was introduced, and stayed unchanged up to June, both in financial and corporate sectors. The financial sector pared back its expectations in June, from 4.5% to 4.0%, where they stayed in July, while corporates lifted them up from 4.0% to 5.0%, up to 6.0% in July. In March and April, households expected two-year ahead inflation to reach 8.0%, or 10.0% as of May.

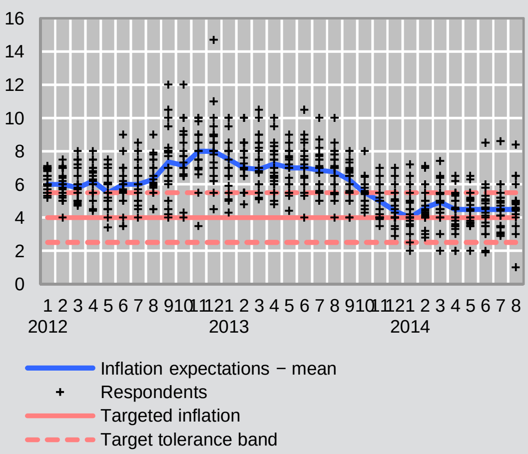
Following low levels recorded since early 2014, the dispersion of responses widened across sectors in Q2. Greater disagreement is probably due to uncertainties about the flood effects on inflation. Dispersion is particularly high in the household sector because of the change in the methodology of the survey.

Table III.0.3 **Households' inflation expectations and perception**
(y-o-y rates, in %)

		Perceived inflation in previous year	One-year ahead expected inflation	Two-year ahead expected inflation
2014	March	10.0	8.0	8.0
	April	10.0	10.0	8.0
	May	10.0	10.0	10.0
	June	15.0	10.0	10.0
	July	10.0	10.0	10.0

Source: Ipsos.

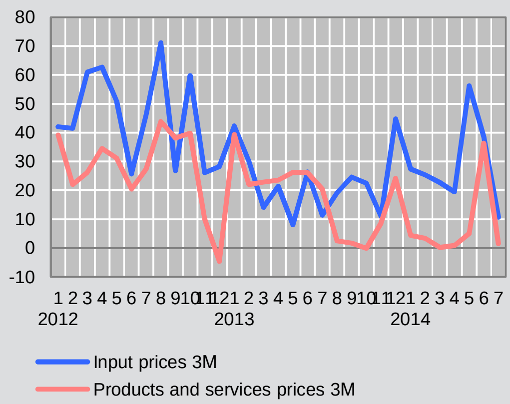
Chart III.0.7 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

With somewhat greater dispersion over the last three months, financial sector expectations have been within the target band since October.

Chart III.0.8 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos and NBS.

The net percentage of enterprises expecting a rise in their input prices over the next three months and the net percentage of enterprises expecting a rise in their product prices declined significantly in July.

The net percentage[7] of enterprises expecting a rise in their input prices over the next three months and the net percentage of enterprises expecting a rise in their product and services prices increased in May and June most probably over the uncertainties surrounding the estimate of flood effects on inflation and announcements of electricity price hikes. In July, these two percentages precipitated down (10.7% and mere 1.5% respectively).

[7] The difference between the percentage of enterprises expecting an increase and those expecting a reduction in the prices of their inputs, products and services. To increase representation, data are weighted by operating revenue.

IV. Inflation determinants

1. Financial market trends

Cuts in the key policy rate drove down money market rates, which, together with cheaper sources of bank funding, resulted in lower prices of dinar corporate and household loans. In addition, a contracted risk premium and elevated non-resident investment in government securities brought about a reduction in rates in this market and moderate appreciation pressures which marked the major part of Q2. However, depreciation pressures emerged in July, on the back of rising uncertainties in the international environment and amid unfavourable news as to the intensity and pace of fiscal consolidation in the coming period.

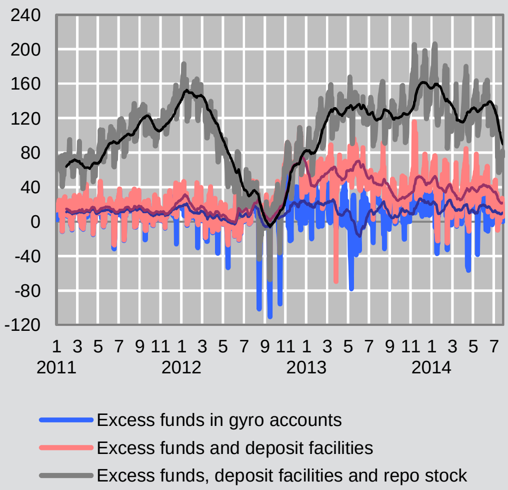
Interest rates

In the course of Q2, the average repo rate[8] fell slightly more than the key policy rate, arriving at 6.4% by end-June.

Average daily trading volumes in the interbank overnight money market went up by RSD 0.6 bln to RSD 2.2 bln relative to Q1. However, trading volumes declined from one month to another as bank excess liquidity gradually increased. BEONIA mirrored the key policy rate in Q2 and touched 6.3% on average in June, down by 0.9 pp from March.

BELIBOR rates moved along the similar path, recording a fall between 0.8 pp and 1.0 pp in Q2. In June, they

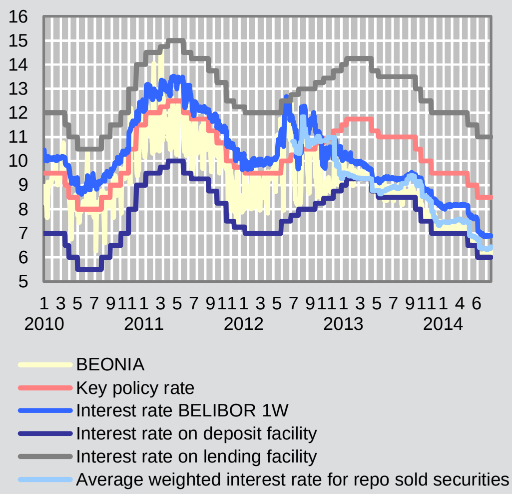
Chart IV.1.1 **Dinar liquidity**
(daily stock and moving averages, in RSD bln)



Source: NBS.

Banking sector liquidity increased slightly in Q2...

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



Sources: Thomson Reuters and NBS.

...and as a result the average repo rate declined somewhat more than the key policy rate.

[8] Rate achieved at repo auctions, weighted by the amount of sold securities.

experienced their historical low of 7.0% for the shortest to 8.3% for the longest maturity on average.

Trading volumes in the overnight interbank market rebounded in July, while rates continued down.

As the key policy rate was lowered and non-resident investment stepped up, rates in the primary market of dinar government securities decreased in Q2. At the same time, rates on the shortest-maturity securities stayed broadly unchanged as the rate on three-month securities went up and the rate on six-month securities lost 0.1 pp. The decline in interest rates was steeper for longer-maturity securities, moving between 0.5 pp for three-year and 1.2 pp for seven-year maturities. The drop was prompted also by heightened non-resident investment in May and June against the background of a reduced risk premium, as well as by the ECB's decision to increase monetary policy expansiveness. As a result, rates trended in June from 7.7% for six-month to 11.8% for seven-year maturity, while the weighted average rate was 9.7%, down by 0.7 pp relative to March. Moreover, high auction performance in Q2 spurred a rise in the stock of debt in respect of sold dinar securities, although substantial amounts of securities fell due in the period observed.

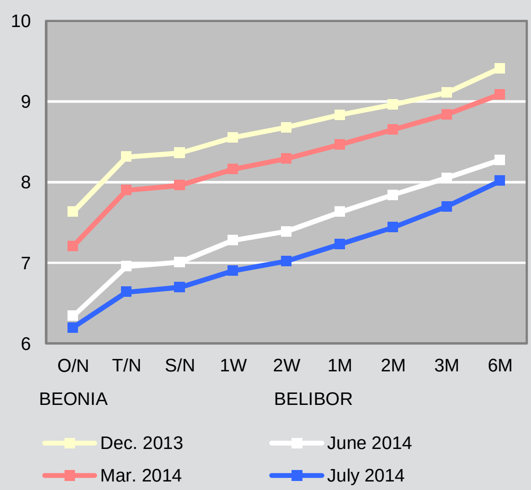
Most rates on government euro securities recorded a moderate decline in Q2, with five-year securities experiencing the sharpest fall (0.2 pp). In June, rates ranged between 3.2% for one-year to 5.5% for ten-year maturity. Besides, ten-year securities were issued in the domestic market for the first time in Q2.

Trading volumes in the secondary market of government securities rose to RSD 81.1 bln in Q2, which is more than double the amount recorded in Q1. This was also due to increased foreign investor participation. One- and two-year securities were most frequently traded. Excluding trading up to two business days from the primary settlement date, trading volumes equalled RSD 58.6 bln. Rates of return declined as well, though less than in the primary market trading. In late Q2, the rates of return moved between 8.2% for the remaining 12-month to 11.5% for 81-month maturity.[9]

Rates achieved at auctions of government securities in July remained unchanged from June.

Interest rates on dinar loans continued down in Q2. In June, the weighted average rate on new dinar loans was

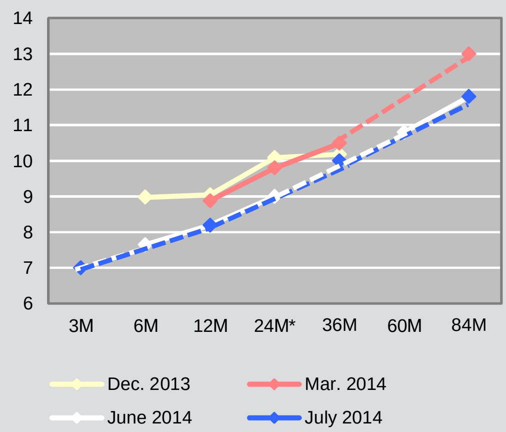
Chart IV.1.3 **Yield curve in the interbank money market**
(average values, p.a., in %)



Sources: Thomson Reuters and NBS.

Money market rates were on a decline throughout Q2, reaching their historical low levels.

Chart IV.1.4 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities whose interest rate is linked to the NBS key policy rate.

Following a decline in Q2, the dinar yield curve stayed unchanged in July.

[9] Excluding the rate on seven-year securities (11.8%), which was equal to the rate in primary trading in these securities.

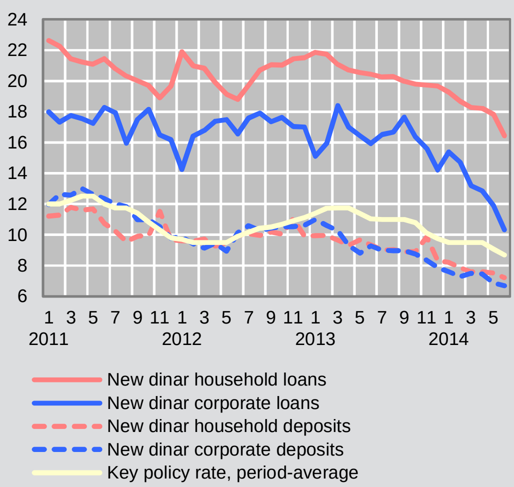
12.2%, down by 4.4 pp relative to March. The decline was steeper for corporate loans as the average price was down by 2.9 pp to 10.3%. Falling from one month to another, rates on corporate loans witnessed the largest fall in June (1.6 pp), when banks began to extend subsidised loans at the rate capped to 5.45% and with the government subsidy of 5%. Households also borrowed in dinars at lower rates that fell by 1.8 pp on average in Q2 to 16.4% in June. In the course of June, the structure of new dinar loans changed in favour of corporate loans (70%), which were cheaper than household loans. As a result, a drop in the average rate exceeded that in either corporate or household loans.

Rates on all types of dinar corporate loans declined, primarily on account of falling rates on current assets and other loans (10.3% in June each), as well as because of the lower price of the least used, dinar investment loans. Banks continued to lower the price of dinar household loans, though less than in Q1. Rates on cash and refinancing loans shed 1.8 pp relative to March, equalling 16.4% in June. Rates on much less prevalent consumer loans declined by 3.3 pp to 17.9%. Since February, when the NBS began to publish data on current account overdrafts by bank, within the initiative to reduce prices of banking products, the average rate on overdrafts has been on a decline, losing additional 0.9 pp in Q2.

Interest rates on new euro loans and dinar euro-indexed loans lost 1.0 pp relative to end-Q1 and reached 5.6% in June. The decline was more pronounced for household loans with the average rate standing at 7.0% in June, while rates on corporate loans edged down to 5.4%. Similarly to dinar loans, rates on euro-indexed current assets and other loans declined to 5.1% and 6.0% respectively. In regard to household loans, FX housing and consumer loans dropped by 0.2 pp and 0.4 pp respectively, while the price of other loans stayed flat. In late June, rates on housing loans equalled 4.7%, on consumer loans – 5.7%, and other loans – 10.8%. The drop in the weighted average rate on euro-indexed household loans (1.2 pp) surpassed that on individual loan types due to a changed structure of new loans in favour of a higher share of housing loans that are cheaper than other loans.

Lending interest rates declined partly due to a reduction in deposit rates, as also confirmed by the NBS July bank lending survey which indicates lower costs of banks' funding sources. In Q2, weighted average rates

Chart IV.1.5 **Interest rates on new dinar loans and new corporate and household deposits***
(weighted average values, p.a., in %)

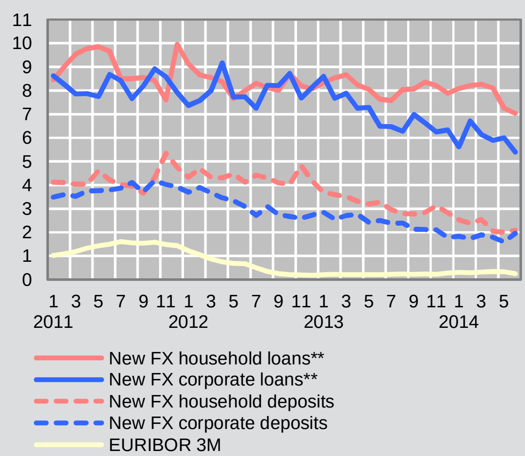


Source: NBS.

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

Dinar lending and deposit rates declined further in Q2...

Chart IV.1.6 **Lending rates on FX loans and corporate and household deposits***
(weighted average values, p.a., in %)



Sources: NBS and European Banking Federation.

* Excluding revolving loans, current account overdrafts and credit card debt.
** Euro and euro-indexed.

....while a somewhat smaller drop was recorded for FX rates.

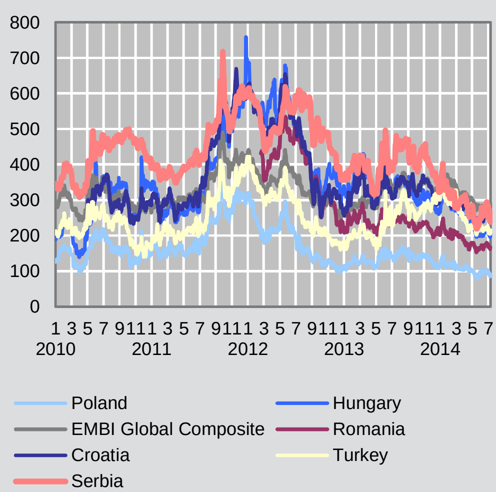
on new deposits touched their new record low since September 2010 when the current interest rate statistics came into effect.

The weighted average rate on new dinar corporate deposits posted the heftiest decline (by 0.8 pp to 6.7% in June), while the rate on household deposits dipped by 0.4 pp to 7.2%. Rates on euro household deposits lost 0.5 pp and came at 2.1%. A paltry rise was noted only for corporate deposits (by 0.1 pp to 2.0%).

Risk premium

Measured by EMBI, risk premia of all countries in the region contracted further in Q2. The largest drop was observed in May because the return on eurobonds of these countries declined more than on US government bonds. A mild decline in risk premia continued into early June when the lowest EMBI was recorded for Q2, under the impact of news about further monetary policy easing by the ECB. The fall in EMBI was stopped thereafter. Until end-Q2, risk premia of the majority of countries recorded a small rise.

Chart IV.1.7 **Risk premium indicator – EMBI by country**
(daily data, in bp)



Source: JP Morgan.

Risk premia of all countries observed declined further in Q2.

By the period-end, the greatest drop in Q2 was observed for risk premia of Hungary (63 bp) and Turkey (47 bp), while in terms of the period average, the decline was the most pronounced for Turkey (75 bp) and Serbia (59 bp).

EMBI for Serbia was 268 bp at end-June, down by 14 bp compared to end-Q1. In addition to global factors, Serbia's risk premium declined in response to announced fiscal consolidation measures. Conversely, the floods that hit Serbia in mid-May did not reflect on EMBI which was on a decline almost until mid-June. The value of 220 bp was recorded in June, similarly to the level recorded last time in early November 2007.

According to the credit default swap (CDS)[10], Serbia's risk premium fell by 93 bp in Q2 to 270 bp in late June.

In early July, Fitch affirmed Serbia's credit rating at B+. Despite the estimate that the May floods will provoke delays, they will not jeopardise the implementation of the announced reforms and the expected adoption of a set of structural laws which lay the grounds for fiscal consolidation. Expectations have also been put forward that Serbia's negotiations with the IMF about a precautionary arrangement will continue until end-2014, that GDP growth will be close to zero in 2014, and that the economy will bounce back next year. The fiscal position remains the key challenge. The deficit is likely to widen further under the impact of costs of restructuring of state-owned enterprises, recapitalisation of state-owned banks and the May floods. Still, Fitch expects a decline in the deficit already next year.

By end-July, Serbia's risk premium, measured by EMBI, stayed unchanged compared to June.

Foreign capital inflow

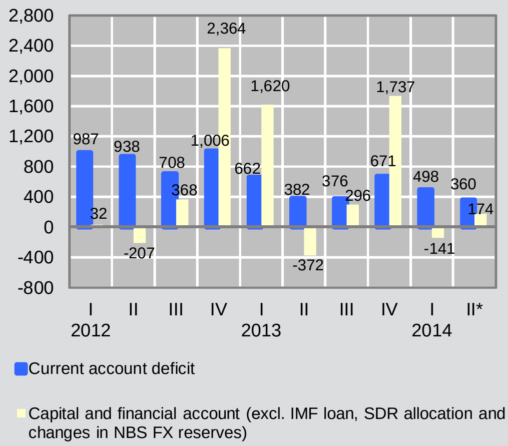
Developments on the financial account were slightly more favourable in Q2 than in Q1. Inflow was registered on account of non-residents' investment in government securities and FDI. At the same time, all sectors reduced their foreign liabilities under financial loans.

Net FDI inflow came at EUR 249.8 mln in Q2, slightly less than a quarter earlier.[11] In the year to date, net FDI inflow measures EUR 550.8 mln. We expect that the

[10] On five-year government bonds in US dollars.

[11] The NBS now compiles its balance of payments data in accordance with the IMF's BPM6. For more information, see text box 1, p. 18.

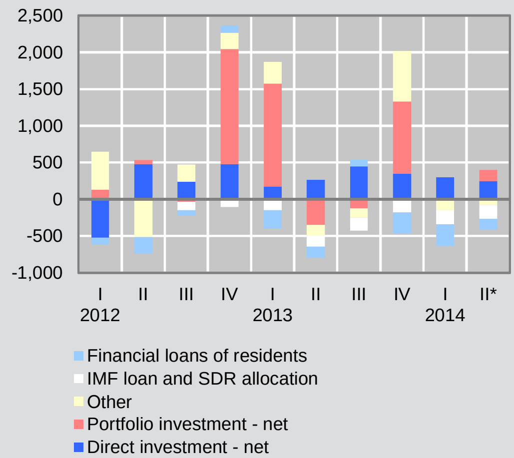
Chart IV.1.8 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

A modest capital inflow and relatively low current account deficit gave a strong contribution to stable movements in the exchange rate.

Chart IV.1.9 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Unlike Q1 when net capital outflow was recorded, the financial account was neutral in Q2.

negotiations on Serbia's EU accession, accelerated implementation of structural reforms and fiscal consolidation, continuing negotiations and an arrangement with the IMF, as well as the recovery of the euro area economy, will bolster the implementation of previously agreed FDIs, bringing them to a total of EUR 1.25 bln this year which corresponds to the EUR 1.0 bln projected under the previous balance of payments methodology.

Amid globally lower risk aversion and anticipated further monetary policy easing by the ECB, foreign investors stepped up their investment in government securities in the course of May and June. As a result, net inflow of portfolio investments was recorded in Q2 (EUR 149.3 mln), in contrast to Q1 when these investments accounted for a net outflow.

Residents repaid their foreign debt to a lesser degree in Q2 than in the quarter before, leading to a net outflow of EUR 143.2 mln. At the same time, banks reduced their foreign liabilities by additional EUR 93.0 mln, chiefly in respect of long-term loans. The government also net repaid its debt by EUR 31.0 mln in Q2. Of this amount, EUR 152.3 mln were foreign debt servicing costs and EUR 121.3 mln loan withdrawals, including withdrawals of EIB loans for the City of Belgrade and municipal and regional infrastructure. Cross-border corporate borrowing also decreased – EUR 19.2 mln net.

Corporates increased their net foreign liabilities under trade credits by EUR 47.7 mln.

The NBS paid out a total of EUR 186.4 mln in Q2 to service its liabilities to the IMF.

Text box 1: Application of new BPM6 methodology and improved coverage of balance of payments transactions

Serbia's balance of payments is developed in accordance with the international standards defined by the IMF in the Balance of Payments Manual (BPM). As the globalisation of the world economy brought about significant changes in the flows of goods, services and capital, the IMF's BPM5 of 1993 was replaced in 2009 by BPM6[1]. The revision of the balance of payments methodology was made in parallel with the revision of the UN System of National Accounts (SNA 2008) to ensure their consistency. One of the revision objectives was to introduce into the balance of payments the concept of economic ownership, used in national accounts and GDP calculation. BPM5 allowed deviations from the change in ownership principle (e.g. in case of goods for processing and migrants' transfers), while such exceptions have now been eliminated. The balance of payments now reflects the transfer of ownership between residents and non-residents, which need not necessarily overlap with cross-border flows of goods, services and capital.

European Commission regulations require EU member states to start applying the new methodology as of mid-2014, and the same is expected from candidate countries.[2] In July 2014, the NBS published the first data on balance of payments based on BPM6 – for 2012, 2013 and the first five months of 2014.[3] At the same time, individual balance of payments items were revised as the coverage of transactions improved. We shall analyse the most important changes envisaged by BPM6 relative to BPM5, and changes which occurred with the improved coverage of transactions, as well as analyse their quantitative effect. The total quantitative effect of these changes on the main balance of payments accounts in 2012 and 2013 is presented in Table O.1.1. The difference in individual balance of payments items compared to earlier published data is due primarily to the better coverage of transactions, and to a lesser extent to the requirements set by BPM6 compared to BPM5.

Key changes in the current account

The main changes envisaged by BPM6 in the current account relate to balances of goods and services, i.e. changes in the treatment of some transactions, because of strict implementation of the change in ownership concept. Only transactions where the ownership of goods changed are now recorded in the balance of goods. Thus the treatment of **goods for processing** has been changed – this is no longer a commodity but a service transaction as the owner of goods does not change. The fee paid/collected for the processing of goods is no longer included in the value of goods but is transferred to services, which diminishes exports/imports of goods and increases exports/imports of services, with a neutral effect on total trade and thus on the current account. As in other countries, in Serbia's balance of payments the identification of goods for processing, in accordance with international standards, requires much more information (the value of domestic/foreign component included during processing in the product owned by resident/non-resident, the value of goods sold after processing in the country of processing or a third country, and the value of processing service collected/paid by goods or another service). In previously published data in Serbia's balance of payments, processing services collected/paid in money were already recorded in services, while cross-border flows of goods for processing were recorded in the balance of goods – according to external trade statistics. Now, the value of goods for processing is excluded from exports and imports of goods, which, with the widened coverage of external trade, increased the current account deficit. The NBS will try to use the existing administrative and other sources to ensure necessary data for more complete harmonisation with methodological requirements. Similarly to goods for processing, **repair on goods** is recorded in the balance of services. In Serbia's balance of payments, repair on goods was already recorded under services. In contrast, according to BPM6, **merchanting** (as a special type of trading in goods which physically does not appear in the compiling economy) is recorded in the balance of goods, as it was the case in Serbia's balance of payments so far.

[1] The sixth edition of the Balance of Payments and International Investment Position Manual (BPM6).

[2] The first data on balance of payments based on the new methodology for the first four months of 2014 had to be submitted to the Eurostat and ECB by 24 June 2014. The NBS submitted data within the stipulated deadline.

[3] The data series for the period before 2012 and the Methodology of the Republic of Serbia's Balance of Payments shall be published by end-2014.

For the purpose of further harmonisation of balance of payments and national accounts, BPM6 envisages that the balance of payments shall separately show **financial intermediation services indirectly measured (FISIM)**. The previous methodology recorded these services in the income account, while they are recorded under services in the new methodology. As this implies reclassification, the impact of this change on the current account balance is neutral. In accordance with BPM6 requirements, Serbia's balance payments shows FISIM separately.

To ensure consistency with national accounts, instead of income and current transfers, the new methodology introduced primary and secondary income. **Primary income** corresponds to the income account in BPM5, whereas it now includes components that were previously recorded in current transfers (taxes on production and imports, rent, subsidies). In primary income BPM6 envisages the separation of income from investments, in accordance with the breakdown of investments in the financial account (direct, portfolio and other investments, and FX reserves). In addition, income should also encompass income in respect of long-term construction works, which are now considered FDIs and not services. Another novelty is the requirement to identify reinvested earnings of investment funds. In Serbia's balance of payments the income account did not contain data on reinvested earnings. Now, owing to better coverage of these transactions, FDI income, in addition to dividends and interest, contains **reinvested earnings**. As in Serbia's case expenditure on the income account in respect of reinvested earnings is much higher than income (inflow on the FDI balance also exceeded the outflow), its inclusion raised the current account deficit (including the net inflow on the FDI balance by the same amounts). **Secondary income**, according to the new methodology, represents current transfers from BPM5. Personal transfers cover all transfers in money and goods between resident and non-resident households (e.g. workers' remittances).

Key changes in the financial account

The key change to the financial account envisaged by BPM6 is presenting FDI by the **asset/liability principle** rather than by the directional principle. This means that FDIs are shown as assets and liabilities and not as investments abroad and in the reporting country. BPM6 differentiates between direct investor in direct investment enterprises, reverse investment (direct investment enterprises in direct investor) and **claims on fellow enterprises abroad**. The last category is a novelty introduced by BPM6 and represents financing between a resident and a non-resident entity which are under the control or influence of the same direct investor, but which do not have control or influence over one another. For this reason, credits between fellow enterprises have been reclassified from other investments to FDI. The exceptions to this rule are interbank lending, interbank derivatives and clearing accounts of financial institutions and their related enterprises. When it comes to Serbian FDI, the effects of these changes are negligible since reverse investments and investments between other fellow enterprises are modest and interbank lending is recorded under other investments. The main effects of the change actually relate to the above mentioned inclusion of **reinvested earnings** and the reclassification of **intercompany lending** from other investments, which increased net FDI and lowered net other investments by the same amount. BPM6 also envisages construction projects longer than a year to be recorded as FDI and those taking less time to remain under services. This caused no changes to Serbia's balance of payments because construction services are provided exclusively through branches and are therefore registered on the FDI account.

As in the case of FDI, under BPM6, **portfolio investments** comprise reinvested earnings of investment funds. The still modest financial derivatives are singled out from portfolio investments and shown as a separate item of the financial account.

The major change introduced by BPM6 to **other investments** concerns the treatment of financing between fellow enterprises. As noted above, this type of financing should now be recorded under FDI, except in the case of financial institutions. In Serbia's balance of payments, intercompany lending has been transferred from other investments to FDI, while interbank lending has stayed within other investments.

Table O.1.1 **Comparison of earlier published data on balance of payments with data following the application of BPM6 and improvement of the transactions coverage**
(preliminary data in EUR mln)

	Earlier published data		Data following application of BPM6 and improvement of coverage	
	2012	2013	2012	2013
I. CURRENT ACCOUNT	**-3,176.5**	**-1,585.5**	**-3,639.4**	**-2,092.0**
1. Goods	**-5,479.9**	**-3,978.8**	**-5,633.8**	**-4,152.4**
2. Services	**155.9**	**334.4**	**138.8**	**319.3**
3. Balance of goods and services	**-5,324.0**	**-3,644.3**	**-5,495.0**	**-3,833.1**
3.1 Exports of goods and services	11,829.3	14,378.3	11,498.0	13,962.9
3.1 Imports of goods and services	-17,153.3	-18,022.6	16,993.0	17,796.1
4. Income (Primary income according to BPM6)	**-799.5**	**-1,094.6**	**-1,091.4**	**-1,412.3**
5. Current transfers (Secondary income according to BPM6)	**2,947.0**	**3,153.4**	**2,947.0**	**3,153.4**
II. CAPITAL ACCOUNT	**-10.6**	**10.8**	**-10.6**	**10.8**
III. FINANCIAL ACCOUNT	**1,882.3**	**2,089.2**	**-2,349.1**	**-2,613.6**
1. Direct investment	**241.9**	**768.5**	**-669.2**	**-1,228.8**
2. Portfolio investment	**1,720.5**	**1,916.6**	**-1,722.3**	**-1,915.9**
3. Financial derivatives			**1.8**	**-0.6**
4. Other investment	**-80.1**	**-595.9**	**40.6**	**531.7**
4.1 Trade loans	517.9	400.9	-692.3	-425.5
4.2. Financial loans	-441.9	-1,224.3	573.7	1,184.7
4.3. Cash and deposits	-156.1	227.5	156.1	-227.5
4.4. Other	0.0	0.0	3.0	0.1
IV. NBS FX RESERVES	**1,137.2**	**-696.7**	**-1,137.2**	**696.7**
V. ERRORS AND OMISSIONS	**167.6**	**182.2**	**163.7**	**164.4**
VI. TOTAL BALANCE	**-1,137.2**	**696.7**	**1,137.2**	**-696.7**
In % of GDP:				
Balance of goods and services	**-18.0**	**-11.4**	**-18.6**	**-12.0**
Current account	**-10.7**	**-5.0**	**-12.3**	**-6.5**

Source: NBS.

Change of the sign convention

The sign convention under BPM6 is in line with the national accounts. Credit and debit entries in the current account are now shown with a positive sign and the net balance is derived as the difference between the two. According to BPM5, debit entries were shown with a minus sign and the net balance was the sum of credit and debit entries. Under BPM6, the change of stock is vital, while previously it was the direction of the cash flow of the transaction, wherefore capital outflow was registered as a negative and capital inflow as a positive change. Under BPM6, an increase in assets and liabilities is shown with a positive and a decrease with a negative sign. As a result, negative balance means a net capital inflow (because it comprises an increase in net foreign liabilities and/or a decrease in net foreign assets) and vice versa – a positive balance means a net capital outflow (because it comprises an increase in net foreign assets and/or a decrease in net foreign liabilities).

Trends in the FX market and exchange rate

Stable trends of the dinar against the euro (115.4–115.9 dinars for one euro) marked the quarter under review. By the period-end, the dinar lost 0.3% vs. the euro in nominal terms, but added 0.2% on average q-o-q.

As the dinar weakened somewhat against the euro and the dollar gained strength vs. the euro, the dinar lost 1.1% q-o-q against the greenback by end-Q2. In terms of the period-average, the dollar lapsed back insignificantly vs. the euro, which together with the dinar's appreciation against the euro, pushed the dinar up by 0.2% vs. the dollar.

As a result, the nominal effective exchange rate of the dinar[12] was 0.2% firmer in Q2 on average.

By contrast to the quarter before, moderate appreciation pressures prevailed in the major part of Q2. The causes may be sought in a lower risk premium and more intensive non-resident investment in government securities – contrary to Q1, foreign investors were net sellers of foreign currency in Q2. FX supply increased in the domestic market, both thanks to more ample inflow from exchange operations, and the influx of FDIs.

Q2 also saw a relatively low current account deficit, similar to Q1-levels, so FX demand by enterprises picked up only slightly. Further, external debt repayment by residents receded.

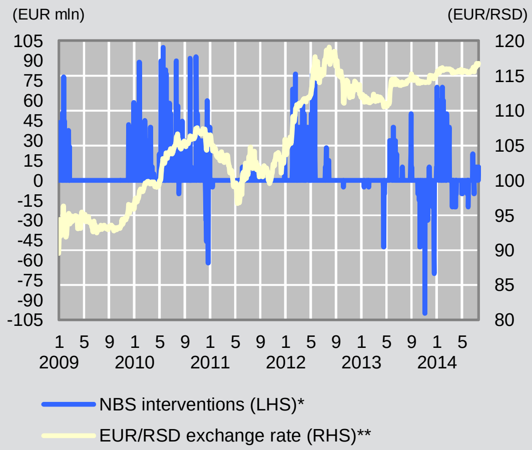
IFEM trading slackened further. Average daily trading volumes (the NBS excluded) amounted to EUR 17.7 mln in Q2. Record low levels of average daily trading were observed in May (EUR 15.7 mln). Exchange rate volatility, measured by EWMA[13] and EGARCH[14], increased marginally in Q2 but remained low.

In contrast to Q1 when it sold FX, the NBS intervened in Q2 by purchasing EUR 170.0 mln. Purchases were most frequent in the first half of April.

The NBS continued to organise three-month and two-week FX swap auctions. At three-month auctions, it sold EUR 11.0 mln and bought the same amount. At two-week auctions, it sold EUR 20.0 mln and bought the same amount.

Depreciation pressures emerged in July, in response not only to mounting geopolitical tensions, notably in connection with the Ukrainian crisis, but also unfavourable news as to the intensity and pace of fiscal

Chart IV.1.10 **Movements in EUR/RSD exchange rate and NBS FX interventions**

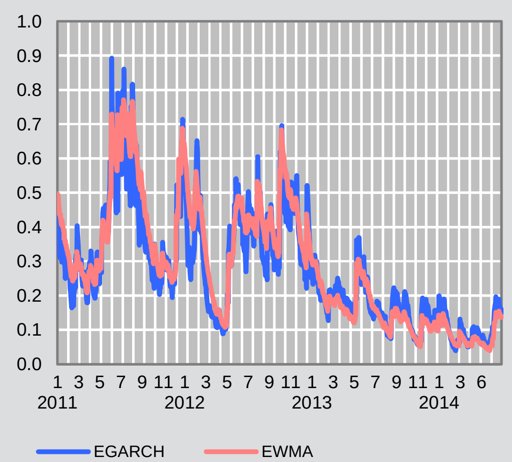


Source: NBS.

* + sale; - purchase.
** 1 EUR in RSD.

By contrast to Q1 when it sold FX, the NBS intervened in Q2 by purchasing FX.

Chart IV.1.11 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

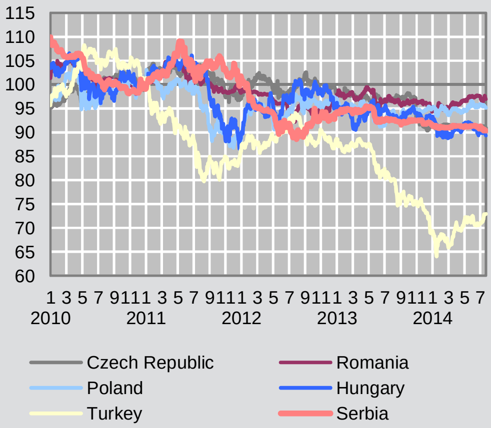
Oscillations of the dinar exchange rate increased somewhat in Q2, but remained at a low level.

[12] Calculated as the geometric mean of nominal exchange rates of EUR/RSD and USD/RSD, with respective weights of 0.8 and 0.2, i.e. according to the formula: $(EUR/RSD^{0.8})*(USD/RSD^{0.2})$.

[13] EWMA – Exponentially Weighted Moving Average.

[14] EGARCH – Exponential General Autoregressive Conditional Heteroskedastic.

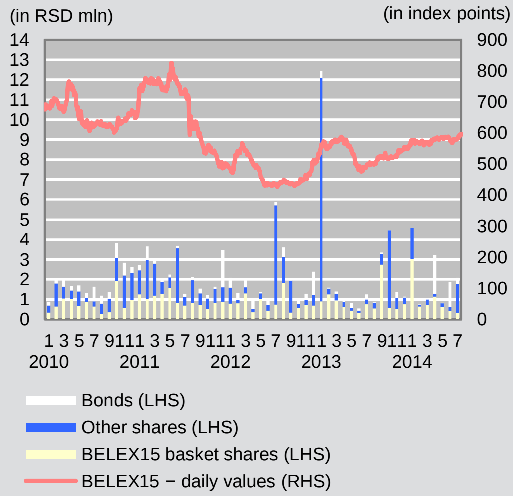
Chart IV.1.12 **Movements in exchange rates of national currencies against the euro***
(daily data, December 31, 2010 = 100)



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

The majority of observed currencies of the region strengthened in Q2.

Chart IV.1.13 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

BSE indices rose slightly in Q2, unlike...

consolidation in the coming period. In July, non-residents reappeared in the FX market as net buyers. The NBS intervened in the IFEM by selling EUR 40 mln and buying EUR 10 mln.

Most currencies of countries in the region running similar exchange rate regimes bounced back in Q2. The Turkish lira appreciated the most (4.0%), following a two-quarter trend. The Romanian lei and Polish zloty headed up by 1.6% and 0.2% respectively. The Czech korona idled relative to end- Q1, while it was only the Hungarian forint that slipped by 1.0%.

Stock exchange trends

Indices of the Belgrade Stock Exchange (BSE) continued slightly up into Q2. By late-June, BELEX15 touched 569.8 points, up by 1.0% from end-March. BELEXline recorded an almost identical rise (0.9%) – 1,132.4 points by end-Q2.

Trading in BSE shares contracted by RSD 3.6 bln from Q1 to RSD 2.7 bln in Q2. Trading decreased from one month to another, with the highest value recorded in April (RSD 1.3 bln). Of the total, the most liquid shares accounted for RSD 2.2 bln, twice less than in Q1.

By contrast to Q1, non-residents bought shares worth RSD 0.4 bln net, most of it in April. Foreign investors increased their net investment in shares until end-Q2 though at a lesser pace than in April.

Quarters when frozen FX savings bonds fall due invariably experience increased trading volumes. Thus, trading in frozen FX savings bonds worth RSD 3.2 bln in Q2 was due mainly to elevated trading in A2014-series bonds in April and A2015-series in June. Yield rates were on an upturn throughout Q2, arriving by end-June at 3.6% for A2015-series and 3.8% for A2016-series.

As in the previous quarter, investors did not trade in corporate bonds.

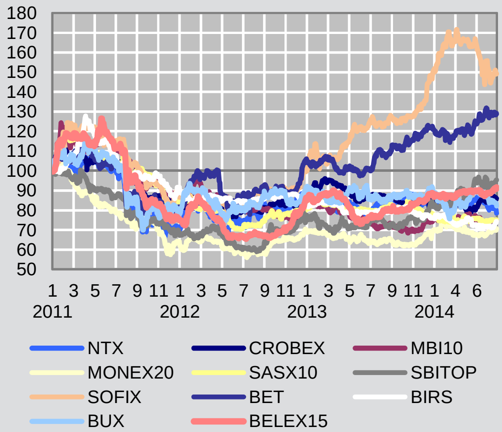
BSE market capitalisation declined by RSD 31.7 bln to RSD 742.5 bln in late June. Regulated market capitalisation was down by RSD 35.5 bln to RSD 402.4 bln, mainly because A2014-series bonds fell due in May. MTP[15] capitalisation expanded by RSD 3.8 bln to RSD 340.2 bln. As a result, the share of market capitalisation in estimated GDP[16] fell by 0.9 pp to 20.4% in late Q2.

Indices of other regional stock exchanges posted divergent movements, moving significantly away from BSE indices. Indices on Ljubljana (14.7%) and Bucharest

[15] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

[16] Estimated GDP over the last four quarters.

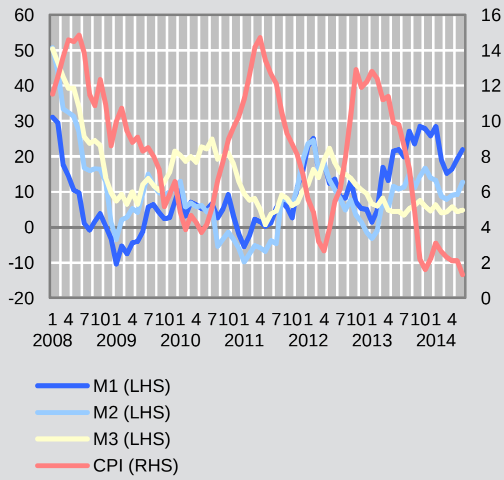
Chart IV.1.14 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

...indices on regional stock exchanges, which recorded more pronounced changes in both directions.

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



Sources: SORS and NBS.

Rising transaction deposits had the strongest impact on acceleration in y-o-y growth in M1 in Q2.

(10.9%) stock exchanges increased the most. In Bulgaria, however, the two-year upward streak was halted over the banking sector crisis. Namely, the Sofia index dipped 8.1%, which implies the sharpest fall in the region.

Along with higher trading volumes on the BSE, July saw BELEX15 and BELEXline going up by 4.8% and 4.3% respectively. In the region, only the Podgorica index recorded a higher rise than in Belgrade.

2. Money and loans

Growth in transaction deposits, the most pronounced in the enterprise sector, led to an increase in dinar monetary aggregates in the course of Q2. In y-o-y terms, the rise was generated primarily by rising balances in household accounts. Corporate loans regained vigour after a longer period thanks to the new subsidised lending programme, while lending to households proceeded at a usual pace.

Monetary aggregates

In Q2, dinar reserve money expanded by 3.7% and 2.8% in nominal and real terms respectively. Still, reflecting contraction in bank FX deposits with the NBS, total reserve money lost 2.1% in nominal and 2.9% in real terms. Y-o-y, dinar reserve money was down by 0.6% in real terms, and total reserve money by 4.9%.

In the quarter under review, dinar reserve money was created mainly based on NBS FX purchases in the IFEM (RSD 21.9 bln) and FX payment operations with Kosovo and Metohija (RSD 10.0 bln). A part was created through monetisation of government FX deposits, but as balances in its dinar accounts increased, the government began to absorb liquidity (RSD 22.7 bln). The rise in account balances was largely due to high tax receipts recorded in June based on final returns of profit tax for 2013, excises and VAT[17]. Moreover, somewhat greater bank investment in repo securities (RSD 5.0 bln) acted in the direction of liquidity withdrawal. In terms of the composition of dinar reserve money, the sharpest rise was noted for balances of local authorities (RSD 4.8 bln), in a surplus since early 2014. Cash in circulation was up by RSD 3.8 bln and required reserves allocated in dinars by RSD 1.2 bln. Bank excess reserves[18] expanded by RSD 1.0 bln. Balances in bank gyro-accounts declined RSD 0.8 bln, while the amount of overnight deposits with the NBS increased RSD 0.7 bln.

[17] High profit tax receipts were recorded owing to economic growth in 2013 and an increase in the tax rate from 10% to 15%. Excise receipts went up owing to the seasonal accumulation of cigarettes prior to the regular July excise adjustment, stricter control of trading in petroleum products, the start of the sowing season and more intensive transit transport. The higher amount of collected VAT reflects high import VAT and the fact that a part of VAT return was carried forward from June to July.

[18] Including balances in bank gyro accounts, vault cash and overnight deposits with the NBS.

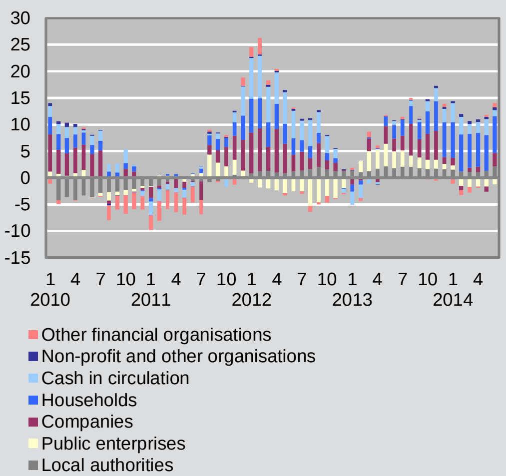
Broader monetary aggregates also rose in the quarter observed. M1 experienced the strongest real growth (10.6%), supported mainly by boosted transaction deposits. M1 movements fully determined the rise in M2 (6.7%) since savings and term deposits were on a downturn. The broadest aggregate M3 posted the smallest rise (2.1%). Against the backdrop of record low y-o-y inflation, growth in money supply fuelled real y-o-y growth in monetary aggregates in Q2. In June, M1, M2 and M3 added 20.4%, 11.3% and 3.5%, in real y-o-y terms, respectively. After longer time, credit growth in Q2 propped up M3, with bank purchases of government securities acting in the same direction.

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

	2013			2014	Share in M3 June 2014 (%)
	Sep.	Dec.	March	June	
M3	12	2.3	19	3.5	100.0
FX deposits	-0.8	-15	0.4	0.2	68.1
M2	5.9	115	5.4	113	319
Time and savings dinar deposits	-13.4	-9.4	-7.9	-6.8	8.9
M1	17.8	23.1	12.6	20.4	23.0
Demand deposit	30.8	313	15.7	28.5	16.4
Currency in circulation	-3.2	8.4	6.3	4.0	6.6

Source: NBS.

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



Source: NBS.

In the course of Q2, the household sector gave the strongest contribution to M2 growth, equally on account of rising transaction and savings deposits.

Broken down by component of money supply M3, the sharpest rise was registered for demand deposits (RSD 37.3 bln), mainly in accounts of enterprises in the sectors of manufacturing, mining, trade and transportation. Dinar deposits of enterprises with longer maturities stayed broadly flat relative to end-Q1. Still, the shift in the maturity structure of corporate deposits in favour of shorter maturities remains visible in the long run. For instance, compared to the same period last year, transaction deposits of enterprises increased by RSD 34.2 bln in June, while savings and term deposits lost RSD 21.4 bln. The maturity structure changed in the majority of sectors, apart from enterprises supplying electricity, gas, steam and air conditioning and trade enterprises – these sectors recorded a y-o-y rise in current account balances (RSD 12.5 and 11.2 bln respectively). Savings deposits of these sectors remained largely unchanged.

Other financial organisations also boosted their transaction deposits in Q2, though at the same time holding smaller balances on savings and term dinar deposits, which is the main reason behind the drop in this category of deposits (RSD 2.2 bln). Balances in household current accounts increased as well.

Household dinar savings continued up in an environment of low y-o-y inflation and more favourable tax treatment. In Q2, they expanded by additional RSD 3.0 bln, increasing by RSD 5.7 bln since the start of the year. Though a new series of frozen FX savings bonds fell due in May, this did not fully feed into the growth in household FX savings which rose by EUR 71.6 mln in Q2. Furthermore, total EUR 124.4 mln were paid out to citizens in respect of maturing frozen FX savings bonds.

Loans

Following an uninterrupted six-quarter downward trend, lending picked up 2.2% in Q2, excluding the exchange rate effect. Contrary to earlier quarters, corporate lending stepped up owing to the new subsidised lending programme. The share of domestic loans in estimated GDP[19] was 49.0% in June, up by 0.8 pp from March.

[19] Estimated GDP over the last four quarters.

The new programme of subsidised corporate lending slowed down the y-o-y drop in domestic loans from 7.9% in March to 4.7% in June.

In regard to sources of funding, banks tapped mainly dinar corporate and household deposits, and to a lesser extent FX deposits. They also held smaller balances in FX accounts with the NBS. On the other hand, banks continued to invest a part of their funds in non-risk securities (repo and government securities). In Q2, banks did not rely on foreign sources to finance their lending because they increased their external receivables and at the same time reduced their external credit liabilities.

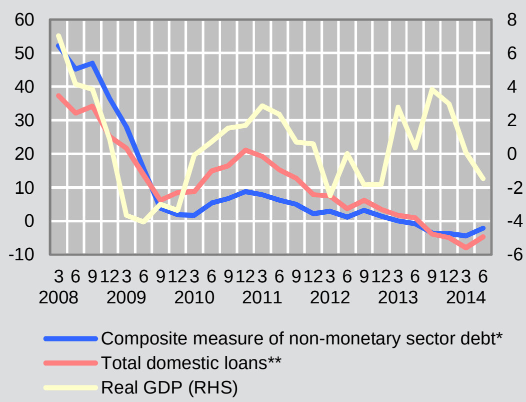
Excluding the exchange rate effect, corporate lending grew RSD 12.1 bln or 2.3% in Q2. Growth was recorded in June when banks began to extend subsidised liquidity and current assets loans.[20] The disbursement of these loans amounted to RSD 28.1 bln in June, with a negligible share of refinancing loans. At the same time, banks continued to assign due receivables to non-financial persons (RSD 4.8 bln in Q2). This, together with maturing subsidised loans granted earlier, diminished the amount of loan receivables.

According to the NBS July bank lending survey[21], banks tightened further the standards for corporate lending in Q2, considering the estimated risks relating to the collection of receivables and expectations as to overall economic activity and the collection of collateral. No further changes in lending standards are expected in Q3. In contrast to Q1, demand for loans, primarily by SMEs, increased in Q2. The need to restructure debts (in conditions of an illiquid economy and deteriorated collection of receivables) and the financing of current assets were the main driving forces behind the increase in demand. These factors, in addition to the new subsidised lending programme, are likely to be the main drivers of the expected growth in demand in Q3.

Consistent with estimates presented in the survey, the majority of loans extended by banks in Q2 concerned current assets and other credits. Besides, the extension of investment loans increased as well.

In Q2, household lending went up by RSD 13.0 bln or 2.6% (excluding the exchange rate effect). Cash loans were disbursed to the highest extent, while housing and consumer loans remained at levels similar to Q1. At the same time, a smaller portion of housing loans (RSD 1.3 bln) concerned the subsidised segment. Of costlier categories, households availed somewhat less of credit card overdrafts and revolving loans, whereas current

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



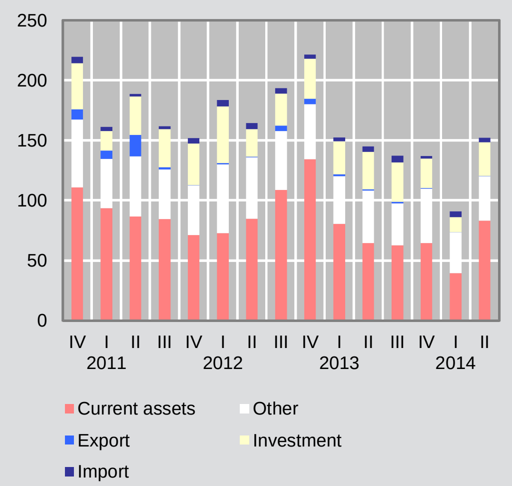
Sources: NBS and SORS.

* As an indicator of total borrowing, it includes domestic loans to the private sector, public enterprises and local authorities, and enterprise cross-border borrowing.

** Excluding the exchange rate effect.

A y-o-y decline in lending decelerated in Q2 under the impact of the new subsidised lending programme.

Chart IV.2.4 **Structure of new corporate loans**
(in RSD bln)



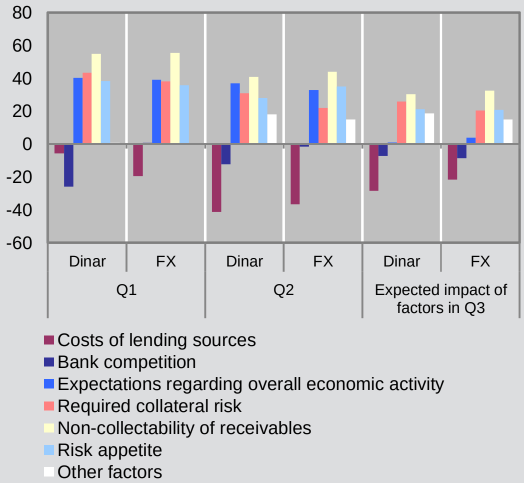
Source: NBS.

A rise in fresh loans was driven by elevated extension of current assets loans.

[20] See text box 2, p. 28.

[21] The NBS began conducting the survey in early 2014. Participation is voluntary and the response rate almost 100%.

Chart IV.2.5 **Impact of factors on corporate lending standards**
(in net percentage)

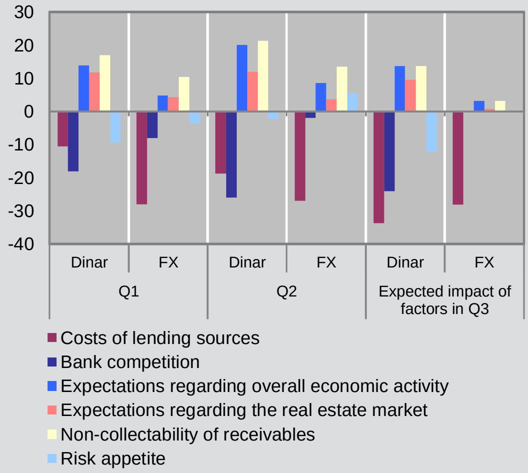


Source: NBS.

* Positive value = contribution to tightening;
negative value = contribution to easing.

Despite a decline in costs of funding sources and the positive impact of competition, increased risk perception caused the tightening of corporate lending standards in Q2.

Chart IV.2.6 **Impact of factors on household lending standards**
(in net percentage)



Source: NBS.

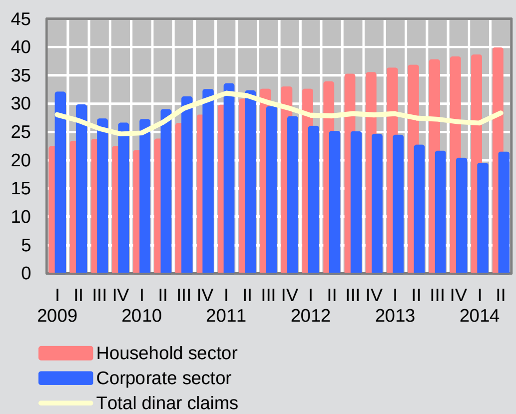
* Positive value = contribution to tightening;
negative value = contribution to easing.

A decline in costs of funding sources and the impact of competition exerted a decisive impact on easing of household lending standards in Q2, while their positive effect is expected in Q3 as well.

account overdrafts remained broadly unchanged from the quarter before.

As indicated by the July bank lending survey, growth in household loans was prompted not only by additional easing of lending standards, but also by rising loan demand. Besides, banks eased the standards for the most sought-after dinar loans – cash and refinancing loans, while standards for FX loans were tightened further. The standards were eased because of cheaper sources of bank funding and greater bank competition, whilst risk perception increased. Interest margins on

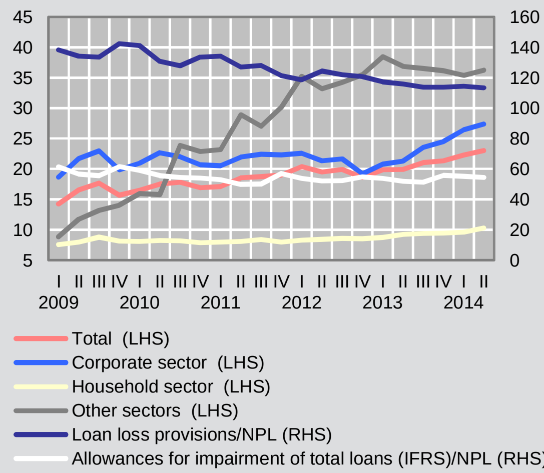
Chart IV.2.7 **Share of dinar in total bank receivables on corporate and household sectors**
(in %)



Source: NBS.

Following a prolonged decline, the degree of dinarisation of corporate loans increased in Q2 owing to subsidised loans.

Chart IV.2.8 **NPLs share in total loans, gross principle**
(%)



Source: NBS.

The subsidised lending programme brought about deceleration in NPL growth in Q2.

dinar loans narrowed. Also, banks offered more favourable loan repayment terms along with additionally reduced accompanying costs. Higher demand was registered for a greater number of banks compared to the April survey. Household demand was led chiefly by the need to refinance the existing obligations, while the unfavourable situation in the labour market had a negative influence on citizens' decisions to borrow.

The share of dinar in total corporate and household loans went up by 1.7 pp from March to 28.3% in June, reflecting primarily the start of the new subsidised corporate lending programme. The share of dinar corporate loans grew 2.0 pp to 21.1%. As households continued to increasingly borrow in dinars, the share of dinar in fresh household loans amounted to almost 72% in Q2. Thus the share of dinar in total household lending was up by additional 1.2 pp to 39.5% in June.

The relatively high share of NPLs is among the factors constraining faster growth in lending activity. Under the gross principle, the share of NPLs in total loans went up by 0.8 pp in Q2 to 23.0% in June. At the same time, the portion of corporate NPLs was up by 0.9 pp to 27.4%, while NPLs in the household sector rose by 0.6 pp to 10.2%. However, despite the high NPL share in total loans, the capital adequacy ratio of around 21% is indicative of unimpaired stability of Serbia's banking sector. Allowances for impairment equalled 54.4% of NPLs in June. At 113.5% in June, loan loss provisions fully covered the level of gross NPLs.

Text box 2: Effects of new subsidised corporate lending programme

Within the framework of fiscal consolidation measures, it did not seem likely that any new subsidised corporate lending programme would be introduced in early 2014. Also, for the first time after several years, there were no plans for the extension of government-subsidised housing loans. However, given the adverse situation in the economy, mounting illiquidity and deteriorated collection of claims, the government adopted in May the decision to launch a new subsidised loan programme to finance corporate liquidity and current assets. Loans with the maturity of up to 18 months and a six-month grace period are extended in dinars (without a currency clause) at the annual rate of 5.45% – with the government subsidising interest of 5%. Of the loans extended by a bank within the programme, no more than 15% may be used for refinancing loans with that bank. Also, the amount of loans extended to large enterprises is capped to 20% of total loans approved. According to the latest data of Serbia's Development Fund, total RSD 59.1 bln in these loans were disbursed by end-July. It is estimated that banks may extend around RSD 140 bln in these loans. This means, provided the disbursement continues at the current pace, that the programme could last for several more months.

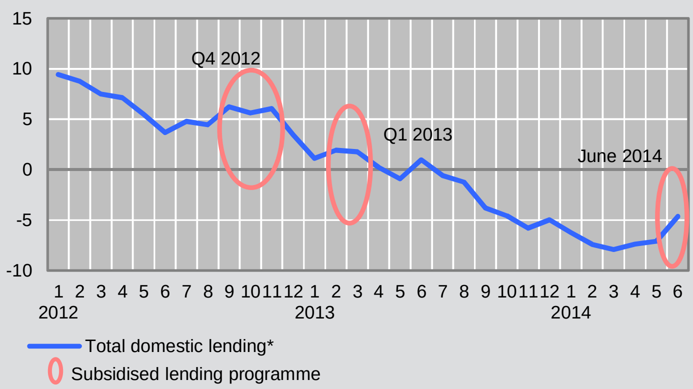
The positive effects were visible already in June when the programme was launched. For the first time after a longer period (six quarters), domestic lending expanded to 2.2% in Q2, excluding the exchange rate effect. At the same time, a y-o-y decline, in place since mid-2013, slowed in June to 4.7%, vs. 7.1% in May and 7.9% in March. According to the July bank lending survey, banks also expect that the programme will give positive impetus to lending activity.

An important novelty and significant breakthrough compared to earlier programmes is that loans are extended only in dinars, without a currency clause. Consequently, the share of dinar corporate loans increased sharply – unlike the household sector, corporates showed no stronger inclination to pure dinar loans up to date. This is corroborated by the amount of fresh dinar corporate loans approved in June (RSD 37.2 bln), which was almost seven times higher than in May, with around 75% related to subsidised loans. As a direct effect of the programme, almost a half (47.5%) of new corporate loans granted in June were dinar-denominated. Hence, the share of dinar in total corporate loans increased in June for the first time after more than a year – by 2.5 pp relative to May, to 21.1%. The increasing share of debt in the domestic currency diminishes corporate exposure to FX risk and increases its resilience to possible exchange rate changes.

These loans contributed to a further reduction in costs of dinar corporate lending. Though the downward trend in rates on dinar loans persisted for some time, the programme provided an additional incentive to the downturn. In June alone, the average price of dinar corporate loans fell by 1.6 pp to 10.3%.

Given the limited amount of these loans that a bank may extend to large enterprises, this programme is directed mainly at SMEs. Further, the programme favours new projects given the limited amount of loans to be used for refinancing with

Chart O.2.1 **Lending activity and subsidised lending programmes**
(y-o-y growth rates in %)



Source: NBS.
* Excluding the exchange rate effect.

the same bank. As SMEs are considered the drivers of economic growth, positive effects on economic recovery may reasonably be expected.

Y-o-y lending contracted last year also on account of the maturing of subsidised loans extended in Q4 2012 (EUR 1.1 bln) and Q1 2013 (EUR 314 mln) because their maturing was not fully offset by new commercial loans. Given the above, an exit strategy would be desirable, in the form of an additional programme with a gradual reduction in the subsidy amount. Though such programme would imply additional budgetary costs, we estimate the costs would be smaller than the programme's positive effect on economic activity and, by extension, on budgetary revenue.

3. Real estate market

Circumstances in the real estate market remained broadly unchanged compared to Q1. Property prices went further down, while the increase in real estate transactions significantly undershot the seasonal levels.

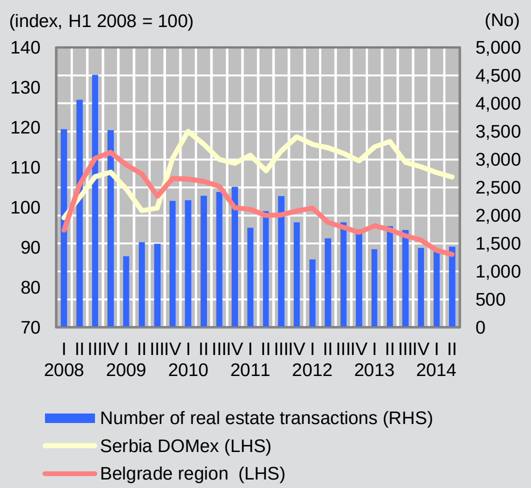
In Q2, DOMex[22] lost 1.0% q-o-q or 7.6% y-o-y. The number of real estate transactions[23] increased slightly – to 1,443. However, the increase (6.8%) significantly undershot the seasonal levels. The Belgrade market revealed similar dynamics.

Property prices fell to EUR 882.5 per m2 on average in Q2. As announced in the NBS April bank lending survey, banks tightened further their standards for housing loans. Although no changes in standards are expected in Q3 according to the July survey, an increase in real estate demand is not likely this year in light of the announced public sector wage cuts.

Given the adverse situation in the construction sector, no major increase may either be expected this year in the supply of new apartments. The number of permits for the construction of buildings fell by 2.4% s-a[24] from the quarter before or by a third relative to the pre-crisis period[25]. Construction enterprises find it increasingly hard to obtain new loans and to stay current on their obligations. This is also confirmed by the fact that more than a half of loans extended to construction enterprises are classified as NPLs, with a further upward tendency. Given the above, the government announced a new set of measures to overcome the crisis in the construction sector.

Operating conditions in the construction sector have improved, which is a prerequisite for improving the situation in the real estate market. For instance, the new Law on Planning and Construction, to be adopted soon, envisages, among other things, electronic issuance of construction permits. This will speed up the issuing of permits, this being a field where Serbia ranks the worst (182th place) according to the World Bank's *Doing Business Report*[26]. Also, new regulations have been adopted in relation to property lease and sale. It is expected that the implementation of new rules, which

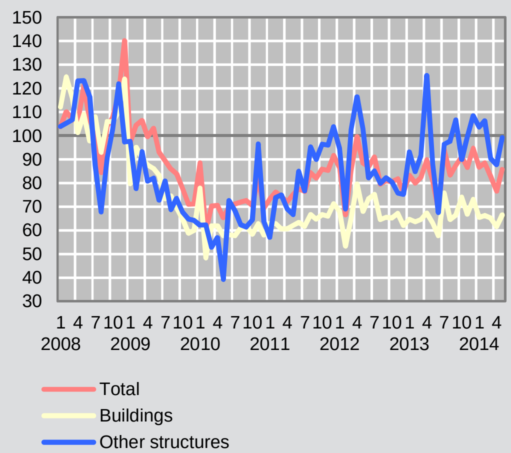
Chart IV.3.1 **DOMex and real estate transactions**



Source: National Corporation for Insurance of Housing Loans.

Property prices declined further, while trading volumes increased slightly in Q2.

Chart IV.3.2 **Indices of the number of issued construction permits**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

The number of issued construction permits declined in April and May relative to Q1.

[22] DOMex is published by the National Corporation for Insurance of Housing Loans and relates only to real estate purchased by insured loans. It shows the ratio of the average value all achieved prices per square meter in a particular period to the average value of all achieved prices per square meter in a base period.

Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror the trends in the real estate market, in light of high unemployment, plummeting wages and muted credit activity.

[23] The number of real estate transactions and apartment prices per square meter also concern only the real estate purchased by insured loans.

[24] April and May.

[25] H1 2008.

[26] *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises,* October 2013.

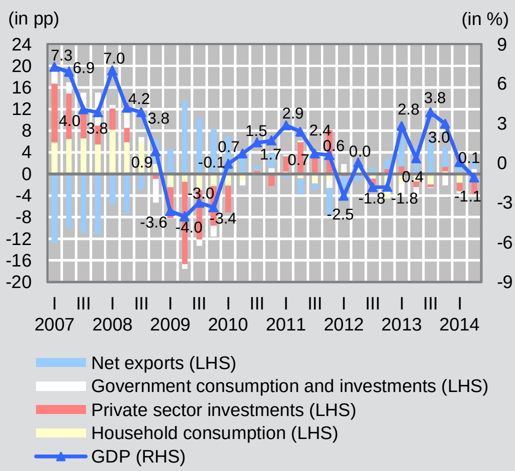
came into effect in late July, will upgrade the quality of services and enhance competitiveness among intermediaries in the real estate market.

4. Aggregate demand

Aggregate demand weakened in Q2 on the back of a negative contribution of net exports triggered by increased import of energy and lower export of the manufacturing industry. Conversely, growth in domestic demand reflected positively on movements in aggregate demand. Total demand also registered a decline y-o-y, with net exports still exerting a positive contribution and private investments a negative one. Total demand is expected to recede in 2014, with the adverse effects of the floods reflecting on net exports, whereas clearing up the damage should help boost investments. Owing to additional fiscal consolidation measures, final consumption will be on a decline at the year-level.

Aggregate demand is estimated to have contracted by 1.1% s-a in Q2. Unlike in the prior period, positive contribution came from domestic (0.5 pp) and negative from net external demand (1.5 pp). Private consumption and government investment rose in Q2, whereas government consumption and private investment decreased. On the other hand, in response to higher imports of energy and reduced exports in manufacturing, net exports had a negative contribution to aggregate demand.

Chart IV.4.1 **Contribution to y-o-y GDP growth rate − expenditure side**



Sources: SORS and NBS calculation.

Note: Q2 2014 is NBS estimate.

Following five upward quarters, aggregate demand witnessed a y-o-y fall in Q2.

Having grown for five straight quarters, aggregate demand fell in Q2 in y-o-y terms (1.1%). With private investment and government consumption slowing further in this quarter, domestic demand had a negative contribution (2.9 pp), while accelerated y-o-y growth of exports relative to imports gave a positive contribution to net exports (1.8 pp).

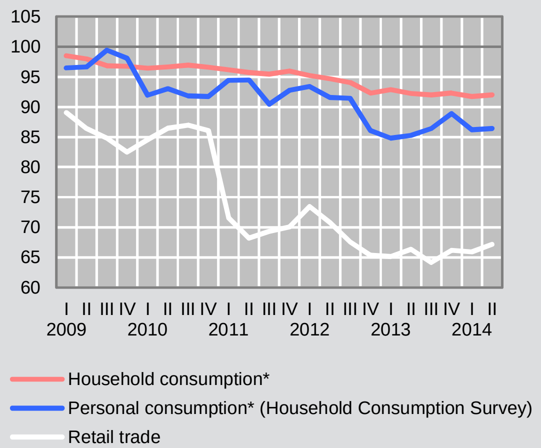
According to estimates, aggregate demand is expected to decline this year in y-o-y terms, mostly in response to a lower positive contribution of net exports. By contrast, domestic demand will have a smaller negative effect, primarily on account of the anticipated growth in investments needed to clear up the damage in the wake of the flooding. Implementation of additional fiscal consolidation measures is expected to impact on a further decline in final consumption of households and the government.

Domestic demand

Private consumption in Q2 is estimated to have edged up slightly (0.3% s-a), which is also mirrored in its y-o-y growth of 0.2%. Such movements are further confirmed by retail trade volumes, which went up 1.9% s-a in Q2, with postal and telecommunication activities registering growth. On the other hand, the import of consumer goods, the volume of services in passenger transport and the number of tourist overnight stays all noted a decline.

The real wage bill, as the main source of income for consumption, rose in Q2 along with the inflow of remittances from abroad, whereas social transfers suffered a decline. Increased household borrowing and the fact that not all of the frozen FX savings bonds maturing for redemption were reinvested into new

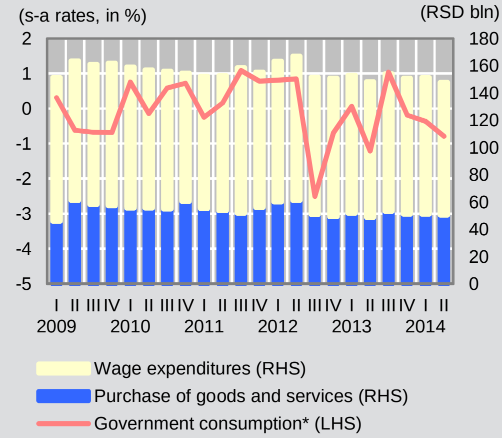
Chart IV.4.2 **Household consumption**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.
* NBS estimates for Q2 2014.

The recovery of retail trade indicates a moderate rise in household consumption in Q2.

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q2 2014.

A further fall in government consumption in Q2 was determined by falling wage outlays and expenditure for the purchase of goods and services.

deposits represent yet another indicator of the existence of additional sources of income for household consumption in Q2.

A negative contribution to aggregate demand in Q2 came from **private fixed investments**, which shrank by 4.7% s-a. This is indicated by the movement of indicators in the construction sector – fewer building permits were issued and the production of construction materials was dampened, while the domestic production of machinery and equipment registered a sharp drop. Conversely, Q2 saw an increase in the import of equipment and the volume of newly-approved investment loans.

Y-o-y, private investments continued to fall throughout Q2. As in Q1, the decline was for the most part attributable to depleted inventories in the automobile and oil industries, as well as reduced agricultural inventories, which were largely exported. By the end of the year, we expect growth in investments on account of clearing up the damage on buildings and replacement of equipment.

Government consumption is estimated to have receded further in Q2 (0.8% s-a), with an 0.2 pp negative effect on total demand. This is illustrated by the trends of public sector labour costs and outlays for the purchase of goods and services, which declined in Q2. Government consumption in Q2 was also lower in y-o-y terms (0.3%),

Table IV.4.1 **Investment indicators**

	2013			2014	
	Q2	Q3	Q4	Q1	Q2
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Hours worked in construction	-9.0	-0.5	-14	6.4	-0.1*
Industrial inventories	0.6	-13	3.3	15	0.7
Industrial production of capital goods (physical volume)	8.3	12.1	-2.4	-9.6	-2.0
Exports of equipment**	-7.8	15.5	-7.2	211	-7.2
Imports of equipment**	-4.1	-2.7	17	-5.2	18
Inventories of capital goods	-15	-2.7	-2.6	-10.3	0.4
Industrial production of intermediate goods (physical volume)	3.7	4.2	15	-4.0	-6.4
Exports of intermediate goods**	4.6	4.9	0.2	11	-0.8
Imports of intermediate goods**	-3.8	-0.8	-0.7	2.3	-5.1
Inventories of intermediate goods	2.2	4.7	14	2.8	2.4
Industrial production of construction materials (physical volume)	19	-0.6	-3.5	10.1	-9.6
Inventories of construction materials	6.6	-2.5	-6.6	4.7	-14
Government investment***	-5.2	2.9	-5.7	13.5	5.6

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

and owing to the expected additional fiscal consolidation measures it will continue to decline in H2.

Unlike consumption, **government investment** in Q2 maintained its upward trend from the beginning of the year in both q-o-q (5.6% s-a) and y-o-y (42.5%) terms. Similar to private investment, government investment is expected to continue rising until the end of the year to provide backing for the clearing up of infrastructure and procurement of equipment in mining and energy. But the growth dynamics will depend on financing options and prompt use of the funds approved by the international community for the clean-up of damages.

Net external demand

Real imports of goods and services rose 1.9% s-a in Q2, driven primarily by the buoyant energy imports. At the same time, real exports of goods and services decreased, as opposed to Q1, by 1.0% s-a, which could be accounted for by the flood-induced reduction in industrial activity.

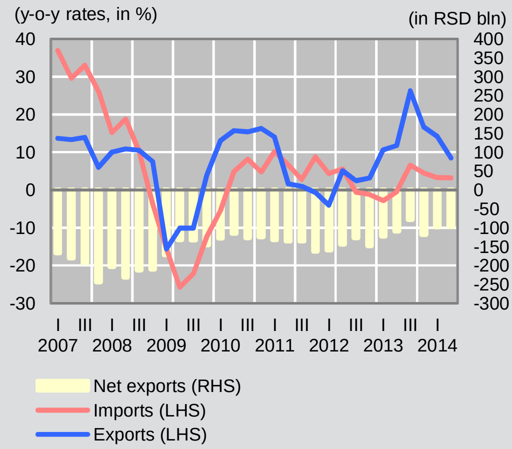
Real growth in exports of goods and services slowed down further at y-o-y level – to 8.4% in Q2. Nevertheless, it continued to outpace the real growth in imports which measured 3.2%. As a result, in Q2 again net exports provided a positive contribution to aggregate demand at y-o-y level.

The fall in exports and the rise in imports reflected on external position indicators which show a mild deterioration compared to Q1. And yet, the exports to imports ratio increased in Q2 by 0.8 pp, to 74.9[27] in June. At the end of that month, commodity exports were 46.2% higher and imports 6.2% lower than pre-crisis[28].

The methodology of the balance of payments statistics has been changed since the previous *Report*.[29] The current account deficit for the prior period has been adjusted upwards relative to the data published earlier. Still, even when measured by the new methodology, the external imbalance will continue to narrow down in 2014. Based on our estimates, this year's current account deficit will amount to 5.9% of GDP compared to the 6.5% last year.

Serbia's external price competitiveness improved somewhat in the course of Q2. Despite modest appreciation of the nominal effective exchange rate[30], the real effective exchange rate of the dinar depreciated by 0.2% in Q2 because prices abroad grew faster than at home. The leading indicator of external demand for

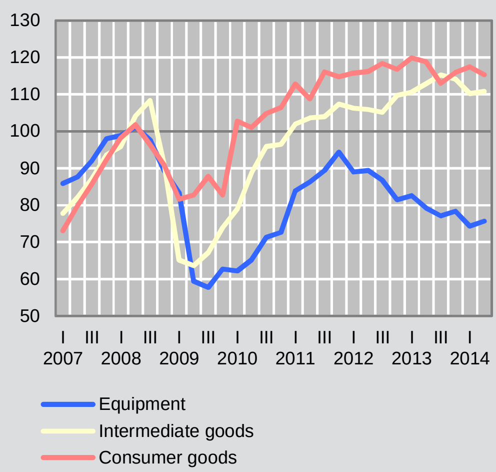
Chart IV.4.4 **Exports and imports of goods and services**
(in previous-year constant prices, ref. 2010)



Sources: SORS and NBS calculation.
Note: Q2 2014 is NBS estimate.

In the course of Q2, exports continued to grow faster than imports in y-o-y terms.

Chart IV.4.5 **Imports by key components**
(s-a, H1 2008 = 100)

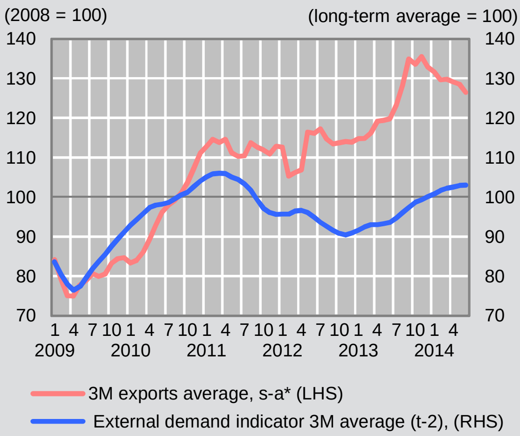


Sources: SORS and NBS calculation.

Growth in imports in Q2 was supported by rising imports of production goods, while imports of consumer goods declined.

[27] 12-month moving average.
[28] H1 2008
[29] See text box 1, p. 18
[30] Calculated as the geometric average of nominal EUR/RSD and USD/RSD exchange rates, with 0.8 and 0.2 weights respectively, i.e. by the formula $(EUR/RSD^{0.8})*(USD/RSD^{0.2})$.

Chart IV.4.6 **External demand and Serbian exports**



Sources: European Commission, SORS and NBS.
* Excluding automobile industry.

Positive perceptions of economic outlook of our trade partners have a positive impact on Serbia's external demand.

Serbian exports[31] continued to move above its long-term level, suggesting a further rise in domestic exports.

Euro-denominated commodity exports declined by 1.6% s-a in Q2 amid a slack in manufacturing industry. Automobile and oil industry exports, which powered export growth in the prior period, edged down in Q2. Other branches of manufacturing holding a significant share in exports recorded a fall in their production levels. Hence, a decrease was registered in the exports of chemical products, electrical equipment, machinery and base metals. On the other hand, the exports of articles of apparel, metal products and pharmaceutical products rallied.

After contraction in the previous two quarters, exports of agricultural products went up by 5.7% s-a in Q2. Wheat exports more or less maintained the dynamics exhibited in the prior quarter, while touching at the level of the mercantile year[32] the historical record of 1.1 mln tons. Corn exports gained more than 30% relative to Q1. From the beginning of the mercantile year (October 2013) to June 2014, corn exports totalled 1.6 mln tons.

Following a drop in Q1, euro-denominated commodity imports rose by 4.4% s-a in Q2. By contrast to Q1, imports of production goods increased – equipment (1.8% s-a) and intermediate goods (0.5% s-a), while imports of consumer goods declined by 1.8% s-a.

5. Economic activity

Contraction in agriculture and industry, caused by the May flooding, led to a 1.1% GDP drop in Q2, both q-o-q and y-o-y. In the wake of heavy floods, annual GDP growth for 2014 had to be revised down to an estimated -0.5%. Nevertheless, the adverse effects of the flooding remain restricted to a short-term period, while positive effects are expected in the medium and long run, primarily on account of investment growth.

Severe floods which struck Serbia in May had an impact on economic activity, which is estimated to have contracted by 1.1% s-a in Q2. The sectors of electricity, gas and steam supply and mining were hit the hardest by direct flood damages and they each individually exerted the highest negative contribution of 0.5pp and 0.2pp, respectively. In addition to this, agriculture, manufacturing and construction also recorded a significant slump. By contrast, a positive push came from the information and communications sector.

Measured by GDP, due to the continued fall in Q2, economy came at 2.3% below the pre-crisis level[33]. According to our estimate, measured by NAVA, economic activity fell 1.1% in Q2 lingering at 2.3% below pre-crisis.

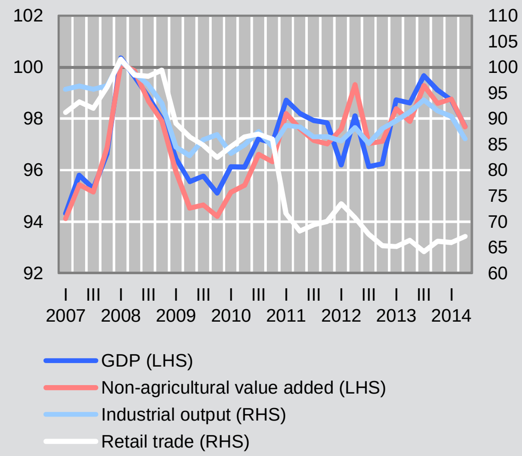
Favourable trends in industrial production during the first four months[34] were disrupted by May flooding.[35] The physical volume of industrial production in Q2 shrank by 3.6% s-a, falling 14.6% s-a in electricity supply and 12.0% s-a in mining. The manufacturing industry suffered the least damage from floods and its physical volume in Q2 decreased by 1.7% s-a.

During the first four months, the growth in manufacturing was driven by the production of motor vehicles, petroleum derivatives and food products. Afterwards, with severe floods in May, most sectors recorded a decline in production which continued into June. In quarterly terms, the highest growth in the physical volume was achieved in the production of petroleum derivatives and the pharmaceutical and tobacco

[31] Leading indicator of external demand for Serbian exports was construed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners – their shares in Serbian exports being used as weights.
[32] July 2013 – June 2014 for wheat.

[33] Level of H1 2008.
[34] A 2.4% s-a growth in manufacturing and 2.1% s-a in total industrial production.
[35] See Text box 3, p 37.

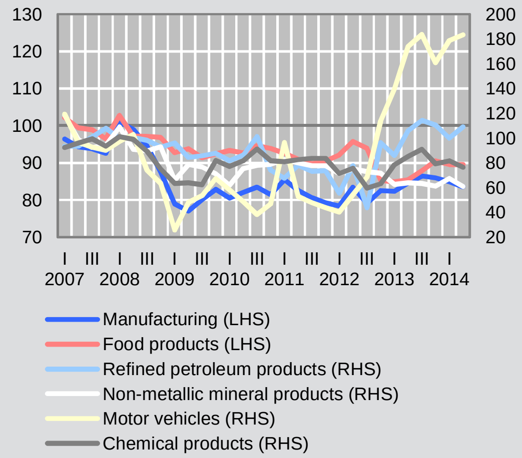
Chart IV.5.1 **Economic activity indicators**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

A decline in industrial production triggered by floods determined movements in economic activity in Q2.

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



Sources: SORS and NBS calculation.

A decline in the physical volume of production was recorded in the majority of manufacturing sectors.

industries, while the production of computers, paper and clothing perked up slightly. In contrast to this, the production of food and beverages and metal products exerted the strongest contribution to the drop in the physical volume of manufacturing. The fall in the physical volume was also recorded in other manufacturing sectors with export-oriented products (chemical products, electrical equipment, machines, rubber and plastics), which may account for lower goods exports in Q2.

Favourable trends in construction recorded in Q1 did not extend into Q2, therefore this sector is estimated to have declined by 5.9% s-a. A downturn in the production of construction materials[36] (9.6% s-a) and the number of issued building permits point to a contraction in this sector which continued to decline in s-a terms during Q2.

Several services sectors were not directly hit by the flooding. The information and communications and the financial activities sectors were among the few to achieve growth in Q2, while activity in the trade sector stagnated. Retail trade volumes rose 1.9% s-a in Q2, but still remained by one third below the pre-crisis level.

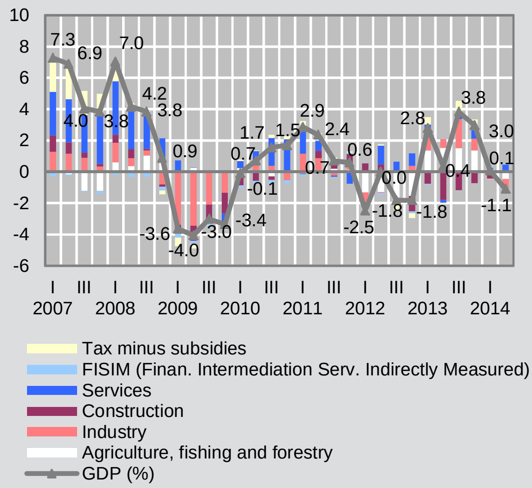
According to preliminary estimates of the Statistical Office, in y-o-y terms, GDP drop in Q2 equalled 1.1%. The largest negative push came from industry (0.8 pp) and agriculture (0.5 pp), while the information and communications sector gave a positive contribution of 0.4 pp.

Y-o-y, the physical volume of industrial production sank 4.4% in Q2, after registering six quarters of growth. The sharpest drop was recorded in the electricity, gas and steam supply sector (13.8%), with a 1.9 pp negative contribution to the fall in the physical volume of total industry. Mining also recorded a steep fall (12.6%), exerting a negative 1.2 pp contribution. Manufacturing gave the same contribution and its physical volume shrank by 1.5%.

Motor vehicle production rose 5.7% y-o-y in Q2. Still, the growth was insufficient to compensate for the slump in the physical volume of production in most sectors. The largest y-o-y fall was noted in the production of metal products (24.1%), with a negative contribution of 1.9 pp to the total y-o-y decline in manufacturing. In addition to this, production weakened in the chemical, textile and machine industries, as did the production of base metals and construction materials. Apart from the automobile industry, other sectors that helped mitigate the y-o-y fall

[36] The production of construction materials is estimated based on the physical volume of production of products made from non-metallic minerals.

Chart IV.5.3 **Contribution to y-o-y GDP growth rate – production side**
(in pp)



Sources: SORS and NBS calculation.

Negative flood effects on agriculture and industry impacted on a y-o-y decline in GDP in Q2.

in the physical volume of manufacturing were the production of food, petroleum products and pharmaceuticals.

According to the Statistical Office, growth recorded in Q1 was revised down relative to preliminary estimates, from 0.4% to 0.1% y-o-y. This means that even if it were not for the floods, economic activity would have registered lower growth than what was expected and forecast in the previous *Inflation Report*. The negative effects of floods on economy have been estimated at 0.9 pp, hence it follows that GDP is likely to fall by 0.5% in 2014. A major negative push to GDP drop will come from agriculture (0.5 pp) and the mining and electricity, gas and steam supply sectors (0.1 pp each). By contrast, the construction sector is expected to give a positive impulse (0.3 pp) in the second half of the year, bearing in mind the need to clear up the damage to buildings and infrastructure.

Last year's high yields of cereals and industrial plants would have resulted in a decline in this year's agricultural output even if the current season posted average yields. Moreover, the floods reflected negatively on fruit and vegetable production and cattle breeding. Namely, one half of Serbia's fruit production, one third of cattle breeding products and one fifth of vegetable produce normally come from the areas that were directly struck by the flooding. Assuming that these areas will underperform by one third, the estimated drop in agricultural production in 2014 will stand at around 6%.

In addition to agriculture, energy and mining are expected to have considerably lower results at the year level. As the main open-pit coal mines were submerged in rainwater, we expect lower coal deliveries for electricity production. Although major works are underway to restore the mines to full operation, production is not expected to normalise before early next year. We therefore expect a fall of around 7% in the mining sector and around 4% in electricity, gas and steam supply in 2014.

Decreased electricity production could lead to reduced activity in manufacturing, which will most likely stagnate in 2014. However, in all probability, the main manufacturing branches – automobile and oil sectors – will continue to grow during the current year. In H2, Fiat Automobiles Serbia is expected to maintain similar production and export dynamics as in the first half of the year[37], especially bearing in mind a mild recovery in the European automobile market – in H1 2014, the sale of new automobiles in the EU rose 6.5% y-o-y.

Efforts to address the consequences of the floods on industrial and housing facilities and infrastructure should stimulate growth in the construction sector, which is expected to go up around 10% in 2014. Moreover, positive contributions to economy are also expected from the services sectors, most notably information and communications. However, bearing in mind the expected additional fiscal consolidation measures, to be introduced in the second half of the year, trade activity in 2014 is estimated to remain at a similar level as in the prior year.

[37] In the first six months of 2014, the exports of Fiat Automobiles Serbia equalled around EUR 800 mln.

Text box 3: Effect of floods on macroeconomic developments in Serbia

The May flooding has caused enormous damage in Serbia. According to preliminary estimates[1], the damage amounts to around EUR 1.5 bln. In addition to direct damages to housing and industrial facilities and infrastructure, indirect consequences include downtime in production during the emergency situation in the country and the inability to utilize some of the production capacities for a certain period due to the inflicted damage[2]. Estimates indicate that floods will have an adverse effect on economy and foreign trade in 2014, which is why the real growth of GDP was revised down and the current account deficit up relative to the expectations stated in the May Inflation Report.

The heaviest flood damages were recorded in electricity production, mining and agriculture. The physical volume of industrial production noted a monthly plunge of 7.8% s-a in May, with the drop in electricity production amounting to 27.3% s-a. A major problem in this sector were the main open-pit coal mines in the Kolubara basin (Tamnava – west field and Veliki Crljeni) which were submerged in floodwater and which normally deliver around 70% of coal to Nikola Tesla power plant that accounts for approximately 50% of the electricity generated in Serbia. In response to reduced production of coal, whose share in total mining output stands at nearly 75%, the physical volume of production in mining slumped by 8.3% s-a in May. In the months ahead, these sectors will continue to underperform as it will take several months to clear up the damage in the wake of the floods (draining the pits and restoring machinery to full operation). This could lead to temporary problems in electricity supply during the winter months when consumption surges on account of heating. As the main pit will most likely remain out of use until the start of the heating season, a need will arise for electricity imports in the period of the year when electricity prices are at their peak in the market, causing in turn an even higher current account deficit. Moreover, reduced production in the summer months means lower exports of electricity, typical for this time of year, and in turn poorer export results. In addition to disrupting production in thermal power plants, the floods decreased labour efficiency in hydroelectric power stations – due to extremely high water levels, these power plants were forced to release water through the dams without harvesting it for electricity production. Our estimates indicate that electricity production in 2014 will be down by 4.2% and mining activity by 6.7%, hence the two sectors will have a negative push on economy by 0.1 pp each.

As for industrial sectors, manufacturing suffered the least direct damages and its May activity declined by 2.9% s-a. The fall in manufacturing largely pertains to reduced usage of capacities caused by lower electricity supply, the engagement of workforce and machinery on reinforcing and building dams, and obstructions in the transport of goods and raw materials during the emergency situation. We estimate that manufacturing will stagnate at the annual level which, coupled with the fall in electricity production and mining, will result in a total drop in industrial production of around 1%, with a 0.2 pp negative contribution to GDP.

Agriculture was another sector to have suffered considerable damages, most notably in fruit production, as around a half of orchards in Serbia are located in the most heavily stricken areas (Western Serbia and Pomoravlje District). Around one third of cattle breeding production also comes from these parts and almost a fifth of vegetable production, both of which sustained heavy losses. However, as far as most stricken areas are concerned, farm plantings can be restored as soon as this season (in vegetable and crop farming). Further, Vojvodina, as the main agricultural region, did not suffer large damages from floods, which helped mitigate the losses in agriculture to a large extent. Assuming that production in the flooded areas will underperform by a third, the total fall in agriculture in 2014 is expected to be around 6%, with a 0.5 pp negative contribution to GDP.

Among the services sectors, trade reported the highest negative effects of the floods. Huge amounts of final goods, equipment and furniture were destroyed in the flooded areas and additional losses were caused on account of non-effected revenues during the halt in business operations. Floods inflicted severe damage to transport infrastructure (roads, bridges, railways) and problems in the transport of people, goods and raw materials, thus disturbing normal business activities and

[1] Based on the Report on Needs Assessment for Remediation and Reconstruction of Flood Affected Areas, published at http://www.obnova.gov.rs.

[2] In the period 15–23 May, the Government declared an emergency situation in the entire country because of extreme rainfall, in order to make all of its resources available for clearing up the damage.

indirectly contributing to a fall in economic activity. Nevertheless, after a short interruption during the emergency situation, transport activity was normalised owing to the fact that main roads and railways were repaired relatively quickly. On the other hand, the consequences of the floods should exert a positive impulse in construction, which recorded a significant drop in 2013. The reconstruction of ruined housing and auxiliary facilities and infrastructure will imply the engagement of primarily domestic construction capacity which, according to our estimates, will give a 0.3 pp push to GDP growth.

Bearing in mind the said estimates, economy will most likely decline by 0.5% this year. However, international experience shows that negative effects of floods on economic activity are mostly focused within the first year, after which period positive effects begin to emerge in the medium and long run, primarily through higher investment.

The effect of the floods on foreign trade is reflected through an increase in the share of the current account deficit in GDP by 1.0 pp. Exports will decline, primarily on account of the fall in agricultural output, given that these products occupy an important position in the structure of exports. In this respect, we may expect lower exports of fresh and processed fruits, vegetables and meat and meat products, while crop exports will most likely change only slightly. Further, stagnating activity in manufacturing will result in this sector's lower exports. On the import side, we are likely to see much higher electricity imports due to reduced domestic production. Growth will also be noted in the imports of oil, gas and construction materials which are required to construct new and reconstruct damaged buildings and infrastructure. This year's current account deficit has been estimated at 5.9% GDP – much higher than previously expected, but still by around 0.6 pp lower than in 2013.

According to the Ministry of Finance estimates, the share of GDP in budget deficit could go up this year by around 1.0 pp because of the floods. At the same time, budget revenue will be lower, mostly on account of dampened economic activity and reduced value of property in the wake of the floods, while budget expenditure can be expected to rise in response to the allocation of additional funds for emergency clear-up in energy, agriculture, infrastructure and private property.

Table O.3.1 **Estimate of flood damage**
(in EUR mln)

	Direct damage	Losses	TOTAL DAMAGE
Damage with direct social effects	**235**	**7**	**242**
- housing facilities	227	4	231
- education	3	0	4
- healthcare	3	3	6
- culture	1	1	2
Economy	**516**	**548**	**1,064**
- agriculture	108	120	228
- manufacturing	56	65	121
- trade	170	55	225
- tourism	1	2	2
- mining and energy	182	306	488
Infrastructure	**117**	**75**	**192**
- transport infrastructure	96	70	166
- communications	9	1	10
- water and sanitation	12	3	16
Other damage	**17**	**11**	**28**
- environment	11	10	21
- governance	7	1	7
TOTAL DAMAGE	**885**	**640**	**1,525**

Source: Report on Needs Assessment for Remediation and Reconstruction of Flood Affected Areas.

The consequences of the floods and their effect on the rise in food prices, if it comes to it, should not pose any threat to achieving the inflation target, given that inflation is below the lower bound of the target tolerance band. Moreover, the shrunken domestic supply of food products can be compensated for from imports without any major inflation pressure because, unlike two years ago, global food prices are at a lower level. This was confirmed by data on June inflation which hit its record low, with the prices of vegetables and fruits declining the most, although they were expected to rise in the aftermath of the floods.

6. Labour market developments

The rise in private and public sector real wages had an effect on the increase of industrial unit labour costs. According to the Labour Force Survey, labour market indicators perked up in Q2, with employment and participation rates going up and unemployment down. Favourable trends were also noted in the formal segment of the labour market given that formal unemployment figures decreased more than the number of employed.

Wages and labour productivity

After suffering a decline in Q1, **real net wages** recorded growth in Q2 which was of similar intensity in both private (1.3% s-a) and public sectors (1.1% s-a). Owing to this, real net wages in the private sector were 16.1% above the pre-crisis level[38] and those in the public sector 11.0% below.

In contrast to a quarter earlier, Q2 real wages rose in most sectors of the economy. The largest growth was recorded in professional and innovative activities and in administration and support service activities. Real wages also increased in mining, electricity supply, trade, information and communications, and transport and warehousing. The average wage in manufacturing remained unchanged relative to a quarter earlier, while a fall was recorded in the accommodation and food services sector, agriculture, real estate, financial activities, construction and education.

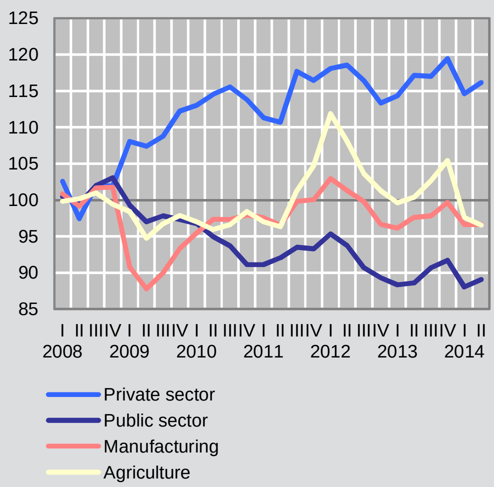
Relative to the same period last year, real net wages in the private sector shrank 0.9% in Q2, while those in the public sector edged up 0.5%.

The average take-home wage in Serbia in Q2 gained 7.5% from the previous quarter and equalled RSD 44,975. Nevertheless, such high growth was partly a result of the low average wage in January when one portion of the wages for January was paid out in the last week of December. It is therefore more accurate to make the comparison with the same period last year, relative to which the average nominal wage was up by 1.6%.

The anticipated cut in public sector wages, originally planned for July, has been postponed until October to coincide with the budget revision. The latest indications point to a 10% cut in public sector wages.

Lower productivity and the growth in real wages drove **unit labour costs** in total industry up by 5.3% s-a in Q2.

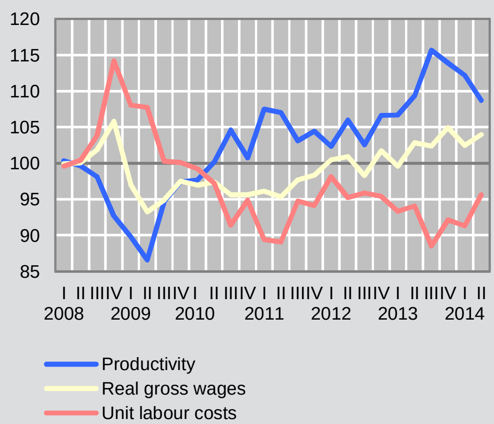
Chart IV.6.1 **Real net wages**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Real net wages recorded approximately the same growth in Q2 in both private and public sector.

Chart IV.6.2 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Despite the increase in Q2, industrial unit labour costs remain below their pre-crisis level.

[38] Level from H1 2008.

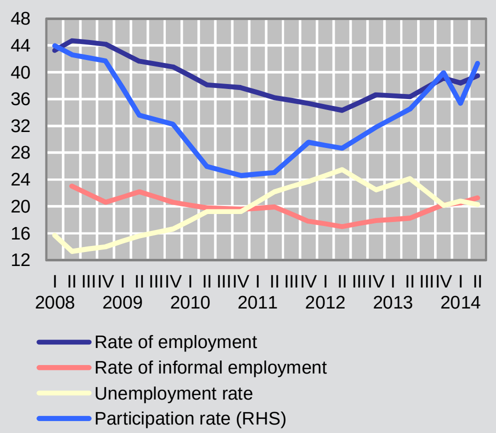
The increase in unit labour costs was lower (2.0% s-a) if only manufacturing is taken into account, given that this sector produces the largest share of tradeables. Yet, in both cases, unit labour costs were lower than pre-crisis – 4.4% in total industry and 2.2% in manufacturing.

Employment

The **Labour Force Survey** indicates that Q2 witnessed a mild improvement in the labour market. Unemployment edged down 0.5 pp and at present it stands at 20.3%. Employment also rose by 1.1 pp to 39.5%, with the increase largely attributable to a rise in informal employment (0.7 pp), which stood at 21.2% in Q2. The number of active persons in the labour market also rose – measured by the participation rate[39], it stands at 62.5%, or 1.3 pp up on Q1.

The highest rise in employment in Q2 was registered in agriculture (31,106 persons), which can be put down to seasonal demands, and in activities of households as employers (24,410 persons). Steady rise in employment continued also in the information and communications sector, professional, scientific and technical activities, and health and social care. Having undergone a steep fall in Q1, employment in the construction sector also went up.

Chart IV.6.3 **Labour market indicators under the Labour Force Survey**
(in %)



Source: SORS.

A decrease in unemployment and an increase in employment led to a mild improvement in the labour market.

On the other hand, slumped activity in mining and manufacturing was mirrored in the fall of employment figures in these sectors, with similar developments recorded in the transport and catering sectors and financial activities.

Unlike the previous quarter, the entire increase in employment relates to persons working full-time, whereas the number of part-time workers declined in Q2. Positive tendencies were somewhat diminished by the worsened position of vulnerable categories in the labour market as unemployment rose by 1.0 pp among the young population (aged 15–24) and by 2.8 pp among long-term unemployed persons.

According to **RAD research**,[40] formal employment decreased by only 121 persons in Q2. The entire reduction is the result of the decline in formal employment in the public sector (551 persons), while private sector employment rose by 430 persons. The largest rise in employment was noted in trade (391 persons) and mining (207 persons), while employment figures in agriculture, financial activities and public administration increased to a much lesser degree. Conversely, a fall was recorded in the number of formally employed in education, catering, construction and electricity, gas and steam supply.

Positive developments in the formal labour market were substantiated by a reduction in unemployment figures which, according to the **National Employment Service**, went down by 17,132 persons in Q2. The number of unemployed workers with previous job experience decreased more (10,979) than the number of first time job seekers (6,153). The largest reduction in formal unemployment was recorded in groups of jobs related to manufacturing (machine industry and metal processing, and electrical industry), and in trade, economics and law, and agriculture. The only group of vocations that registered an increase in unemployment in Q2 was education, which corresponds to the reduction in formal employment in the education sector. The number of unemployment beneficiaries declined by 4,508 in Q2, reaching 61,070 persons in May, the lowest level since January 2012.

Amendments to the Labour Law were adopted in July, creating conditions for more flexible developments in the labour market. Major changes from the previous version of the Law include the extension of the maximum length of the fixed-term contract from one to two years and the

[39] Calculated as the share of active population (employed and unemployed) in total population of working age (aged 15–64).

[40] RAD research is conducted twice a year, in March and September, while data for the remaining months are obtained based on an assessment.

introduction of more flexible forms of work – employment from home and part-time employment. In addition, severance pay and seniority bonus will be calculated only with respect to the years of service with the last employer, while the basis for calculating vacation pay will include only the base wage, without any additional allowances. These changes should encourage employers to take on new workers more easily than before.

During Q2, the National Employment Service conducted a survey[41] among employers about their employment plans and needs for certain vocations, knowledge and skills. Preliminary results indicate that in 2014 we can expect a 7.7% gross job creation rate[42] and an 8.1% gross job destruction rate, which adds up to a negative net job creation rate of 0.4%. Next year, net job creation rate will most likely be positive, equalling 2.6%.

7. International environment

The spillover of further euro area growth in Q2 translated into lower unemployment in the labour market. Following a temporary drop in Q1, the US economy recuperated in Q2, but the economic growth outlook was revised downward. Improvement of labour market conditions enabled the Fed to continue to taper quantitative easing.

The risk of deflation in the euro area prevailed in Q2 as well, impacting on the ECB's decision to cut its key interest rate and introduce a negative deposit facility rate.

The Ukrainian crisis still looms as the major risk to further economic developments in Europe.

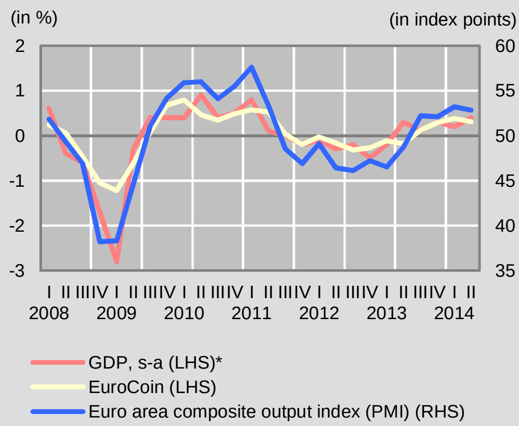
Because of heightened geopolitical tensions, global oil prices surged in Q2, while favourable forecasts of this year's yields of main agricultural crops precipitated a downfall in world food prices.

Economic activity

The **euro area** economy is likely to grow further in Q2 (0.4% s-a[43]). The growth will be based on wider foundations both across countries and sectors. Domestic demand will continue to be the main driver of growth, while the contribution of net exports will be smaller mainly because of a slowdown in emerging markets. Though declining, the leading indicator – PMI Composite, trended in Q2 above the level marking recession (50 points), reaching 52.8 in June.

Following vigorous growth in Q1 (0.8% s-a), the German economy is expected to slow down. Domestic investments will remain the key driver of growth, while the introduction of minimum wage from the start of next year implies that future economic growth will also be based on strengthening of domestic consumer demand. This gains in particular importance in light of the economic slowdown in China, which is the most important German export market, and possible tightening of economic relations with Russia, with which Germany fosters solid economic links. Divergent movements were recorded in other larger economies of the euro area. The Spanish economy grew in Q1 (0.4% s-a) and the set of fiscal incentives will stoke domestic demand in the coming period. A decline in domestic demand, along

Chart IV.7.1 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



Sources: Eurostat, Markit Group and Banca d'Italia.
* Consensus Forecast estimate for Q2 2014.

Indicators suggest that the economic recovery of the euro area proceeded in Q2.

[41] Employer survey is a project which the National Employment Service has been conducting since 2011 with EU support. The survey gathers information about the needs of employers with respect to workforce vocations, competencies, knowledge and skills. The information is then compared with the vocations, qualifications, knowledge and skills of the unemployed in order to soften the disbalance in competencies in the labour market and reduce structural unemployment.

[42] Gross job creation/destruction rate is the ratio of the newly-hired/dismissed persons and the total number of employees in companies observed at the beginning of the year. Net job creation rate is the difference between gross job creation rate and gross job destruction rate.

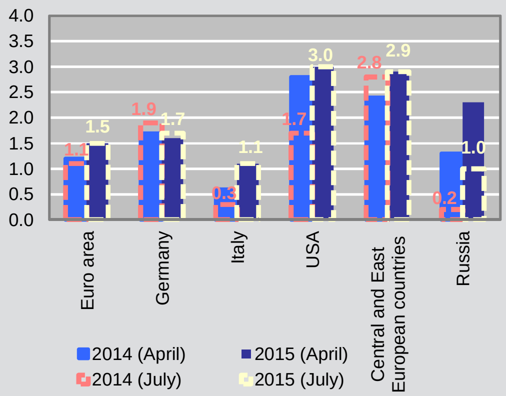
[43] June Consensus Forecast.

with slow growth in exports, led to economic stagnation in France in Q1, with key indicators pointing to such trend in Q2 as well. Italian GDP lost 0.1% s-a in Q1, mainly due to poor labour market performances and consequently dampened domestic demand. According to the preliminary estimate, the decline continued into Q2 (0.2% s-a).

IMF's projections about economic activity in the euro area mainly confirm the Consensus Forecast predictions (growth of 1.1% in 2014), with prevailing risks relating to the fragmentation of credit markets and high unemployment in some economies. As the situation in the labour market improved somewhat, the unemployment rate fell to 11.5% in June, down by 0.5 pp y-o-y.

According to the July Consensus Forecast, economic growth in **central and eastern Europe** was revised down by 0.2 pp from April to 1.5%. Such expected slowdown was triggered by the continuation of the Ukrainian crisis, prompting downward revisions for Ukraine, Russia and Baltic countries whose economies are strongly linked to Russia. On the other hand, central European countries are

Chart IV.7.2 **Revisions of real GDP growth forecasts for 2014 and 2015 by the IMF***
(%)



Sources: IMF WEO (April 2014) and IMF WEO Update (July 2014).
* Revision compared to April WEO.

Based on the latest IMF estimate, the United States and Russia are poised for significantly lower growth, while Germany is headed for stronger growth than expected earlier.

likely to experience somewhat more robust growth, owing mainly to ECB's expansionary measures. Further, following the crisis which erupted in early 2014, Turkey's economy is gradually normalising and the expected GDP growth rate was revised upward.

Strong trade links of most countries of the region with Russia could weaken if the EU and US continue to tighten the economic sanctions against Russia. Besides, a possible energy crisis in case no agreement is reached between Russia and Ukraine in regard to natural gas transport could hit most severely the region of central and eastern Europe as there is no alternative route for gas supply.

The expected economic slowdown in the **US**, precipitated by the cold wave, was greater than forecast and GDP was slashed by 0.5% s-a in Q1. However, the leading economic activity indicator – ISM Manufacturing, continued to move in the expansion zone[44] in Q2, signalling a temporary drop in economic activity in Q1 and expected recovery already in Q2. Private consumption, the only GDP component that recorded growth in Q1, also shows the signs of vigorous acceleration in Q2 as the Consumer Confidence Index recorded continuous growth in Q2, reaching in June its highest level since January 2008. Under the preliminary estimate, the US economic activity rose by 1.0% s-a in Q2.

The temporary downturn in Q1 did not reflect on the US labour market that continued to improve in Q2 as well. The unemployment rate was reduced by as much as 0.6 pp in Q2, to 6.1% in June, while non-agricultural employment rose on average by 230,000 per month since the year-start. As suggested by the July Consensus Forecast, the GDP growth forecast for 2014 was revised down to 1.6% because of the sharp contraction in Q1. The IMF expects growth at 1.7%.

Economic activity in **China** continued below the long-term growth trend, as a consequence of structural adjustments to the new growth model based on strengthening of domestic demand and gradual currency appreciation. However, the Chinese economy is estimated to rise in future at a relatively high rate of around 7%. Current indicators show that 2014 growth will reach 7.3%[45], while the IMF forecasts 7.4%.

[44] In June, the 13-consecutive month was above 50 points, which a level dividing expansion from recession.

[45] According to Consensus Forecast.

Inflation developments

Risks of deflation continued to prevail in the euro area in Q2 as well. June inflation remained at the March level (0.5% y-o-y) and slid to 0.4% y-o-y in July, which is significantly below the ECB's target of below, but close to, 2%. Low inflation was driven mainly by falling food prices over the previous months. It is expected to stay low in the months ahead. However, in its press releases, the ECB states that long-term inflation expectations are anchored close to the target, which should buoy up inflation's return to the target in the coming period.

In most countries of **Central and Eastern Europe**, y-o-y inflation trended low in Q2. It remained negative in Bulgaria, Montenegro, Macedonia and Bosnia and Herzegovina. As in the previous period, dented demand and low prices in the euro area are the main factors determining low prices in the region. Russia, Ukraine and Turkey are an exception, as currency depreciation in these countries in Q1 pushed prices up in Q2.

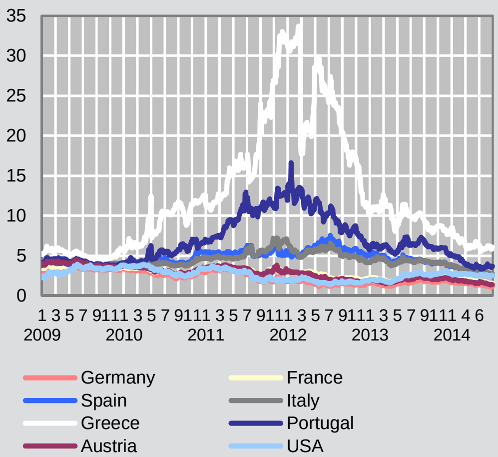
By contrast to Europe, inflation in the **US** rose in Q2 by 0.6 pp to 2.1% in June. The main contributors to growth were food and electricity prices. According to the Consensus Forecast, 2014 is likely to see inflation of 1.8%, which is close to the long-term target.

Monetary policy

The risk of deflation in the euro area, which prevailed into Q2 as well, determined the **ECB's** decision to further ease its monetary policy. In June, the ECB cut its key interest rate by 10 bp to 0.15%, introducing for the first time a negative deposit facility rate (-0.1%). In addition, the ECB introduced Targeted Long-Term Refinancing Operations and announced more intensive outright purchases of private sector asset-backed securities. Both of these non-standard measures aim to boost lending to the non-financial sector.

Some central banks in **Central and Eastern Europe** continued to ease their monetary policies in Q2. The absence of inflationary pressures enabled the Hungarian central bank to trim its base rate by 30 bp. Furthermore, as depreciation pressures, present in early year, diminished, the Turkish central bank began to loosen monetary policy, reducing its base rate by 125 bp. On the other hand, as the crisis in Ukraine heightened, pressures grew stronger in FX markets in Ukraine and Russia, which is why the monetary authorities of these two countries raised their key rates by 300 bp and 50 bp respectively. In July, monetary policy was tightened further in Russia and Ukraine, while easing ensued in Hungary and Turkey.

Chart IV.7.3 **Yield on 10-year bonds of euro area members**
(daily data, in %)



Source: Bloomberg.

The yields on sovereign bonds of highly-indebted euro area members decreased further in Q2.

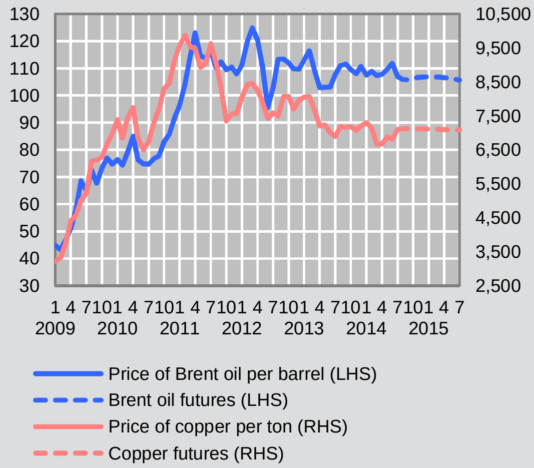
In the course of Q2, the Fed continued to reduce its monthly purchases of US Treasury notes and mortgage-backed securities. The same decision was made in July and purchases stand at USD 25 bln as of August. This is consistent with market expectations that the current quantitative easing (QE3) will end at the close of the year and that the key rate will be raised in 2015.

Financial and commodity markets

Positive trends from the euro area real sector spilled over to the financial market and yields on securities of the highly indebted EU member countries continued to plummet. In May, Portugal's three-year IMF-EU aid programme came to an end. The programme helped stabilise public finance and eliminate external imbalances. Furthermore, Greece continued with successful eurobond issue, selling in July three-year bonds at the rate of 3.5%.

End-of-period, the dollar gained 0.8% against the euro in Q2. The euro strengthened in April because of favourable economic indicators for the euro area and

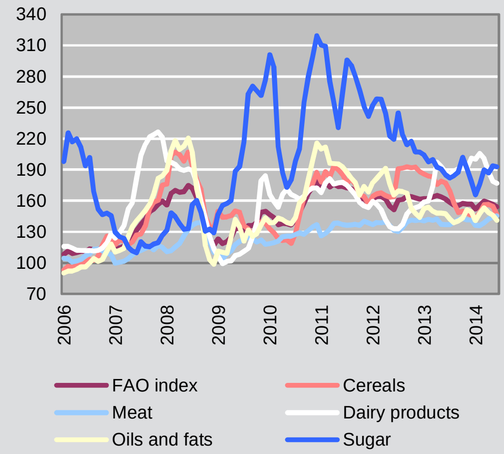
Chart IV.7.4 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

International oil and copper prices edged up in Q2 amid heightened geopolitical tensions and higher demand.

Chart IV.7.5 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

World food prices declined in Q2, reflecting favourable prospects for the global production of cereals and industrial plants.

more unfavourable developments in the US in Q1. Still, after the May ECB's meeting and the announcements of possible cuts in the key rate, the euro steadily depreciated vs. the dollar until end-Q2. ECB's monetary policy easing and a gradual reduction in Fed's monetary accommodation are likely to bolster the dollar against the euro in the period ahead, as also indicated by July movements.

In June, Standard & Poor's downgraded Bulgaria's rating by one notch – from BBB to BBB-, while the outlook was revised from negative to stable. As indicated in the agency's press release, the reasons for such decision lie in the unstable political situation in Bulgaria, which poses risk to the implementation of reforms. Standard & Poor's also revised the outlook on Slovenia from stable to negative, while the rating was kept at A-. The reasons lie in fiscal pressures, rising sovereign debt and weak economic growth prospects. In contrast, Romania's credit rating was raised in May to investment grade (from BB+ to BBB- with a stable outlook), owing to significant progress made in removing external imbalances, upgrading the fiscal position and improving financial stability. In May, Fitch revised Slovenia's outlook from negative to stable, in response to lessened risks in the banking sector and improved fiscal position, while the credit rating was kept at BBB+. Furthermore, Greece's credit rating was raised by one notch, from B- to B because the country achieved a primary budget surplus in 2013.

Gold prices rose by 3.5% in Q2, end-of-period. Gold prices were under the strongest sway of developments in Ukraine, which generated pressures on price growth. By mid-quarter, gold prices declined temporarily after the ECB and central banks of Switzerland and Sweden signed an agreement on coordinating gold transactions so as to avoid market disturbances.

In Q2, prices of Brent oil went up, fuelled by occasional heightening of geopolitical tensions in Iraq, Syria and Libya. At end-June, they were 4.8% higher than in March. However, the easing of tensions and significant revision of GDP growth in the US drove down oil prices by 7.3% in July. In Q2, global copper prices remained under the impact of demand from China, which increased slightly in that period. By late June, copper prices firmed 4.8% relative to end-March.

World food prices recorded a continuous monthly fall in Q2 – in June, the FAO index was by 3.7% lower relative to March. The sharpest downward revisions were made for cereal prices owing to positive production prospects in the current season and diminished uncertainties regarding deliveries from the Black Sea region. The forecasts of record soybean yields pushed down prices of vegetable oil, while bolstered production and low demand dragged down prices of milk and dairy products. In contrast, as the porcine epidemic diarrhoea virus spread across the US, the global meat prices expanded in Q2.

V. Inflation projection

Y-o-y inflation is expected to return within the target tolerance band in Q4 2014 and stay therein throughout 2015. Inflation's return within the target band will be supported by the waning of the disinflationary pressures from food prices, while low aggregate demand will remain the key disinflationary factor. The effect of low aggregate demand will be reinforced by the expected fiscal adjustment measures. The risks to the projected inflation path are associated primarily with developments in the international environment, fiscal movements at home and the outcome of this year's agricultural season.

GDP growth projections have been revised down because of the May flooding and the expected stronger fiscal consolidation. GDP is projected to contract by 0.5% in 2014 and to stagnate in 2015.

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

Initial conditions

Consistent with the expectations stated in the May *Report*, y-o-y inflation moved below the lower bound of the target tolerance band in Q2. In fact, it plunged to 1.3% in June, its lowest level in the past 50 years. Core inflation (CPI excluding food, energy, alcohol and cigarettes) also continued down, settling at end-Q2 at the lower bound of the target tolerance band (2.5%). Inflationary pressures were running low as a result of stable inflation expectations and exchange rate, absence of major cost-push pressures and weak aggregate demand. Looking at CPI components, the current target undershooting is due primarily to food prices which were 4.4% lower in June than in the same month a year earlier. The May flooding had no major effect on food prices, which can be explained by the fall in international primary agricultural commodity prices and low domestic demand.

At quarterly level, consumer prices inched up by 0.8% in Q2, led by the seasonal increase in prices of unprocessed food and travel arrangements.

After relatively robust growth in place since Q4 2013, primary agricultural commodity prices have been on the decline since mid-May in both domestic and international markets. It should be noted, though, that average wheat and corn prices fell less in the domestic market[46] than on the Budapest Commodity Exchange, which is probably due to the flooding. Domestic corn and wheat prices in Q2 were below the levels recorded in the same period a year earlier (by 16.3% and 5.1% respectively). Their fall proceeded in July, which means that the cost-push pressure in the production of food remains low.

One year-ahead inflation expectations of the financial sector were stable in Q2 and continued to revolve around the target, while those of businesses were on the target. The financial sector and businesses expect inflation to stay within the target tolerance band in the medium term, too.

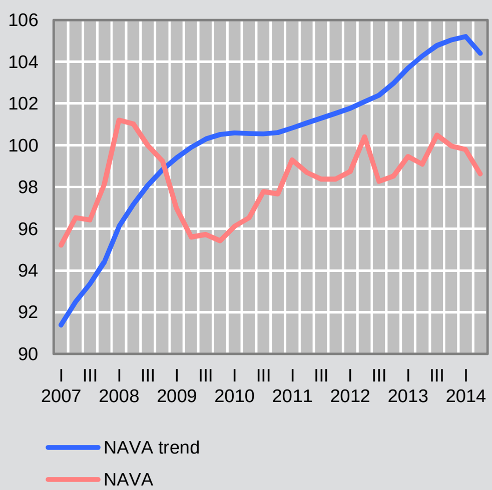
For the major part of Q2, the dinar was under appreciation pressures, thanks chiefly to the fall in the country risk premium and increased non-residents' investment in

[46] At end-Q2, corn and wheat prices in the Novi Sad Commodity Market were 1.8% and 3.5% lower than at end-Q1 (2.7% and 17.2% in the Budapest Commodity Exchange).

government securities (unlike Q1, non-residents were the net sellers of foreign exchange in Q2). In the first ten days of June, EMBI for Serbia fell to 220 bp, close to the level last recorded in early November 2007. In July, however, depreciation pressures emerged on the back of mounting geopolitical tensions, but also unfavourable news regarding the pace and scope of fiscal consolidation in the coming period. Consequently, non-residents resumed their role of net buyers in the foreign exchange market. The NBS intervened in the IFEM by buying EUR 170.0 mln in Q2 and by selling EUR 40.0 mln and buying EUR 10.0 mln in July.

Consolidated budget deficit in H1 amounted to 6.0% of GDP (7.6% including below-the-line expenses). Of this amount, 3.7 pp related to interest payments. The outlook for the budget deficit depends on the dynamics and method of financing flood damage restoration works, as well as on the pace and scope of fiscal consolidation. Based on the estimate of the Ministry of Finance, this year's budget deficit could be higher by around 1.0% of GDP because of the flooding and could reach 8.0–8.5% of GDP (including below-the-line expenses). The revised budget should be adopted in September, while the announced cut in public sector wages and pensions is expected from October.

Chart V.0.1 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Output gap remains markedly negative.

Based on NBS estimates, GDP contracted by 1.1% in Q2 in both s-a and y-o-y terms due to the flood damage suffered by industry (above all, energy and mining) and agriculture. On the expenditure side, a negative contribution is expected from net exports, given that energy imports increased and exports of manufacturing industry declined.

The disinflationary pressures from aggregate demand did not increase to the extent suggested by the estimated fall in economic activity as the economic downturn in Q2 was caused primarily by flooding, i.e. a supply-side shock. Still, the size of the negative output gap[47] indicates that the disinflationary pressures generated by aggregate demand will remain strong in the medium term.

The international environment in Q2 was marked by the still present geopolitical tensions (Iraq, Syria, Libya). This sparked a temporary rise in global oil prices in Q2, driving them up to the level of USD 115.0 per barrel. Already in July oil prices retreated to below USD 104.0 per barrel. The crisis in Ukraine continues to represent risk to economic developments in Europe.

According to the June Consensus Forecast, the euro area economy grew 0.4% s-a in Q2. Positive trends in the real sector spilled over to the financial market and the yields on sovereign bonds of highly-indebted euro area countries continued to narrow down. On the other hand, deflation risks prompted the ECB to trim its main refinancing rate by 10 bp (to 0.15%) and to introduce for the first time ever a negative interest rate on deposit facilities (-0.1%). Unlike the ECB, the Fed proceeded with the tapering of its monthly asset purchases which amount to USD 25.0 bln beginning from August.

External assumptions of the inflation projection

The assumptions for the euro area's GDP growth in 2014 and 2015 have been slightly revised from the May projection – to 1.1% and 1.6%[48], respectively. Domestic demand in the euro area should be supported by monetary policy and improved terms of financing, while a positive

[47] Output gap is calculated based on NAVA (GDP less agricultural production and net taxes). NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

[48] The assumption for the euro area's GDP growth in 2014 and 2015 is consistent with the latest Consensus Forecast.

effect on the economy should also come from progress made in fiscal consolidation and structural reforms and the recovery of demand for exports.

Though euro area inflation measured 0.4% y-o-y in July, medium-term inflation expectations remain firmly anchored below, but close to, 2.0%. According to Consensus Forecast, the markets expect no change in the ECB's main refinancing rate in the coming twelve months.

The movements of primary agricultural commodity prices internationally have a decisive impact on the movements of these prices locally. Although the May projection envisaged a rise in these prices this year, the current commodity futures herald a considerable fall. This taken into account, the projection assumes that the composite index of international primary agricultural commodity prices will go down by 8.0% this year[49].

Even though oil futures suggest a decline in both 2014 and 2015, the projection is more conservative in assuming oil prices[50] will stay close to the level of USD 107.0 per barrel.

Table V.0.1 **Projection assumptions**
(changes relative to the previous projection are given in brackets)

	2014		2015	
External assumptions				
EU inflation (Q4 to Q4)	1.0%	(-0.2)	1.3%	(-0.2)
ECB policy rate (year-end)	0.15%	(-0.1)	0.15%	(-0.1)
Euro area GDP growth	1.1%	(-0.1)	1.6%	(+0.1)
International prices of primary agricult. commodities (Q4 to Q4)*	-8.0%	(-23.0)	8.0%	(+4.0)
Brent oil price per barrel (year-end, USD)	107.0	(-)	107.0	(-)
Internal assumptions				
Administered prices (Dec to Dec)	9.5%	(-0.4)	8.3%	(-0.5)
Trends				
Appreciation trend of the real exchange rate (average)	1.6%	(-0.2)	1.7%	(-0.3)
Real interest rate trend (average)	2.5%	(-0.2)	2.9%	(-0.1)

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

Projection

Inflation projection

Y-o-y inflation is most likely to remain below the lower bound of the target tolerance band in Q3. Under the central projection, it will return within the target tolerance band in Q4 (4.0±1.5%) and stay therein until the end of the projection horizon. From mid-2015, y-o-y inflation is expected to stabilise around the target (4.0%).

In the coming period, inflation movements will be under the decisive impact of food prices, notably prices of fruit and vegetables. Due to the low last year's base, these prices could rise more sharply than other CPI components, leading to a reduction and waning of their disinflationary effect by the end of this year. On the other hand, the fall in prices of primary agricultural commodities will provide for continuing disinflationary pressures on food prices on that account at least until the next agricultural season.

Low domestic demand continues to be the main disinflationary factor in both short and medium term. The disinflationary effect of this factor could be reinforced to a degree by the recent flooding. The expected fiscal consolidation measures will be working in the same direction, weighing down on government and household consumption.

The movement of inflation expectations shows that their effect on inflation remains neutral. We expect that the stability of inflation expectations in the coming period will be buttressed by the achieved stability of prices.

The pressure on prices of imported products is rather modest owing to the relative stability of the dinar in the last year and very low inflation levels abroad.

Administered prices should grow 9.5%[51] in 2014 and contribute around 2.0 pp to headline inflation. Broken down by components, the strongest contribution to this growth is expected to come from the increase in electricity prices and excise tax on cigarettes (0.8 pp and 0.6 pp, respectively). Still, it should be noted that though we have assumed the increase in electricity prices (15.0%) to take place in Q4, it is not as yet known whether it will come about this year at all and if yes, in

[49] This index comprises the prices of wheat, corn and soybean as the most important inputs to the domestic food production.

[50] Brent.

[51] Administered prices should grow faster than headline CPI beacause of the need for gradual removal of price disparities.

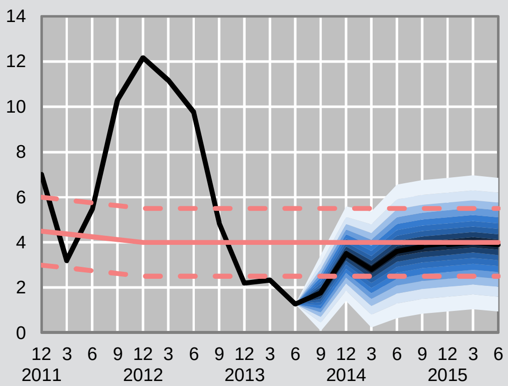
what percentage. Absent the increase in electricity prices, the inflation outturn will be lower than projected.

The risks to the projected inflation path are associated with developments in the international environment, fiscal movements at home, and to a lesser degree, with the outcome of this year's agricultural season.

Further tightening of geopolitical tensions, notably the crisis in Ukraine, could generate multiple negative effects worldwide – it could affect global commodity markets, capital and energy flows and slow down the nascent economic recovery of the euro area. Potential negative effects on economic developments at home are numerous too – ranging from reduced export opportunities to a rise in the country risk premium and a decrease in capital inflows. Still, their impact on inflation cannot be determined conclusively at this point.

A slower pace of growth of the euro area economy could lead to a widening of the negative output gap and hence, stronger disinflationary pressures from aggregate

Chart V.0.2 **Inflation projection**
(y-o-y, in %)



Source: NBS.

Y-o-y inflation is expected to return within the target tolerance band in Q4 and to stay therein until the end of the projection horizon.

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%.

demand. An increase in investor risk aversion in the international financial markets, however, would probably dampen capital inflows and usher in depreciation and consequently, trigger pressures on domestic prices. In addition to a potential rise in international prices of primary agricultural commodities, inflationary pressures could also stem from potential disruptions in energy flows because of dented supply. The pressures could arise if these disruptions cause a standstill in production, this however, being a highly unlikely scenario.

In the circumstances described, the efforts to reduce fiscal imbalance are of critical importance. This year's consolidated budget deficit will be additionally burdened by the need to restore flood damage. From the aspect of public finance sustainability, the implementation of fiscal adjustment measures should start as soon as possible. This would also increase the resilience of the domestic economy to potential external shocks. The risk to inflation projection in the area of fiscal policy could manifest, on the one hand, as the implementation of stronger-than-expected fiscal consolidation measures (a higher-than-expected cut in wages and pensions), and as a potential increase in the VAT rate, on the other. Note, however, that the latter would have a one-off inflationary effect only.

Though this year's agricultural season is nearing its end, the possibility that fruit and vegetable prices could deviate from the projected path cannot be disregarded given that these prices are the most volatile component of CPI, i.e. they cannot be predicted with a high degree of reliability. Hence, deviation of these prices and thus, of their impact on inflation is possible in either direction.

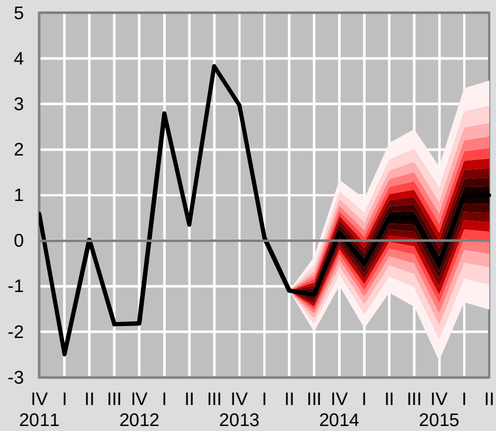
On balance, the risks to the inflation projection are judged to be symmetric.

Looking ahead, monetary policy easing will depend primarily on the Executive Board's assessment of the potential inflationary effect of developments in the international environment, as well as on the pace and scope of fiscal consolidation at home.

GDP projection

The projection of GDP growth for 2014 and 2015 has been revised down from the previous *Report* due to the May

Chart V.0.3 **GDP growth projection**
(y-o-y rates, in %)



Source: NBS.

GDP is projected to fall by 0.5% in 2014 and to stagnate in 2015.

flooding and the announced sharper fiscal consolidation measures than anticipated earlier. Thus, GDP is projected to fall by 0.5% in 2014 and to stagnate in 2015. The experience of other countries shows that elementary disasters of similar strength have a short-term negative effect on economic and foreign trade activity, which however turns into a positive or neutral long-term effect owing to increased capital inflows and vigorous investment.

The economic contraction in 2014 will be led by the fall in activity in the sectors of mining and energy and by the downturn in agricultural production. It is expected, however, that the negative effects of flooding will be moderated by the faster pace of activity in the construction industry in H2, driven by the need to restore damage on property and infrastructure. On the expenditure side, the contribution of net exports to GDP will remain positive, albeit smaller than previously expected because of higher imports of energy, construction materials and equipment, on the one hand, and lower exports of manufacturing industry, on the other. At the same time, damage restoration efforts should have a positive impact on investments and their contribution to GDP. As in the previous projection, the contribution of government and household consumption will remain negative due to the expected fiscal consolidation measures.

In 2015, GDP is most likely to stagnate (0.0% growth). The largest positive contribution should come from net exports as a result of further recovery of the euro area and slower growth in imports against the background of fiscal consolidation. Though flood damage restoration will lead to increased investment next year, we estimate that the positive contribution of net exports and investments will be neutralised by the somewhat steeper drop in final consumption which can be reasonably expected given that the announced fiscal consolidation measures are sharper than anticipated originally. More specifically, in addition to public sector wages, it seems highly probable that pensions will be adjusted as well.

The risks to GDP projection are associated with the pace of economic recovery of the euro area, i.e. Serbia's key foreign trade partners, especially in case current geopolitical tensions escalate further and cause disruptions in global trade, energy and financial flows, as well as with the pace and scope of fiscal consolidation that will have a negative short-term impact on aggregate demand. A significant factor for the achievement of GDP projection is the dynamics of flood damage restoration, particularly in the fields of construction and energy, but this will depend on the availability of the sources of financing. The projection operates on the assumption that the energy security of the country will be maintained despite reduced capacities in the energy supply system. On balance, the risks to GDP projection are judged to be symmetric.

Projections by other institutions

According to the projections of other institutions (IMF, European Commission, Consensus Forecast), this year as well the average annual inflation rate in Serbia should stay within the target tolerance band (4.0±1.5%) and GDP should grow 0.8–1.1% in 2014 and 1.5–2.1% in 2015. The current account deficit is forecast at around 5.0% of GDP. It should be taken into account, however, that the IMF and the European Commission have not as yet revised their projections to account for the effect of recent flooding.

Based on the July Consensus Forecast, the average annual inflation rate will amount to 3.1% in 2014 and 4.6% in 2015, less than projected in April. The projections of GDP and current account deficit were also revised down – GDP growth should measure 0.8% in 2014 and 2.1% in 2015, and the current account deficit – 5.2% and 5.3% of GDP[52], respectively.

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

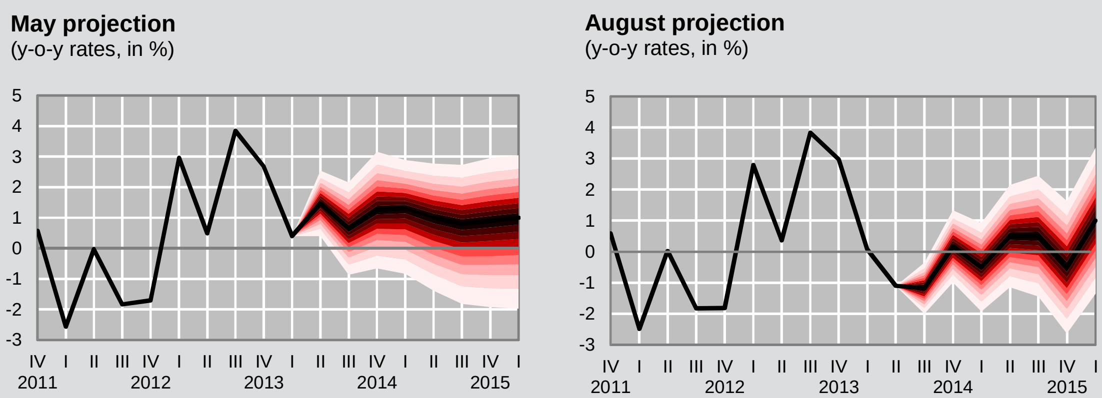
	2014		2015	
	Previous	New	Previous	New
Inflation (annual average, in %)				
National Bank of Serbia	3.1	2.3	4.2	3.2
IMF	4.0	-	4	-
European Commission	3.8	-	4.5	-
Consensus Forecast	3.8	3.1	4.9	4.6
GDP (%)				
National Bank of Serbia	10	-0.5	10	0.0
IMF	10	-	15	-
European Commission	11	-	19	-
Consensus Forecast	12	0.8	2.5	2.1
Current account deficit (% of GDP)				
National Bank of Serbia**	3.9	5.9	-	3.8
IMF	4.8	-	4.6	-
European Commission	4.6	-	4.3	-
Consensus Forecast*	5.7	5.2	6.1	5.3

Sources: NBS, IMF WEO (April 2014), European Commission (Spring forecast 2014) и Consensus Forecast (April 2014 and July 2014).

* Calculated based on the NBS projection of nominal GDP in dollars from May and August 2014.

** The projection is based on the new balance of payments methodology.

Chart V.0.4 **Current vs. previous GDP growth projection**

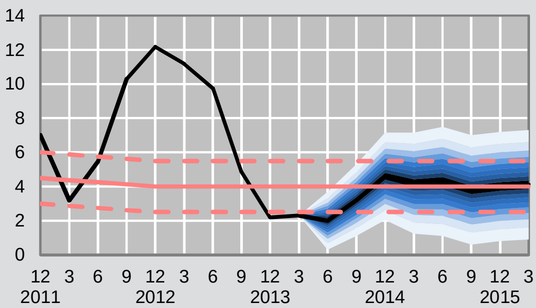


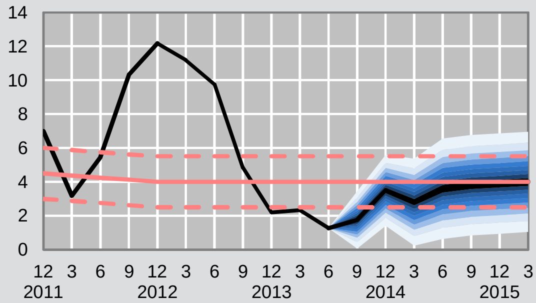
Source: NBS.

GDP growth projections for 2014 and 2015 have been revised down from May.

[52] Recalculated by the NBS since Consensus Forecast shows the current account deficit in absolute (dollar) terms.

Chart V.0.5 **Current vs. previous inflation projection**





Source: NBS.

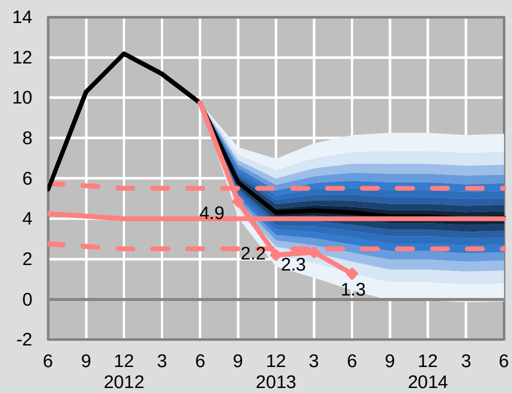
The projected spread of inflation outcomes until mid-2015 is lower than in the May projection.

Comparison with the previous projection

A sharp decline in the prices of primary agricultural commodities in the last three months, which began right after the publication of the May Report, made the cost-push pressure in the production of food much weaker than assumed by the previous projection. For this reason, inflation's return within the target tolerance band has been delayed from Q3 to Q4. Consequently, the new projection envisages slightly lower inflation levels in H1 2015 compared to the previous one. Inflation projection from H2 2015 onwards has remained unchanged, and so has the medium-term projection band.

During the last twelve months, y-o-y inflation was moving close to the lower edge of the band projected in August 2013. Inflation deviated from the central projection as the disinflationary effect of food, notably fruit and vegetable prices, and aggregate demand proved stronger than envisaged before.

Chart V.0.6 **Achievement of August 2013 inflation projection**
(y-o-y rates, in %)



Source: NBS.

During the last twelve months, y-o-y inflation was moving close to the lower bound of the August 2013 projection band.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014
EXTERNAL LIQUIDITY INDICATORS (in %)											
FX reserves/imports of goods and services (in months)	6.1	9.0	7.5	5.4	9.7	8.4	8.8	7.7	7.5	7.0	6.7[1)]
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.0	299.6	242.6	285.5	276.2	273.4
FX reserves /GDP	24.3	38.5	33.8	24.9	36.6	35.8	38.3	36.9	35.0	32.6	31.9
Debt repayment/GDP	5.2	10.8	10.7	11.0	13.5	12.7	13.3	14.0	14.0	13.5	12.4
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.4	37.6	36.1	32.2	30.1	25.8
EXTERNAL SOLVENCY INDICATORS (in %)											
External debt/GDP	61.7	61.3	61.1	64.2	76.9	84.1	76.6	86.6	80.6	80.4	79.9
Short-term debt/GDP	13.7	14.6	13.5	15.4	16.6	18.7	12.8	15.2	12.3	11.8	11.7
External debt/exports of goods and services	234.9	205.7	214.2	219.1	277.0	246.9	216.4	223.0	184.7	178.1	172.8
FINANCIAL RISK EXPOSURE INDICATORS (in %)											
FX reserves/M1	290.3	356.1	306.7	300.4	393.4	416.6	429.6	402.1	330.4	335.3	293.1
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	192.8	191.8
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	73.6	81.2	83.0	85.2	73.0	85.0	87.8	96.3	99.3	100.8	107.7[1)]
MEMORANDUM: (in EUR million)											
GDP	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	31,994	7,357	7,607[1)]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,788	25,676	25,340
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,191	4,150	4,495	994	942
Central bank foreign exchange reserves	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,189	10,428	10,125
Short-term debt[2)]	951	968	1,044	1,832	1,843	1,752	601	455	186	129	157
Current account balance	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,639	-2,092	-498	-360[1)]

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

Methodological notes:

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

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

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

Debt repayment/GDP (in %) - ratio of debt repayment to GDP during period under review, excl. early repayment of a portion of debt to London Club creditors.

Debt repayment/exports (in %) - ratio of debt repayment to exports of goods and services during period under review, excl. early repayment of a portion of debt to London Club creditors.

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

Short-term debt/GDP − ratio of end-of-period short-term debt at remaining maturity to GDP.

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

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

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

1) NBS estimate.

2) At original maturity.

Notes:

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

2. Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5.

3. As of 1 January 2010 the Serbian Statistical Office applies the general trade system of registration of exports and impots which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4. In September 2010, the methodology of external debt statistics was changed – public sector external debt includes liabilities under SDR allocation (EUR 435.9 mln) used in December 2009. Private sector external debt excludes loans concluded before 20 December 2000 in respect of which no payments are made (EUR 844.4 mln, of which EUR 387.8 mln relates to domestic banks and EUR 456.6 mln to domestic enterprises).

5. Foreign debt repayment does not include: short-term debt repayment and advance debt repayment.

Table B
Key macroeconomic indicators

	2005	2006	2007	2008	2009	2010	2011	2012	2013	Q1 2014	Q2 2014
Real GDP growth (in %)[1)]	5.4	3.6	5.4	3.8	-3.5	1.0	1.6	-1.5	2.5	0.1	-1.1
Consumer prices (in %, relative to the same month a year earlier)[2)]	17.7	6.6	11.0	8.6	6.6	10.3	7.0	12.2	2.2	2.3	1.3
NBS foreign exchange reserves (in EUR million)	4,921	9,020	9,634	8,162	10,602	10,002	12,058	10,914	11,189	10,428	10,125
Exports (in EUR million)[3)]	5,329	6,948	8,114	9,577	8,041	9,521	11,147	11,498	13,963	3,306	3,653[5)]
- growth rate in % compared to a year earlier	19.1	30.4	-	18.0	-16.0	18.4	17.1	3.2	21.4	16.0	7.3[5)]
Imports (in EUR million)[3)]	9,612	11,970	15,503	18,267	13,098	14,243	16,497	16,993	17,796	4,113	4,538[5)]
- growth rate in % compared to a year earlier	0.7	24.5	-	17.8	-28.3	8.7	15.8	3.0	4.7	2.6	3.8[5)]
Current account balance[3)]											
(in EUR million)	-1,778	-2,356	-5,320	-7,135	-1,770	-2,082	-3,305	-3,639	-2,092	-498	-360[5)]
as % of GDP	-8.8	-10.1	-18.7	-21.8	-6.1	-7.4	-10.5	-12.3	-6.5	-6.8	-4.7[5)]
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	20.8	20.3
Wages (average for the period, in EUR)	209.7	260.0	347.1	400.5	337.4	330.1	372.5	364.5	388.6	361.4	388.7
RS budget deficit/surplus (in % of GDP)	0.7	-1.7	-1.1	-1.9	-3.3	-3.5	-4.1	-5.7	-4.8	-8.4	-5.1
Consolidated fiscal result (in % of GDP)	1.1	-1.5	-1.9	-2.6	-4.5	-4.8	-5.0	-6.6	-5.0	-7.6	-4.4
RS public debt, (external + internal, in % of GDP)[4)]	52.2	37.7	31.5	29.2	34.7	44.5	48.2	60.2	63.8	64.9	65.6
RSD/USD exchange rate (average, in the period)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	84.47	84.30
RSD/USD exchange rate (end of period)	72.22	59.98	53.73	62.90	66.73	79.28	80.87	86.18	83.13	83.89	84.85
RSD/EUR exchange rate (average, in the period)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	115.75	115.58
RSD/EUR exchange rate (end of period)	85.50	79.00	79.24	88.60	95.89	105.50	104.64	113.72	114.64	115.38	115.79
MEMORANDUM:											
GDP (in EUR million)	20,306	23,305	28,468	32,668	28,952	27,968	31,472	29,601	31,994	7,357	7,607[5)]

1) At constant prices of previous year.

2) Retail prices until 2006.

3) Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM5. Due to methodological incomparability, extports and imports growth rates are not shown. Trade with Montenegro is registered within relevant transactions as of 2003. As of 1 January 2010, the Serbian Statistical Office applies the general trade system of registration of exports and imports which is a broader concept and includes all goods entering/exiting country's economic territory, apart from goods in transit. The Statistical Office has published comparable data for 2007, 2008 and 2009. Previous years are disseminated using the special trade system. Trade with Montenegro is registered within relevant transactions as of 2003.

4) Government securities at nominal value.

5) NBS estimate

Notes:

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

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Executive Board meetings and changes in the key policy rate

2013

Date	Key policy rate (p.a, in %)	Change (in basis points)
17 January	11.50	+25
5 February	11.75	+25
12 March	11.75	0
11 April	11.75	0
14 May	11.25	-50
6 June	11.00	-25
11 July	11.00	0
8 August	11.00	0
10 September	11.00	0
18 October	10.50	-50
7 November	10.00	-50
17 December	9.50	-50

2014

Date	Key policy rate (p.a, in %)	Change (in basis points)
16 January	9.50	0
13 February	9.50	0
6 March	9.50	0
17 April	9.50	0
8 May	9.00	-50
12 June	8.50	-50
10 July	8.50	0
7 August	8.50	0
11 September		
16 October		
13 November		
11 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 12 June 2014

At its meeting today, the Executive Board decided to cut the key policy rate by half a percentage point, to 8.5 percent.

The decision was based on the assessment that the y-o-y inflation rate would continue to revolve around the lower bound of the target tolerance band and that the recent flooding would not lead to an increase in inflationary pressures.

Inflationary pressures are expected to stay low, supported by stable inflation expectations and exchange rate attributable to monetary policy measures, favourable balance of payments trends and the fall in the country risk premium.

Besides, the risks from international environment also subsided, partly in response to increased monetary policy accommodation on the part of the ECB. The Executive Board judges that the ECB's move should have a positive impact on liquidity in the international capital markets.

The Executive Board maintains that the recent flooding will take its toll on economic activity, especially in the energy and agricultural sectors. Hence, it may reasonably be expected that the GDP will stagnate this year and that the balance of payments trends will be less favourable than anticipated earlier. Nevertheless, this year again, the share of the current account deficit in GDP will be lower than in the year before.

The scope of flood damage will call for additional fiscal policy efforts in the coming period. The Executive Board expects, however, that the Government will remain committed to the implementation of fiscal consolidation, structural reforms and measures aimed at further improving the business environment.

The next rate-setting meeting will be held on 10 July.

Press release from Executive Board meeting held on 10 July 2014

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 8.5%.

Though y-o-y inflation rate is currently moving around the lower bound of the target and inflationary pressures are rather low as a result of low aggregate demand (main medium-term disinflationary factor), stable exchange rate and anchored inflation expectations, the Executive Board decided to keep the rate on hold, mindful of potential risks to the Serbian economy in the period ahead.

The Executive Board stated that the recent flooding is taking its toll on economic activity, particularly in the sectors of energy, mining and agriculture, and making the growth prospects for this year bleaker than anticipated. For the same reason, the balance of payments developments are likely to be less favourable than earlier expected. Still, the impetus to economic activity will come from subsidised lending, flood damage restoration works and the expected accelerated implementation of the South Stream project.

The flood relief and damage restoration efforts will exert a one-off upward effect on government expenditure. Nonetheless, the Executive Board expects the Government will remain committed to the implementation of fiscal consolidation measures and structural reforms.

The decision to keep the rate unchanged was also underpinned by the Board’s awareness of the still present, though less pronounced, risks relating to liquidity levels in the international capital markets.

The next rate-setting meeting is scheduled for 7 August.

Press release from Executive Board meeting held on 7 August 2014

At its meeting today, the NBS Executive Board voted to keep the key policy rate at 8.5%.

Y-o-y inflation is moving below the lower bound of the target tolerance band and is expected to return within the target band by the year-end. Such movements are attributable to low inflationary pressures, reflecting mainly low aggregate demand and the continuing disinflationary impact of prices of primary agricultural commodities, relative stability of the dinar exchange rate and inflation expectations.

However, considering the expected depletion of effects of low food prices and the risks that may adversely affect economic developments at home in the coming period, the NBS Executive Board decided to keep the key policy rate on hold.

In taking the decision, the NBS Executive Board also took into account the persistent uncertainties emanating from the international environment, which may negatively impact the country's risk premium and foreign capital flows. The risks of further heightening of geopolitical tensions also relate to the postponement or slowdown of the initiated economic recovery of euro area. The NBS Executive Board expects that consistent implementation of fiscal consolidation measures and structural reforms in the period ahead may contribute to the alleviation of external risks.

At its meeting today, the NBS Executive Board adopted the August Inflation Report, to be presented at the press conference on Wednesday, 13 August.

The next rate-setting meeting is scheduled for 11 September 2014.

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