National Bank of Serbia

2015
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 13 August 2015.

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

BRICS – Brazil, Russia, India, China and South Africa

CPI – Consumer Price Index

ECB – European Central Bank

EIB – European Investment Bank

EMBI – Emerging Markets Bond Index

FAO – UN Food and Agriculture Organization

FDI – foreign direct investment

Fed – Federal Reserve System

FISIM – Financial Intermediation Services Indirectly Measured

GDP – gross domestic product

H – half-year

IFEM – Interbank Foreign Exchange Market

IMF – International Monetary Fund

LHS – left hand scale

mln – million

NAVA – non-agricultural value added

NBS – National Bank of Serbia

NPLs – non-performing loans

OFI – other financial organisation

OPEC – Organization 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 Organization

y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I. Overview

Consistent with our expectations, inflationary pressures remained muted in the second quarter and year-on-year inflation continued to move below the lower bound of the target tolerance band.

Inflationary pressures remained muted in the second quarter, on account of the majority of domestic factors, subdued inflation in the international environment and low prices of primary commodities in the world market. The quarterly price growth was almost fully determined by the seasonal rise in prices of travel packages and an upturn in cigarette and petroleum product prices. Consistent with expectations presented in the May *Inflation Report*, year-on-year inflation continued to move below the lower bound of the target tolerance band. This was due mainly to the absence of expected administered price adjustments over the past year and a fall in petroleum product prices triggered by the collapse of global oil prices late last and early this year. The major positive contribution to year-on-year inflation was provided, this time again, by prices of food, notably fruits and vegetables.

Economic recovery in the euro area has accelerated and its positive effects are gradually spreading to the region of Central and Eastern Europe.

Economic activity in the euro area has accelerated owing to the European Central Bank's quantitative easing and low oil prices. Positive effects are gradually spreading to the region of Central and Eastern Europe, Serbia included. After a temporary halt in early 2015, growth has accelerated in the United States of America as well, which could, given more favourable labour market trends, motivate the Federal Reserve System to raise its policy rate by the year-end.

The expected asymmetric exit of leading central banks from accommodative monetary policies is one of the primary sources of uncertainty in the international financial market.

Although liquidity in the international financial market is currently very high and is conducive to capital inflows to emerging economies, movements in financial and commodity markets are marked by uncertainties as to the effects of an asymmetric exit of leading central banks from accommodative monetary policies, prices of oil and other primary commodities in the coming period, as well as persisting geopolitical tensions.

Improved macroeconomic prospects, along with ample global liquidity, contribute to stability of the domestic foreign exchange market.

The dinar exchange rate was stable in the second quarter. End-of-period, the dinar weakened by 0.3% against the euro, but gained 0.9% in terms of quarter-average. Stability in the domestic foreign exchange market was achieved owing to improved macroeconomic prospects of the country, but primarily thanks to favourable balance of payments and fiscal trends, as confirmed by the successful first review of the arrangement with the International Monetary Fund in June, affirmation of the country's credit rating by Fitch and Standard & Poor's, and stable movements in the country's risk premium. To ease excessive short-term volatility of the exchange rate and without any intention to influence its trend, the National Bank of Serbia intervened in the interbank foreign exchange market in the second quarter, by purchasing EUR 150.0 million and selling EUR 30.0 million.

The National Bank of Serbia continued to ease monetary policy by reducing the key policy rate to its lowest level since inflation targeting was introduced as a monetary strategy.

The key policy rate was cut by 150 basis points to 6.0% in the second quarter. It was lowered further, to 5.5% in August, which is its lowest level since inflation targeting was introduced. Continued monetary policy easing was underpinned by the persistent disinflationary effects of demand and low cost-push pressures. Also, it was assessed that in an environment of ample global liquidity, fiscal consolidation and the arrangement with the International Monetary Fund serve as a fillip to investors' interest in Serbia and, together with the expected narrowing in external imbalances, buttress the stability of the foreign exchange market. Cuts in the key policy rate reflected on a fall in interest rates in the interbank money and loan market.

As indicated by results of the July bank lending survey, trends in the credit market were somewhat more favourable than in the first quarter.

Lower costs of corporate and household borrowing fuelled the demand for loans. Compared to the quarter before, trends in the credit market were more favourable – June was the first month this year to see monthly growth in lending. The growth was driven mainly by corporate lending, and to a lesser extent by lending to households and other financial organisations. Y-o-y, domestic lending decelerated since April, primarily owing to the base effect, i.e. end of the subsidised lending programme. The coming period is likely to see further slowdown in lending as over 80% of total extended subsidised loans fall due this year, whereas the volume of new loans is modest given the persistently low demand and sluggish economic recovery.

Internal imbalances are narrowing owing to fiscal consolidation measures.

Favourable fiscal movements continued into the second quarter. Consolidated budget deficit amounted to RSD 35.3 billion in the first half of the year (1.9% of gross domestic product), which is significantly below the criterion defined with the International Monetary Fund. At the same time, primary surplus came at 2.0% of gross domestic product. This will contribute to a lower than projected deficit at the year-level.

The narrowing in internal imbalances went in step with a further reduction in external imbalances.

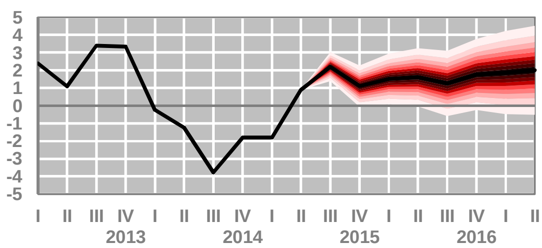
In the first half of the year, the current account deficit was by around 30.0% lower year-on-year. This was a result of a higher surplus on the balance of services, an increase in remittances inflow and lower expenditure on account of foreign direct investments. The current account deficit is expected to reach 4.2% of gross domestic product in 2015. It will narrow mainly on the back of tumbling oil prices and the recovery of mining and electricity production sectors from last year's floods. Moreover, foreign direct investments are expected to almost fully cover the current account deficit.

Stronger than expected growth in gross domestic product was achieved in the second quarter owing to a further rise in the industry, spurred by external demand and lower prices of energy products, and the recovery of the construction sector.

Good results in the industry and construction sector brought about stronger than expected growth in gross domestic product in the second quarter (1.9% seasonally-adjusted or 0.9% year-on-year). Continued growth in industrial production may be associated with lower energy prices (conducive to lower costs), further economic recovery in the euro area (which spurred external demand), and the recovery of the mining-energy complex following last year's floods. Such positive trends also reflected on gradual restoration of economic activity to its pre-crisis level. On the expenditure side, the strongest impetus was lent by elevated private investment and private consumption. Investment stepped up owing to reforms in the fields of labour and bankruptcy legislation, new legal solutions in construction, and improved financial position of enterprises. Private consumption went up in response to a higher disposable income, driven mainly by falling oil prices and growth in remittances.

Relative to the May projection when we expected stagnation, gross domestic product is now expected to grow 0.5% this year. The economic growth projection of 1.5% for the next year remains unchanged.

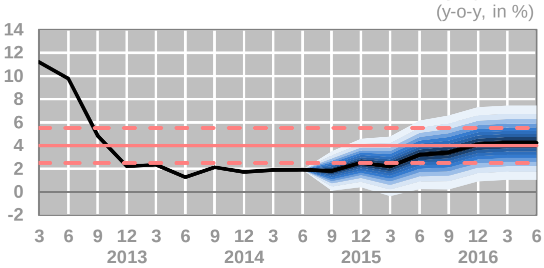
GDP growth projection
(y-o-y rates, in %)



Compared to our forecasts from the May *Inflation Report,* we now expect better performances in the industry and construction sector, as well as weaker negative effects of fiscal consolidation. In addition, due to adverse weather conditions, the decline in agricultural production will be steeper than expected. On the expenditure side, consistent fiscal adjustment, accompanied with structural reforms, is likely to drive up investments and net exports. A negative contribution to gross domestic product is expected from final consumption of households and the government. However, the fall in consumption this year should be less severe than anticipated three months ago and is the main reason for the upward revision of growth in gross domestic product for 2015.

Year-on-year inflation will revolve around the lower bound of the target tolerance band over the coming twelve months. Its more durable return within the target tolerance band is expected in mid-2016.

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



Under our central projection, year-on-year inflation will revolve around the lower bound of the target tolerance band over the coming twelve months, possibly entering the band late this year or early next year. Inflation is expected to trend closer to the 4.0% target in the second half of 2016. Looking ahead, administered prices will be the main inflationary factor (the August electricity price increase and low last year's base for cigarette prices). In contrast, disinflationary effects will still be generated by global prices of primary commodities (oil and primary agricultural commodities), dampened aggregate demand, low inflation in the international environment and restrictive fiscal policy at home. The risks to the projected inflation path relate to developments in the international environment, movements in primary commodity prices and administered prices.

The character of monetary policy in the coming period will depend primarily on the assessment of the inflationary effect of developments in the international environment and movement in prices of primary agricultural commodities.

As external risks persist, the character of monetary policy will depend primarily on the assessment of their potential inflationary effect. An important factor will also be this year's agricultural season, i.e. movement in primary agricultural prices in the domestic and international markets.

II. Monetary policy since the May *Report*

Following a cut in May, the key policy rate was lowered in June for the fourth month in a row, by 50 bp to 6.0%. In July, the key policy rate was kept unchanged, only to be lowered in August, again by 50 bp to 5.5%, which is its lowest level since inflation targeting was introduced.

Continued monetary policy easing was underpinned by the majority of domestic factors and by low inflation abroad and low primary commodity prices in the international market. Also, it was assessed that in an environment of high global liquidity, fiscal consolidation at home and the arrangement with the IMF served as a fillip to investors' interest in Serbia, and together with the expected narrowing of external imbalances, buttressed the stability of the foreign exchange market.

The key policy rate was kept on hold in July, given the scope of prior monetary policy easing (200 bp in the period March–June) and its impact on inflation's return within the target tolerance band, as well as caution over potential indirect effects of the Greek crisis on Serbia, those direct being relatively weak.

Y-o-y inflation continued to move below the lower bound of the target tolerance band in the period following the May Report. Under the projection released at the time, y-o-y inflation was to return within the target tolerance band (4±1.5%) in H2 and stay within the band until the end of the projection horizon. Consumer prices were expected to rise steadily as a result of low last year's base and the increase in prices of several products (cigarettes, petroleum products and electricity) which largely contributed to the undershooting of the inflation target tolerance band in the past year. The inflation projection was slightly lower than the one released in February because of the assumption of a somewhat weaker administered price growth. On the other hand, GDP projection envisaged stagnation in 2015, in contrast to the decline projected in February, while the projection of 1.5% GDP growth in 2016 remained unchanged. A more favourable economic outlook for 2015 reflected a somewhat faster recovery of the euro area and a smaller than expected drop in final consumption, supported also by lower prices of oil.

Starting from the May projections of inflation and economic activity and incoming information on economic developments, the NBS Executive Board concluded in both its **May** and **June** meetings that there was room for further monetary easing and monetary policy contribution to the recovery of the domestic economy. **The key policy rate was cut by 50 bp in each meeting, down to 6.0%.** Lowering the key policy rate, the Executive Board voiced its expectation of an adequate response of banks, i.e. reduction of their lending rates, notably rates on dinar lending, in order to support credit growth, and by extension, economic activity growth in the period ahead.

The Executive Board decided to proceed with monetary easing, given that no major inflationary pressures were expected going forward. The absence of these pressures was indicated by the stabilisation of both short- and medium-term inflation expectations within the NBS target band. The rate was lowered based on the assessment that strong disinflationary pressures would emanate from aggregate demand, prices in the international environment and global market of primary commodities in the medium run. These disinflationary pressures were expected to be underpinned by tighter fiscal policy at home which reaffirmed the economic policy makers' commitment to strengthening public finances. Together with structural reforms and successful implementation of the programme with the IMF, this was expected to have a positive effect on the country risk premium and investors' perception of Serbia.

Besides, movements in the international environment were more favourable than late last year, as the already high global liquidity resurged on the back of the ECB's quantitative easing programme. At the same time, the timing of the anticipated rise in the Fed's rate was moved forward – to Q3 according to analysts or to year-end according to interest rate futures. Given the low, and even negative yields in advanced economies, high global liquidity and investors' search for higher yields were expected to have a positive effect on capital inflow to Serbia. The Executive Board assessed that this, coupled with a low current account deficit, should contribute to the stability of the exchange rate and the foreign exchange market.

After reviewing current monetary and macroeconomic trends and projections in its **July** meeting, the Executive Board decided to keep the **key policy rate on hold**. That decision was taken in view of the effects of prior monetary policy easing and its contribution to the expected return of inflation within the target band, as well as potential risks associated with the Greek crisis, which warranted caution. Despite the fact that direct effects on the Serbian economy, stemming from the economic relations with Greece, were relatively small, the Executive Board estimated that there were risks of indirect negative effects on capital flows and the cost of debt servicing for emerging economies, Serbia included.

External risks have lessened after Greece reached an agreement with international creditors, which, along with Serbia's arrangement with the IMF and the more favourable than expected economic and balance of payments performances, contributes to the relative stability of the foreign exchange market and improved investor perception. Having this in mind, as well as the disinflationary effect of the majority of domestic factors, low inflation abroad and stabilisation of inflation expectations within the target tolerance band, the Executive Board **decided to lower the key policy rate in August by 50 bp to 5.5%**, which is its lowest level since inflation targeting was adopted as the new monetary policy framework of the country.

The Executive Board highlighted that the continued successful implementation of fiscal consolidation measures and structural reforms, along with the arrangement with the IMF, contributes significantly to the sustainability of public finances and Serbia's macroeconomic prospects, thus reducing the vulnerability of the domestic economy to external shocks.

Text box 1: Inflation target set for the period until end-2018

In cooperation with the Government, in August the NBS Executive Board set the y-o-y inflation target for 2017 and 2018[1] at 4%, with the target tolerance band of ±1.5 pp. The medium-term inflation target and the target tolerance band remained unchanged relative to those set for the period until end-2016. Such decision was guided primarily by the fact that the price convergence process has not ended and that it may speed up once the domestic economy exits recession.

Table O.1.1 **NBS inflation targets from 2009**

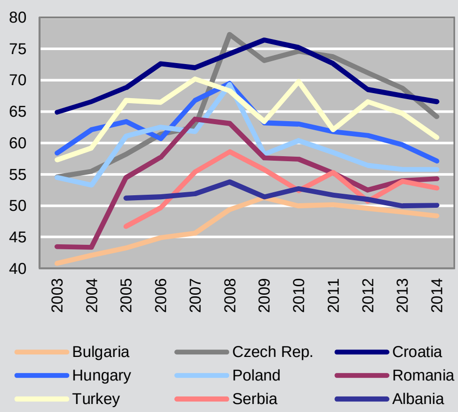
2009	8.0% ± 2.0 pp
2010	6.0% ± 2.0 pp
2011	4.5% ± 1.5 pp
2012–2018	4.0% ± 1.5 pp

Source: NBS.

Price convergence is the main reason why the inflation target in emerging economies, including Serbia, is higher than in advanced economies (where price stability is usually quantified as the inflation rate ranging from 2.0% to 2.5%). As the convergence of prices in Serbia to the EU levels has not ended, i.e. due to the crisis and falling domestic demand the level of Serbian prices compared to those in the EU is lower today than it was five years ago, the NBS Executive Board made the decision to keep the inflation target unchanged. Namely, in 2014 domestic prices made up 52.8% of the average EU level, down from 55.8% in 2009. At the same time, the degree of price convergence changed each year (on the back of volatility of the real effective exchange rate of the dinar) and was reversed in the major part of the period observed. A departure from EU price levels since the crisis erupted was also recorded in other countries of the region (see Chart O.1.1).

Broken down by product groups, a low degree of convergence is particularly pronounced in the field of administered prices – at end-2014, they accounted for 44.4%[2] of the EU level, down by 0.9 pp relative to end-2013. The decline was prompted mainly by the absence of electricity price adjustments last year and muted growth in prices of other products and services within this category. However, given the need to remove price disparities, administered price growth will be faster in the coming period compared to the growth in general price levels and targeted inflation. It should be borne in mind that, even after the August increase, electricity prices remain significantly below their regional peers. Besides, consistent with the EU accession process, excises on cigarettes are likely to go up, and the arrangement with the IMF envisages adjustments of administered prices aimed at bringing them closer to the market level. With this in mind, annual administered price growth is expected at 5–8% in the target period. Given the administered price share of around 20% in the consumer basket, the inflation rate will be higher by 1.0–1.6 pp compared to inflation that would be achieved in an environment of completed administered price adjustment.

Chart O.1.1 **Degree of price convergence in Serbia and countries of the region**
(EU28=100)



Source: Eurostat.

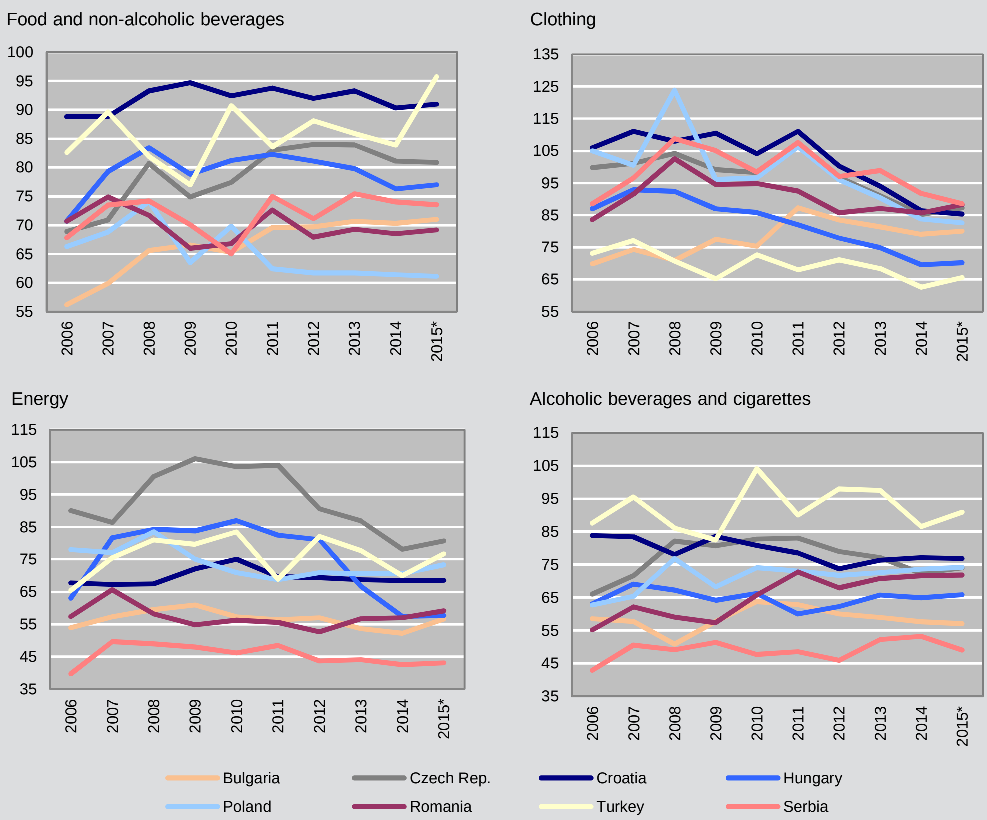
Though it is hard to predict the dynamics of the convergence of local prices to the EU average in the years ahead, speedy economic recovery may lead to its renewed acceleration. Namely, in the pre-crisis period of 2005–2008 when Serbia's GDP grew by around 5% in average real terms a year, the level of prices rose from 46.7% to 58.6% compared to the EU average. Thus, as the Serbian economy exits recession, labour productivity in Serbia may grow faster than in the euro area. As a result, as it was the case until 2008, local prices may rise at a quicker pace relative to EU prices (the Balassa-Samuelson effect).

[1] See Appendix, p. 62.

[2] EU-28 average.

In addition, caution should be exercised although y-o-y inflation has been very low for two years already, trending below the lower bound of the target tolerance band for the major part of time, which could be taken as an argument to lower the targeted inflation rate. Such trends were due primarily to one-off factors, such as falling prices of primary commodities in the global market (oil, primary agricultural commodities and industrial raw materials) and muted growth in domestic administered prices. With the depletion of the disinflationary effect of these factors, inflation will gradually rise and return with the (current) target boundaries. An additional argument for keeping prices at the level of 4.0% is the possibility to ensure a higher degree of flexibility and predictability of monetary policy. In case of a lower inflation target and stronger inflationary pressures, monetary policy would have to respond more vigorously in order to ensure inflation moving within the target tolerance band, which may adversely affect the already slow expected economic recovery.

Chart O.1.2 **Price convergence by product groups**
(EU28 = 100)



Sources: Eurostat and NBS.
* June–May 2015 average.

As inflation has moved over the past years within a range wider than defined by the target tolerance band, the band has remained unchanged until end-2018. Such volatility of inflation was influenced mainly by the absence of a medium-term framework for administered price adjustment, with clearly defined rules and dynamics of adjustment, including instability in the agricultural market driven by structural issues and the absence of adequate systemic measures in agrarian policy. In the meantime, the agricultural market has been liberalised (customs and levies on imports of the majority of agricultural products have been abolished) and price volatility has consequently diminished. However, the medium-term plan of administered price adjustments remains undefined, which may trigger more pronounced inflation volatility in the coming years.

The priority of monetary policy is to reduce the volatility of inflation and stabilise it within the target tolerance band. Given the main causes of elevated inflation volatility, provided the Government introduces a well-defined mechanism of administered price adjustments and adopts measures aimed at the stabilisation and creation of a more favourable market environment in agriculture, the volatility of y-o-y inflation would be considerably diminished. Stabilising inflation within the target band would imply price stability, which represents the basis for sustainable economic growth and higher employment.

III. Inflation movements

Consistent with expectations presented in the May Inflation Report, y-o-y inflation continued to move below the lower bound of the target tolerance band in Q2. The major positive contribution to y-o-y inflation was provided, this time again, by prices of food, notably of fruits and vegetables. What acted in the opposite direction were the absence of expected administered price adjustments over the past year and a fall in petroleum product prices prompted by tumbling global oil prices in H2 2014.

Inflationary pressures remained muted in Q2, on account of the majority of domestic factors, subdued inflation in the international environment, and low prices of primary commodities in the global market. The quarterly price growth was almost fully determined by the seasonal rise in prices of travel packages and rising cigarette and petroleum product prices.

Inflation expectations which stabilised within the target tolerance band were another reason behind low inflationary pressures. The financial sector expects inflation to move around the mid-point and the corporate sector expects it to trend below the mid-point over the next year.

Inflation movements in Q2

Inflationary pressures remained muted in Q2, on account of the majority of domestic factors, subdued inflation in the international environment and low prices of primary commodities in the global market. Since the start of 2015 consumer price growth was under the strongest sway of the seasonal growth in fruit and vegetable prices and the recovery of global oil prices expressed in dinars.

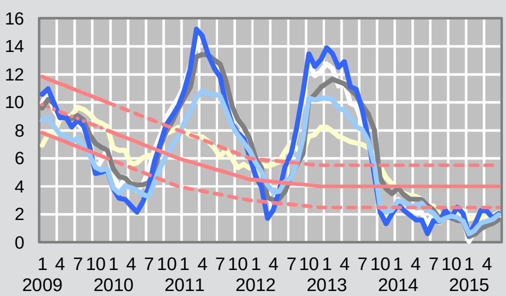
In Q2, y-o-y inflation continued to move below the lower bound of the target tolerance band and reached 1.9% in

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

	2014			2015	
	II	III	IV	I	II
Consumer prices (CPI)	0.8	0.3	-0.6	14	0.7
Unprocessed food	4.9	0.8	-4.0	8.6	-0.2
Processed food	-0.5	0.2	0.2	17	0.3
Industrial products excluding food and energy	-0.1	-0.3	-0.6	-0.1	0.9
Energy	-0.4	10	-18	0.7	0.7
Services	16	0.7	16	-0.5	15
Core inflation indicators					
CPI excluding energy	0.9	0.2	-0.4	15	0.7
CPI excluding energy and unprocessed food	0.3	0.1	0.3	0.3	0.9
CPI excluding energy, food, alcohol and cigarettes	0.8	0.2	13	-0.5	10
Administered prices	0.2	-0.6	-14	-0.1	0.8

Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

June – the same level as at end-Q1. The major positive contributor (1.1 pp in June) to y-o-y inflation remained prices of food, notably of fruits and vegetables. What acted in the opposite direction were the absence of expected administered price adjustments over the past year and a fall in petroleum product prices prompted by tumbling global oil prices by late 2014 and early 2015 (contribution: -0.5 pp in June).

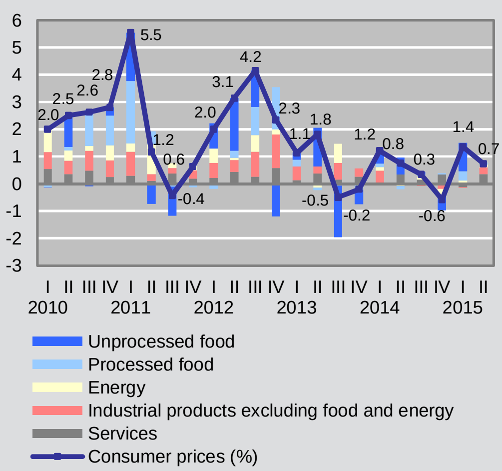
In quarterly terms, consumer price growth in Q2 was consistent with expectations presented in the May *Inflation Report*. It reached 0.7%, chiefly on the back of the seasonal rise in prices of travel packages, as well as rising cigarette and petroleum product prices. Unlike Q1 when consumer price growth was fuelled mainly by the seasonal food price growth, notably of unprocessed food, the contribution of prices of food and non-alcoholic beverages in Q2 was almost neutral.

Within the category of food, **unprocessed food prices** recorded a mild fall because the growth in fruit and fresh meat prices was neutralised by a decline in prices of vegetables and eggs. At the same time, **processed food prices** increased a tad, on account of moderate growth in prices of non-alcoholic beverages, vegetable oil and sugar. In y-o-y terms, the positive contribution of food and non-alcoholic beverages to headline inflation was due primarily to the persistently high y-o-y growth rates of fruit and vegetable prices, while a drop in prices of primary agricultural commodities slowed down the growth in other food prices. In Q2, customs duties on EU imports were raised on some dairy products (cheese and butter), in response to elevated supply in the domestic market in conditions when EU milk quotas were lifted and exports to Russia banned[1]. As a result, retail prices of dairy products edged up by 0.1% in Q2.

Following a reduction in Q1 and amid a vigorous decline in global oil prices, **petroleum product** prices in the domestic market gained 3.2% in Q2 (contribution to headline inflation: 0.2 pp). This reflects moderate recovery in global oil prices at the start of the quarter. Still, petroleum product prices were by around 4% lower than a year ago. On the other hand, price reductions were recorded for household gas (5.4%) and firewood – as a result, price growth in the **energy** category stayed at the Q1 level of 0.7% (contribution to inflation: 0.1 pp).

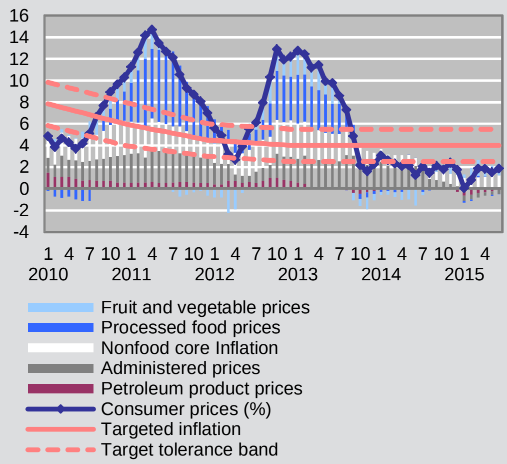
Due to a 44.2% seasonal increase in travel package prices at the onset of the tourist summer season, **prices of services** gave the strongest contribution to headline inflation (0.35 pp). A rise in prices of other services was

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

[1] Decision Amending the Decision on Determining Agricultural and Food Products Imported Subject to Special Duty and the Amount of Special Duty (RS Official Gazette, No 22/15), in effect until 30 June 2015.

insignificant, notably due to the still low domestic demand.

Industrial product prices excluding food and energy rose by 0.9% in Q2, mainly on the back of cigarette price hikes. A 4.0% rise in cigarette prices came about after a longer period in which producers did not increase retail cigarette prices, and even reduced them by late 2014 – despite an increase in excise taxes. On the other hand, relative stability of the exchange rate since the start of 2015 and dented domestic demand limited a rise in prices in other product groups, which is why it was moderate.

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) was 1.0% in Q2, mainly on account of the seasonal increase in travel package prices (contribution to core inflation: 0.65 pp). In y-o-y terms, core inflation continued to move below the lower bound of the target tolerance band and touched 2.1% in June.

In quarterly terms, **administered prices** picked up by 0.8% (contribution to CPI: 0.1 pp), mainly on account of the upward adjustment of cigarette prices in April. Y-o-y, administered prices remained on a downward path, but the decline moderated relative to Q1 and equalled 1.5% in June.

Producer and external prices

Industrial producer prices in the domestic market rose by 1.0% in Q2. In terms of consumption purpose, the main impetus to price growth came from rising prices of non-durable consumer goods, followed by intermediate goods. In terms of product groups, the sharpest rise in producer prices was observed in the production of petroleum products, chemicals and chemical products, and the production of food and beverages. A decline was noticed in mining (contribution: -0.5 pp). A low y-o-y rise in these prices of 1.2% signals the persistently low cost-push pressures on inflation.

Despite a mild rise in quarterly terms (0.7%), **agricultural producer prices**[2] sped down to 5.8% y-o-y in June due to the high base effect from Q2 2014. Broken down by component, a decline was observed for vegetables (11.5%), fruits (5.0%) and cattle products

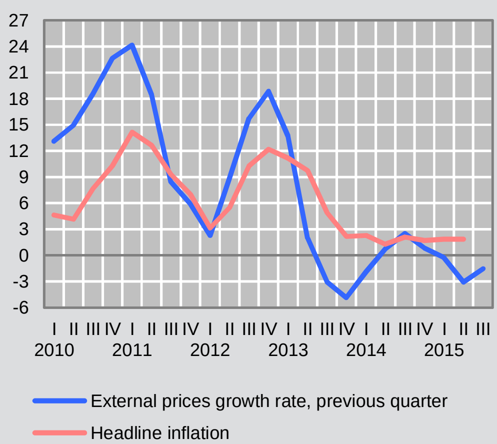
Table III.0.2 **Price growth indicators**
(y-o-y rates, in %)

	IX 2014 / IX 2013	XII 2014 / XII 2013	III 2015 / III 2014	VI 2015 / VI 2014
Consumer prices	2.1	17	19	19
Domestic industrial producer prices	10	0.2	0.7	12
Agricultural producer prices	-0.1	-7.9	-3.0	-5.8
Prices of elements and materials incorporated in construction	3.8	4.6	0.7	10

Sources: SORS and NBS calculation.

(5.6%), while prices of cereals and live cattle went up. In Q2, cereal prices generally mirrored stock market trends. Thus, the upturn in this category (1.9%) was led by higher corn prices, while wheat prices were on a decline. In regard to rising live stock prices (8.7%), particularly pronounced was the rise in pig prices (17.7%), following their vigorous decline in Q1 caused by elevated supply in the domestic market.

Chart III.0.4 **Domestic inflation and external prices**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

[2] Producer prices in agricultural and fishing sectors.

After the seasonally expected drop in Q1, **prices of elements and materials incorporated in construction** picked up by 1.2% in Q2, leading to mild acceleration of their y-o-y growth from 0.7% in March to 1.0% in June.

A moderate rise in external dinar-denominated prices[3] extended into Q2 (1.1%). It was driven by upward adjustments of global oil prices, following three consecutive quarters of decline. In addition to oil prices, another contributor to the quarterly rise in external prices were rising export prices of Germany – they continued up in Q2 (0.2%), but at a significantly slower pace than in Q1[4]. On the other hand, growth in dinar-denominated external prices moderated on account of mild nominal appreciation of the dinar against the euro (0.9%). In y-o-y terms, dinar-denominated external prices declined further in Q2 (1.5%), though at a slower rate than in Q1 due to a waning base effect.

Inflation expectations

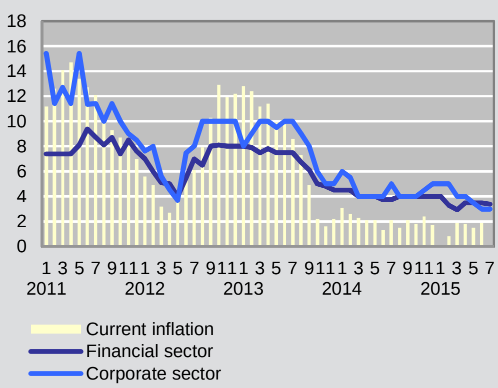
Both short- and medium-term inflation expectations stabilised within the target band as economic entities expect y-o-y inflation to stay within the target tolerance band in July 2016 and July 2017. Stable inflation expectations are a key prerequisite for stable inflation and higher efficiency of monetary policy measures.

According to the August **Bloomberg** survey, for the seventh month in a row the financial sector expects **one-year ahead** inflation of 4.0%. Financial sector expectations have been within the target tolerance band for almost two years already. As indicated by the **Ninamedia** survey[5], financial sector expectations stood at 3.5% from April to June, but declined to 3.4% in July.

Since early 2015, corporate sector expectations have been on a continuous decline. The corporate sector now expects y-o-y inflation at 3.0% in July 2016.

One-year ahead expectations of the household sector moved at around 5.0% from February. However, they upped to 8.0% in July (at the same time, perceived inflation rose to 9.7%), mainly due to the announced electricity price hike in August. In terms of qualitative household expectations, the number of those expecting a moderate or slight increase in prices in the coming year continued up in July (two thirds of respondents), while the number of those who expect a significant price increase went down (15%). The number of respondents expecting prices to remain flat or to decline remained high (14%).

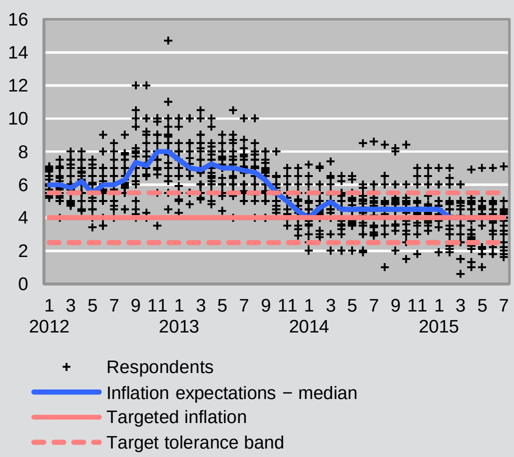
Chart III.0.5 **Current inflation and one-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Gallup, Ipsos, Ninamedia and NBS.

* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Chart III.0.6 **One-year ahead expected and targeted inflation – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

[3] As an indicator of external prices, we used the weighted average indices of global oil and food prices, and export prices of Germany as one of our most important foreign trade partners. Weights are determined according to the share of these categories in the structure of Serbian imports.

[4] A 1.3% rise in these prices in Q1 was due mainly to rising labour costs following the introduction of the minimum wage in January 2015.

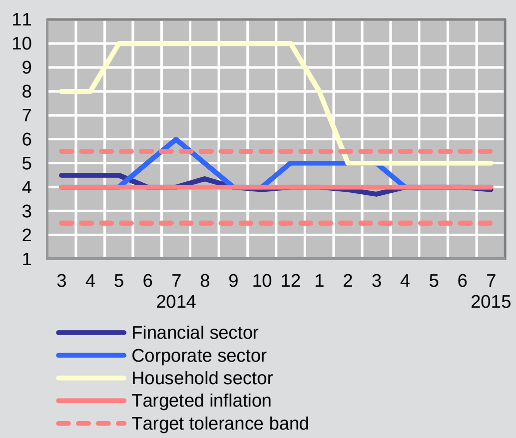
[5] Ninamedia clipping d.o.o. Novi Sad has been conducting a survey on expectations of economic entities since December 2014, in accordance with the methodology applied so far.

From April, both the financial and corporate sectors expect that **two-year ahead inflation** will be on the midpoint. In July, the financial sector reduced slightly its medium-term expectations – to 3.9%. Medium-term expectations of the household sector have been within the target tolerance band since February (at 5.0%).

The dispersion of financial sector responses, which is the lowest among all sectors, remained largely unchanged relative to the quarter before. It has been relatively stable over the past year both according to Bloomberg and Ninamedia surveys. At the same time, the dispersion of responses of corporate and household sectors continued down in the absence of major inflationary pressures.

Although the net percentage[6] of enterprises expecting a rise in their product prices increased in Q2 (11.8%), it remained lower than the net percentage of enterprises expecting a rise in their input prices (18.9%). In addition, both net percentages have been on a decline over the past year. According to our estimate, this was due to subdued inflationary pressures and dented domestic demand which limits the pass-on of larger production costs to consumers.

Chart III.0.7 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia.
* The survey was not conducted in November 2014.

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

IV. Inflation determinants

1. Financial market trends

A reduction in the key policy rate weighed on money market rates and the price of dinar private sector borrowing. The government also borrowed in the domestic market at more favourable rates, on account of both the reduced key policy rate and credible fiscal policy.

The fact that macroeconomic prospects of the country have improved, most notably balance of payments and fiscal trends, has also been confirmed by the successful review of the arrangement with the IMF, maintenance of the country's credit rating and stable movement in the country's risk premium, which contributed to stable movements in the exchange rate.

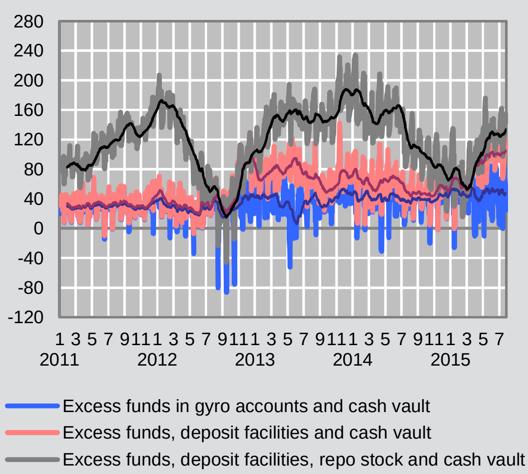
Interest rates

The average repo rate[7] reached 4.0% by end-June, down by 2.0 pp relative to end-March. This drop was somewhat steeper than the cut in the key policy rate (1.5 pp), partly because the decline at the first repo auction, held in early April after a six-week break, also reflected the March reduction in the key policy rate.

Higher dinar liquidity of banks influenced a decline in trading volumes and interest rates in the interbank overnight money market in Q2. Average daily trading volumes in this market amounted to RSD 2.1 bln, down by RSD 7.5 bln from Q1. Trading volumes were at their lowest in May (RSD 0.9 bln), but increased to RSD 1.8 bln in June. BEONIA was also on a decline in Q2, consistent with rising liquidity of banks and a reduction in the key policy rate. It equalled 4.4% on average in June.

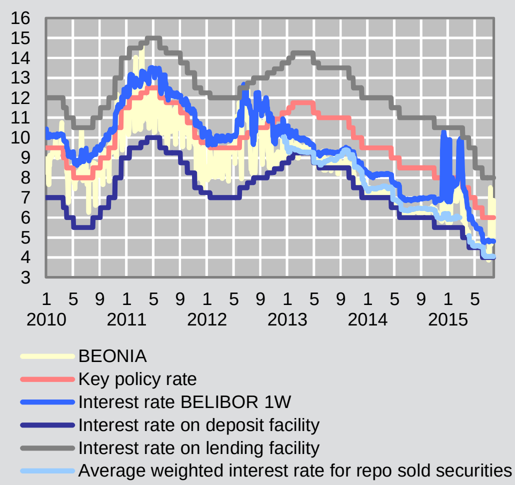
BELIBOR rates also declined at a steeper pace than the key policy rate. Relative to March, they dropped between 2.8 pp and 3.2 pp. In June, they ranged from 4.7% for the shortest and 6.3% for six-month maturity on average. In the course of Q2, the yield curve slope moderated further, on account of lower inflation expectations of the financial sector.

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



Source: NBS.

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



Sources: Thomson Reuters and NBS.

[7] The rate achieved at repo auctions weighted by the amount of sold securities.

The NBS May decision to narrow the interest rate corridor relative to the key policy rate from ±2.5 pp to ±2.0 pp also contributed to more stable movements in interest rates in the interbank money market.

In July, all rates in the interbank money market fell slightly, apart from the overnight market rate.

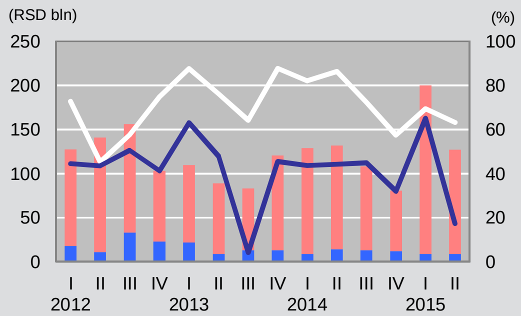
Rates at auctions of dinar government securities also declined in Q2. In addition to the reduction in the key policy rate, this was also due to improved fiscal position. Positive effects of fiscal consolidation mitigated the risk of investment in government securities and the government's need to borrow. The longest term over which the government borrowed in Q2 was three years – 8.2% in April. In May and June, in addition to even shorter maturities, a smaller amount of securities was offered for sale. Auctions of six-month and one-year securities were organised in June, at rates of 5.3% and 6.2%, down by 1.7 pp and 2.2 pp relative to end-Q1. June also saw an auction of two-year amortised government bonds at a variable coupon linked to the key policy rate. The fixed margin was reduced to 1.2% annually, from 1.3% at end-Q1 auction. Due to the reduced maturity and volume of securities offered for sale, including consequently smaller yields, non-residents cut back significantly on their investment. As of May, they did not even participate in purchases in this market.

Non-residents were not purchasers of euro securities either. The rates of these securities were also on a decline.

The drop was the most pronounced for one-year securities (by 0.9 pp to 1.6%), while rates on two- and three-year securities fell by 0.6 pp and 0.4 pp to 2.9% and 3.9% respectively.

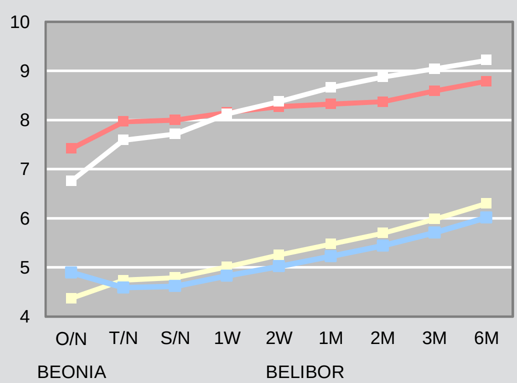
Activity abated in the secondary market of government securities as well. Total trading volumes in this market equalled RSD 51.7 bln, over twice less than in Q1. Most traded were three- and two-year bonds, while rates of return generally mirrored primary trading trends. In June,

Chart IV.1.4 **Primary market of government dinar securities – performance ratio and foreign investor participation**



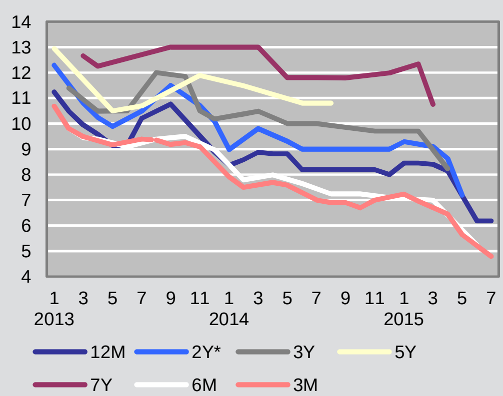
Source: Ministry of Finance.

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



Sources: Thomson Reuters and NBS.

Chart IV.1.5. **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

* Excluding coupon securities with the rate linked to the NBS key policy rate.

rates in this market ranged from 5.2% for the remaining five-month to 9.1% for 80-month maturity.

The decline in the key policy rate and interbank money market rates also weighed on the price of dinar borrowing. The weighted average rate on dinar corporate and household loans fell by 3.0 pp in Q2 to 13.5% in June. Given the predominance of household loans (around two thirds) in the structure of total new dinar loans in Q2, the decline in the average price of dinar loans was largely determined by a change in interest rates on household loans, which fell by 2.1 pp on average to 15.8%. However, the decline was more pronounced for rates on corporate loans, which fell by 3.6 pp to 10.2% – below the level recorded in the period when banks extended subsidised loans at lower interest rates.

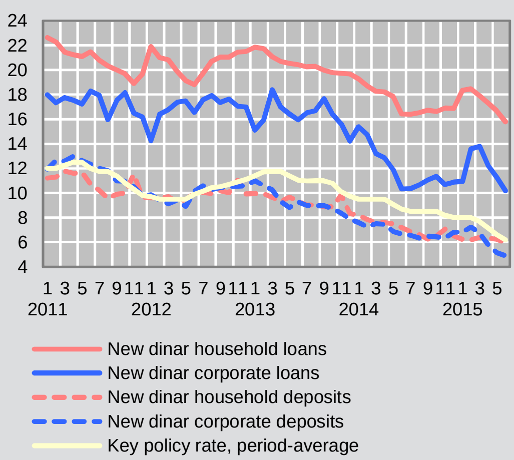
Rates declined on almost all types of dinar corporate loans. At the same time, rates on the most popular, current assets loans, fell by 3.5 pp to 10.8%. The decline was the sharpest for other loans (by 4.0 pp to 9.3%). Rates on investment loans also declined (to 10.5%). An increase was noted only for the least used, export loans (to 12.7%). All rates on dinar household loans also fell (between 1.4 pp and 4.4 pp), ranging in June between 11.8% for housing and 16.6% for the most popular, cash loans.

The price of FX and FX-indexed lending also declined, though at a lesser degree compared to dinar borrowing. The weighted average rate on new euro loans and euro-indexed dinar loans fell by 1.2 pp in Q2 to 4.9% in June. The average price of corporate loans declined by this amount as well, equalling 4.8% in June. Rates on all types of FX and FX-indexed corporate loans decreased – to 4.7% for current assets loans, 5.4% for investment and 4.3% for other loans. In Q2, citizens also borrowed at lower interest rates, which fell by 0.8 pp to 6.2% on average. At the same time, rates on housing and consumer loans went down, and those on cash and other loans went up. In June, the price of FX-indexed housing loans moved between 3.9% for housing and 9.1% for other loans.

According to the July bank lending survey, a decline in costs of lending sources was one of the main factors in mitigation of credit standards. Data on interest rates indicate that the drop was more pronounced for rates on new dinar deposits, which fell by 1.7 pp to 5.0% in June. Rates on dinar corporate deposits fell by 1.9 pp to 4.9%, and rates on citizen savings by 0.4 pp to 6.0%. The weighted average rate on new euro deposits declined less – by 0.3 pp to 0.9%, due to falling rates on corporate deposits (by 0.4 pp to 0.7%) and citizen savings (by 0.2 pp to 1.1%).

A decline in lending rates outstripped the drop in deposit rates, which led to a reduction in interest margins both in dinars and euros. As the difference in the decline in dinar rates was somewhat more pronounced, the dinar interest margin fell to a larger extent.

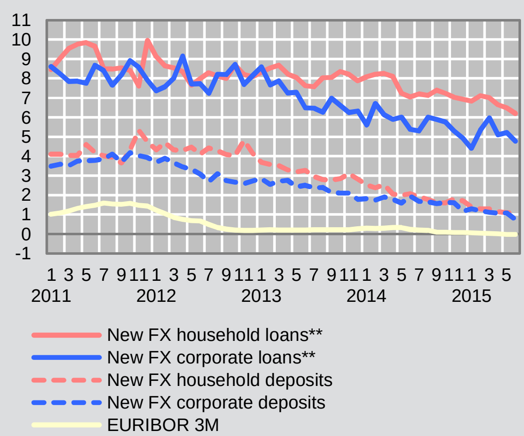
Chart IV.1.6 **Interest rates on dinar corporate and household loans and deposits***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on FX corporate and household loans and 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.

Risk premium

Measured by EMBI, Serbia's risk premium was relatively stable – in Q2 it went up by 18 bp to 297 bp. In addition to Serbia, EMBI increased in almost all countries of the region: Romania (23 bp), Poland (22 bp), Croatia (10 bp) and Hungary (3 bp). It declined only in Turkey (-3 bp). EMBI Global went down in Q2 (by 18 bp to 392 bp), mainly due to large reductions in some countries (Ukraine, Belarus, Venezuela etc). In July, Serbia's risk premium remained largely unchanged (down by 2 bp to 295 bp).

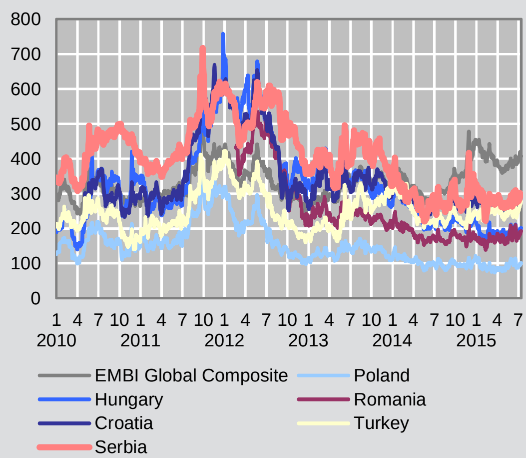
Serbia's risk premium, i.e. the difference in yields between Serbia's eurobonds and the benchmark ten-year US Treasury note, was under the impact of both domestic and global factors. Of domestic factors, the strongest positive influence came from improved macroeconomic position, notably fiscal and external, including successful completion of the first review of the arrangement with the IMF. In contrast, a significant negative fall-out came from global factors, notably the crisis in Greece, including the euro area, as well as the expected rate hike by the Fed, and to some extent the crisis in the capital market of China and its slowdown.

The impact of each of these factors on risk premia of different emerging economies varied. The Greek crisis impacted on risk premia of emerging economies notably in terms of the sentiment of investors and their greater reluctance to invest in riskier assets. However, analysts believe that the character of Fed's monetary policy has a greater impact on risk premia of emerging economies as it largely determines global liquidity. The majority of emerging economies lack sufficient domestic savings and import capital, and are therefore particularly sensitive to changes in external financing costs. What could a shift in Fed's monetary policy mean was felt by financial markets in May 2013. However, after the initial shock, many emerging economies adjusted their economic policies, which should limit the adverse impact of a possible reversal in capital flows. ECB's quantitative easing is also likely to mitigate that effect. With its fiscal consolidation measures, Serbia bolstered investor risk perception, which is expected to lessen influences of possible shocks in the international financial market.

Foreign capital inflow

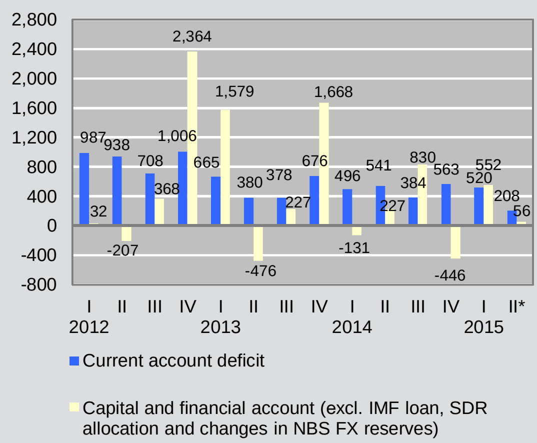
Q2 saw an exceptionally low current account deficit, notably owing to a lower deficit in trade in goods and

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



Source: JP Morgan.

Chart IV.1.9 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

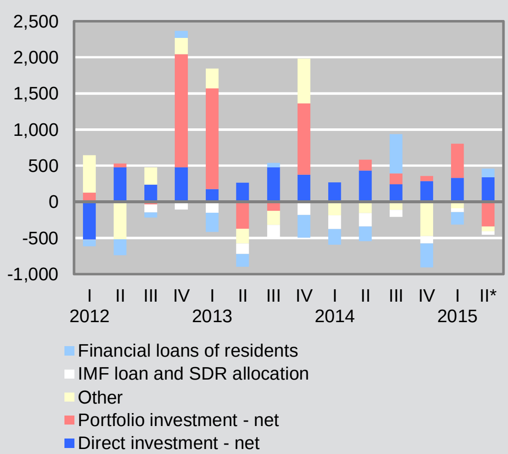
higher remittances inflow compared to Q1. At the same time, net capital inflow was minimal.

Broken down by financial account component, net capital inflow from direct non-resident investment and an increase in government credit liabilities was somewhat higher than the outflow from portfolio investment and a reduction in credit liabilities of the private sector and NBS's external obligations.

According to preliminary data, Q2 saw a net **FDI** inflow of EUR 343.0 mln, or EUR 675.4 mln since the start of 2015. In terms of structure, investment in debt instruments accounted for EUR 116.1 mln, reinvested earnings EUR 135.0 mln, equity investment EUR 91.9 mln.[8] At the same time, net outflow from paid and collected dividends arrived at EUR 88.8 mln, and interest payments at EUR 26.9 mln.

The FDI inflow is expected at around EUR 1.3 bln in 2015, notably through investment in manufacturing, trade and the financial sector. The inflow is likely to almost fully cover the expected current account deficit. Over the past years, the share of FDIs in tradeables has been on a rise. In the medium run, this will contribute to further growth in exports, a reduction in external imbalance, and improved sustainability of the country's external position.

Chart IV.1.10 **Structure of the financial account**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

Q2 saw a capital outflow of EUR 341.0 mln in respect of **portfolio investment**, whilst interest payments to foreign investors amounted to EUR 114.8 mln. This was not due to changed foreign investor perception of local securities – as also confirmed by stable risk premium movements, but rather due to the government's smaller financing needs. A reduced volume and maturity of securities offered for sale by the government reflected on weaker activity of non-residents in this market and, as a part of securities in their ownership fell due, contributed to a fall in portfolio investment. At the same time, residents stepped up investment in foreign, primarily debt securities, which also triggered an outflow.

Resident liabilities arising from **financial loans** went up by EUR 55.4 mln in Q2. Only net government borrowing increased (by EUR 204.4 mln). The loans disbursed included IBRD loans for flood recovery and road repair, and EIB loans for Corridor X and public sector development. Other residents reduced their external credit liabilities. Of this, NBS payments to the IMF amounted to EUR 54.9 mln, or EUR 108.3 mln in the entire 2015. Banks continued repaying their external debt, though at a lesser pace than in Q1. They reduced their liabilities by EUR 56.3 mln in Q2 and EUR 142.9 mln in H1. In respect of cross-border financial loans, enterprises repaid EUR 31.3 mln net. Their external liabilities under trade loans fell by EUR 23.3 mln net. Since the start of 2015, liabilities of enterprises on these grounds fell by EUR 46.6 mln and EUR 15.0 mln respectively.

Trends in the FX market and exchange rate

The dinar was stable in Q2. It ranged between 120.0 and 120.9 for one euro. End-of-period, in Q2 the dinar weakened insignificantly against the euro (0.3%), but gained 0.9% on average relative to Q1.

The postponement of the Fed's decision to raise the policy rate was the main reason why the euro gained 3.6% against the dollar in Q2, following its pronounced weakening in Q1. As a result, the dinar appreciated by 3.4% against the dollar in Q2 end-of-period.

[8] According to the IMF's BPM6, reinvested earnings and intercompany debt are included within FDIs. This change is explained in more detail in Text box 1 of the August 2014 *Inflation Report*.

Stability in the domestic FX market was achieved owing to improved macroeconomic prospects of the country, notably improved balance of payments and fiscal trends, as also confirmed by successful completion of the first review of the arrangement with the IMF in June, affirmation of the country's credit rating by Fitch and Standard & Poor's, and stable movement in the country's risk premium. A significantly lower current account deficit in Q2[9] was driven by a lower deficit in trade in goods, surplus on the balance of services and elevated inflow of remittances. The inflow of remittances and the fact that a new series of frozen FX saving bonds fell due brought about higher purchases of foreign cash in respect of exchange operations. At the same time, FX supply increased also under the FDI inflow, while external borrowing of residents (government) went up. Unlike the quarter before, non-residents cut back on their investment in dinar government securities. Throughout Q2, particularly in June, they were net FX purchasers from banks. Still, such trends did not result in dinar's weakening, partly because banks, faced with the maturing of earlier extended dinar subsidised loans and a rise in currency-indexed assets on other grounds, increased their FX supply. Moreover, judging by stable movements in EMBI, investor perception of Serbia did not deteriorate.

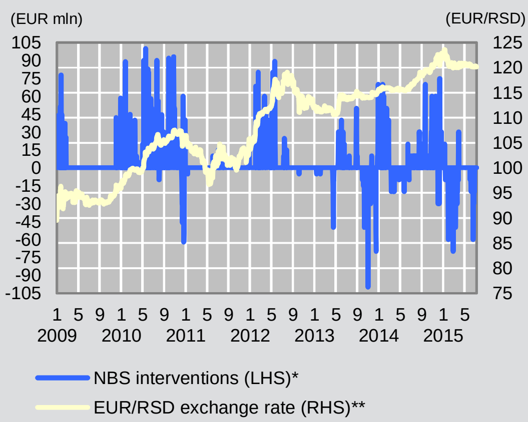
In Q2, trading in the IFEM reached EUR 31.7 mln on average per day, down by EUR 10.2 mln from Q1.[10] Broken down by month, average daily trading volumes were relatively equal. The highest value was recorded in June (EUR 33.2 mln). Measured by EWMA[11] and EGARCH[12], volatility of the exchange rate subsided in Q2.

Without the intention to influence the exchange rate trend, the NBS intervened in the IFEM in Q2 mainly on the purchase side as it bought EUR 120.0 mln net. It intervened the most in April when it purchased EUR 140.0 mln and sold EUR 30.0 mln. Thereafter, until end-Q2, it intervened only once – by purchasing EUR 10.0 mln.

The NBS continued to organise two-week and three-month FX swap auctions. Following a rise in Q1, the volume of transactions at two-week swap auctions was restored to its earlier levels in Q2 (EUR 39.0 mln was sold and the same amount purchased). At three-month auctions, EUR 14.0 mln was bought and the same amount sold. The amount of interbank FX swaps (performed only in April) was also reduced – total EUR 16.4 mln.

Appreciation pressures prevailed in July, when the dinar strengthened by 0.4%. To ease daily exchange rate

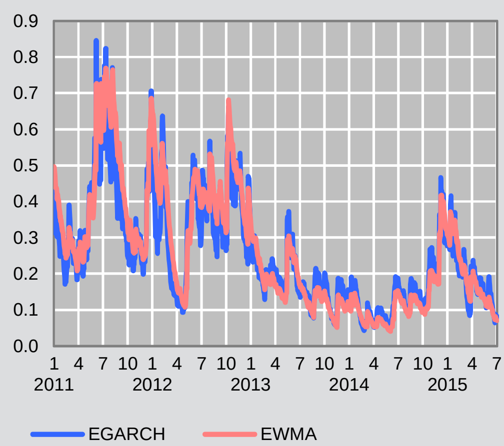
Chart IV.1.11 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.

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

Chart IV.1.12 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

[9] May saw a current account surplus of EUR 17.1 mln. Last time, surplus was recorded in January 2005 when a part of imports was implemented in the preceding months due to the start of application of the VAT system in 2005.

[10] Excluding NBS.

[11] EWMA – Exponentially Weighted Moving Average.

[12] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

volatility, the NBS intervened in the IFEM by purchasing EUR 230.0 mln.

End-of-period, the majority of currencies of other countries of the region running similar exchange rate regimes weakened against the euro. The Turkish lira (5.1%) and Hungarian forint (5.0%) weakened the most, while the Polish zloty and Romanian leu depreciated somewhat less – by 2.5% and 1.4%. Appreciation was noted only for the Czech koruna – by 1.0%.

Stock exchange trends

In Q2, BELEX15 (the index of the most liquid shares) and BELEXline (the general index of shares) amounted to 645.8 and 1,328.6 points, down by 3.1% and 3.4% respectively. As on the majority of other stock exchanges in the region, the decline was set in train in mid-May and may be linked to negative news as to the servicing of Greek liabilities to creditors. However, July saw mild recovery in indices, accompanied by rising volumes.

A decline in stock prices was also followed by a reduction in total trading in shares on the Belgrade Stock Exchange (BSE). In Q2, trading volumes reached RSD 2.5 bln, down by RSD 4.3 bln from Q1. The peak was recorded in May (RSD 1.0 bln).

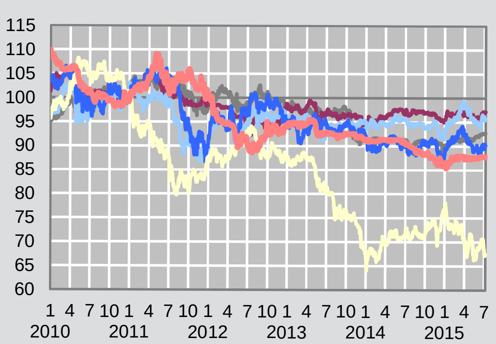
Around two fifths of total trading in shares in Q2 concerned transactions of foreign investors. As in Q1, they were net sellers of domestic shares, though to a significantly smaller degree (RSD 43.6 mln).

Total trading in frozen FX saving bonds amounted to mere RSD 96.6 mln in Q2. Of this, RSD 77.4 mln related to trading in A2016-series bonds and the rest to the series which matured in mid-May. The rates of return on the A2016-series fell to 2.9% by end-Q2.

BSE market capitalisation contracted by RSD 59.8 bln in Q2 to RSD 720.6 bln in late June. Of this, regulated market capitalisation fell by RSD 45.0 bln, mainly due to the maturing of A2015-series bonds in May. MTP[13] capitalisation contracted as well – by RSD 14.8 bln to RSD 345.1 bln. The share of market capitalisation in estimated GDP fell by 1.6 pp to 18.5% in late Q2.

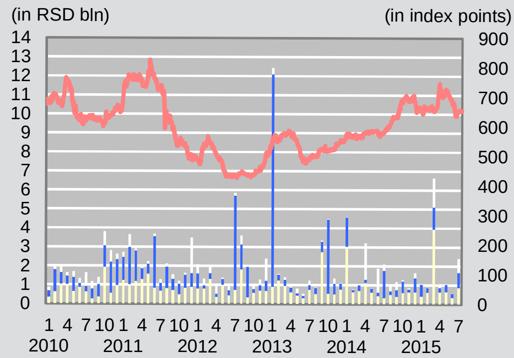
Indices on regional stock exchanges recorded divergent movements. The decline in indices on stock exchanges in Ljubljana (7.4%), Skopje (6.5%) and Sofia (5.0%) was

Chart IV.1.13 **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.

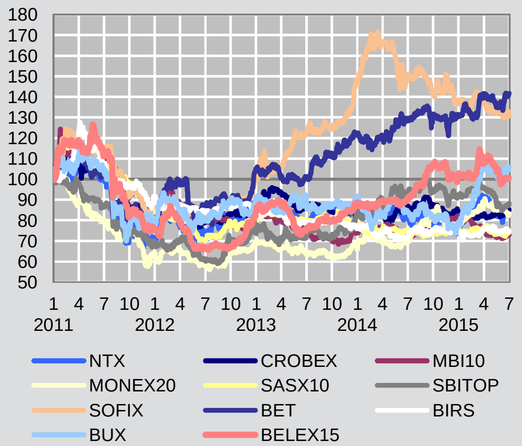
Chart IV.1.14 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

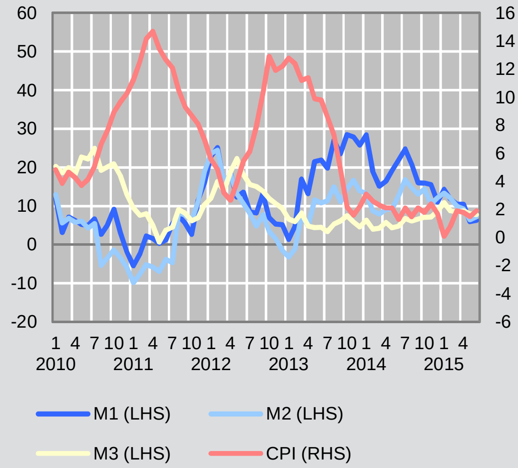
[13] MTP is the multilateral trading platform, set up by the Belgrade Stock Exchange and incorporating currently listed shares of companies not eligible for regulated market listing.

Chart IV.1.15 **Stock exchange indices across the region**
(in index points, normalised, December 31, 2010 = 100)



Sources: BSE and regional stock exchanges.

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



Sources: SORS and NBS.

steeper than that on the BSE. In contrast, the Budapest index continued vigorously up (11.2%). The Bucharest index also increased a tad (3.1%).

2. Money and loans

Although money supply increased in Q2, its y-o-y growth slowed down further. One of the reasons was lending activity, declining for the second consecutive quarter and decelerating y-o-y. Nevertheless, relative to Q1, the credit market saw some improvement, as lending recorded monthly growth in June, for first time since the beginning of the year.

Monetary aggregates

In Q2, dinar reserve money rose by 3.6% in nominal and 2.9% in real terms, and was the main factor behind total reserve money growth (2.4% in nominal and 1.7% in real terms). Y-o-y, dinar reserve money gained 22.2% in June, while total reserve money added 3.0% in real terms.

Dinar reserve money increased on account of NBS's net FX purchases in the IFEM (worth RSD 14.4 bln) and FX payment transactions with Kosovo and Metohija (RSD 11.1 bln). Government dinar deposits fell by RSD 15.8 bln, but a (sizeable) portion of these funds was used to purchase foreign currency from the NBS, primarily for the redemption of frozen FX savings bonds which fell due, so the government mopped up RSD 3.2 bln of liquidity. In early April, the NBS continued to organise repo sale auctions, withdrawing RSD 20.0 bln in Q2.

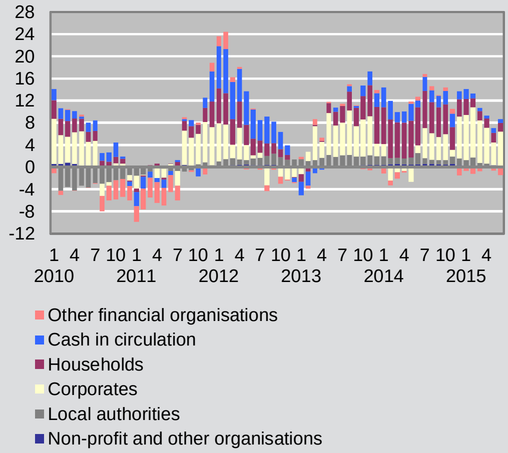
In terms of the structure of dinar reserve money, overnight bank deposits with the NBS increased the most (by RSD 15.6 bln). A rise was also recorded for currency in circulation (RSD 4.6 bln), account balances of other sectors and calculated required reserve allocations in

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

	2014		2015		Share in M3 June 2015 (%)
	Sept.	Dec.	March	June	
M3	4.4	6.8	6.5	5.8	100.0
FX deposits	1.7	5.2	5.9	6.1	68.3
M2	10.7	10.3	7.9	5.2	31.7
Time and savings dinar deposits	4.1	13.2	6.7	7.5	9.1
M1	13.7	9.1	8.4	4.3	22.7
Demand deposit	16.6	11.1	11.7	5.4	16.3
Currency in circulation	7.3	4.8	1.1	1.7	6.3

Source: NBS.

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



Source: NBS.

dinars (by RSD 3.5 bln each) and vault cash (by RSD 0.3 bln). The only item that recorded a drop were bank gyro account balances (by RSD 13.6 bln).

Q2 also saw expansion in broad monetary aggregates in real terms, most notably M1 (6.5%), owing to growth in company transaction deposits. M1 was the main factor driving M2 up (4.1%), since savings and term deposits went down. The broadest aggregate M3 recorded the smallest growth (1.5%). In y-o-y terms, money supply growth decelerated further. Therefore, M1, M2 and M3 were higher by 4.3%, 5.2% and 5.8% in June in real terms, compared to the same period last year.

In Q2, the strongest impulse to M3 creation came from growth in bank net FX reserves (an increase in foreign receivables and a drop in foreign liabilities) and bank investments in government securities. On the other hand, contraction in lending to the private sector worked in the opposite direction.

A breakdown by M3 components in Q2 shows that demand deposits increased the most (RSD 24.0 bln). Most of this growth was generated in company accounts, mainly in manufacturing and mining sectors. Balances in household current accounts increased as well. At the same time, companies in the said sectors decreased longer-term dinar account balances. This, along with a decline in deposits of public enterprises, was the main reason behind the RSD 1.1 bln fall in this deposit category.

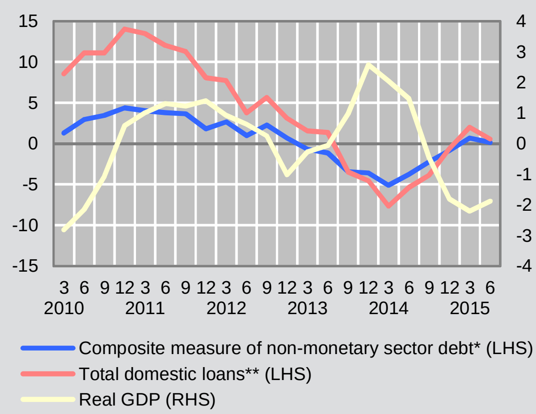
As of April this year, dinar household savings were on a rise again. They gained RSD 3.5 bln in Q2, reaching RSD 40.0 bln by late June, close to their July 2014 peak. Households mainly opted for three–six and 12–24 month savings deposits. Although a new series of frozen FX savings bonds fell due in May, this made no significant addition to household FX savings, which gained EUR 16.4 mln in Q2 (EUR 122.7 mln since the start of the year), reaching EUR 8.4 bln by end-June. Of these, FX demand deposits and those termed between one and two years increased the most. Lower wages and pensions are probably one of the reasons why FX savings grew less than usual in the period of redemption of frozen FX savings bonds, as also indicated by a higher volume of FX purchases in exchange operations.

Since the start of the year, corporate FX deposits also went up (EUR 80.8 mln), partly owing to a rise in exports, as indicated by the growth in deposits of companies in export-oriented industries.

Loans

Excluding the exchange rate effect[14], domestic lending declined by 0.2% in Q2 and its share in estimated GDP fell by 0.2 pp to 48.1% in June. Nevertheless, compared

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



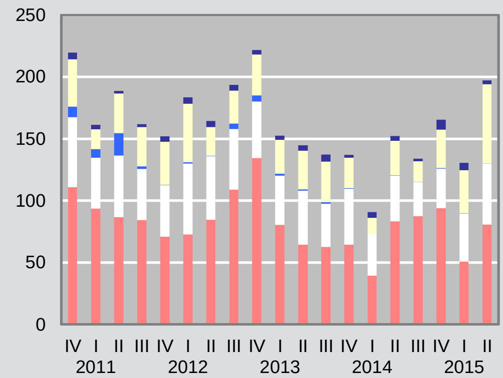
Sources: NBS and SORS.

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

** Excluding the exchange rate effect.

[14] Calculated at the dinar exchange rate against the euro, Swiss franc and US dollar as at 30 September 2014 (the so-called programme exchange rate used for the purpose of monitoring the IMF arrangement), according to the currency composition of loan receivables.

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



Source: NBS.

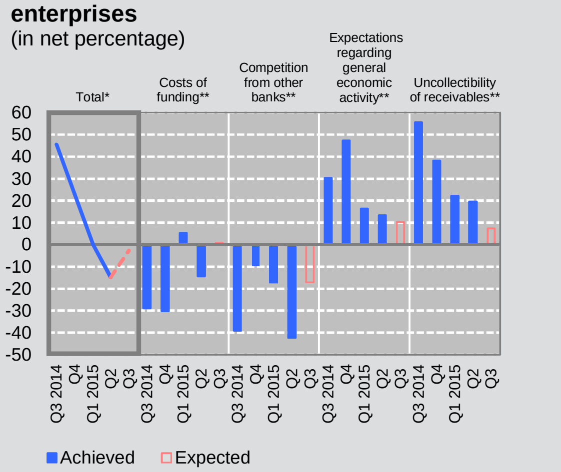
to the Q1 drop of 1.0%, trends in the lending market were more favourable – June was the first month this year to see monthly growth in lending. The growth was mainly driven by corporate lending and to a lesser extent by household and OFO lending.

Y-o-y, domestic lending growth decelerated since April and measured 0.6% in June at the programme exchange rate. Corporate lending slowed to 0.5% and household lending to 3.0%.

Measured by the programme exchange rate, corporate loans dropped by 1.3% in Q2. Newly approved loans to corporates increased relative to Q1, with around one third of their volume referring to refinanced loans i.e. loans with amended terms of repayment. A bulk of these loans was intended for current assets financing (41%). Investment loans made up a higher share (32%), which is a positive signal, while other types of loans accounted for around 25%.

More favourable trends are indicated also by results of the July bank lending survey[15]. For the first time since the survey began, the banking sector reported relaxation of corporate credit standards. Namely, a certain number of banks eased their standards driven by competition and cheaper sources of funding, despite the persisting risks

Chart IV.2.5 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to enterprises**
(in net percentage)

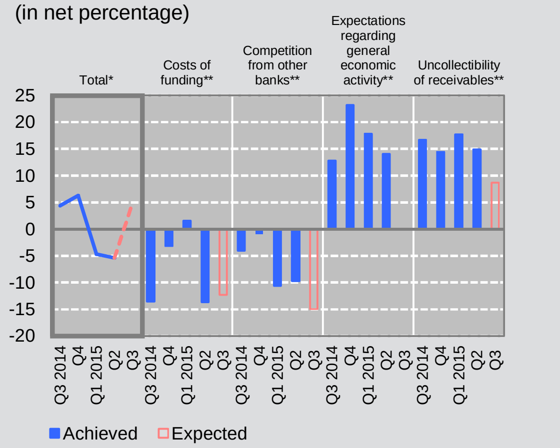


Source: NBS.

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

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

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



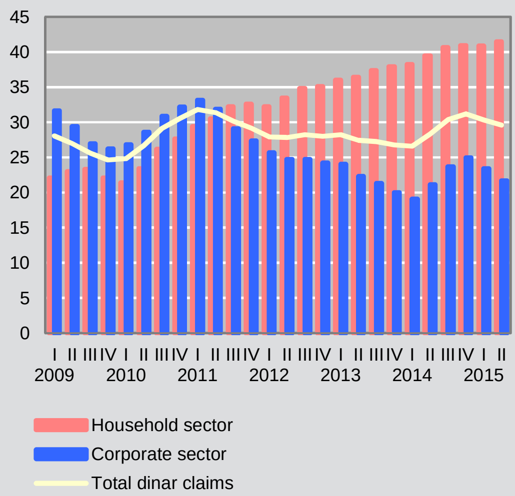
Source: NBS.

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

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

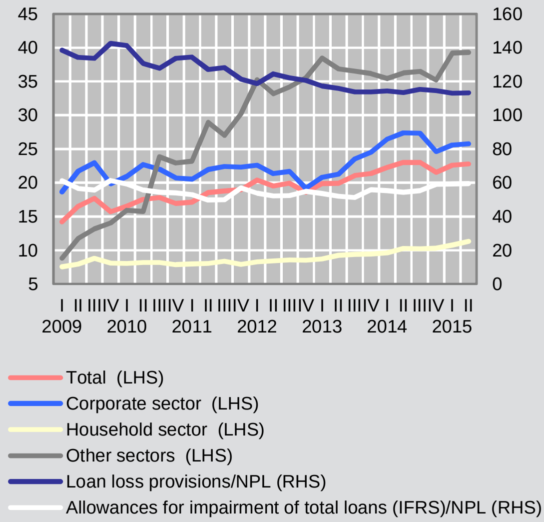
[15] The NBS has conducted the survey since early 2014. Participation is voluntary and the response rate almost 100%.

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



Source: NBS.

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



Source: NBS.

associated with the collection of receivables and collateral and unfavourable expectations regarding future economic growth. As banks reported, margins and associated costs continued to decline into Q2 and corporates were also offered more favourable terms of repayment. At the same time, requirements regarding collateral and maximum loan amount were tightened. Consistent with expectations from the April survey, corporate loan demand increased motivated by the need to finance current assets and refinance the existing liabilities. The same factors are likely to drive the expected pick-up in demand in Q3.

Opposite to Q1, household lending expanded by 1.4% in Q2. New lending increased relative to Q1. As in the past period, cash loans were predominant, accounting for more than half of new loans (52%). Housing loan approval remained subdued, as expected, given the relatively low household income and unfavourable trends in the real estate market. Consumer loans upped slightly, while lending under costlier categories – revolving loans, credit cards and current account overdrafts remained more or less the same as in previous months. A higher amount of new loans in Q2 is partly attributable to amended repayment terms under existing, primarily housing loans, after the NBS implemented its Decision on Measures for Preserving Stability of the Financial System in the Context of Foreign Currency-Indexed Loans.

According to the July bank lending survey, some banks relaxed their standards for household loans, motivated by the same reasons as in corporate lending. They cut down interest margins and accompanying costs, and offered longer repayment terms, while keeping unchanged loan security terms – collateral, down-payments and mortgage. According to banks' assessment, household demand increased for almost all loan categories. Citizens showed most interest in cash and refinancing loans, while for the first time in three quarters housing loan demand went up as well. Banks expect further recovery of demand, which should be driven by the need to refinance the existing liabilities and by real estate purchases.

The share of dinar loans in total corporate and household loans continued to decline in Q2 (by 0.7 pp), down to 29.6% at end-June. Lower interest rates motivated the corporate sector to predominantly borrow in foreign currency in Q2, which is why the degree of dinarisation of corporate lending dropped further, by 1.7 pp to 21.7%. As opposed to the corporate sector, households mostly borrowed in the currency of their income and the dinarisation of household lending increased by 0.6 pp to 41.5%.

According to survey responses, together with expectations regarding economic activity, uncollectible receivables are the main factor which aggravates the relaxation of credit standards. In Q2, the NPL share in total loans upped by 0.2 pp to 22.8% in June. The increase was more pronounced for households (by 0.6 pp to 11.3%[16]) than corporates (by 0.2 pp to 25.8%).

However, despite the high share of NPLs in total loans, the capital adequacy ratio of around 21% indicates that stability of the domestic banking sector is not impaired. In June, allowances for impairment for total loans stood at 59.6% of NPLs. At 113.2% in June, loan loss provisions[17] continued to fully cover the amount of gross NPLs. The NPL Resolution Strategy, developed by the Serbian Government and NBS, in cooperation with the IMF, WB and EBRD is expected to offer a marked-based and long-term sustainable solution to NPLs.

3. Real estate market

Situation in the real estate market mildly improved in Q2 as prices, turnover and the number of construction permits edged up. The effort to improve legislation in this area continued, which should bolster activity in the real estate market and improve Serbia's standing in international comparisons.

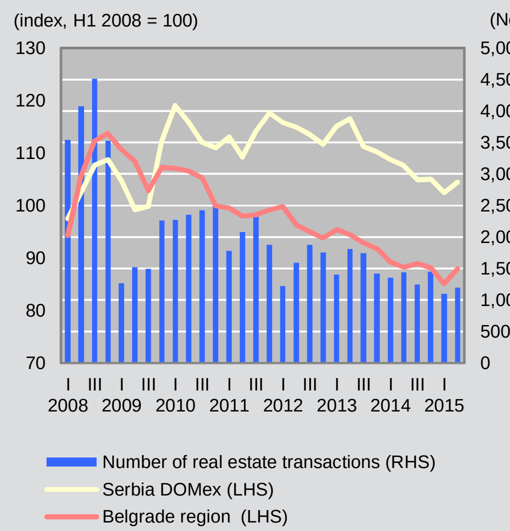
After falling in Q1, real estate prices in Serbia as measured by DOMex[18] rose by 1.9% in Q2, practically returning to their end-2014 level. The growth was driven by Belgrade real estate prices (going up by 3.3%), while other regions recorded a drop. Y-o-y, real estate prices were on a decline for the eighth quarter in a row (2.0%), though slowing down from Q1 (5.8%). In Q2, the average real estate price in Serbia equalled EUR 864.4 per square metre.

Having hit its lowest value since 2007 in Q1, real estate turnover[19] slightly recovered in Q2 (8.2%). Turnover edged up in all regions, though somewhat more markedly in Belgrade, Šumadija and Western Serbia, whose share in total turnover mildly increased. Despite the mild improvement, turnover remained below the last-year levels in all regions, which indicates that the real estate market still feels the crisis. Underlying such trends are primarily the low purchasing power of the population and tightened housing loan standards, as confirmed by results of the bank lending survey.

Positive results were recorded on the supply side, as the number of construction permits issued edged up in Q2. This came mainly as a result of a new simplified issuance procedure, effective as of March. The total number of construction permits issued in April and May surpassed the last year's figures by 30%, or 25% if only buildings are observed.

Apart from regulations pertaining to permit issuance, another two laws adopted in July are expected to improve the situation in the real estate market. Amendments to the Mortgage Law provided for out-of-court mortgage foreclosures, enhancing the protection of both creditors and debtors. They also regulated more precisely debtors' rights and obligations, and methods and mechanisms for the protection of their interests, putting them in a more favourable position compared to the previous law.

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



Source: National Mortgage Insurance Corporation.

[16] With entrepreneurs and private households included, the share increased by 0.5 pp, to 12.3%.

[17] Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but only serve to calculate bank capital. They are calculated on a group basis by asset classes that provisioning levels are defined for (0%, 2%, 15%, 30% and 100% for receivables classified in A, B, C, D and E categories, respectively).

[18] DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans. Though it does not monitor purchase/sale transactions financed by own funds or uninsured loans, DOMex is judged to mirror trends in the real estate market, considering high unemployment levels, declining wages and muted lending activity.

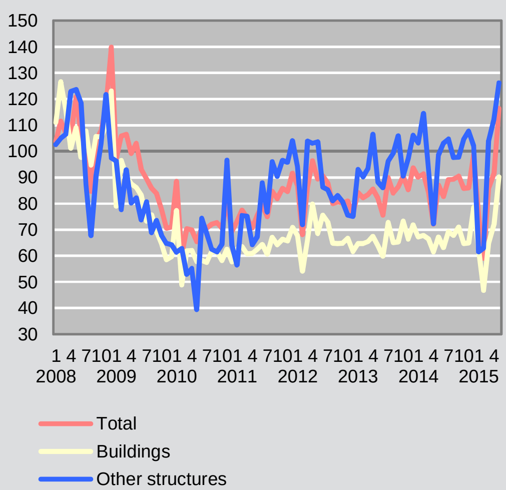
[19] The number of real estate transactions and flat prices per square meter also relate only to real estate purchased by insured loans.

The adoption of the Law on the Conversion of the Right of Use on Construction Land into Ownership Right for a Fee enables the completion of ownership transformation of building land. Investors are offered the possibility to convert the right of use on construction land into ownership or the right to lease up to 99 years, after paying the fee for the land in question at the market price. Since the inability to acquire ownership of construction land was one of the major obstacles to the implementation of numerous construction projects, the Law created preconditions for significant speeding up of investments.

In addition, June saw the ratification of the IBRD Loan Agreement for the project of improvement of land administration in Serbia, aimed at upgrading the Serbian property cadastre so that it reaches standards of most advanced countries.

By adoption of these regulations, certain deficiencies that were earlier noted as significant obstacles to doing business in Serbia were removed, which should improve Serbia's ranking in international business competitiveness lists.

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



Sources: SORS and NBS calculation.

4. Aggregate demand

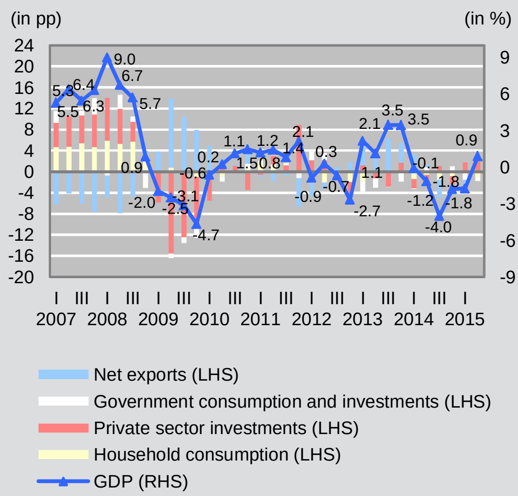
Business environment reforms, coupled with the improvement in the financial position of businesses mainly as a result of the fall in oil price, reflected positively on private investments. As private investments increased and fiscal consolidation depressed final consumption less than expected, domestic demand contributed positively (by 1.9 pp) to the growth in aggregate demand in Q2. Net external demand gave a neutral contribution due to slowing of goods and services exports in real terms.

Y-o-y growth in aggregate demand (0.9%) in Q2 was also chiefly driven by private investments and, after three quarters, by net exports as well. On the other hand, final consumption of households and government, together with government investments, gave negative contributions, continuing their y-o-y fall into Q2.

Domestic demand

Having been on the downside for a whole year, **household consumption** edged up by 0.5% s-a in Q2,

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



Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2015.

adding 0.4 pp to aggregate demand. This is indicated chiefly by an upswing of retail trade turnover by 1.7% s-a and higher imports of durable consumer goods. Y-o-y, the fall in household consumption accelerated to 1.4%, giving a negative 1.0 pp contribution to aggregate demand.

Quarterly rise of household consumption is also signalled by movement of its main sources. The net wage bill grew 2.1% s-a in real terms, while social insurance transfers gained 1.1% s-a. Consumer and cash loans stepped up in Q2, and higher receipts were recorded from the sale of foreign currency.

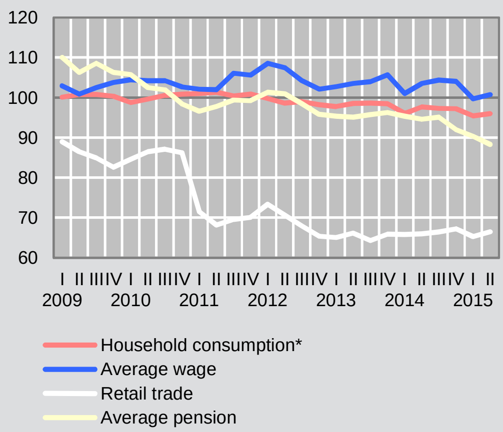
Reforms in the area of labour and bankruptcy legislation, as well as new legal solutions in construction improved the investment climate in Serbia. These improvements, together with a better financial position of companies as a result the fall in oil prices, propelled **private investments** into the major contributor (by 1.4 pp) to the growth of aggregate demand in Q2, which came at around 7.9% s-a. This is signalled primarily by indicators in the construction sector, i.e. increased production of construction material and number of construction permits issued, as well as the continued upswing of equipment imports. Investment loans to corporates went up, while FDI inflow subsided relative to Q1. Growth of private investments accelerated to 10.4% y-o-y, giving a positive contribution to the growth of aggregate demand (1.7 pp).

Table IV.4.1 **Investment indicators**

	2014			2015	
	II	III	IV	I	II
Real indicators (s-a data, quarterly growth, in %)					
Industrial inventories	0.8	-2.1	-13	5.4	-0.7
Industrial production of capital goods	-14	13	-14	14.1	-4.7
Exports of equipment*	-3.5	-18	-13	29.7	-5.2
Imports of equipment*	0.6	-0.1	2.0	7.5	6.3
Inventories of capital goods	3.3	11	6.8	3.2	3.1
Industrial production of intermediate goods	-6.5	18	-19	6.3	17
Exports of intermediate goods*	-2.0	0.1	15	2.9	4.5
Imports of intermediate goods*	-16	-2.6	17	4.3	2.4
Inventories of intermediate goods	2.6	-0.3	-10	-0.3	2.1
Industrial production of construction materials	-7.3	2.3	2.3	-6.7	9.2
Inventories of construction materials	2.2	-3.1	-13	-3.1	-4.0
Government investment**	39.7	-35.2	5.7	-216	50.2

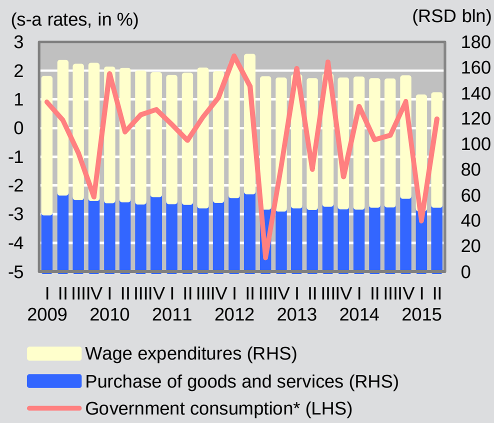
Source: SORS and NBS calculation.
* Exports and imports are denominated in euros.
** Government investment is deflated by the industrial producer price index.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q2 2015.

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q2 2015.

Government consumption is estimated to have mildly picked up in Q2 (0.3% s-a), boosting aggregate demand by 0.1 pp. The rise in government consumption was aided by higher expenditures for the purchase of goods and services (5.6% s-a), while public wage expenditures continued to decline as expected (0.8% s-a). In y-o-y terms, the fall in government consumption slowed to 3.0%, contributing negatively to aggregate demand (0.6 pp).

After three quarters of decline, **government investments** increased by 50.2% s-a in Q2, adding 0.6 pp to the growth in aggregate demand and slowing their y-o-y fall to 7.1% in real terms.

Net external demand

Following two quarters of relatively strong growth, goods and services exports decelerated to 1.1 % s-a in real terms in Q2. Real goods and services imports displayed similar growth dynamics (0.9% s-a), so net exports provided a neutral contribution to aggregate demand in Q2.

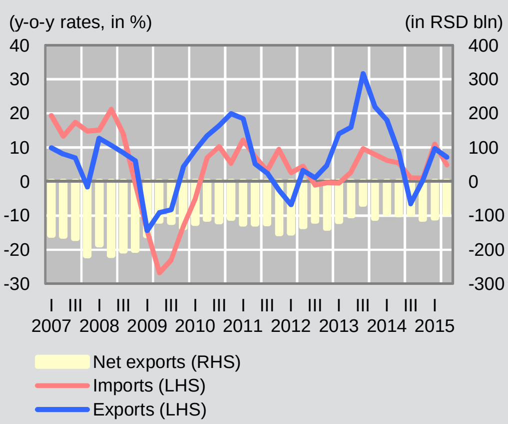
Observed y-o-y, real goods and services exports continued their relatively strong upward trend (7.1%), while imports growth slowed down considerably – from 11.0% in Q1 to 4.9% in Q2. Therefore, unlike in the three previous quarters, in Q2 net exports gave a positive impetus to aggregate demand (0.4 pp).

External demand indicator[20] continued up in Q2, reflecting an improvement in the economic climate in our major trade partners. A decline in unit labour costs in manufacturing, which produces the majority of tradeables, drove cost competitiveness up, while price competitiveness dropped only mildly, due to the real appreciation of the effective exchange rate of the dinar in Q2 (0.5%).

Strong growth of commodity exports in Q1 (8.5% s-a) lost steam in Q2 (0.6% s-a), restrained by a slowdown in agricultural exports and performance of key export-oriented branches of manufacturing (automobiles and petroleum products). Motor vehicle exports dropped by 6.7% s-a, despite higher automobile sales in key export markets, which may signal that markets are gradually becoming saturated with the Fiat model manufactured in Serbia. Nevertheless, Kragujevac-based Fiat remains Serbia's single largest exporter, reporting EUR 361.7 mln worth of exports in Q2 and EUR 735 mln since the beginning of the year.

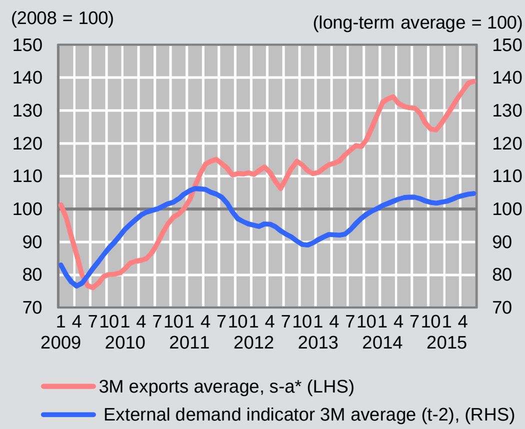
Apart from motor vehicles, Q2 also saw a decline in exports of base metals and metal products, which were among the leading exporting branches in Q1. As these branches continued to record a marked export growth y-o-y, the fall in Q2 is in part attributable to the high base from the previous quarter. Similar trends were recorded in

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



Sources: SORS and NBS calculation.
Note: NBS estimate for Q2 2015.

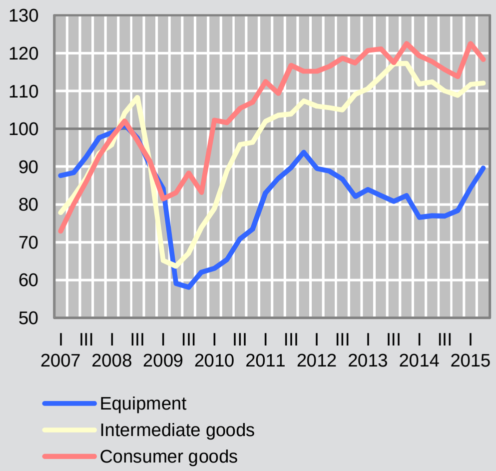
Chart IV.4.5 **External demand and Serbian exports**



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

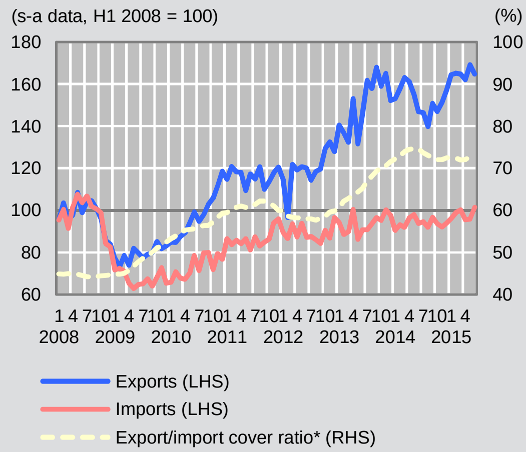
[20] Leading indicator of external demand for Serbian exports was construed based on movements in the European Sentiment Indicator (ESI). It includes 20 of Serbia's most important foreign trade partners – their shares in Serbian exports being used as weights.

Chart IV.4.6 **Imports by key components**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

Chart IV.4.7 **Commodity trade in euros**



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

exports of pharmaceuticals and tobacco and tobacco products. Petroleum product exports also continued to shrink, reflecting mainly the price drop, given that Serbia's Oil Company NIS reported a growing demand for motor fuels in regional markets.

On the other hand, growth in agricultural commodity exports extended into Q2 (6.3% s-a), though at a slower pace than in Q1. Wheat exports went up, but observed in terms of mercantile year[21] they were twice lower due to the poorer quality of last year's harvest. Given that this year's wheat harvest is of much higher quality and that the output is close to last year's level of 2.4 mln tons, the current mercantile year[22] will likely bring better export results. Corn exports in Q2 followed similar dynamics as in Q1, while in the mercantile year to date[23] record 2.8 mln tons were exported. Nevertheless, weather conditions were not conducive to corn harvest and are bound to reflect on the output, so the following mercantile year is expected to yield much lower exports. Fruit and vegetable exports grew at a similar rate as in Q1, though gaining 10% y-o-y.

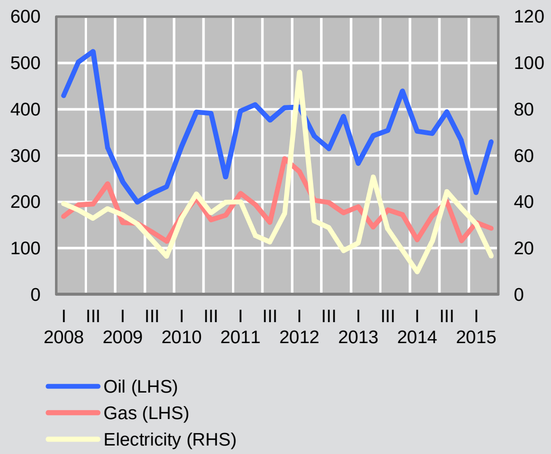
Exports of food products continued up in Q2, mostly on account of higher meat and vegetable fats exports. Positive contributions to export growth also continued from exports of chemical products, rubber and plastic products and clothing. Exports of electrical equipment bounced back as well. Positive movements were also recorded in electricity exports, which rose by 36.4% y-o-y in Q2, after pre-flood production levels were reached.

As imports of consumer goods receded (3.5% s-a), euro-denominated commodity imports edged down by 0.8% s-a in Q2. Imports of intermediate goods stagnated (0.3% s-a), while imports of equipment continued up (6.3% s-a), signalling an increase in investments. Nevertheless, given that, similarly to the previous quarter, the share of non-classified products in imports was relatively high, reclassification will likely result in upward revision of growth rates of all imports components.

Observed by economic destination of the EU, Q2 saw further decline in energy imports. Much of the downward pull came from lower imports of natural gas, reflecting its price decline[24], and electricity, owing to the recovery of domestic production, while oil and petroleum product imports increased, primarily due to the price increase in the international market. Imports of capital goods contracted as well, which can be explained to some extent by lower imports of components used in the automobile industry. On the other hand, durable consumer goods imports grew on the back of a greater volume of imports of electrical machines and appliances and medicinal and

[21] July 2014 – June 2015.
[22] July 2015– June 2016.
[23] October 2014 – September 2015.
[24] Price of natural gas follows the price of crude oil with a time lag, so its lower price at the start of 2015 is a consequence of a drop in crude oil price from H2 2014.

Chart IV.4.8 **Energy imports**
(s-a data, EUR mln)



Sources: SORS and NBS calculation.

pharmaceutical products, as did intermediate goods imports, due to greater imports of industrial raw materials (iron and steel, non-ferrous metals, non-metallic minerals).

Foreign trade indicator improved in Q2, considering that the export/import cover ratio[25] increased by 1.0 pp, to 72.9% in June. Commodity exports were 64.7% and commodity imports 1.5% above their pre-crisis levels[26].

[25] 12-month moving average.

[26] H1 2008.

Text box 2: Further reduction in external imbalances in H1 2015

External imbalances continued down during H1 2015. The current account deficit in the first six months equalled EUR 728.0 mln (4.7% of GDP), narrowing by EUR 309.0 mln (around 30%) from the same period last year. The narrowing of the current account deficit came as a result of an increase in the surplus on the balance of services and the secondary income account, as well as a reduction in the deficit on the primary income account, whilst the deficit on the balance of goods edged slightly up. Although reduction in oil prices and a speedier economic recovery of our main foreign trade partners (euro area and CEFTA countries) had a positive effect on the foreign trade deficit, it was still somewhat higher than a year ago, primarily due to lower exports of motor vehicles and electricity.

Exports of goods amounted to EUR 5.6 bln in H1 2015, rising by EUR 309.0 mln from H1 2014, while imports of goods went up by EUR 327.0 mln, arriving at EUR 7.5 bln. As a result, the deficit on the balance of goods increased by EUR 18.0 mln. The rise in exports can be put down primarily to a good agricultural season and higher exports of agricultural and food products and tobacco. Also, favourable trends in the global steel market contributed to the re-starting of production in the Smederevo steel plant, so H1 witnessed a significant rise in exports of iron and steel, and a more moderate rise in exports of industrial machinery, non-ferrous metals and furniture. Positive contribution to improvement in foreign trade imbalances continued coming from exports of chemical and pharmaceutical products and rubber and plastic products. At the same time, exports of motor vehicles slumped due to lower demand for the latest Fiat model manufactured in Serbia. Exports of electric equipment also declined as the demand from Russia, which is an important exports destination for this type of products, subsided. The fall in oil prices and consequently lower prices of petroleum products reflected on lower exports of this type of products, whilst flood damage in the energy sector induced a decline in electricity exports. Nevertheless, Q2 saw a recovery in electricity production, so electricity exports recorded a y-o-y growth in May and June.

Y -o-y rise in imports of goods in H1 2015 came primarily as a result of higher imports of natural gas due to increased consumption in chemical industry and production of base metals, as well as a result of higher imports of electricity, given that domestic production capacities were not fully recovered in Q1. Boosted production of base metals fostered growth in imports of metal ore and scrap metal, coke and stone coal. The rise in imports was also recorded for industrial machinery, telecommunications and audio equipment, transport equipment, coffee and citrus fruit. On the other hand, the most significant contribution to the reduction in the foreign trade deficit came from lower imports of crude oil and petroleum products due to fall in crude oil prices in the global market. Also, re-started production of base metals in the Smederevo steel plant led to a partial substitution of iron and steel imports, while lower purchasing power of households reverberated in lower imports of road vehicles.

Table O.2.1 **Serbia's current account balance**[1)]
(EUR mln)

	H1 2014	H1 2015	Difference
I CURRENT ACCOUNT	-1,037.0	-727.9	309.1
1. Goods	-1,898.2	-1,915.9	-17.7
1.1. Credit	5,278.8	5,587.8	309.0
1.2. Debit	7,177.1	7,503.7	326.7
2. Services	141.6	250.6	109.0
2.1. Credit	1,679.9	1,931.2	251.3
2.2. Debit	1,538.4	1,680.6	142.2
3.Goods and services	-1,756.7	-1,665.3	91.3
3.1. Credit	6,958.8	7,519.0	560.2
3.2. Debit	8,715.4	9,184.3	468.9
4. Primary income	-745.0	-698.1	46.9
4.1. Credit	292.9	263.2	-29.7
4.2. Debit	1,037.9	961.3	-76.6
of which: interest	458.5	528.7	70.1
5. Secondary income	1,464.6	1,635.6	170.9
5.1. Credit	1,640.4	1,841.1	200.8
5.2.Debit	175.7	205.6	29.8

Sources: SORS and NBS.
Note: Preliminary data.
1) BPM6 methodology.

Significant positive contribution to the reduction in foreign trade imbalances came from the EUR 109.0 mln rise in the surplus on the balance of services, brought about by a larger increase in exports relative to imports of services (EUR 251.0 mln vs. EUR 142.0 mln). Exports outpaced imports of services in almost all categories, the most substantial rise being recorded for exports of services of transport, telecommunications and other business services. Exports of construction services rose on account of increased hiring of domestic enterprises on construction works abroad, while the favourable spell of weather and prolonged winter tourist season reflected on the increase in exports of travel services. As regards imports of services, the sharpest rise in H1 was recorded for travel, transport and other business services, while imports of construction services fell from H1 2014.

Positive contribution to the narrowing of the current account deficit in H1 2015 also came from lower deficit on the primary income account (EUR 47.0 mln), which was brought about by a steeper fall in expenditures (EUR 77.0 mln) than in income (EUR 30.0 mln). Moreover, employee compensations kept the surplus trend, while investment income recorded lower deficit than in H1 2014. The largest portion of this reduction (EUR 99.0 mln) related to income from direct investments, which recorded significantly lower expenditures under payment of dividends and reinvested earnings, which could be linked to poor business results in 2014 caused by the economic downturn. Reduction was also registered for equity income, while a mild rise recorded in dividend payments was fully offset by substantially lower amount of reinvested earnings of domestic legal persons abroad. A sharper y-o-y rise in expenditure in H1 2015 was also recorded for interest on portfolio investment (by EUR 73.0 mln), while expenditure under income from other investment remained at nearly the same level as in H1 2014. Owing to adequate reserve management and more favourable inter-currency trends in the global financial market, H1 2015 witnessed a y-o-y rise in income from FX reserves (EUR 12.0 mln).

Positive contribution to the shrinking of the current account deficit in H1 2015 came from the rise in the surplus on the secondary income account (EUR 171.0 mln), attributable to the fact that increase in income (EUR 201.0 mln) massively exceeded the rise in expenditures (EUR 30.0 mln). As in previous years, the largest surplus was recorded for current transfers, of which workers remittances accounted for the largest share – measuring 8.6% of GDP in H1, and rising by EUR 117.0 mln in the review period. Still, it is possible that this rise does not relate entirely to the inflow of new remittances and that it may partly be explained by the inclusion of previously received remittances into the payment system against the backdrop of a reduction in other sources of household consumption (wages and pensions). Apart from remittances, the rise in surplus was recorded for current government transfers, which is largely the result of higher inflow of official aid.

According to our estimate, the current account deficit will continue down in H2 as well, given the upward revision of economic growth forecasts for Serbia's key trade partners and the likely further rise in our exports. Also, based on the estimate of analysts and judging by the trend in futures, no major rise in oil prices is likely until the end of the year, which will have a positive impact on Serbia as a net energy importer. Assuming crude oil prices hover around the current level of USD 50 per barrel by the end of the year and the current exchange rate of the dollar against the euro is maintained, we estimate that contribution of lower oil and gas prices to the narrowing of the current account deficit in 2015 will measure between 1.0 and 1.5 pp. According to our estimate, the current account deficit will amount to around EUR 1.3 bln or 4.2% of GDP in 2015, down by approximately EUR 600 mln or 1.8 pp from 2014, and will be almost entirely covered by FDIs.

Apart from favourable cyclical movements, the reduction in foreign trade imbalances was aided by the structural adjustment of the domestic economy, i.e. reallocation of resources from non-tradable to tradable sectors, improved external competitiveness and growth based on investments and exports. All of this helped narrow the current account deficit from 21.6% of GDP in 2008 to 6.0% in 2014. It is therefore essential that the authorities continue the structural reform effort aimed at improving the business climate, preserving macroeconomic stability and consolidating public finances. This should ensure further inflow of FDIs into export-oriented sectors, which in the medium and long term improve the production potential and ensure sustainable growth.

5. Economic activity

Further rise in industry, encouraged by lower energy prices and external demand, as well as the recovery of construction, contributed to GDP growth in Q2. GDP rose in y-o-y terms as well, owing primarily to the recovery of the mining-energy complex from the consequences of last year's floods.

Compared to our expectations from the May Inflation Report, we now expect better results in industry and construction and weaker negative effects of fiscal consolidation in 2015 – therefore, even despite a bad agricultural season, our estimate is that GDP will edge up by 0.5% in yearly terms.

Good results in industry and construction contributed to stronger GDP growth in Q2 (1.9% s-a) than previously anticipated. Further rise in industrial production (6.7% s-a in Q2) may be linked to lower energy prices, which helped reduce expenditures, as well as to further economic recovery of the euro area that spurred external demand. These positive trends paved the way for the gradual return of economic activity to its pre-crisis level – measured by GDP, economic activity was 0.4% lower, whilst measured by NAVA, it was 0.3% higher than in H1 2008.

Owing to sooner than expected rebound of the mining-energy complex, GDP rose in Q2 in y-o-y terms as well – according to the preliminary estimate of the Statistical Office, its growth measured 0.9%. In addition to industry, positive contribution to y-o-y growth came from financial activity and construction which recuperated in Q2 after the Q1 fall. Negative contributions to GDP trends in Q2 continued from agricultural production and service sectors with a significant share of the state.

Consistent with expectations from the previous *Inflation Report*, the mining and energy sectors seem to have fully recovered and that their production is back to pre-flooding volumes. This is indicated by a vigorous rise in the physical volume of production in mining (13.2% y-o-y) and energy (31.0% y-o-y) in Q2, recorded for the first time after the drop that spanned four consecutive quarters. These sectors also recorded a q-o-q rise in the physical volume of production (18.9% and 31.3% s-a, respectively).

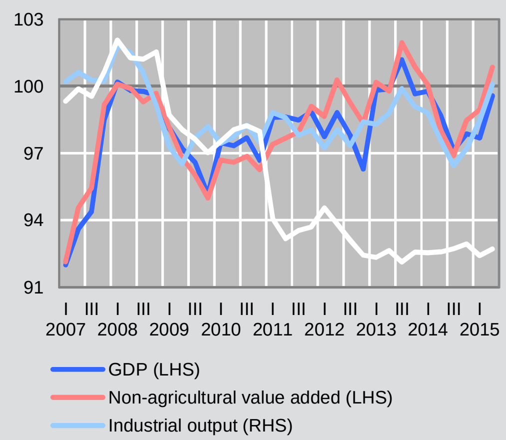
Expansion in the physical volume of production in Q2 was also recorded for manufacturing (1.0% s-a), which

Table IV.5.1 **Annual GDP growth and contributions**

	2013		2014		2015*	
	%	pp	%	pp	%	pp
GDP	**2.6**	**2.6**	**-1.8**	**-1.8**	**0.5**	**0.5**
Agriculture	20.9	1.5	0.8	0.1	-10.4	-0.9
Industry	6.0	1.2	-7.1	-1.5	7.9	1.6
Manufacturing	5.7	0.8	-1.7	-0.3	4.5	0.7
Mining and energy	8.8	0.4	-21.3	-1.0	21.6	0.8
Construction	-3.9	-0.2	0.9	0.0	5.0	0.2
Services	0.3	0.1	-0.5	-0.2	-1.4	-0.7
Net taxes	-1.1	-0.2	-0.6	-0.1	0.6	0.1

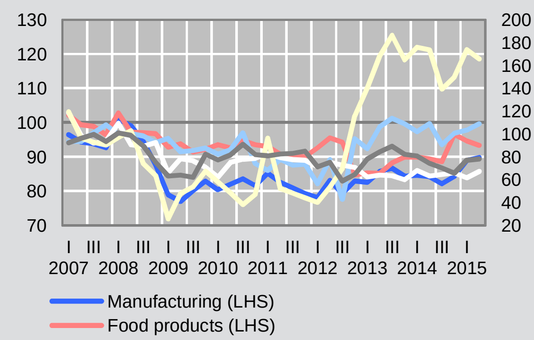
Sources: SORS and NBS calculation.
* NBS estimate.

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



Sources: SORS and NBS calculation.

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



Sources: SORS and NBS calculation.

sped up to 7.5% y-o-y, due to the low base. Physical volume of production rose in 16 of the existing 24 branches of manufacturing, while dropping in the remaining eight. Positive trends continued in the export-oriented branches of manufacturing (production of petroleum, chemical and pharmaceutical products, rubber and plastic) that saw a further rise in the physical volume of production, which indicates that export demand remains one of the drivers of industrial growth. Positive trends in the global iron and steel market since H2 2014 reflected on the further increase in production of base metals, whose physical volume of production was on the rise for the fourth consecutive quarter. On the other hand, physical volume of motor vehicles production dropped slightly in Q2, which may be ascribed to mild market saturation with the Fiat model manufactured in Kragujevac. Physical volume of production shrank in food industry and production of machinery and equipment.

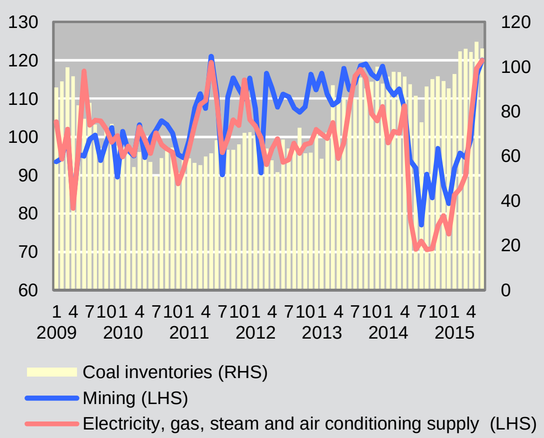
Trends in the construction industry from the beginning of the current year resembled the ones recorded in early 2014. This is illustrated by the stagnation of the value of construction works performed in Q1 (-0.9% y-o-y) and a mild rise in effective working hours at construction sites (1.2% y-o-y). When available indicators are taken into consideration, Q2 could see a pick-up in activity (around 4% s-a), given the higher number of construction permits issued in April and May, following the implementation of the new Law on Planning and Construction which shortened the deadline for construction permit issuance to 30 days. Q2 also recorded a rise in the physical volume of production of construction material (9.2% s-a) and in other areas closely related to construction trends (furniture manufacturing and wood processing). If positive trends from Q2 were to continue until the end of the year, 2015 could see a rise in activity of around 5%.

Negative contribution to GDP in 2015 is likely to come from agricultural production, which, according to our estimate, will post a drop of around 10%, given the unfavourable spell of weather during July. Heat wave and dry spell affected corn and industrial crops during an important stage of their vegetation (kernel formation and imbibition). It is therefore estimated that yields of these crops will be significantly lower than the previous year. This drop will be particularly pronounced in the case of corn, whose yield will be significantly below the record figure set last year, but also below its decade average. Lower production is also expected in case of soybean and sunflower, as well as the sugar beet which, due to the problem with purchase of the yields in 2014, was sown on the area one third smaller than a year earlier.

On the other hand, higher production was recorded for wheat, whose yield this year is also of higher quality, and for fruit growing, vegetable farming and viticulture, which saw a substantial fall due to the consequences of the last year's flooding. Mild growth of production may be expected in animal husbandry, as indicators show a rise in the number of livestock and a higher scale of processing in slaughterhouses since the beginning of 2015.

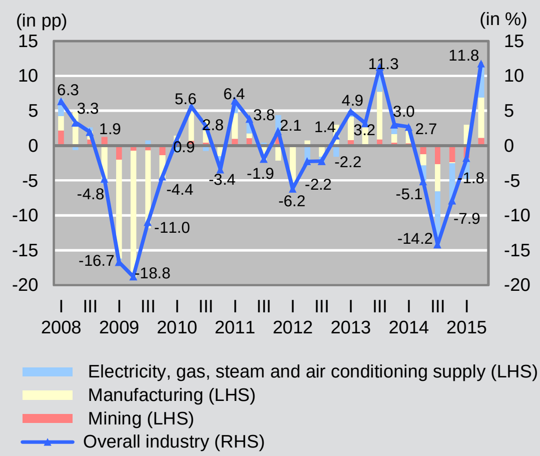
Positive trends in Q2 were also registered in the sector of trade, given that retail trade turnover edged up by 1.7% s-a. This may partly be explained by the fall in the domestic prices of petroleum products, which led to a rise in

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



Sources: SORS and NBS calculation.

Chart IV.5.4 **Contributions to y-o-y growth of the physical volume of industrial production**

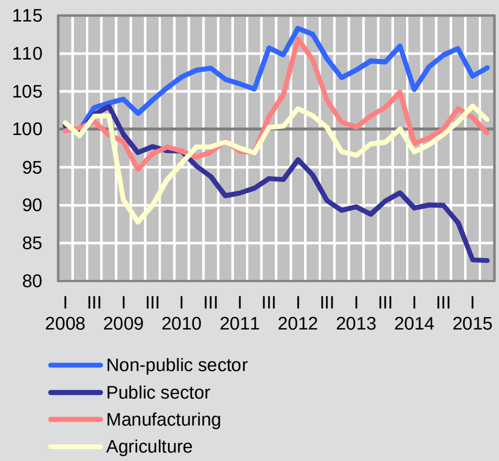


Sources: SORS and NBS calculation.

disposable income of households. Apart from trade, indicators show positive trends in transport (rise in the physical volume of services) and accommodation and food service sector (higher number of tourists' overnight stays). On the other hand, the fall in the sector of service activities with a significant share of the state continued in Q2 due to fiscal consolidation measures. In yearly terms, it is expected that service sectors will make negative contribution to GDP trends, but it should be borne in mind that since the beginning of the year economic activity indicators have been showing that this contribution will be lower than previously anticipated.

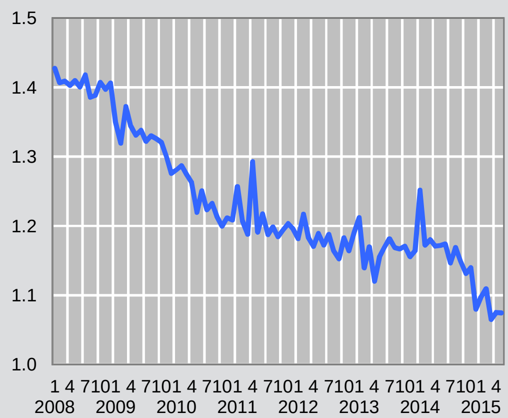
Compared to our forecasts from the May *Inflation Report*, industry and construction are in for better results, the negative effect of fiscal consolidation will be weaker, while the drop in agricultural production will be sharper than expected due to the unfavourable spell of weather. It is not likely that positive trends in industry will be significantly offset by the expected lower volume of motor vehicles manufacturing and temporary suspension of production in the Fiat plant during summer months. According to our estimate, GDP growth in 2015 will measure around 0.5% in real terms.

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



Sources: SORS and NBS calculation.

Chart IV.6.2 **Ratio of average nominal net wage in public and non-public sector**
(s-a data, H1 2008 = 100)



Sources: SORS and NBS calculation.

6. Labour market developments

Weighed down by fiscal consolidation measures, real net wages continued to fall in y-o-y terms in Q2, but recorded s-a growth relative to the previous quarter owing to the recovery in non-public sector wages. Further vigorous rise in industrial production in Q2 led to an increase in productivity and a decrease in unit labour costs. Labour market developments are characterised by a rise in formal employment amidst higher participation rate and by a further y-o-y drop in the unemployment rate.

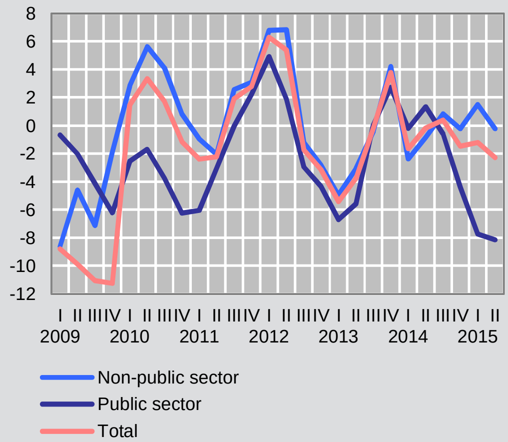
Wages and labour productivity

The rise in real net wages in Q2 was primarily driven by the recovery of wages in the non-public sector which jutted up by 1.0% s-a, whilst real net wages in the public sector stagnated following two consecutive quarters of fall. The rise in net wages in the non-public sector and their stagnation in the public sector helped reduce the difference between average wages in these sectors.

The largest rise in real wages in Q2 was registered precisely in the sectors that witnessed a sharp drop in real wages in Q1 (financial activities, administrative and auxiliary service activities, transport and storage). The recovery of wages in Q2 was registered in mining and electricity, gas and steam supply, which are recuperating from last year's flooding. Unlike in Q1, real wages in manufacturing fell slightly, while agriculture and sectors with a high share of the state (education, healthcare and public administration) experienced a further drop in wages, though at a slower pace than in Q1.

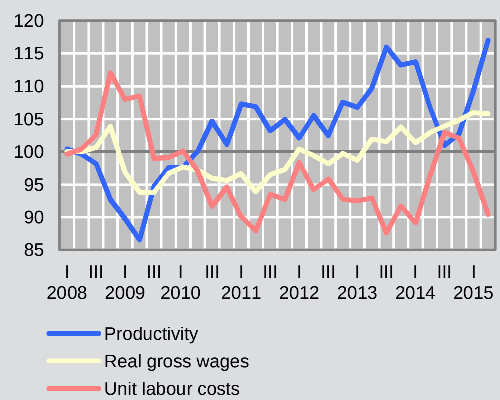
Continuation of a strong y-o-y fall in real wages in the public sector (8.1% in Q2) led to a decrease in total wages, while real net wages in the non-public sector stayed flat. Such trends are also confirmed by sector analysis, given that this strong fall continued in public administration, education, healthcare and social

Chart IV.6.3 **Real net wage movements**
(y-o-y growth, in %)



Sources: SORS and NBS calculation.

Chart IV.6.4 **Movements in productivity, real gross wages and unit labour costs in industry**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

protection i.e. sectors with the dominant share of the state. In the non-public sector, real net wages climbed in y-o-y terms in manufacturing, construction, information and communications, agriculture and administrative and auxiliary service activities. Also, recovery was recorded in mining, accommodation and food service sector and financial activities. Net wages in transport, electricity, gas and steam supply and real estate activities dipped in y-o-y terms.

Real net wage bill inched up in Q2, driven largely by a rise in the non-public sector wage bill (2.5% s-a). After declining for three quarters, real net wage bill in the public sector edged up in Q2 (1.0% s-a), which may be partly explained by the fact that wages paid out by public enterprises in the mining and energy sector rose once the production returned to the pre-flooding levels. The average nominal take-home wage in the Republic of Serbia rose by 7.2% from Q1 to RSD 44,271 in Q2, which is close to the level recorded a year ago.

Continuation of positive trends in industrial production and increased productivity reflected on further **drop in unit labour costs** in Q2 (6.6% s-a), which was additionally aided by a slight fall in gross real wages in total industry. Unit labour costs in manufacturing continued down (4.1% s-a), indicating further improvement in cost competitiveness of the domestic industry.

Employment

According to the **Labour Force Survey**, unemployment rate rose by 2.4 pp, arriving at 19.2% in Q1, while dipping by 1.6 pp in y-o-y terms.[27] Moreover, employment rate continued up (0.6 pp from Q4, and 2.7 pp from Q1 2014). Employment growth was registered against the backdrop of higher participation rate and was entirely led by improvement in the formal segment of the labour market, while informal employment slumped (by 4.8 pp from Q4).

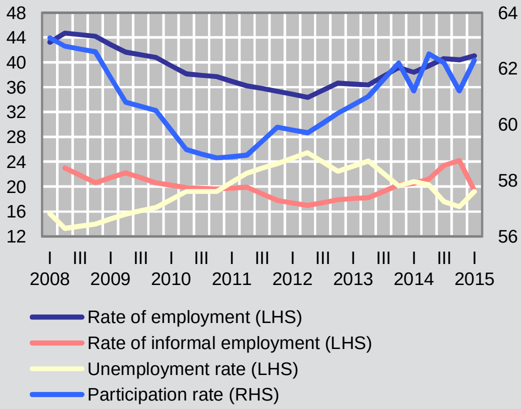
The increase in formal employment may be partly explained by heightened inspection monitoring and efforts to fight the grey economy in the labour market, which is also indicated by the fact that the strongest rise in employment in Q1 was recorded in trade and accommodation and food service sectors, which are typically burdened by the grey economy. Also, construction and agriculture's seasonal drop in employment, typical for Q1, was significantly smaller than in the same period last year[28].

After two quarters, the rise in employment was propelled by an increase in the number of full-time workers, while the number of part-time workers went down. Positive trends in the labour market were partly offset by a rise in

[27] It should be borne in mind that due to some methodological changes in the latest Survey, newest results are not entirely comparable with the results of the previous survey.

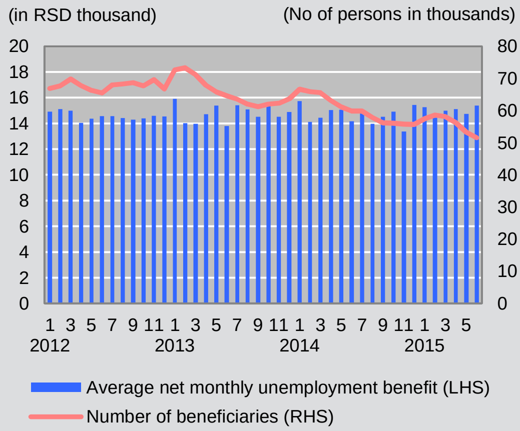
[28] In Q1 2015, the number of workers in construction and agriculture fell by 12,858 and 42,380 persons respectively, while in Q1 2014 these sectors recorded a drop of 29,876 and 52,888 persons.

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



Source: SORS.

Chart IV.6.6 **Average monthly unemployment benefit**



Source: National Employment Service.

the unemployment rate among youth population (15-24 years), which climbed by 5.8 pp to 47.7% in Q1, but was 4.1 pp lower relative to the same period last year.

According to **RAD survey**, the number of the formally employed fell slightly in Q2 (by 1,597 persons) – it shrank in the non-public and rose in the public sector. Broken down by sector, formal employment went deeper down in construction, transport, financial activities and information and communications, as well as in public administration and healthcare. On the other hand, unlike in Q1, the number of employees rose in industry, trade and agriculture, and the number of the employed in education continued up.

National Employment Service data on unemployment trends indicate that after a strong rise in Q1, the number of the unemployed went significantly down (by as many as 20,490 persons) i.e. returned to the average recorded in H2 2014. Still, slight improvement in this segment of the market is also indicated by the fact that y-o-y fall in the number of the unemployed continued for the sixth consecutive quarter.

The number of the unemployed fell in Q2 in all sectors save for education. The sharpest fall was recorded for professions connected with the manufacturing industry (mechanical engineering and metal processing and electrical engineering), trade and agriculture, which corresponds to the rise in the number of formally employed persons in these sectors, according to the RAD survey. During Q2, the number of users of unemployment benefits dipped by 6,617 to 51,250 persons in June.

Table IV.6.1 **Employment and unemployment trends**
(in thousand, end-of-period)

	2014		2015	
	Q3	Q4	Q1	Q2
Formal employment	**1,704.9**	**1,718.8**	**1,716.1**	**1,714.5**
Farmers	**454.2**	**450.5**	**434.3**	**434.3**
Total employment	**2,159.1**	**2,169.3**	**2,150.4**	**2,148.8**
Total unemployment	**748.5**	**741.9**	**766.5**	**746.0**
First time job seekers	261.4	256.3	259.5	252.5
Workers with previous job experience	487.2	485.6	507.0	493.5

Sources: SORS and National Employment Service.
* Latest available data under the Labour Force Survey.

The implementation of the recently adopted Law on the Manner of Determining the Maximum Number of Employees in the Public Sector should facilitate public sector reform, improve efficiency of public administration and contribute to fiscal consolidation. The adoption of this law was also necessary from the aspect of implementation of the arrangement with the IMF, which envisages a reduction in the number of public sector employees by 5% on a yearly basis in the following three-year period. The implementation of this law is expected to help bring expenditures for public sector wages from the current 11.8% of GDP to 8% of GDP by end-2018. In the short-term, the application of the law could lead to a temporary rise in unemployment which should to some extent be cushioned by attrition and hiring of redundant persons in the private sector.

7. International environment

The growth in economic activity in the euro area has been accelerating since the end of last year owing to the ECB's quantitative easing, which also reflected positively on economic movements in most parts of Central and Eastern Europe. The growth in the USA stepped up in Q2, which could, given favourable labour market trends, drive the Fed to increase its policy rate by the end of the year.

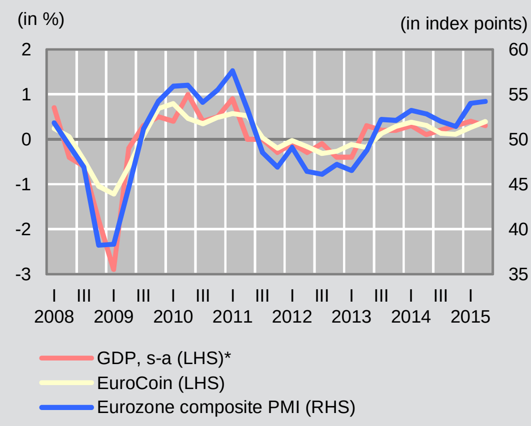
High global liquidity is still conducive to portfolio inflows to Central and Eastern European countries. In such conditions, accompanied by low oil prices and inflation target undershooting, these countries too proceeded with monetary easing. The expected asymmetric exit of leading central banks from an accommodative monetary policy remains one of primary sources of uncertainty. Though significantly lower, uncertainty over the situation in Greece persists.

Economic activity

Factors which positively affected **GDP growth in the euro area** in Q1[29] should continue to boost growth in Q2 as well. GDP growth of 0.4% s-a in Q1 was driven by domestic demand. Household consumption continued to spur growth owing to greater disposable income caused by a lower price of oil, while low costs of borrowing positively impacted investment. Unlike in the previous period, net exports had a mildly negative effect, considering that stronger final consumption drove up the rate of imports, while dampened global demand drove down the rate of exports. According to the June Consensus Forecast, the euro area economy will grow 0.5% s-a in Q2.

Observed by country, it appears that GDP has been growing more evenly than in the previous period, since all larger euro area economies are on a path of sustainable growth. The slowdown in GDP growth in Germany (from 0.7% s-a in Q4 to 0.3% s-a in Q1) has been estimated to be temporary and higher growth rates are expected as soon as in Q2, primarily on account of private consumption, which is indicated by the continued retail trade growth and the Consumer Confidence Index, which reached its 13-year maximum in June. The leading indicator of production activity (PMI Manufacturing) continued to move in the expansion zone, averaging 51.7 points.

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

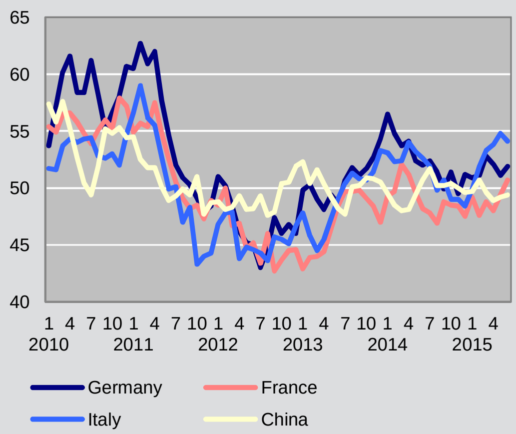


Sources: Eurostat, Markit Group and Banca d'Italia.
* Preliminary estimate for Q2 2015.

Household consumption was the key driver of robust GDP growth in France as well, which amounted to 0.6% s-a in Q1. Growth is expected to continue in Q2, albeit at a somewhat slower pace. It should result primarily from service activities, although a gradual recovery in manufacturing sectors was noted towards the end of the quarter (PMI Manufacturing returned to above 50 points after 13 months). After more than three years, in Q1 Italy's GDP recorded quarterly growth (0.3% s-a), which is expected to continue at a similar rate in Q2 as well. Further growth is indicated mainly by the movement of the production indicator PMI Manufacturing, which averaged 54.2 points in Q2, its highest level in the last four years. Available data for Spain show that relatively strong GDP growth (0.9% s-a in Q1) continued into Q2 (1.0 s-a), in line with expectations.

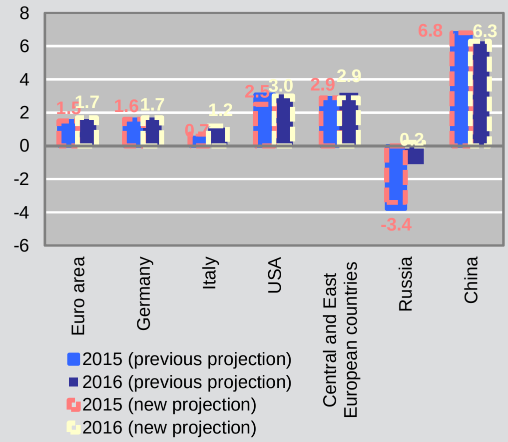
[29] Low price of oil, the ECB's accommodative monetary policy and the depreciation of the euro against other major world currencies.

Chart IV.7.2. **PMI Manufacturing for selected countries**
(index points)



Source: Markit Group.

Chart IV.7.3 **Revisions of real GDP growth forecasts for 2015 and 2016 by the IMF**
(in %)



Sources: IMF WEO (April 2015) and IMF WEO Update (July 2015).

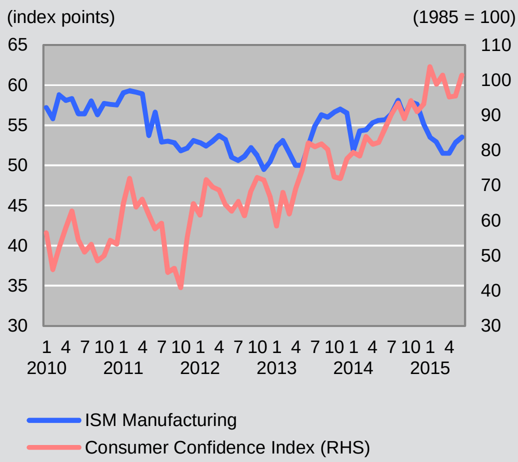
According to the latest forecasts of the IMF and the Consensus Forecast, euro area growth in 2015 will be 1.5%. However, a high rate of unemployment is still a hindrance to faster growth. Although reduced to 11.1% in June, unemployment remains well above the pre-crisis level. Furthermore, euro area growth could be dampened by the slowdown in economic growth of the BRIC countries, continued geopolitical tensions and uncertainty over the situation in Greece.

Economic growth in **Central and Eastern Europe** slowed down in Q1 relative to end-2014, as a consequence of continued spillover of negative effects of the geopolitical crisis in Ukraine. Still, the majority of countries in the region started to experience positive effects of the euro area recovery. The strongest growth in Q1 was recorded in Romania and the Czech Republic (4.3% and 4.0% y-o-y, respectively), while GDP increased at a slower pace in Bulgaria, Poland, Hungary, Slovakia and Slovenia. On the other hand, growth was moderate in the Baltic states, whose economies are strongly linked to Russia.

Economic growth outlook for the region improved on the back of faster euro area growth and weaker than expected negative effects of the Russian economic crisis. According to the July Consensus Forecast, GDP in the region as a whole is likely to stagnate in 2015, though it was revised upward by 0.4 pp relative to the April forecast. The greatest contribution to regional recovery should stem from faster than expected growth in Central European countries, caused by stronger euro area growth and the undertaken accommodative monetary policy measures. While the outlook for countries in Southeast Europe is also somewhat better, analysts estimate that structural problems, reflected in high unemployment rates, growing public debt and a high share of NPLs, restrict the ability to fully utilise the ongoing recovery of the euro area.

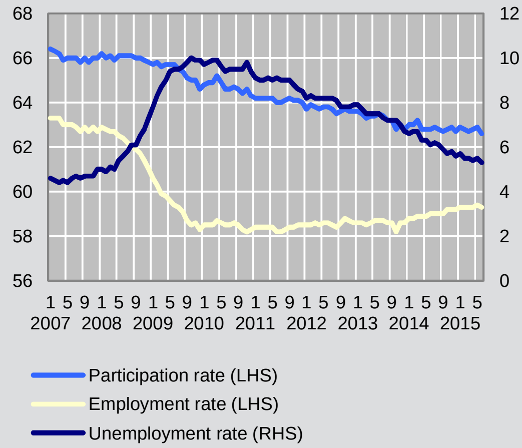
Forecasts of Russia's GDP have been revised upward since the beginning of the year. According to the July Consensus Forecast, Russia's GDP is expected to drop by 3.5% in 2015, by 0.5 pp less than according to the April forecast, while the IMF issued a similar forecast in its WEO Update in July (-3.4%). Weaker GDP drop than expected initially is attributable to the recovery of oil prices since the beginning of the year and the substitution of a part of imports following the ruble's depreciation. On the other hand, forecasts of growth in Ukraine have been revised down from April. The latest Consensus Forecast indicates that GDP is expected to fall by 9.4% in 2015 due to ongoing tensions in the eastern parts of the country which negatively reflect on production and exports, and due to fiscal consolidation measures which limit final consumption.

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



Source: Institute for Supply Management, Conference Board.

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



Source: Bureau of Labor Statistics.

A mild slowdown in GDP growth of the **USA** in Q1 to 0.15% s-a, caused by declining exports and slower growth in private consumption, has been estimated to be temporary and linked to another cold winter[30], which negatively affected production, supply chains and transport. In spite of this, labour market situation continued to improve in Q2, with unemployment rates declining to 5.3% in June, the lowest level since April 2008, while nonfarm payroll employment increased to an average of around 220,000 per month. Still, other labour market indicators (participation rate, number of part-time workers, rate of wage increase) show that full employment, one of the Fed's two primary objectives, has not been reached yet.

The movement of leading economic activity indicators pointed to GDP growth in Q2, albeit at a slower pace than in 2014. The composite index of production activity (ISM Manufacturing) was on the rise throughout Q2 and equalled 53.5 points in June, i.e. 2.0 pp higher than in March. The growth in economic activity from the aspect of demand was also confirmed by the Consumer Confidence Index which, having declined in April, started growing and reached the March level of 101.4 points in June. According to preliminary estimates, GDP growth in Q2 came at 0.6% s-a and was primarily driven by private consumption. Still, a slowdown in growth in Q1 led to a downward revision of growth in 2015 to 2.5% according to the IMF's July WEO Update (down by 0.6 pp relative to April), while the July Consensus Forecast indicates growth of 2.4%, i.e. 0.5 pp lower than the April forecast.

GDP growth in China in Q2 stayed the same as in Q1 (7.0% y-o-y) and is on target for 2015. Although it is slower than in 2014, growth in industrial production has been gradually accelerating since early 2015, reaching 6.8% y-o-y in June, as a result of low energy prices and accommodative monetary policy measures implemented by the central bank starting from November 2014. The IMF's GDP growth forecast for 2015 remained unchanged from April (6.8%), while the Consensus Forecast revised its estimate down by 0.2 pp to 6.8%. Gradual transition from the export-oriented economic growth model towards a model which gives a larger role to domestic demand remains the key challenge for economic policy makers.

Inflation movements

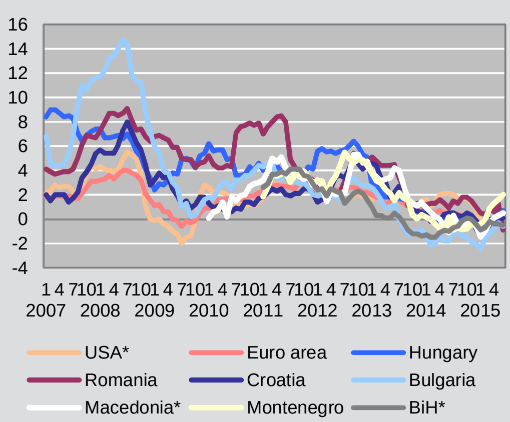
After five months, in May **euro area** inflation moved to the positive zone (0.3%), in spite of the ongoing decline in energy prices. Although it was somewhat lower in June (0.2%), inflation was positive, primarily due to the growth in food prices. Euro area inflation is still very low

[30] Economic activity fell by 0.5% s-a in Q1 2014 due to cold weather which hit a large part of the country.

(below 0.5% for an entire year) and there are fears that it could return to the negative zone as a consequence of a further fall in energy prices. Still, the ECB believes that its monetary policy measures will help avert the secondary effects of the hitherto slump in oil prices and, although inflation will remain low in the coming months, it will rise towards the end of the year, chiefly as a result of the low base caused by the drop in oil prices in late 2014. According to the ECB, the gradual growth in inflation should continue in 2016 and 2017 owing to the expected economic recovery, effects of the euro's weakening and the assumption embedded in oil futures markets of somewhat higher oil prices in the years ahead. The quarterly ECB Survey of Professional Forecasters published in July predicts low, but slightly higher inflation rates than indicated by the April survey, both in the short and the long run (0.2% in 2015, 1.3% in 2016 and 1.6% in 2017). Expectations were revised up thanks to monetary policy measures and expected economic recovery. According to the IMF, euro area inflation will remain somewhat lower, close to zero this year and 1.1% next year, reflecting the still large negative output gap.

There are still deflationary pressures in some countries in **Central and Eastern Europe**, though they are gradually waning. Deflation is the most pronounced in Bulgaria with negative inflation rates for over a year, but in the last several months it was weaker than in the period before. Deflation is diminishing in Poland as well, while prices in Croatia are stagnant. In Q2, inflation rates moved to the positive zone in Hungary, the Czech Republic, Macedonia and Montenegro. Inflation grew in only a few countries (Turkey, Russia and Ukraine) because of country-specific

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



Sources: Eurostat, Bureau of Labor Statistics and statistical offices of selected countries.
* CPI.

factors, including currency depreciation. The June data confirm the opinion of most analysts that the peak of deflationary pressures in the region is behind us and that inflation is on a gradual upturn. However, despite the moderate growth, inflation will remain low for some time and will most probably stay below the target set for this year by inflation targeters in the region.

Inflation continued to move below the target in the **USA** as well, reflecting above all the drop in energy and import prices. However, the Fed expects inflation to return to the 2% target in the medium run as the effects of these temporary factors fade and the labour market recuperates. The first increase in consumer prices from the start of the year was recorded in June, though only by 0.1% y-o-y. Energy prices increased on a monthly level, but are still 15.0% lower than in June last year. However, if those prices and volatile prices of food are excluded, inflation is significantly higher (1.8% y-o-y in June). Market-determined inflation expectations stayed low, although they were slightly higher than in early 2015, while survey-based expectations are still stable.

Monetary policy

Central banks of advanced economies are still pursuing accommodative monetary policies, which, along with falling global oil prices, created positive conditions for economic recovery. The ECB's monetary policy will become increasingly accommodative in the coming period. On the other hand, the USA and the United Kingdom are nearing the decision to start increasing their policy rates. As a matter of fact, the beginning of the Fed's policy rate increases is one of the primary factors of uncertainty in the international environment.

The ECB will continue the implementation of the Expanded Asset Purchase Programme (APP) in the monthly amount of EUR 60.0 bln until September 2016 or longer if this turns out to be necessary for bringing inflation back to the target. Ending with June, the ECB purchased close to EUR 200 bln of government bonds, making the total bonds purchased in the APP amount to around EUR 300 bln. In addition, on several occasions the ECB increased the borrowing limit for Greek banks within Emergency Liquidity Assistance in order to prevent their potential illiquidity and mitigate the risk of capital outflows from the country.

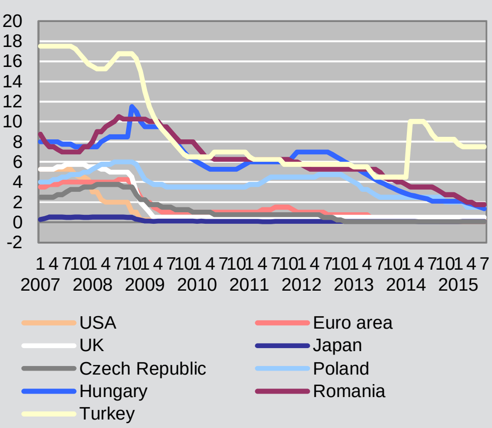
Data indicate that the ECB's monetary policy measures are gradually resulting in lower costs and greater availability of corporate and household loans, which should boost economic growth. However, the dynamics of lending are still constrained, primarily by credit risk and adjustments of bank balance sheets. In addition, in the period under review, the euro area was especially shaken by the uncertainty over the resolution of the Greek crisis. At the same time, the ECB expects that the full implementation of monetary policy measures should help close the output gap and support a sustainable return of inflation to target in the medium run, while firmly anchoring medium- and long-term inflation expectations. The acceleration of structural reforms should ensure economic growth, creating positive effects for the global economy.

Yields on ten-year German government bonds, the most important benchmark yield for investors in Europe, were driven to a record low (close to zero) by the ECB's purchases of government bonds. Yields on government bonds of other countries in the euro area (with the exception of Greece) decreased as well. However, positive movements in investor sentiment and expectations that the Fed will increase its policy rate led to a gradual decrease in investment in government bonds, pushing up their yields. Occasional oscillations in the market were caused chiefly by the crisis in Greece and events in the Chinese stock exchange. Yields on German government bonds have been gradually rising since April, as have yields on US government bonds, though to a lesser extent, so the difference between them, while still large, has somewhat decreased.

Monetary policies of central banks of countries in **Central and Eastern Europe** were accommodative owing to the ECB's accommodative monetary policy, low oil prices and extremely low inflation. The Hungarian central bank continued the cycle of successive 15 bp cuts in the policy rate which started in March, leaving the policy rate in July at 1.35%. In May, the central bank of Romania also reduced its policy rate by 25 bp to 1.75%. Other regional banks did not change their policy rates. In order to support economic activity, the Russian central bank also reduced its policy rate further in Q2 (by a total of 250 bp to 11.50%), and again in July, to 11.0%.

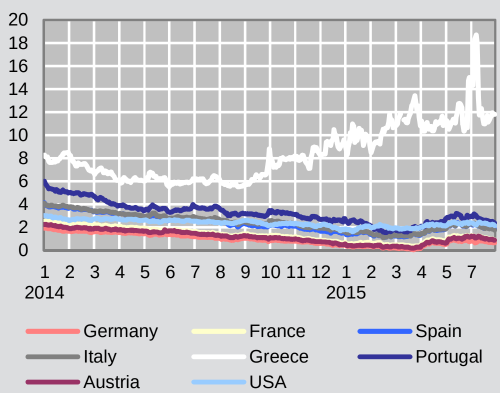
In order to achieve maximum employment and price stability, the **Fed** has not changed the target band for its policy rate (0–0.25%) yet. In a meeting held in late July, it said that it would increase the policy rate once the labour market improves further and when it becomes positive that inflation will return to the 2% target in the medium run. It also stated that economic conditions may require the policy rate to remain for a while below the level considered "normal" in the long run, even when employment and inflation approach their target levels. The Fed reiterated that the significance of the initial policy rate increase should not be exaggerated, as monetary policy will take a long time to adjust even after that. This will be aided by the continued implementation of the reinvestment policy within the quantitative easing programme in order to keep bonds owned by the Fed at a high level for as long as it is required. Still, the market now expects that the first policy rate increase will not happen before December, while the IMF recommends that the Fed refrains from increasing its policy rate until the beginning of the next year so as to preclude significant volatility in the global financial market and negative consequences to other countries.

Chart IV.7.7 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

Chart IV.7.8 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

Financial and commodity markets

Movements in the financial and commodity markets are still marked by uncertainty over the effects of the asymmetric exit of leading central banks from accommodative monetary policies, and by the movement of global prices of oil and other primary commodities. The situation in the international environment was additionally complicated by the often dramatic news regarding the crisis in Greece and the developments in China.

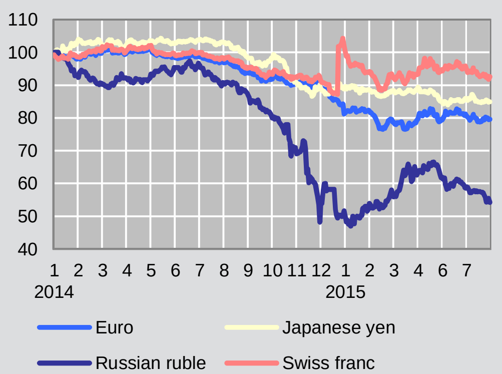
The dollar marked temporary losses amid expectations that the increase in the Fed's policy rate would be delayed due to poor results of the US economy. The dollar weakened by 3.6% against the euro in Q2, following significant growth in the previous three quarters (12%, 4% and 7%) and having reached its highest value since 2003 in late March (1.05 dollars per euro). The dollar began strengthening again in July (2.3% against the euro), while expectations of different monetary policies of the Fed and the ECB in the coming period are setting the stage for its further strengthening.

The dollar's weakening in Q2 contributed to the recovery of oil prices. Despite somewhat greater supply in OPEC countries, the rise in global demand resulted in an average growth in the price of oil by 15.1% in Q2 relative to Q1. The average price of oil, however, is still significantly lower than in the same period a year before (by 43.4%). Moving mostly in the interval between 60 and 65 dollars per barrel, it recorded no significant oscillations in the period observed. However, as the dollar strengthened in July and the sanctions against Iran were lifted, the price of oil began dropping anew, falling to 56 dollars per barrel at the end of the month. No increase in the price of oil should be expected by the end of the year, as the price movements will be strongly affected by the still abundant global supply, lack of intention of OPEC countries to cut back on production, Iran's return to the market, the slowdown in Chinese growth and uncertain dynamics of global recovery.

Though helpful for global recovery, the fall in oil prices in the global market created fiscal and external problems in many exporting countries. The situation was similar in exporting countries of other primary commodities, the prices of which are reaching their minimum values. The price of gold also continued down in Q2 and was, on average, 2.1% lower than in Q1. Such a trend could endure in the period ahead, with the further strengthening of the dollar and the US economy, as investors will move away from gold towards higher-yield assets.

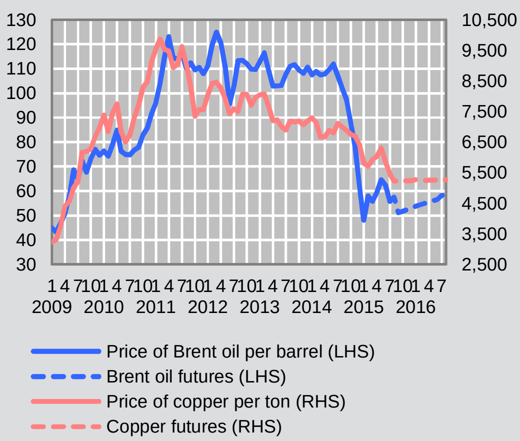
According to the VIX, a measure of the implied volatility of Standard & Poor's 500 index options, volatility in financial markets declined until end-Q2, when the oscillations of the VIX became stronger. There was significant volatility in July as well, when the VIX moved between 13 and 20. Although it remained at a relatively low level, in the last six months the VIX jumped above 20 on five occasions. According to the EM-VXY, a measure of expected short-term volatility in emerging market currencies, there are no indications of rising instability. In fact, this index declined from 10.6% in Q1 to 9.6% in Q2.

Chart IV.7.9 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



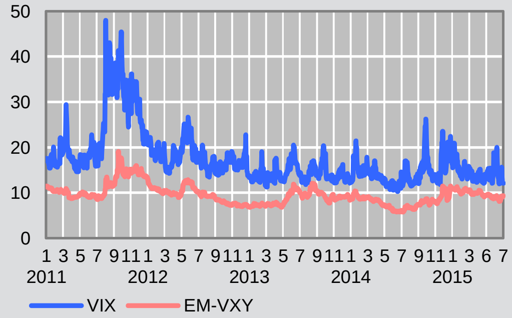
Source: IMF database.
* Growth indicates appreciation.

Chart IV.7.10 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

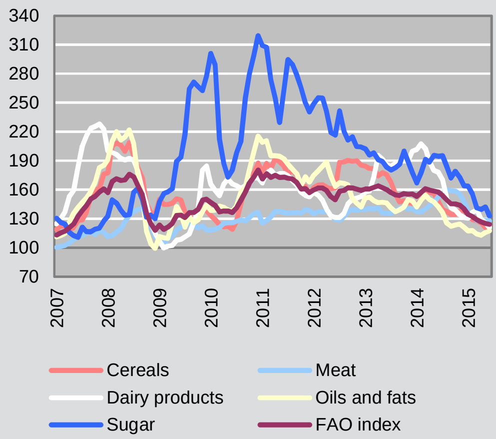
Chart IV.7.11 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

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

Chart IV.7.12 **World food price index**
(in real terms, 2002−2004 = 100)



Source: FAO, UN.

While the volatility measures still show no alarming signs of growing risk, analysts are pointing out that there are many sources of potentially high volatility in markets which investors need to be aware of (primarily the strong fall in the price of oil and other primary commodities, as well as the effects of the asymmetric exit of leading central banks from extremely accommodative monetary policies).

In Q2, world food prices, measured by the FAO index, continued the decline begun in April 2014. This index fell to 124.0 bp at end-Q2, indicating that the real world food prices declined by 3.7% relative to the last quarter, and by as much as 21.2% relative to the same period last year. The decrease varied across markets. The strongest decline was recorded in the market of dairy products (13.2%), where movements seemed relatively favourable in the beginning of the year, but were reversed by the abolition of the EU milk quota, along with the large unsold inventories of dairy products in New Zealand, uncertainty over the rate of China's imports and the ongoing sanctions on Russian imports. This resulted in the real drop in dairy prices by as much as 32.3% relative to June 2014. The prices of sugar also declined significantly in Q2 (5.9%), because of news of higher than expected production in Brazil (the largest global producer and exporter of sugar), India (largest global consumer of sugar) and Thailand. First signs that there is still a possibility of a global deficit in this market in 2015/2016, following five consecutive seasons of supply outstripping demand, were not enough to lift the pressure to reduce sugar prices. The prices of cereals also dropped in Q2 (3.9%), with June being the first month since the start of the year when they recorded real monthly growth. Still, relative to June last year, real prices of cereals were 17.0% lower. Although unfavourable weather conditions in some regions may justify an expected rise in prices, it did not happen because of large supplies carried forward and a still generally positive outlook for production. The prices of meat have been relatively stable since March, while the prices of oil are the sole component of the index that increased in Q2 (3.0%), chiefly due to unfavourable weather conditions in leading producer countries. However, the real prices of oil were still 17.5% below the level of June 2014.

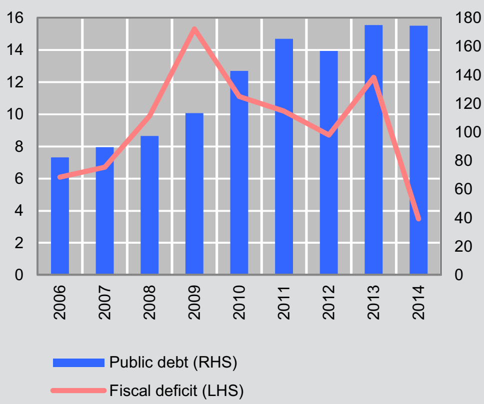
Text box 3: Situation in Greece and its effect on Serbia

Although the Greek debt crisis began back in 2010, when many private investors estimated the Greek public debt as risky and decreased their exposure accordingly, the situation became dramatic in the last several months. It started when the ECB stopped accepting Greek government bonds as collateral for its ordinary loans in February this year, having assessed Greek fiscal position as unsustainable. This allowed Greek banks to only use loans for emergency liquidity assistance (ELA), for which lower quality collateral is permissible as well. The withdrawal of funds on this account kept growing until the situation tightened in late June, when the negotiations between Greece and its international creditors (European Commission, the ECB and the IMF) broke down, and a referendum was held on whether Greece should accept their offer. The ECB then limited the amount of ELA loans which Greek banks could use and did not approve Greece's request for the temporary extension of the loan programme which was ending in late June. Without it, Greece could not settle its due liabilities to the IMF, thus becoming the first advanced economy defaulting on its debt to the IMF. In order to prevent a banking system collapse, Greece introduced extreme measures: capital control and temporary closure of commercial banks and the stock exchange.

In mid-July, Greece and its European creditors reached an agreement with the aim of resolving the crisis and keeping Greece in the euro area. The agreement envisaged further macroeconomic adjustment of the Greek economy and a set of reforms (primarily pertaining to value added tax and the pension system) as a basis for the mobilisation of over EUR 35 bln from EU funds by 2020 in order to support the Greek economy (EUR 20.0 bln from structural and investment funds and EUR 15.0 bln from agricultural funds). In the meantime, Greece was approved a short-term bridge loan in the amount of EUR 7.16 bln, allowing it to settle its July liabilities to the ECB and overdue payments to the IMF. Furthermore, the ECB increased the limit on ELA loans to Greek banks.

Assuming that Greece starts implementing reforms immediately, the IMF stresses that Greek public debt will reach almost 200% of GDP in the next two years, while it estimates its financial needs at around EUR 85 bln by end-2018. Therefore, the IMF warns that medium-term sustainability of Greece's fiscal position requires that European creditors write off its debt. It is underscored that the difficult situation in Greece cannot be resolved by measures on the one side only – neither just by reforms, nor only through debt write-off. Greek debt is owned mainly by euro area member states (62%), followed by institutional creditors – the IMF (10%) and the ECB (8%). Only 17% of the debt is owned by private creditors, and the remaining 3% by the Greek central bank.[1]

Chart O.3.1 **Fiscal deficit and public debt of Greece**
(% of GDP)



Sources: Eurostat and Bloomberg.

Uncertainty in the international financial market increased as a reaction to the Greek crisis, especially to the June breakdown of negotiations and the possibility of grexit. Interest rate spread on government securities of peripheral and core countries of the euro area widened, the euro weakened against other major world currencies, and world stock markets recorded a fall. Still, considering how dramatic the situation was, the effect on international markets was relatively moderate. However, further development of the Greek situation and its effects, primarily on the recovery of the euro area economy, will remain a primary source of uncertainty in the international environment, despite the agreement between Greece and its European creditors. It yet remains to be seen how reforms in Greece will be implemented and whether European creditors will be prepared to write off the debt.

[1] *Bloomberg Brief, Economics Europe, January 2015.*

In assessing the potential impact of the Greek crisis on Serbia, it should be taken into account that its direct effects are negligible, since Serbia's direct exposure to Greece through the trade and the financial channel is limited. Indirect effects through the impact on euro area economy and/or international financial markets are possible just as in the case of any other country.

The insignificance of direct effects is indicated by the fact that our trade relations with Greece are limited – only 1.1% of total Serbian exports go to Greece, and only 1.5% of total imports come from this country[2]. Furthermore, the financial exposure of our banks, enterprises and sovereign to Greece is exceptionally low. Domestic banks did not lend to Greek economic entities, investments of domestic enterprises in the Greek economy are low, and the only sovereign participation in loans to Greece is through the Serbian share in the IMF. On the other hand, Greece is exposed to Serbia primarily through FDI, in the total amount of EUR 1.2 bln so far, primarily in commercial banks. Loans approved by Greek banks to Serbian enterprises amount to around EUR 450 mln.

Serbian banks in majority Greek ownership (four banks holding around 13% of total banking sector assets) are not branches of Greek banks, but independent legal entities with paid in share capital in Serbia. They are strictly regulated, even more rigorously than in the parent market, which allowed for the build-up of liquidity and adequate capital buffers that can be used in situations such as this one when it is important to alleviate the negative consequences of bad news and the psychological impact. The NBS has intensified its monitoring of these banks' operations, especially regarding their liquidity and relations with parent groups, in order to react in a timely fashion, in accordance with its legal mandate, and to ensure the protection of depositors' interests and financial system stability. The liquidity indicator of these banks has been above the prescribed level and no withdrawals of funds by parent banks have been identified thus far. The NBS will continue to carefully monitor the operations of these banks, and if necessary, react by measures within its remit in order to prevent potential negative effects on the Serbian financial system.

To conclude, the Greek crisis has a limited direct effect on Serbia and could potentially affect it through indirect channels. Possible instability in the international financial market could affect capital inflows to Serbia, risk perception and the exchange rate. However, the Greek crisis has so far caused no excessive shocks in the international financial market, nor any withdrawal of investors from higher-risk assets. It appears that the more significant issue is whether the Greek crisis will constrain economic growth in the euro area, which receives 45% of Serbian exports. Potentially slower than expected growth of the euro area could negatively affect our exports and, consequently, our economic recovery. For now, the majority of leading institutions and analysts did not change their projections of GDP growth of the euro area. In fact, the IMF and the ECB estimate that there is somewhat more optimism than before in terms of balance of risk: on the positive side, there are quantitative easing measures of the ECB, low price of oil, weaker euro and growing confidence; on the negative side, in addition to the Greek crisis, there are low inflation, a slowdown of emerging economies, geopolitical tensions and instability of the financial market due to asymmetric monetary policies of leading central banks. The euro area also needs structural reforms in order to increase potential output, i.e. to prevent a situation of inflation returning to target in the medium run with high levels of unemployment, which would not be socially acceptable.

[2] Data for 2014; the percentages remained the same as in the first five months of 2015.

V. Inflation projection

Under our central projection, y-o-y inflation will be revolving around the lower bound of the target tolerance band over the coming twelve months, possibly entering the band late this year or early next year. Inflation is expected to trend closer to the 4.0% target in H2 2016. The most important inflationary factor in the coming period will be administered prices (electricity price increase in August and low last year's base for prices of cigarettes). Disinflationary pressures, by contrast, will be coming from global primary commodity prices (oil and primary agricultural commodities), weak aggregate demand, low inflation in the international environment, and tight fiscal policy at home. The risks to the projected inflation path are associated with developments in the international environment, prices of agricultural commodities and administered prices.

As the fall in consumption turned out to be softer than anticipated earlier, the projection of GDP growth for 2015 has been revised up from 0.0% to 0.5%. In 2016, GDP is projected to grow 1.5%, led by investment and net exports and to a lesser degree by household consumption.

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 continued to move below the lower bound of the target tolerance band (4.0±1.5%) in Q2 and amounted to 1.9% in June. Inflationary pressures remained subdued, as a result of the majority of domestic factors, as well as low inflation abroad and low prices of primary commodities in the international market. Q-o-q, consumer prices rose by 0.7%, driven almost entirely by the rise in prices of cigarettes and petroleum products and the seasonal hike in prices of travel packages. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been running below the target tolerance band since August 2014, reached 2.1% y-o-y at end-June.

Y-o-y inflation has been moving below the lower bound of the target tolerance band since March 2014. The undershooting of the inflation target band can be put down primarily to factors with a temporary effect – first, the unusually small growth in administered prices in 2014 (1.1%)[31] and their first ever y-o-y fall in H1 2015, the decline in primary agricultural commodity prices in 2014 and the collapse of global oil prices from mid-2014.

Extended period of low inflation and anticipation of weak inflationary pressures in the period ahead have helped stabilise short- and medium-term inflation expectations. One-year ahead inflation expectations of the financial sector and businesses have been within the target band for around a year and a half now. Two year-ahead inflation expectations of both sectors are also within the target band.

The exchange rate of the dinar against the euro was very stable in Q2, as a result of the country's improved macroeconomic prospects, notably more favourable

[31] Due to the need for gradual removal of price disparities, this growth averaged 10% in the past several years.

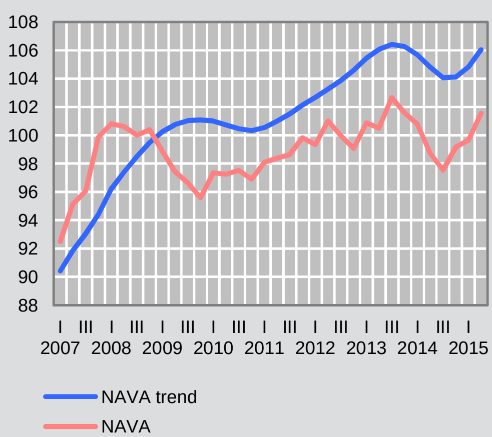
balance of payments and fiscal movements, echoed by the IMF's decision to complete the first review under the stand-by arrangement in June and by the affirmation of Serbia's credit rating by Fitch and Standard & Poor's. The current account deficit was considerably lower, while the purchase of foreign cash from exchange dealers stepped up. The supply of foreign exchange from FDI and resident (government) external borrowing increased as well. In order to ease excessive short-term volatility of the exchange rate, but without any intention to influence the exchange rate trend, the NBS intervened in April by both selling and buying foreign exchange in the IFEM (buying EUR 110.0 mln net), whereas from end-June it intervened only on the side of purchase (buying EUR 240.0 mln in total until end-July).

The Monetary Conditions Index indicates that the monetary policy stance has been expansionary for more than a year now, which is consistent with the current undershooting of the inflation target tolerance band. The expansiveness of monetary conditions in Q2 is suggested both by the sustained depreciation gap of the real exchange rate (dinar's depreciation against the euro in the past year exceeded the inflation differential between Serbia and the euro area) and the real interest rate[32] (the recovery of banks' liquidity and the reduction of the key policy rate pushed the real interest rate below the neutral level).

After successful completion of the first review under the arrangement with the IMF, which focused on public finances as at end-Q1, favourable fiscal developments continued into Q2. Consolidated budget deficit amounted to 1.9% of GDP in H1 2015 and was significantly lower than the ceiling envisaged by the agreement with the IMF (RSD 35.3 bln vs. RSD 96.3 bln). At the same time, primary surplus of 2% of GDP was posted. While the IMF places this year's consolidated budget deficit at 5.3% of GDP, the Fiscal Council assesses the deficit could amount to mere 3.5% of GDP. Starting from the IMF's projection of deficit, end-2015 public debt would amount to around 80% of GDP. The key risk to its movement is associated with the possible further strengthening of the US dollar.

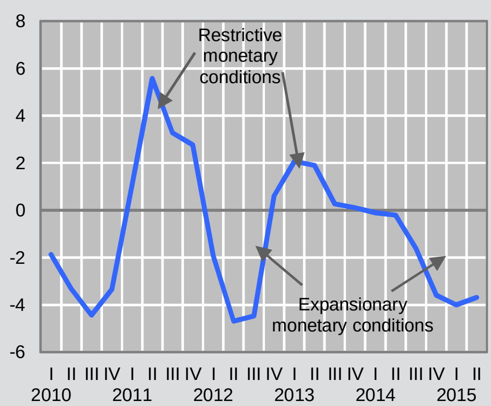
According to NBS estimate, GDP grew 1.9% s-a in Q2 (0.9% y-o-y). On the expenditure side, its growth was led by investment and household consumption. Investment increased on the back of improvement in the country's macroeconomic and fiscal prospects, changed labour and bankruptcy legislation and new legal arrangements in the construction industry, while private consumption rose driven by higher disposable income (due to a fall in oil prices), stronger inflow of remittances and a larger wage bill. On the production side, positive contributions to GDP growth came from industrial production and construction industry and

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



Sources: SORS and NBS calculation.

Chart V.0.2 **Monetary conditions index**
(in %)



Sources: NBS.

[32] Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

negative from agriculture. Within industrial production, the strongest contribution originated from manufacturing, though a pick-up in activity was also registered in energy and mining – two sectors that continue their recovery from the May 2014 flooding.

Strong growth in economic activity in Q2 was powered primarily by supply-side factors (recovery of production capacities in energy and mining), though demand-side factors also played a role. This caused a narrowing of the negative output gap[33], which nevertheless remains large, indicating further disinflationary pressures from aggregate demand in the medium run.

Owing to the ECB's accommodative monetary policy stance, depreciation of the euro and the fall in oil prices, economic recovery of the euro area is steadily gaining ground. After 0.4% s-a growth in Q1, economic activity indicators suggest that the euro area's GDP continued growing at a similar pace in Q2. Nevertheless, the euro area's growth projected for this and the next year remains significantly slower than that of the US economy, where positive developments in the real sector encouraged the Fed to end its asset purchase programme by the end of last year. The markets expect the Fed will start raising its policy rate before the end of this year.

Inflation projection assumptions

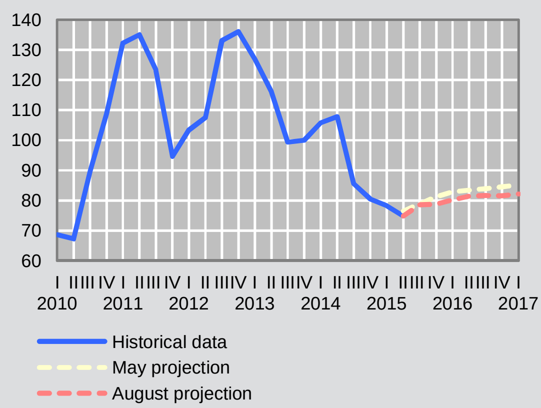
External assumptions

The assumption for the euro area's GDP growth in this and the next year has remained unchanged from the May projection – 1.5% in 2015 and 1.8% in 2016.[34] To achieve these growth rates, domestic demand in the euro area should be supported by monetary policy measures, and the consequent improvement in financial conditions, progress in the implementation of fiscal consolidation and structural reforms, as well as by lower oil prices which will have a positive effect on real disposable income of households and the lowering of costs for businesses. Improved price competitiveness could also bolster the demand for euro area exports. At the same time, the euro area is faced with the tepid pace of structural reforms and the need for balance sheet adjustment across a number of sectors, which will probably continue to slow down its recovery in the medium term.

After hitting record low in January (-0.6%), y-o-y price growth in the euro area returned to the positive territory in May and amounted to 0.2% in June. Though inflation should stay low in the coming period as well, we expect it to rise by the end of the year due to the base effect, i.e. lower inflation last year as a result of the oil price collapse. Owing to the unconventional measures of the ECB and the weakening of the euro vis-à-vis other world currencies (because of the divergent character of the monetary policies pursued by the ECB and most other central banks), its rise is likely to continue in 2016. Consistent with the announcements of ECB officials, the markets expect no change in the ECB's main refinancing rate over the coming twelve months (Consensus Forecast).

International prices of primary agricultural commodities[35] were on the decline until the end of Q2, when they made a huge, though temporary leap amid predictions that this year's agricultural season would be much worse than expected because of unfavourable weather conditions. However, not long thereafter it turned out that the said effects were overestimated and prices reverted by end-July to their pre-leap levels. As a result, food production costs remain relatively low. Consistent with commodity futures, we have revised our assumption for commodity prices slightly down relative to the May projection.

Chart V.0.3 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



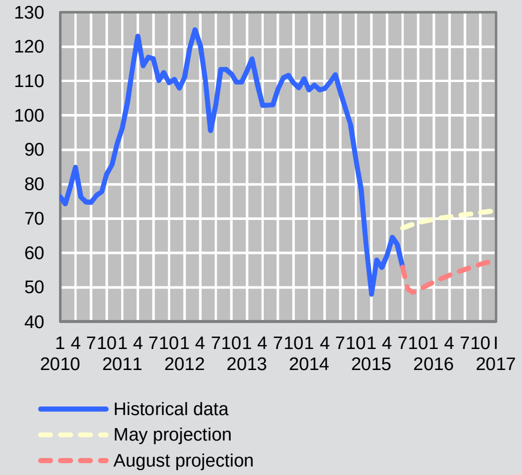
Sources: BSE, CBOT and NBS.

[33] 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.

[34] The assumption for the euro area's GDP growth in 2015 and 2016 is consistent with the latest Consensus Forecast.

[35] Measured by the composite index which comprises dollar prices of wheat, corn and soybean in the benchmark commodity markets.

Chart V.0.4 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

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

	2015		2016	
External assumptions				
EU inflation (Q4 to Q4)	0.8%	(+0.3)	13%	(+0.1)
ECB policy rate (year-end)	0.05%	(-)	0.05%	(-)
Euro area GDP growth	15%	(-)	18%	(-)
International prices of primary agricult. commodities (Q4 to Q4)*	-2.0%	(-3.0)	3.0%	(-10)
Brent oil price per barrel (year-end, USD)	51	(-19)	58	(-14)
Internal assumptions				
Administered prices (Dec to Dec)	4.8%	(-)	5.0%	(-)
Trends				
Appreciation trend of the real exchange rate (average)	13%	(-0.1)	14%	(-)
Real interest rate trend (average)	2.8%	(-0.1)	2.8%	(-0.1)

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

Though they are likely to grow in the period ahead, we expect them to record a mild fall in 2015 as a whole, and to record a moderate growth in 2016.

After rising in April, oil prices[36] have been on the decline for the last two months. Taking this into account, as well as the movement of oil futures, we have revised our assumption for oil prices down relative to the May projection. We expect oil prices to amount to around USD 50 per barrel at end-2015 and to rise moderately in 2016.

Internal assumptions

Consistent with the expected movements in international prices of primary agricultural commodities and further strengthening of the US dollar, the projection assumes their local counterparts will also go up moderately in this and the next year.

Having been extremely weak in 2014, administered price growth should be slightly higher this year, albeit considerably lower than its average in the previous several years. As in May, these prices are projected to grow by around 5.0% in 2015, driven mainly by prices of electricity (upward revision) and cigarettes (low last year's base). Administered price growth in 2016 should stay in the region of 5% as well.

The projection operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and conditioned by the removal of price disparities, notably in terms of administered prices, and by the Balassa-Samuelson effect[37].

We have also assumed, consistent with the announcements from the Government, continued fiscal consolidation in the coming period that will ensure public finance sustainability and put public debt on a downward path from 2017 onward. In line with this, the country risk premium should also be stable.

Projection

Inflation projection

Y-o-y inflation will stay low over the coming twelve months, revolving around the lower bound of the target tolerance band and possibly entering the band late this year or early next year. It is expected to trend closer to the 4.0% target in H2 2016. Looking ahead, inflationary pressures will be generated by administered prices

[36] Brent.

[37] In transition economies, the convergence of income levels towards the levels recorded in advanced economies is accompanied by the relatively faster growth in prices (price convergence).

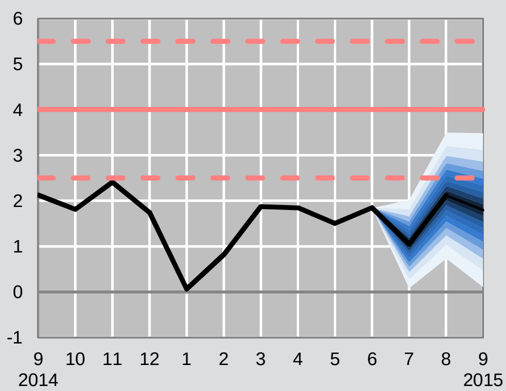
(August electricity price increase and low last year's base for cigarette prices), but their effect on inflation will be moderated by the hitherto drop in prices of primary commodities (oil and primary agricultural commodities), dampened aggregate demand, low inflation in the international environment and restrictive fiscal policy at home. These factors are expected to contain y-o-y inflation growth so that it stays below 4% in 2016 as well.

Short-term inflation projection

Under the short-term inflation projection, i.e. projection for Q3 2015, y-o-y inflation will continue to move below the lower bound of the target tolerance band. For the first time since records began administered prices posted a y-o-y fall, which spanned seven consecutive months. However, the increase in electricity prices by around 12% in early August (0.6 pp contribution to inflation)[38] should restore them to y-o-y growth. The possibility of inflation entering the target tolerance band in that month cannot be excluded either.

At quarterly level, consumer price growth in Q3 will be led by administered prices (electricity and cigarettes), while prices of unprocessed food, poised for a seasonal drop, will be working in the opposite direction. Despite downward revision of the price of natural gas for households in July (by slightly more than 11%), the negative contribution to inflation on this account will be negligible given the small share of natural gas in the CPI basket (0.6%).

Chart V.0.5 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been undershooting the target tolerance band since August last year, will continue to move below the lower bound of the band in Q3. At quarterly level, core inflation will be lower than in Q2 and will be driven by the rise in prices of travel packages.

Medium-term inflation projection

Looking at the main CPI components, the key inflationary factor will be administered prices, i.e. prices of electricity and cigarettes. In contrast to the previous projection, the expected contribution of petroleum product prices is now much lower, given that the global price of crude oil recorded yet another fall in the meantime and is currently close to the level registered in January (around USD 50 per barrel). As before, we expect that the medium-term price growth will be slowed down by low aggregate demand, but also by low inflation in the international environment and restrictive fiscal policy at home.

The contribution of administered prices to y-o-y inflation is currently negative, primarily because of the postponing of the electricity price increase last year. However, it is expected to become positive from August (the month of electricity price increase) and to exert decisive influence on y-o-y inflation growth in the coming period. In addition to higher electricity prices, inflation growth will be also significantly affected by the drop-out from its calculation of the fall in cigarette prices that took place late last and early this year. According to our estimates, cigarette prices will go up by 8–9% (around 0.4 pp contribution to inflation), less as a result of excise tax increase and more as a result of producers' decision to raise prices after lowering them by the end of 2014.

Food prices are not expected to affect inflation significantly over the projection horizon. Within this group, two different trends are likely at y-o-y level – a moderate rise in the prices of industrial food products (food inflation), on the one hand, and the slowing of growth in fruit and vegetable prices, on the other. The rise in food inflation is envisaged because of the anticipated growth in prices of primary agricultural commodities in

[38] Of which, 7.5 pp relating to the introduction of electricity excise tax and 4.5 pp to the increase in tariff.

H2 (corn prices already went up in July), these being the key inputs in the production of food. However, as this growth is expected to be modest, food inflation will, despite the rise, remain low. Fruit and vegetable prices were rather high last year and we expect their growth to lose steam due to the base effect. As a result, though positive, their contribution to y-o-y inflation will dwindle, possibly turning neutral early next year.

Domestic demand continues to be a disinflationary factor in the medium term. Its effect will be reinforced by the fiscal consolidation measures that will weigh down primarily on government consumption. The fall in household consumption should end this year. From 2016, household consumption is expected to perk up.

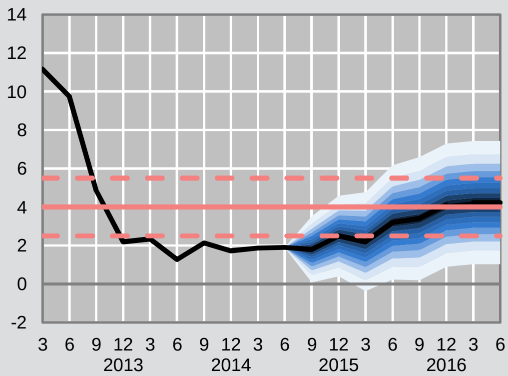
The pressure on domestic prices should be further alleviated by the relative stability of the exchange rate of the dinar against the euro over the past several months and subdued inflationary pressures in the international environment, which are likely to continue.

The risks to the projected inflation path relate primarily to the impact of developments in the international environment on the country risk premium and capital inflow, movements of primary agricultural commodity prices, as well as to the outcome of this year's agricultural season. The risks are also associated with the movement of administered prices in 2016.

The key features of the international environment are divergent monetary policies of leading central banks and tensions over the Greek debt crisis. This crisis, and the start of the Fed's rate hike, could influence capital flows to emerging market economies, Serbia included. A potential increase in investor risk aversion in the global financial market could dampen capital inflows to Serbia, and consequently, put pressures on domestic prices. On the other hand, the ECB's monetary accommodation and consistent implementation of fiscal consolidation at home could give rise to capital inflows and help sustain disinflationary pressures.

Based on currently available information from international markets, we have assumed that the prices of primary agricultural commodities (corn, wheat and soybean) will record a mild fall this year and a moderate rise next year. However, as primary commodity prices are generally rather volatile, the likelihood that they will deviate from the assumed path is not at all negligible. Over the past two years high inventories of cereals have been built up, which, coupled with the current low oil

Chart V.0.6 **Inflation projection**
(y-o-y, in %)



Source: NBS.

The fan chart depicts probability of various inflation outcomes in the next eight quarters. Central projection is within the darkest central band and the probability that inflation would lie in it is 10%. 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%.

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

	2015		2016	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	-	2.2	-	3.8
European Commission	2.4	-	4.1	-
Consensus Forecast	3.0	2.3	4.3	3.9
GDP (%)				
IMF	0.0	0.0	-	1.5
European Commission	-0.1	-	1.2	-
Consensus Forecast	0.2	-0.2	1.8	1.7
Current account deficit (% of GDP)				
IMF	-	4.3	-	4.1
European Commission	3.8	-	3.7	-
Consensus Forecast*	4.3	4.8	3.9	4.6

Sources: IMF (IMF press release for Serbia, 11 May 2015 and Republic of Serbia: First Review Under the Stand-By Arrangement, Country Report No. 15/161), European Commission (Spring forecast 2015) and Consensus Forecast (April and July 2015).

* Calculated based on the NBS projection of dollar GDP in April and July 2015.

prices, could lead to a sharper drop in cereal prices in the near term. Namely, lower oil prices put downward pressure on cereal prices, since they lower the costs of energy and fertilisers and discourage production of biofuels from cereals. This taken into account, the risks to the projected path of primary agricultural commodity prices are judged to be tilted to the downside.

On the other hand, although we have assumed that this year's agricultural season in Serbia will be below average, high temperatures and drought from mid-July could push the yields further down. Experts say that corn and soybean crops are affected the most and underline that these weather conditions are not conducive to fruit either. Reliable estimates of the actual size of negative effects will be available in a month or two. The risks to the inflation projection associated with the outcome of this year's agricultural season are therefore tilted to the upside. Still, the seasonality effect on agricultural commodity prices is judged to be weaker than before thanks to the increased openness of our market to the EU.

As regards administered prices, deviations from the assumption for 2016 are possible in either direction, i.e. their growth could equally turn out to be higher or lower than assumed.

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

Since May 2013, when the cycle of monetary policy easing began, the NBS key policy rate has been cut by 6.25 pp in total. Despite low inflationary pressures last year, the key policy rate was lowered at a cautious pace mainly because of increased uncertainties in the international environment. As these uncertainties persist, the character of monetary policy in the coming period will depend primarily on the assessment of their potential inflationary effect. An important factor in this context will be also this year's agricultural season, i.e. movement of primary agricultural commodity prices in the domestic and international markets.

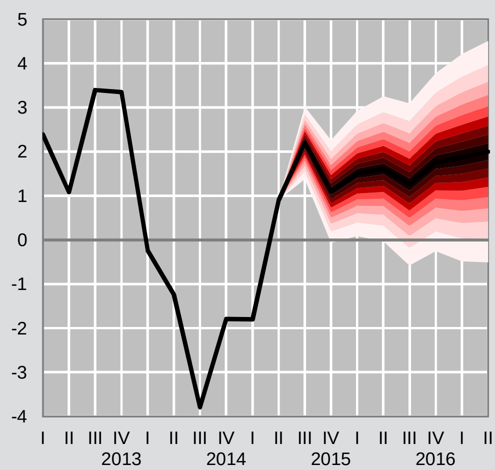
GDP projection

GDP is projected to grow 0.5% this year and 1.5% in 2016. Relative to the May projection, the projection for 2015 has been revised up by 0.5 pp, while that for 2016 has been kept unchanged.

Like in May, we expect that consistent fiscal adjustment and implementation of structural reforms will lead to higher investment and net exports. At the same time, negative contribution to GDP in 2015 will originate from household and government consumption that will be weighed down by fiscal consolidation. However, the fall in consumption should be less severe than what we anticipated three months ago and this is the main reason why we have revised the GDP projection for 2015 upwards. Namely, consumption will record a softer real fall owing to several factors: higher disposable household income propped up by lower prices of oil and petroleum products, growth in remittances, increased wage bill, and low and stable inflation. At the same time, the positive contribution of net exports will be also smaller than envisaged in May, but not that much to offset the effect of revised consumption on GDP. Though the recovery of external demand, especially demand from the euro area, benefits our exports, the contribution of net exports will be lower because of the increase in imports, which is consistent with a milder drop in consumption and higher investment.

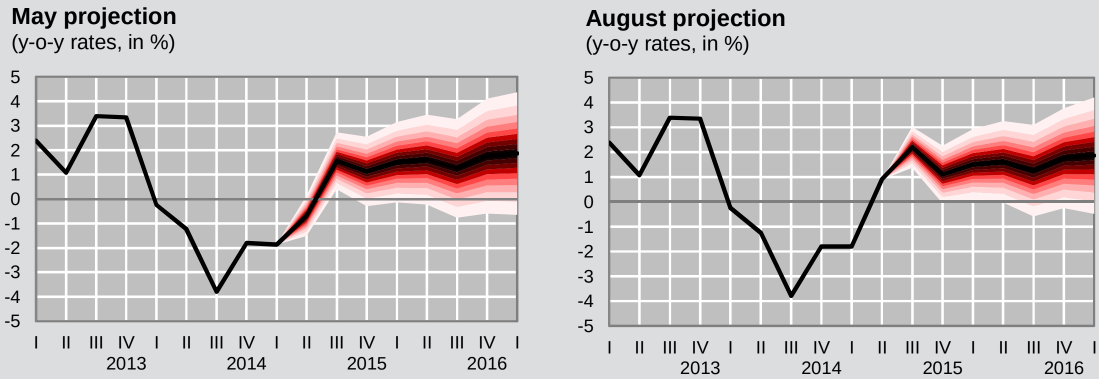
On the production side, smaller final consumption is expected to dampen activity, notably in the service sectors. However, the largest negative contribution to this year's GDP is no longer expected from these sectors, but from agriculture. Namely, high base, attributable to a very

Chart V.0.7 **GDP growth projection**
(y-o-y rates, in %)



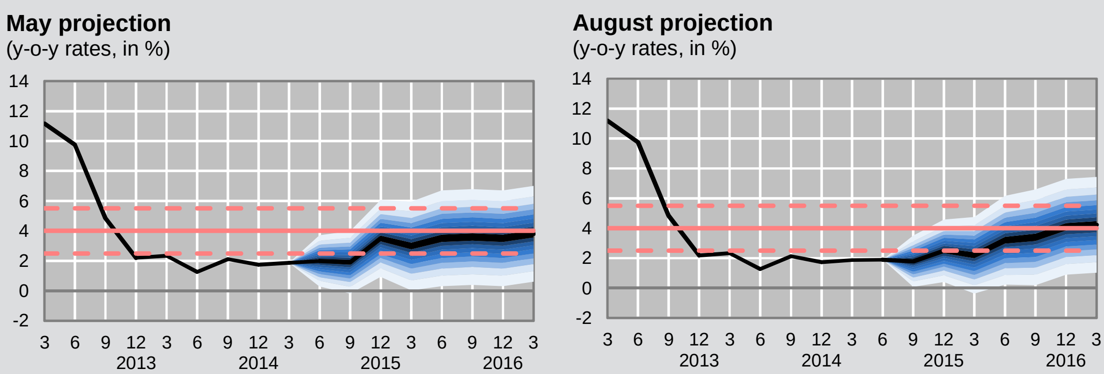
Source: NBS.

Chart V.0.8 **Current vs. previous GDP growth projection**



Source: NBS.

Chart V.0.9 **Current vs. previous inflation projection**



Source: NBS.

good season last year, and below average agricultural season this year, due to high temperatures and drought, will lead to an around 10% drop in agricultural production in 2015. On the other hand, the contribution of industrial production should be positive both on account of manufacturing and the recovery of production in the sectors of energy and mining, which should record two-digit growth rates this year after significant flood damage to their capacities in 2014. Besides, over the past several months signs of recovery have cropped up in the construction industry, which can be put down primarily to infrastructure projects. We therefore expect the contribution of construction industry to this year's GDP to be positive as well.

Economic activity growth in 2016 should be led by investment and net exports, and for the first time after four years, some positive contribution is also expected from household consumption. In accordance with the expected continuing reduction of the budget deficit, government consumption is likely to contract in 2016 too.

The risks to GDP projection are associated mainly with the speed of economic recovery of the euro area and the pace and scope of fiscal consolidation and structural reforms at home.

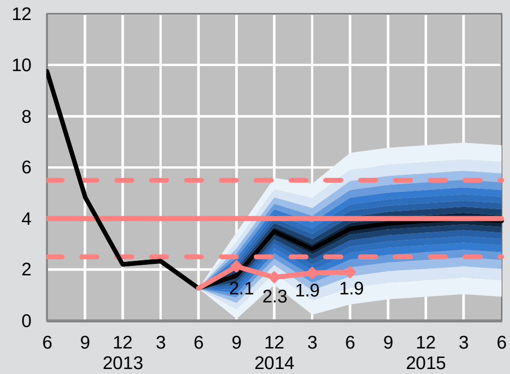
Even though the sustained low level of oil prices and implementation of unconventional ECB measures could lead to its acceleration, the recovery of the euro area could be slowed down by an unfavourable turn of events regarding Greece's financial troubles, as well as by the tightening of the current geopolitical tensions.

As regards internal factors, risks are associated with a potentially higher-than-estimated short-term negative impact of fiscal consolidation and structural reforms on GDP, due to the anticipated cut in the number of public sector employees based on the recently adopted Law on the Manner of Determining Maximum Number of Employees in the Public Sector. On the other hand, consistent implementation of fiscal consolidation measures and structural reforms should exert a positive impact on GDP in the medium term. What is more, the expected increase in public sector efficiency and the reform of state-owned enterprises may as well result in a faster than expected economic growth.

Given the uncertainties overshadowing this year's agricultural season and the relatively high share of agricultural and food products in exports, the contribution of exports to GDP could turn out to be both higher and lower than estimated.

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

Chart V.0.10 **Achievement of August 2014 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Comparison of projections and their outcome

Our new inflation projection is lower in the next twelve months than the one published in the May Report, mainly because of the stronger than expected disinflationary effect of the prices of primary commodities (oil and primary agricultural commodities). Consistent with this, a more durable return of inflation within the target tolerance band is now expected to take place around mid-2016. The medium-term projection spread has remained unchanged.

During the last year, y-o-y inflation was moving below the central projection rate from the August 2014 Inflation Report, staying however within the projection range. Inflation deviated from the central projection chiefly due to the y-o-y drop in administered prices in H1 2015 (these prices were expected to rise, but declined instead reducing y-o-y inflation by around 2 pp), and to a lesser degree, to the sharp fall in global oil prices since mid-2014.

Table A

Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Q1 2015	Q2 2015
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	7.6	6.6	6.9	6.7[2)]
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.3	240.3	271.2	309.9	325.6	312.2
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	30.0	32.2	31.7
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.1	13.3	14.2	12.2	9.9
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.2	32.6	32.5	25.0	20.1
EXTERNAL SOLVENCY INDICATORS (in %)												
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	75.1	78.1	81.9	81.7
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.1	14.3	12.0	9.7	9.9	10.1
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.7	178.7	182.2	176.8
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	278.1	318.8	292.1
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	201.9	193.6
OPENNESS OF ECONOMY (EXPORTS + IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	98.4	110.3	107.7[2)]
MEMORANDUM: (in EUR million)												
GDP[1)]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,221	8,119[2)]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,746	25,829	26,735	26,532
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,156	4,540	4,691	881	802
Central bank foreign exchange reserves	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515	10,293
Short-term debt[3)]	951	968	1,044	1,832	1,843	1,752	601	455	197	106	183	178
Current account balance	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-520[2)]	-208[2)]

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan
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 (excl. early repayment of a part of debt to London Club creditors) to GDP during period under review.

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

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.

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) According to ESA 2010.

2) NBS estimate.

3) 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 imports 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 now includes liabilities under SDR allocation (EUR 486.8 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 944.3 mln, of which EUR 423.3 mln relates to domestic banks and EUR 520.9 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	2014	Q1 2015	Q2 2015
Real GDP growth (in %)[1]	5.5	4.9	5.9	5.4	-3.1	0.6	1.4	-1.0	2.6	-1.8	-1.8	0.9
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	1.7	1.9	1.9
NBS foreign exchange reserves (in EUR million)	4,922	9,020	9,634	8,162	10,602	10,002	12,058	10,915	11,189	9,907	10,515	10,293
Exports (in EUR million)[3]	5,329	6,948	8,110	9,583	8,043	9,515	11,145	11,469	13,937	14,451	3,529	3,990[6]
- growth rate in % compared to a year earlier	19.1	30.4	-	18.2	-16.1	18.3	17.1	2.9	21.5	3.7	6.8	9,2[6]
Imports (in EUR million)[3]	9,612	11,970	15,468	18,267	13,099	14,244	16,487	16,992	17,782	18,096	4,434	4,750[6]
- growth rate in % compared to a year earlier	0.7	24.5	-	18.1	-28.3	8.7	15.7	3.1	4.7	1.8	7.1	3.8[6]
Current account balance[3]												
(in EUR million)	-1,778	-2,356	-5,474	-7,126	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-520[6]	-208[6]
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-7.2[6]	-2.6[6]
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	18.9	19.2	
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	379.3	344.0	371.3
RS budget deficit/surplus (in % of GDP)[4]	0.5	-1.7	-1.6	-1.7	-3.2	-3.4	-4.0	-5.9	-5.2	-6.4	-2.4	-0.5
Consolidated fiscal result (in % of GDP)[4]	1.2	-1.5	-1.9	-2.6	-4.4	-4.6	-4.8	-6.8	-5.5	-6.7	-2.4	-1.5
RS public debt, (central government, in % of GDP)	50.2	35.9	29.9	28.3	32.8	41.8	45.4	56.2	59.6	71.0	75.1	73.8
RSD/USD exchange rate (period average)	66.87	67.03	58.39	55.76	67.47	77.91	73.34	88.12	85.17	88.54	108.15	108.86
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	99.46	111.42	107.73
RSD/EUR exchange rate (period average)	82.99	84.11	79.96	81.44	93.95	103.04	101.95	113.13	113.14	117.31	121.50	120.44
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	120.96	120.22	120.60
MEMORANDUM:												
GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,075	7,221	8,119[6]

[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, exports and imports growth rates are not shown. 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] Includes below-the-line items (payment of called guarantees, bank recapitalisations and debt takeover) in line with IMF methodology, as of 2008 on RS budget level and as of 2005 on consolidated level.

[5] According to ESA 2010.

[6] NBS estimate.

Notes:

1. Data are subject to corrections in line with 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.

Appendix 1. National Bank of Serbia's Memorandum on Inflation Targets until 2018

National Bank of Serbia's
Memorandum on Inflation Targets until 2018[1]

To define the framework for medium-term monetary policy decision making and to anchor and stabilise inflation expectations, the Executive Board of the National Bank of Serbia hereby sets the inflation target for the years 2017 and 2018.

In line with the *Agreement between the National Bank of Serbia and the Government of the Republic of Serbia on Inflation Targeting*[2] and the *Memorandum of the National Bank of Serbia on Monetary Strategy*[3], pursuant to which the National Bank of Serbia has committed to set inflation targets in cooperation with the Government, the Executive Board of the National Bank of Serbia hereby sets **the headline inflation target (with a tolerance band), measured as an annual percentage change in the consumer price index**, for the period January 2017–December 2018 at the level of 4% with a tolerance band of ±1.5 percentage points. The earlier defined inflation targets for 2015 and 2016 have not been changed.[4]

The trajectory of targeted inflation reflects the intention to achieve price stability without causing macroeconomic disruptions. The inflation targets for 2017 and 2018 are set above the quantitative definition of price stability and inflation targets of advanced economies (2.0% or 2.5%) due to the assessment that the process of structural reforms and the liberalisation of prices, i.e. nominal, real and structural convergence to the European Union, will not be completed by 2018.

It should be borne in mind that the inflation target is a medium-term objective, i.e. that the actual inflation may temporarily deviate from the target due to exogenous shocks. The National Bank of Serbia will allow temporary deviations from the target if bringing inflation back to the target in the short term warrants monetary changes that would cause additional macroeconomic disruptions. This applies to sudden changes in primary commodity prices or to deviations of the planned growth in product prices under the Government's direct or indirect regulation.

In cooperation with the Government, the National Bank of Serbia may change the targets set for inflation. Such changes will be made in exceptional circumstances only and will be explained by the National Bank of Serbia.

[1] Adopted at the NBS Executive Board meeting of 13 August 2015.
[2] Adopted at the Government session of 19 December 2008.
[3] Adopted at the NBS Monetary Policy Committee meeting of 22 December 2008.
[4] See the National Bank of Serbia's Memorandum on Inflation Targets until 2016.

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Executive Board meetings and changes in the key policy rate

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	8.50	0
16 October	8.50	0
13 November	8.00	-50
11 December	8.00	0

2015

Date	Key policy rate (p.a, in %)	Change (in basis points)
15 January	8.00	0
12 February	8.00	0
12 March	7.50	-50
9 April	7.00	-50
11 May	6.50	-50
11 June	6.00	-50
9 July	6.00	0
13 August	5.50	-50
10 September		
15 October		
12 November		
10 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 11 June 2015

The Executive Board stated that inflation is moving below the lower bound of the target tolerance band and that it is expected to return within the band in the second half of the year supported by past monetary policy measures and the impact of administered and petroleum product prices which had a temporary disinflationary effect in the prior period.

In deciding to cut the key policy rate, the Executive Board was guided by an assessment that strong disinflationary pressures will emanate from aggregate demand, prices in the international environment and global market of primary commodities in the medium run. These disinflationary pressures will be underpinned by tighter fiscal policy at home and the effects of the ECB's quantitative easing which, together with the expected successful completion of the first review under the arrangement with the IMF, should have a positive effect on the country's risk premium and investors' perception of Serbia as an investment destination. Coupled with a low current account deficit, this will have a positive impact on exchange rate stability and movements in the foreign exchange market, assessed the Executive Board.

The Executive Board assesses that continued monetary easing will have a positive effect on lending activity and expects an adequate reaction of banks through a decrease in lending rates, particularly on dinar lending, in order to support economic growth in the period ahead.

Although movements in the international environment are more favourable, due mostly to increased global liquidity, uncertainties remain which warrant a cautious monetary policy stance, the Executive Board advised.

The next rate-setting meeting of the Executive Board will be held on 9 July 2015.

Press release from Executive Board meeting held on 9 July 2015

At its meeting today, the NBS Executive Board decided to keep the key policy rate at 6%.

Following the analysis of monetary and macroeconomic trends and projections, the Executive Board judged that year-on-year inflation is moving below the lower bound of the target tolerance band, but is expected to return within the band in the coming months. Inflation's return within the target band will be aided by the effects of past monetary policy measures and factors exerting temporary disinflationary effect in the prior period, such as the expected growth in administered prices and the diminishing impact of a decrease in prices of primary commodities. Dented aggregate demand and low inflation abroad will continue to generate more lasting disinflationary effects. The Executive Board noted that the results of economic and foreign trade activity have improved from the start of the year which, coupled with fiscal consolidation, has contributed to the reduction in external imbalances and stabilisation of the foreign exchange market.

In making the decision to keep the key policy rate unchanged, the Executive Board bore in mind the effects of monetary policy easing so far and its impact on the expected return of inflation to within the target tolerance band, as well as of potential risks associated with the Greek crisis, which suggest caution. Despite the fact that direct effects on the Serbian economy, stemming from the economic relations with Greece, are relatively small, the Executive Board estimated that there are risks in the form of indirect negative effects of the Greek crisis on capital flows and the cost of debt servicing by emerging economies, Serbia included.

The Executive Board assessed that the continued successful implementation of fiscal consolidation measures and structural reforms, along with the recently concluded arrangement with the International Monetary Fund, have significantly contributed to the sustainability of public finances, as well as to the reduction of Serbia's exposure to external shocks and the negative effects which may arise from the above risks.

The next rate-setting meeting of the Executive Board will be held on 13 August 2015.

Press release from Executive Board meeting held on 13 August 2015

The NBS Executive Board decided in its meeting today to cut the key policy rate by half a percentage point to 5.5%.

The Executive Board stated that y-o-y inflation continued to move below the lower bound of the target tolerance band and amounted to 1.0% in July.

The decision to lower the key policy rate was taken in view of the disinflationary effect of the majority of domestic factors, low inflation abroad and the stability of inflation expectations within the target tolerance band.

It was concluded that external risks have lessened after Greece had reached an agreement with international creditors, which, along with Serbia's arrangement with the IMF and the more favourable than expected economic and balance of payments performances, contributes to the relative stability of the foreign exchange market and improved investor perception. The country's macroeconomic outlook has improved also owing to the effects of fiscal consolidation which, at the same time, diminishes the exposure of the domestic economy to adverse external shocks, assessed the Executive Board.

The Executive Board also adopted the August Inflation Report that will be presented to the public on Wednesday, 19 August 2015.

The next rate-setting meeting of the Executive Board is scheduled for 10 September.

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