National Bank of Serbia

August 2016

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 statutory task of the National Bank of Serbia.

The August *Inflation Report* was considered and adopted by the NBS Executive Board in its meeting of 11 August 2016.

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
EU – European Union
FAO – UN Food and Agriculture Organization
FDI – foreign direct investment
Fed – Federal Reserve System
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
OFO – other financial organisation
OPEC – Organization of the Petroleum Exporting Countries
pp – percentage point
Q – quarter
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
y-o-y – year-on-year

Other generally accepted abbreviations are not cited.

Contents

I Overview

Like in the previous period, inflationary pressures remained low in the second quarter of the year under the impact of the majority of domestic factors and low cost-push pressures from the international environment. As oil prices and food production costs stayed relatively low, food and petroleum product prices continued to provide a negative contribution to year-on-year inflation, largely offsetting the effects of last year's increase in the prices of cigarettes, electricity and non-food products and services. Year-on-year inflation slowed to 0.3% in June, while core inflation continued to move below the lower bound of the target tolerance band and came at 1.5% in June.

Inflationary pressures remained very low as a result of the disinflationary effect of the majority of domestic factors and low cost-push pressures from the international environment.

Despite sound economic performances early in the year, global growth prospects for the period ahead have been revised downward, due in part to the United Kingdom's decision to leave the European Union. Economic growth in the euro area, our main trade partner, is expected to slow down on account of Brexit from this year's 1.5% to 1.3% in 2017. Though global prices of oil and primary agricultural commodities rallied slightly over the past months, they are still lower than a year ago and are decreasing again from July. In the environment of extremely low inflationary pressures and weaker global recovery prospects, leading central banks stated their readiness to continue pursuing accommodative monetary policies for longer than initially expected. Their prompt reaction was most helpful in alleviating Brexit-induced turbulences in the financial market within a relatively short period of time.

In the period since the May Report, developments in the international environment were marked by somewhat weaker global recovery prospects, due in part to the United Kingdom's decision to leave the European Union and the associated increased uncertainty in international financial and commodity markets.

The value of the dinar against the euro remained broadly unchanged in the second quarter. Depreciation pressures were mostly generated by reduced foreign investment in dinar securities, heightened foreign exchange demand of local enterprises for import purposes and Brexit-induced turmoil in the international financial market in late June. Working in the opposite direction were the increased inflow of foreign direct investment, higher foreign cash purchases from natural persons in exchange transactions, sound export performances, growth in net foreign currency-indexed assets, and interventions of the National Bank of Serbia. Appreciation pressures have prevailed since end-June, supported by the country's lower risk premium. Serbia's risk premium decreased after Brexit, which may be associated with foreign investors' improved perception of emerging markets

The relative stability of the dinar exchange rate was preserved despite increased volatility in the international financial market.

amid expectations that monetary policy measures of leading central banks would remain accommodative longer than previously thought, but also with the positive assessment of the International Monetary Fund after its June visit and the Fitch's decision to raise Serbia's credit rating. The National Bank of Serbia kept a close eye on developments in the international financial market and evaluated the intensity of external shocks, responding in a timely and measured fashion to excessive short-term fluctuations of the exchange rate in either direction, by selling EUR 255.0 million, net, in the second quarter and buying EUR 355.0 million in July.

The monetary policy was eased further in July, when the key policy rate of the National Bank of Serbia was cut to 4%.

The key policy rate of the National Bank of Serbia was cut in February and kept on hold until July, when it was trimmed to 4%. Uncertainty in the international commodity and financial markets, heightened by the United Kingdom's decision to leave the European Union, warranted greater caution when making key policy rate decisions in this period. As the markets calmed down soon after Brexit and global prices of oil and primary agricultural commodities declined again, the Executive Board assessed in its July meeting that low inflationary pressures would persist in the period ahead and decided to ease the monetary policy stance further. It was assessed that the narrowing of internal and external imbalances increased the country's resilience to external shocks and that the risks from the international environment could be moderated by the more accommodative policies of leading central banks. In August, the key policy rate was kept unchanged, in consideration of the expected effects of past monetary easing and the inflation outlook for the period ahead.

Substantial past monetary easing continued to have a positive impact on the loan market.

Owing to past monetary policy easing, the cost of borrowing for the government and the private sector subsided further in the second quarter. The rate on two-year dinar government securities fell by 0.7 percentage points to 4.3% relative to the first quarter, and the rate on three-year dinar government securities – by 0.6 percentage points to 5.4%. The average weighted interest rate on dinar loans to corporates and households was 9.1% in June, down by 0.4 percentage points relative to March. Following a temporary seasonal deceleration in early 2016, lending activity accelerated in the second quarter, so domestic loan growth came to 3.5% year-on-year in June, excluding the exchange rate effect. Lending activity is expected to expand further in the period ahead due to the expected acceleration of economic activity and past monetary easing. This is consistent with the expectations of commercial banks stated in the July bank lending survey. Looking ahead, the monetary policy will continue to encourage

economic growth through lending activity, to the extent permitted by movements in key factors of inflation and uncertainties from the international environment.

Fiscal performances improved further in the second quarter, supporting the sustainability of public finances and increasing Serbia's resilience to external shocks.

The fiscal outlook improved further in the second quarter, guided primarily by a sustainable improvement in tax revenue collection. At around 0.9% of GDP, the consolidated budget deficit was down by almost a half from the same period last year and well below the ceiling agreed within the third review of the arrangement with the International Monetary Fund. With interest expenses excluded, a surplus of 3.1% of GDP was recorded at general government level. During their June mission, the representatives of the International Monetary Fund gave a positive assessment of economic performances and the overshooting of fiscal targets. The projected deficit for 2016 has been revised down to 2.5% of GDP.

Substantial narrowing of internal and external imbalances reflects full coordination of monetary and fiscal policy measures.

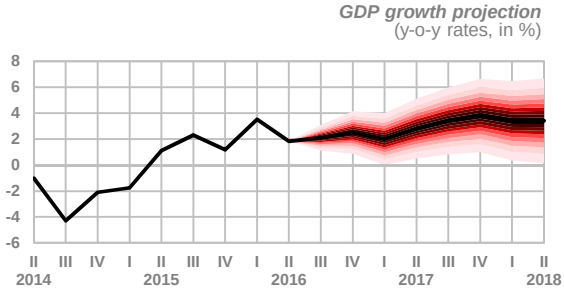
Foreign trade imbalances continued to narrow in the first half of 2016 as exports of goods and services rose faster than imports. The current account deficit was almost 20% down from the same period a year earlier and was more than fully covered by net inflow of foreign direct investment. Thanks to an improved business environment and structural reforms, net inflow of foreign direct investment was 5.4% of GDP in 2015, which, in relative terms, was the highest in the region. Strong inflow of foreign direct investment continued in the first half of the year and was 6.5% higher than in the same period a year earlier. We estimate that the share of the current account deficit in GDP will continue down this year (by around 0.6 percentage points to 4.2% of GDP) and that it will remain fully covered by foreign direct investment.

According to our estimate, after exceptionally strong seasonally-adjusted growth in the first quarter, economic activity stagnated in the second quarter, though still recording high year-on-year growth.

According to our estimate, economic activity stagnated in the second quarter – after exceptionally strong seasonally-adjusted growth (by 1.8%) in the first quarter, GDP decreased mildly (by 0.1%) in the second quarter. Positive trends continued in the manufacturing industry, mostly as a result of realisation of earlier investment and economic recovery in the euro area. Activity increased in a number of services sectors as well, primarily on account of a gradual recovery in private sector wages and employment. Conversely, major overhauls in the electric-energy system affected the activity of the mining and energy sector. On the expenditure side, a positive contribution came from all components of domestic demand, while, by contrast to the first quarter when they made a substantial positive contribution, net exports' contribution in the second quarter was negative. Very strong export growth in the first quarter extended into the second quarter as well, but imports, mostly of equipment

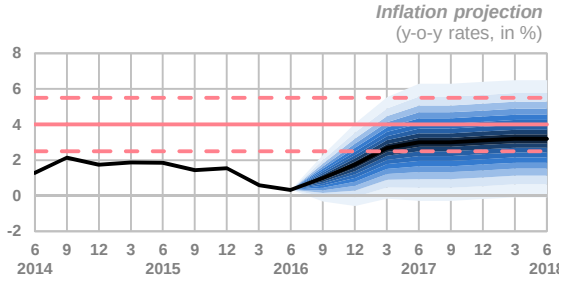
and intermediate goods for industrial production and construction purposes, grew at a faster pace.

Economic recovery should accelerate to around 2.5% this and around 3.0% next year, led by investment and exports but also by a recovery in household consumption.



According to our estimate, GDP growth will accelerate to around 2.5% in 2016 and around 3% in 2017, mostly reflecting more favourable developments in the manufacturing, construction and some services sectors. Assuming an average agricultural season, positive contribution of agriculture is also expected this year, but could in fact be even higher than currently estimated given the performances in the year so far. On the expenditure side, robust growth in investment is expected to continue owing to effective implementation of infrastructure projects and an improved investment environment, supported by reduced operating expenses from interest rates on existing loans and lower cost of new borrowing. The contribution of net exports is also expected to be positive, as signalled by favourable trends in foreign trade in the year so far, i.e. faster growth in exports relative to imports in real terms. A positive contribution is also expected to come from household consumption, underpinned by a rise in employment and private sector wages, but also by higher disposable income on account of lower cost of new borrowing and repayment of existing loans, as well as lower oil prices.

According to our latest projection, year-on-year inflation should start rising moderately in the coming months, make its way back within the target tolerance band in the first half of 2017 and continue to move within the band thereafter.



Year-on-year inflation should start rising in the coming months and make its way back within the target tolerance band in the first half of 2017. It is expected to continue to move within the band until the end of the projection horizon. Such movements will be driven primarily by the low base effect from prices of petroleum products, gradual increase in aggregate demand at home and inflation abroad, i.e. in the euro area, while low food production costs will continue to hold inflation back for some time yet. The risks to the projected inflation path relate primarily to future movements in global prices of primary commodities, developments in the international financial market and, to a certain degree, to administered price growth at home.

The new inflation projection is lower than the one published in the May Report, due primarily to the downward revision of assumptions regarding global prices of oil and primary agricultural commodities.

The new inflation projection is slightly lower than the one published in the May Report, and the projected inflation range remains symmetric. The lower projected inflation is attributable to the downward revision of assumptions regarding global prices of oil and primary agricultural commodities relative to the May projection, and a sharp drop in vegetable prices at home in the second quarter. Inflation's return within the target tolerance band will,

therefore, be somewhat slower – rather than in early 2017, inflation is now expected to make its way back within the target band by mid-2017.

Looking ahead, monetary policy decisions of the National Bank of Serbia will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, notably those coming from the international environment. As before, the National Bank of Serbia will keep a close eye on future movements in global prices of primary agricultural commodities and oil, and developments in the international financial market.

The monetary policy stance in the period ahead will continue to depend primarily on developments in the international environment.

II Monetary policy since the May *Report*

In the period following the May Report, the NBS Executive Board lowered the key policy rate further, cutting it by 25 bp to 4.0% in July.

Uncertainties in the international commodity and financial markets, particularly in terms of movements in the prices of oil and other primary commodities, coupled with different monetary policies of leading central banks, indicated the need for heightened caution when making decisions on the key policy rate this year. Britain's decision to leave the EU spurred additional instability in the international financial market. Not long after Brexit, however, markets calmed down, and the global prices of oil and primary agricultural products resumed their downward path. In light of this, the Executive Board assessed in its July meeting that the coming period could see low inflationary pressures and decided to additionally ease its monetary policy. It was assessed that the narrowing of internal and external imbalances would boost the Serbian economy's resilience to external shocks that afflict other economies. Also, external risks could be moderated by the Fed's monetary tightening which was slower than expected earlier and the ECB's further monetary accommodation.

Since the May *Report*, decisions on monetary policy were based on the May inflation projection forecasting that inflation would return within the bounds of the target tolerance band early next year, and stabilise at slightly above 3.0% thereafter. Such inflation movements were expected considering the low-base effect of the prices of petroleum products and fruit and vegetables, further recovery of global prices of primary commodities, and gradual increase in aggregate demand at home and inflation abroad. The risks to the May inflation projection were symmetrical and pertained mostly to movements in international primary commodities prices and developments in the global financial markets, and, to some extent, to the agricultural season in Serbia and growth in administered prices in 2016.

In May, the GDP growth projection was revised up on account of the continued investment growth and significantly improved export performances since the start of the year. The anticipated GDP growth rate this year was 2.25–2.5% (compared to 1.8% in February), and around 3.0% in 2017 (compared to 2.2% in February).

In consideration of such inflation and GDP projections, and taking into account recent information on developments at home and abroad, the NBS Executive Board **did not change the key policy rate in either May or June (4.25%)**. The decisions to keep the rate unchanged were taken primarily in consideration of uncertainty prevailing in the international environment and the anticipated effects of past key policy rate cuts on inflation movements in the period ahead.

The persistent uncertainties in the international commodity and financial markets and the anticipated weakening of disinflationary pressures amid expected global prices of primary commodities warranted cautious monetary policy of the NBS in this period. The recovery of global prices of oil and primary agricultural products continued. Considering the anticipated rise in inflation in the euro area and Serbia's accelerated economic growth, this recovery was expected to sustain gradual rise in y-o-y inflation over the coming period. Differing views about the pace of the Fed's policy rate increase gave rise to uncertainties, which reflected on capital flows in almost all emerging economies, including Serbia.

Instability in the international financial and commodity markets was amplified in the wake of the Britons' Leave vote. The direct impact of such decision on Serbia is minimal considering its limited direct exposure to the economy of the United Kingdom through both trade and financial channels; nevertheless, indirect effects are possible, mostly through the impact of Brexit on the euro area, which is Serbia's main trade partner. Owing to anticipated economic and political insecurities, concerns over the possible consequences of Brexit on the EU's economy curtailed the euro area's growth projections, most notably for 2017. In light of those uncertainties, it appears that investors expect that the Fed will put off raising the policy rate and that the ECB's monetary policy will be more accommodative. This would have a positive effect on liquidity in the international financial market and capital flows towards emerging economies, such as Serbia.

In consideration of low inflationary pressures emanating from most domestic factors that are expected to continue in the coming period, the anticipated slowdown in the euro area's growth and sustained high liquidity in the international financial market, as well as the decline in the prices of oil and primary agricultural products in the global market from end-June onwards, the Executive Board **in its July meeting opted for another cut in the key policy rate – down to 4%**. Market participants' inflation expectations have been additionally lowered, indicating low inflationary pressures in the period ahead.

The Executive Board assessed that fiscal consolidation measures and structural reforms would be continuing, along with the narrowing of external imbalances, boosting the Serbian economy's resilience to external shocks. In June, the IMF and rating agencies also acknowledged improved macroeconomic performances of the Serbian economy and its prospects for the coming period. Fitch Ratings raised Serbia's credit rating in June, with stable outlook for its further increase.

Besides trimming the key policy rate, the Executive Board also adopted amendments to the Decision on the Key Policy Rate of the National Bank of Serbia, **narrowing the interest rate corridor even further, from ± 1.75 pp to ± 1.50 pp relative to the key policy rate**. The Executive Board believes that this measure will help strengthen the monetary policy transmission mechanism through the interest rate channel.

Taking into account the expected effects of past key policy rate cuts, as well as the anticipated inflation movements in the coming period, the Executive Board decided **not to change the key policy rate in its August meeting**. As the Executive Board assessed, the return of year-on-year inflation within the target tolerance band will be led primarily by the low-base effect of petroleum product prices, gradual increase in aggregate demand at home and a steady rise in inflation abroad, while low food production costs will continue to hold inflation back for some time yet.

III Inflation movements

Inflationary pressures remained subdued in Q2. Despite the recovery of global prices of oil and primary agricultural commodities in Q2, cost-push pressures remained relatively weak. Additionally, the contribution to muted inflationary pressures continued from most domestic factors, as well as from low inflation in the international environment, particularly in the euro area which is our main foreign trade partner. Prices grew at the quarterly level, led by prices of petroleum products, travel packages and fruit, while vegetable prices worked in the opposite direction.

Inflation expectations also point to low inflationary pressures as short- and medium-term expectations of the financial sector and medium-term expectations of corporates declined further.

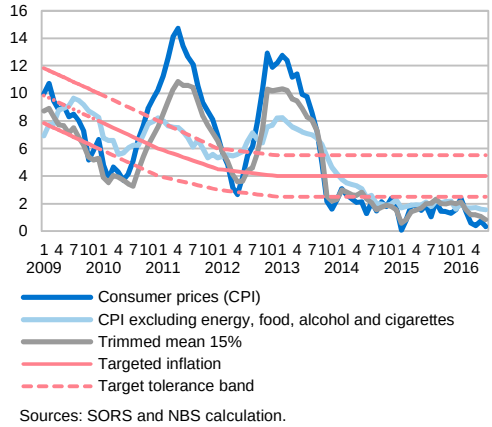
Inflation movements in Q2

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, but ended the quarter at 0.3% – the lower than expected level. With their negative contribution to June y-o-y inflation, prices of unprocessed food (-0.9 pp) and petroleum products (-0.3 pp) significantly offset the positive contribution of administered prices (0.8 pp) and prices of non-food products and services (0.6 pp). The continuing relatively high contribution of administered prices is due to last year's increase in electricity and cigarette prices.

Consumer prices rose by 0.5% in Q2, which was below our expectations as unprocessed food prices – instead of rising – showed a 0.6% drop, on account of vegetable prices. Processed food prices declined as well, while prices of energy, services and industrial products excluding food and energy worked in the opposite direction.

The impact of food prices on quarterly inflation was negative again in Q2 (-0.1 pp). The contributions of processed and unprocessed food prices turned out almost

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



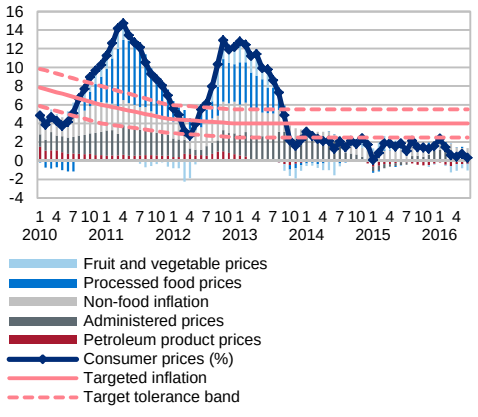
Sources: SORS and NBS calculation.

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

	Share in CPI	2015 III	2015 IV	2016 I	2016 II
Consumer prices (CPI)	100.0	-0.1	-0.5	0.4	0.5
Unprocessed food	11.6	-6.3	-5.9	5.5	-0.6
Processed food	20.5	0.9	-0.3	0.9	-0.3
Industrial products excluding food and energy	28.7	0.5	1.7	-0.2	0.5
Energy	15.5	2.2	-2.0	-1.4	1.7
Services	23.7	0.4	0.7	-0.5	1.1
Core inflation indicators					
CPI excluding energy	84.5	-0.5	-0.2	0.7	0.3
CPI excluding energy and unprocessed food	72.9	0.6	0.8	0.0	0.5
CPI excluding energy, food, alcohol and cigarettes	45.1	0.2	0.9	-0.4	0.9
Administered prices	18.7	3.7	1.0	0.1	-0.4

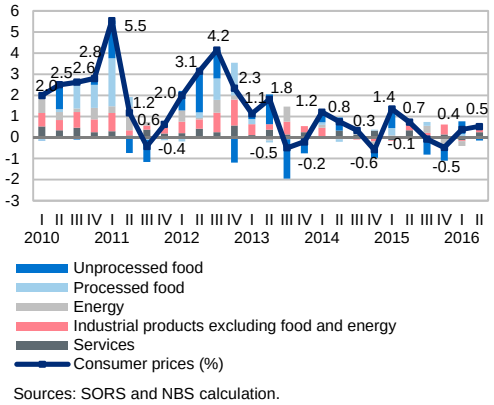
Sources: SORS and NBS calculation.

Chart III.0.2 **Contribution to y-o-y consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

Chart III.0.3 **Contribution to quarterly consumer price growth**
(in pp)



Sources: SORS and NBS calculation.

equal. Within **unprocessed food**, vegetable prices lost 9.1% (contribution: -0.4 pp), mainly in June.[1] Conversely, fruit prices (16.4%, contribution: 0.3 pp) and fresh meat prices (2.2%, contribution: 0.1 pp) went up in Q2. The decline in **processed food** prices (0.3%) was prompted by falling prices of milk and dairy products.

Global oil prices continued up from Q1. As a result, **petroleum product** prices in the domestic market edged up in Q2 (6.9%, contribution: 0.3 pp), after three quarters of decline. Thus, despite a decline in prices of natural gas, heating and solid fuels, **energy** prices added 1.7%. In contrast, similarly to global oil prices, which remained lower than in the previous year, domestic petroleum product prices were down by around 7% y-o-y in June.

Services prices gained 1.1% in Q2 (contribution: 0.3 pp), on account of the seasonal increase in travel package prices by around 40% (contribution: 0.3 pp).

Prices of **industrial products excluding food and energy** were also higher (0.5%, contribution: 0.1 pp), reflecting primarily the seasonal growth in prices of clothes and footwear.

Core inflation (measured by CPI excluding prices of energy, food, alcohol and cigarettes) rose by 0.9% in Q2, mirroring prices of travel packages, clothes and footwear. In y-o-y terms, since August 2014, core inflation has been moving below the lower bound of the target tolerance band. It came at 1.5% in June.

Administered prices declined somewhat in Q2 (0.4%, contribution: -0.1 pp), reflecting a decrease in natural gas prices (-16.1%). At the same time, y-o-y growth in administered prices slowed down, from 5.6% at end-Q1 to 4.4% at end-Q2. Their y-o-y growth is still due to the electricity and cigarette price hike in the past year (contribution of 0.5 pp and 0.4 pp, respectively).

Producer and external prices

Producer and external prices went up in Q2, but cost-push pressures remained muted – compared to the same period last year these prices were either lower or slightly higher.

Following the Q1 decline, **industrial producer prices in the domestic market** edged up in Q2 (0.9%). The rise

[1] For instance, in June tomato prices fell by almost 30%, cucumbers by over 40% and aubergines by over 60%.

was led by prices of petroleum product producers, which may be associated with the recovery of global oil prices. Another contribution, though smaller, came from prices of manufacturers of paper and paper products and prices of food manufacturers. In contrast, producer prices dipped somewhat in the field of electricity, gas and steam supply and the production of chemicals and chemical products.

In y-o-y terms, industrial producer prices in the domestic market continued down in Q2. They lost 1.6% in June, y-o-y.

Agricultural producer prices continued up in Q2 to 1.2%, reflecting prices of producers of corn and wheat, industrial plants and live cattle (notably pigs). On the other hand, producer prices of milk and poultry recorded a decline. Y-o-y, following five months of decline, agricultural producer prices increased in May (0.7%).

Following a three-quarter decline, **prices of elements and materials incorporated in construction** gained 1.9% in Q2. In y-o-y terms, the decline was moderated relative to March and arrived at 1.0% in June.

The quarterly rise in external prices expressed in dinars[2] continued in Q2 (2.0%), mainly reflecting growth in global oil prices. Q2 also saw an increase in world food prices, as well as in average EU prices, which are used to approximate external services prices. A mild nominal depreciation of the dinar against the euro in Q2 (0.1%) also had a negligible impact on the rise in external dinar prices. These trends slowed down the y-o-y decline in external prices – to 1.5% in June.

Inflation expectations

Inflation expectations of market participants remained low. In the period from the previous *Inflation Report*, short- and medium-term expectations of the financial sector and medium-term expectations of corporates declined further.

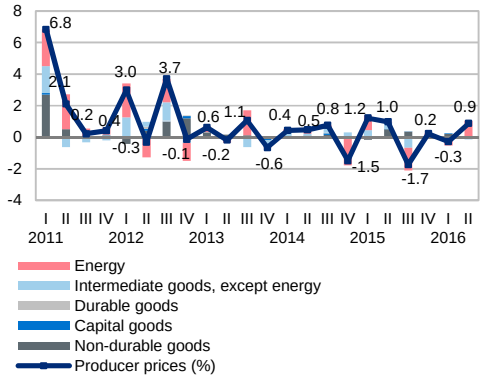
According to the Bloomberg survey, **one-year ahead** financial sector expectations have been within the target band for almost three years now. They have been trending between 2.8% and 3.0% over the recent months. According to the latest, August data, the financial sector

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

	2015		2016	
	Sep.	Dec.	Mar.	June
Consumer prices	1.4	1.5	0.6	0.3
Domestic industrial producer prices	-1.2	0.7	-1.5	-1.6
Agricultural producer prices	5.8	-2.2	-0.4	0.7*
Prices of elements and materials incorporated in construction	-1.7	-1.6	-1.5	-1.0

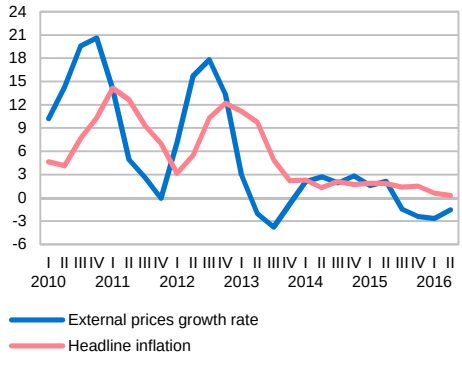
Sources: SORS and NBS calculation.
* May on May.

Chart III.0.4 **Contribution to quarterly producer price growth**
(in pp)



Sources: SORS and NBS calculation.

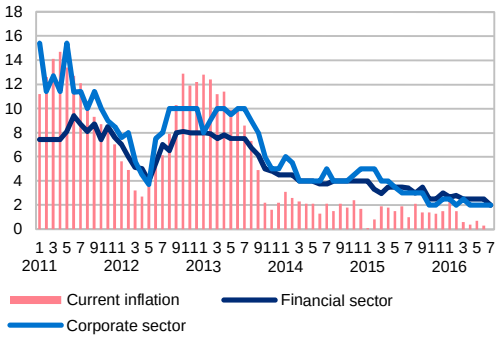
Chart III.0.5 **Domestic inflation and external prices**
(y-o-y rates, in %)



Sources: Destatis, FAO, Bloomberg and NBS calculation.

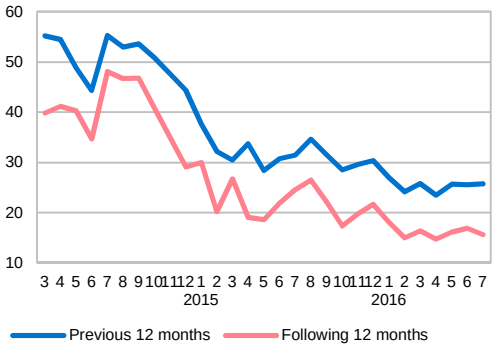
[2] The weighted average of the world oil and food price index, EU consumer prices and export prices of Germany as one of our main foreign trade partners have been used as the indicator of external prices. Weights are determined according to the share of these categories in the structure of Serbia's imports.

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



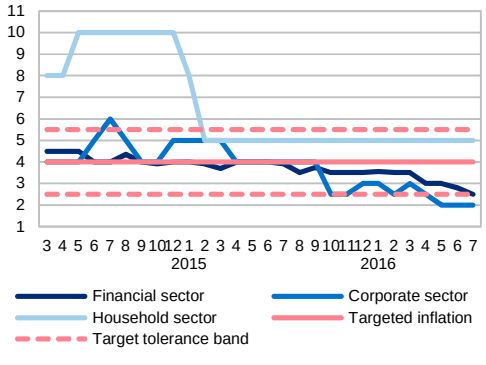
Sources: Gallup, Ipsos/Ninamedia and NBS.
* Ninamedia agency since December 2014, and Ipsos and Gallup in the prior period. The survey was not conducted in November 2014.

Chart III.0.7 **Household perceived and expected inflation**
(in index points)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).
* The survey was not conducted in November 2014.

Chart III.0.8 **Two-year ahead inflation expectations***
(y-o-y rates, in %)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).
* The survey was not conducted in November 2014.

expects August 2017 inflation to reach 2.8%. Based on the **Ninamedia** survey,[3] financial sector expectations measured 2.5% from March until July when they fell to 2.0%. Since April, corporate sector expectations have been stable at 2.0%.

One-year ahead inflation expectations of households, usually higher than in other sectors, stabilised at 5% from October 2015 to July 2016, while only temporarily picking up to 6.0% in March and May. Relatively stable household expectations are also signalled by the qualitative survey,[4] according to which much lower inflation is expected than in the past period. Also, expected inflation remains below perceived inflation, implying that households, as usual, consider prices to have increased more than they actually did over the past twelve months. The fact that expected inflation is lower than perceived inflation implies that the households believing that prices went up in the past twelve months do not expect the trend to continue over the next year.

Moving within the target band since the survey was introduced in March 2014, **medium-term inflation expectations** of the financial sector declined further. Following the April cut to 3.0%, the financial sector pared its expectations further back, to 2.5% in July. Corporate expectations also declined, to 2.5% in April and 2.0% in May, where they stayed thereafter. Medium-term household expectations are higher, but stable at 5.0% since February last year.

The dispersion of financial sector responses – the lowest across sectors, remains relatively stable according to both Bloomberg and Ninamedia surveys. The dispersion of corporate sector responses increased in the first two months of the year, but began to contract thereafter, reaching its four-year low. Though much higher, the dispersion of responses in the household sector fell to its two-year low.

In Q2, the net percentage[5] of enterprises expecting their input prices to rise over the next three months declined

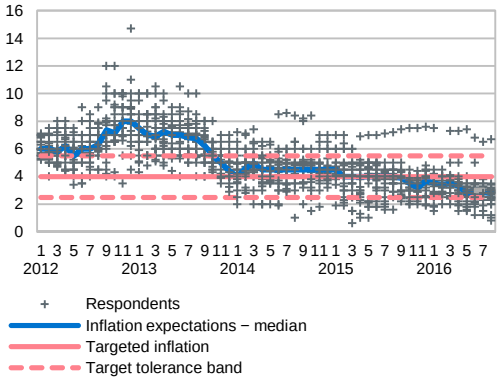
[3] Ninamedia clipping d.o.o. Novi Sad has been conducting a survey on expectations of economic entities since December 2014.

[4] For more information about households' qualitative expectations see the February 2016 Inflation Report, Text box 2, p. 15.

[5] 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.

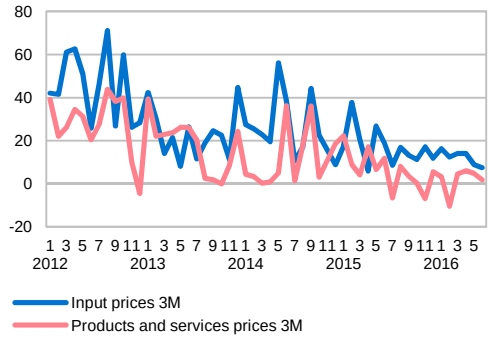
(from 14.0% to 7.6%), as well as the net percentage of enterprises expecting a rise in prices of their products (from 4.6% to 1.8%). Owing to the achievement of macroeconomic stability, the percentage of enterprises not expecting a change in their product prices rose from 89.7% at end-Q1 to 97.2% at end-Q2.

Chart III.0.9 **Targeted inflation and one-year ahead inflation expectations – financial sector**
(y-o-y rates, in %)



Sources: Bloomberg and NBS.

Chart III.0.10 **Expectations of enterprises regarding a change in prices of their inputs, products and services**
(net percentage, "+" = increase, "-" = decrease)



Sources: Ipsos/Ninamedia and NBS (Ninamedia since December 2014).

IV Inflation determinants

1. Financial market trends

Interbank money market rates rose marginally in Q2. Government and private sector borrowing costs declined further, reflecting past monetary policy easing, improved macroeconomic performances and a lower country risk premium, as confirmed by the credit rating upgrade in June.

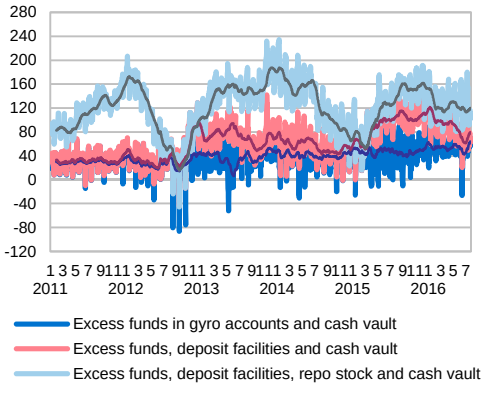
The dinar was relatively stable in Q2. Though the turbulences in the international financial market following Brexit were also felt in the domestic FX market, they were swiftly moderated by appropriate and timely response of the NBS. Since then, central bank interventions have been aimed at preventing excessive short-term strengthening of the dinar – driven also by greater participation of foreign investors in the government securities market.

Interest rates

In Q2 the average repo rate[6] rose by 0.5 pp to 3.0% in late June. From end-May, the spread between the average repo rate and the key policy rate began to narrow as almost the entire excess dinar liquidity offered by banks was withdrawn at repo auctions. As of July, this trend has been further supported by the NBS decision to additionally narrow the corridor of interest rates relative to the key policy rate, from ±1.75 pp to ±1.5 pp.

Interest rates in the interbank money market increased less than the average repo rate in Q2. BEONIA averaged 2.7% in June, up by 0.1 pp from March. Consistent with a gradual contraction in excess dinar liquidity of banks, trading volumes in the interbank overnight money market expanded to RSD 3.5 bln on average, up by RSD 0.7 bln from Q1.

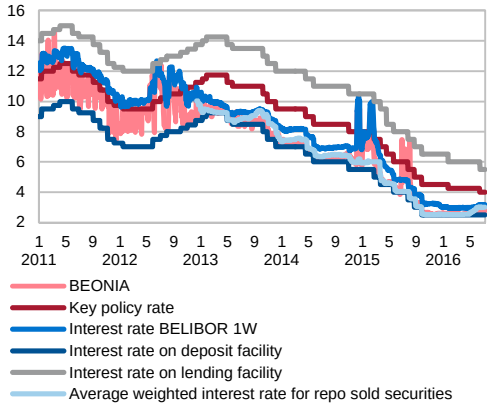
Chart IV.1.1 **Dinar liquidity**
(daily stock and 30-day moving averages, in RSD bln)



Source: NBS.

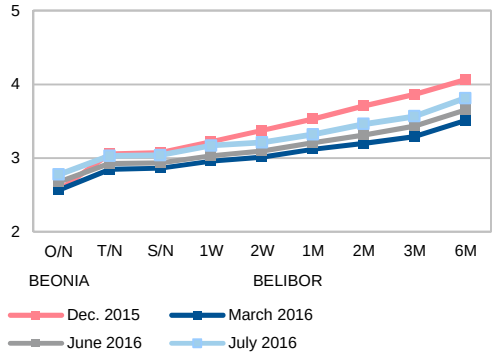
[6] Rate recorded at repo auctions weighted by the amount of sold securities.

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



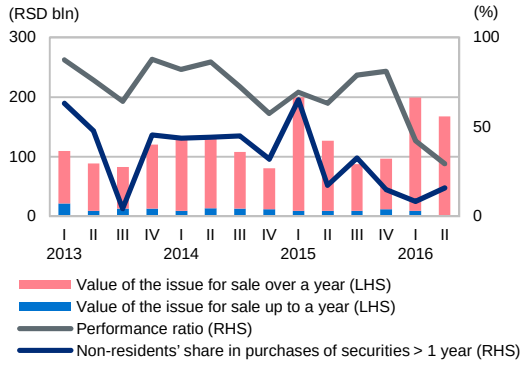
Sources: Thomson Reuters and NBS.

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



Sources: Thomson Reuters and NBS.

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



Source: Ministry of Finance.

Average monthly BELIBOR rates picked up by the same amount (0.1 pp), moving in June from 2.9% for the shortest to 3.7% for six-month maturity. End-of-period, the rise was somewhat stronger (up to 0.25 pp – for the longest maturity). A moderate rise in interbank money market rates continued in July and trading volumes increased as well.

Rates on dinar government securities continued down in Q2. In June, owing to past monetary policy easing and significant improvement in macroeconomic indicators, the government borrowed at half the rates recorded two years ago. In Q2 the rate on two-year securities fell by 0.7 pp to 4.3%, and the rate on three-year securities by 0.6 pp to 5.4%. The shortest term at which the government borrowed was one year – the only maturity with broadly unchanged yield rates relative to Q1 (4.0%). At the auction of two-year amortising bonds at a variable coupon linked to the key policy rate, the fixed margin declined further (by 0.2 pp to 0.3 pp). Rates continued down in July. At the auction of seven-year dinar securities, the yield rate was 6.0%, down by 4.8 pp compared to the earlier auction held in March 2015.

Although they bought a somewhat greater amount of securities in the primary market than in Q1, the share of foreign investors in the primary purchase of dinar securities was not high. Their behaviour was influenced primarily by the continuing high uncertainty in the international financial market. In Q2 they participated only in auctions of three- and one-year dinar securities. However, their participation increased at the July auction of seven-year securities. This may be associated with investors' rising exposure to emerging markets following Brexit, as it was expected that monetary policy measures of the leading central banks would remain accommodative for a period longer than previously thought, as well as with positive assessments of the IMF following their June visit and an upgrade of the country's credit rating.

A similar decline (between 0.2 pp and 0.7 pp) was observed also for rates at auctions of euro government securities. The rates recorded at Q2 auctions moved between 0.9% for one-year and 4.2% for ten-year securities.

Trading volumes in the secondary market of government securities amounted to RSD 131.2 bln in Q2, up by RSD 51.8 bln from Q1. Most traded were securities at the original maturity of two and three years. Foreign investors were more active on the sale side in Q2 as well. The yield rates were declining – in June, they ranged

from 3.5% for the remaining four-month to 6.0% for the remaining 62-month maturity.

In the loan market, rates on private sector loans continued down in Q2, touching their new all-time lows. Such trend was prompted by past monetary policy easing, low interest rates in the euro area and higher interbank competition.

The weighted average rate on dinar corporate and household loans fell by 0.4 pp in Q2 and came at 9.1% in June. A decline was recorded for household loans where the average price was down by 1.1 pp to 10.5% in June. The rates on all types of loans were reduced. The sharpest drop (1.3 pp) was noted for rates on cash and other loans, which equalled 10.7% and 9.3% in June respectively. The rate on home refurbishment loans fell by 0.8 pp to 6.7%, and the rate on consumer loans by 0.1 pp to 9.9%.

The weighted average rate on new dinar corporate loans stayed unchanged from March, equalling 6.6% in June. Rates on investment loans declined (by 0.4 pp to 7.7%), as well as rates on current assets loans (by 0.2 pp to 5.9%), while the price of export loans rose to 4.5% and the price of other loans to 7.5%.

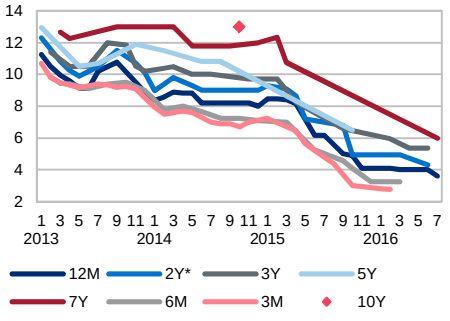
The weighted average rate on new euro loans and dinar euro-indexed corporate and household loans dropped by 0.4 pp to 3.7% in Q2. The average rate on corporate loans declined by the same amount – to 3.5% in June. The drop was the most pronounced for euro-indexed current assets loans (by 0.7 pp to 3.4%). The rates on investment loans shrank as well (to 3.9%), followed by other loans (to 3.6%) and import loans (to 2.4%). The reduction in the average rate on household loans (by 0.7 pp to 4.7%) was under the strongest impact of falling rates on housing loans (by 0.4 pp to 3.5% in June). Rates on cash (3.7%) and consumer loans (5.7%) were also lower. It was only the price of other loans that went up (to 7.4%).

In Q2, the rates on dinar corporate and household deposits fell by 0.3 pp each, equalling 2.4% and 3.3% in June respectively. The rate on household FX savings was down by 0.1 pp to 0.8%, while the rate on new corporate deposits stayed flat (0.5%).

Risk premium

Serbia's risk premium, i.e. the difference in yields on Serbia's dollar eurobonds and US treasury securities, was under the sway of both global and domestic factors. The UK referendum on EU membership was doubtless the

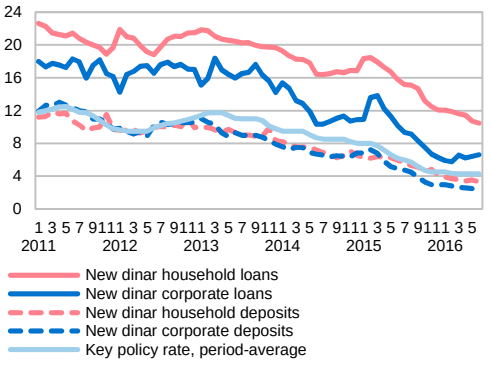
Chart IV.1.5 **Interest rates in the primary market of government securities**
(p.a., in %)



Source: Ministry of Finance.

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

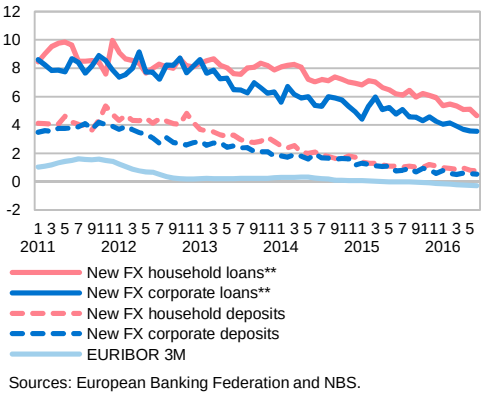
Chart IV.1.6 **Interest rates on dinar loans and deposits of corporates and households***
(weighted average values, p.a., in %)



Source: NBS.

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

Chart IV.1.7 **Interest rates on FX loans and deposits of corporates and households***
(weighted average values, p.a., in %)

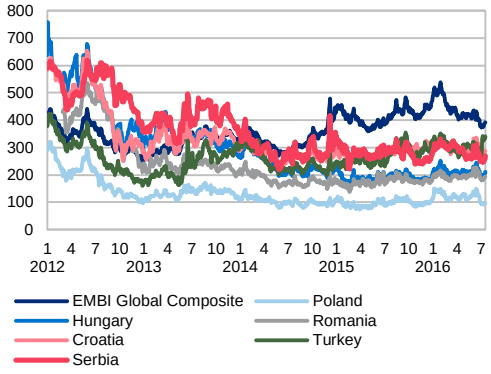


Sources: European Banking Federation and NBS.

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

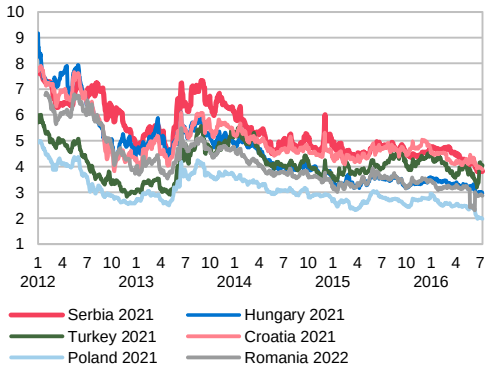
** Euro and euro-indexed.

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



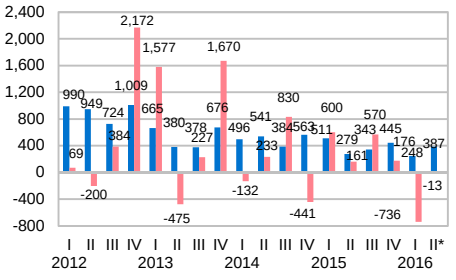
Source: JP Morgan.

Chart IV.1.9 **Yields on eurobonds of countries in the region**
(in %)



Source: Bloomberg.

Chart IV.1.10 **Current account deficit and net capital inflow**
(in EUR mln)



Sources: SORS and NBS.
* Preliminary data.

key global factor – it had a dominant impact on markets, particularly as the month of June drew closer, prompting fluctuations in risk premia of all emerging economies, including Serbia. The unexpected referendum result initially urged investors to turn to advanced markets and precipitated a rise in risk premia of emerging economies. Nonetheless, markets recovered relatively quickly and recorded a lower risk premium at the close than at the start of the second quarter. In July, risk premia of almost all emerging economies contracted.

Measured by EMBI, Serbia's risk premium lost 40 bp in Q2 and another 15 bp in July, reaching the level of 269 bp. Q2 also saw a reduction in EMBI Global (by 27 bp). Risk premia of South American countries also declined, while in the region they were either at a higher or the same level as at end-Q1, but also dropped in July.

Besides global, domestic factors were also behind the sharp reduction in Serbia's risk premium – most notably the narrowing in internal and external imbalances, aided by consistent implementation of fiscal consolidation measures and structural reforms. Better macroeconomic performances of the Serbian economy and its improved prospects were confirmed in June also by the IMF. Fitch Ratings upgraded the country's credit rating in the same month (from B+ to BB–, with a stable outlook). According to Fitch's statement, the upgrade was due to better macroeconomic performances, political stability, successful fiscal consolidation, banking sector stability and the implementation of reforms agreed under the three-year arrangement with the IMF. In addition, Standard & Poor's affirmed Serbia's long-term foreign and local currency sovereign credit ratings at BB-, with a stable outlook. The affirmation reflects the view that the new government will continue to implement the fiscal consolidation and structural reform programme, which should further increase investors' confidence in Serbia.

Foreign capital inflow

The FDI inflow turned out higher and the outflow in respect of portfolio investment and a reduction in resident foreign credit liabilities lower compared to Q1. In addition, bank holdings in accounts abroad decreased in Q2.

According to preliminary data, net **FDI** inflow came to EUR 495.6 mln in Q2, or EUR 830.8 mln in H1 2016. The Q2 inflow was 6.5% higher than in the same period last year, when it was also high and more than sufficient to cover the current account deficit. Investments originated

mainly from EU countries. As last year, they were diversified across a number of projects, most notably in manufacturing, financial sector, construction, trade, transportation and telecommunications. Net foreign payments in respect of dividends and interest amounted to EUR 188.0 mln and EUR 12.1 mln respectively.

We expect a net FDI inflow worth around EUR 1.6 bln in 2016, or around 5% of GDP. It should fully cover the current account deficit, estimated at 4.2% of GDP this year. Investments are likely to be channelled primarily to export-oriented sectors, contributing to sustainable economic growth in the years to come. The key contribution to the FDI inflow should come from continued structural reforms, further improvement in the business and investment climate, recovery of Serbia's trade partners and progress in the European integration process.

In Q2, net capital outflow (EUR 331.3 mln) was recorded in respect of **portfolio investment**, but was lower than in Q1. The outflow was driven by a further reduction in foreign investors' exposure to emerging economies following the start of monetary policy normalisation by the Fed, but also by turbulences in the international financial market on the eve and immediately after Brexit. At the same time, residents stepped up their investment in foreign, most notably debt securities, which also resulted in an outflow. Total EUR 110.1 mln were paid to foreign investors in respect of interest under portfolio investment in Q2.

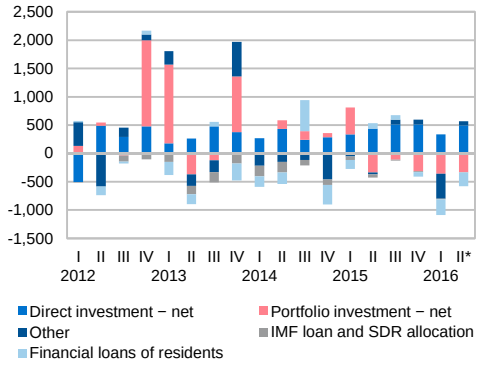
Resident liabilities arising from **financial loans** declined by EUR 250.9 mln in Q2. Banks repaid the highest amount (EUR 196.5 mln), while the liabilities of enterprises under cross-border loans and government liabilities contracted by EUR 25.7 mln and EUR 21.5 mln respectively.

In April, the NBS made the payment to the IMF for the last instalment of debt principal (EUR 7.2 mln) thereby fully settling its liabilities arising from the 2009 stand-by arrangement. The implementation of the current three-year precautionary arrangement, approved in early 2015, has been on track, without the need to draw down the funds.

Trends in the FX market and exchange rate

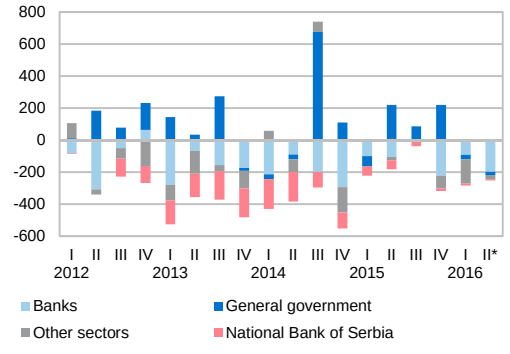
Depreciation pressures were fuelled in Q2 by the continued withdrawal of foreign investors from dinar

Chart IV.1.11 **Structure of the financial account**
(in EUR mln)



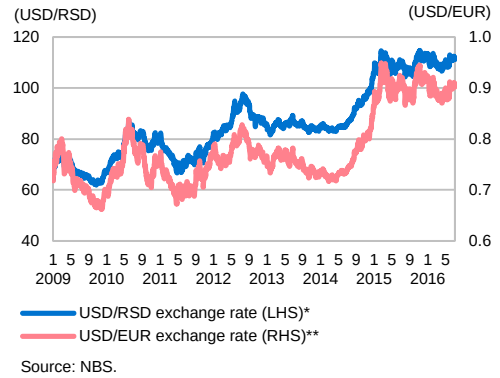
Sources: SORS and NBS.
* Preliminary data.

Chart IV.1.12 **Financial loans of residents – change in net borrowing**
(in EUR mln)



Source: NBS.
* Preliminary data.

Chart IV.1.13 **Movements in RSD/USD and EUR/USD exchange rates**



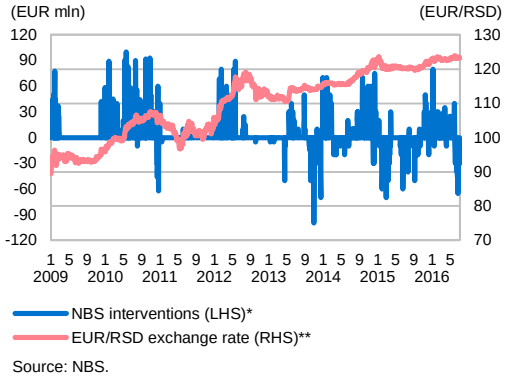
Source: NBS.
* 1 USD in RSD.
** 1 USD in EUR.

government securities and rising FX demand of domestic enterprises. However, due to elevated FDIs and exports, higher purchases of foreign cash by natural persons, an increase in bank net assets indexed to the FX clause, and NBS interventions, impacted on relatively stable movements in the FX market in the period observed. End-of-period, the dinar lost 0.3% against the euro in Q2, or 0.1% at the quarter average level.

Though the turbulences in the international financial market following the publication of the referendum result were also felt in the domestic FX market, they were swiftly moderated by appropriate and timely response of the NBS and its communication with the public. Thereafter, the NBS intervened only by purchasing FX in order to prevent excessive short-term strengthening of the dinar. The appreciation pressures in July were spurred by increased interest of foreign investors in dinar government securities and smaller than usual amounts of FX purchases by domestic enterprises. The dinar exchange rate against the euro remained broadly unchanged relative to June.

After the referendum result was published, in Q2 the euro weakened by 1.9% against the dollar end-of-period. At the same time, the dinar lost 2.2% against the dollar.

Chart IV.1.14 **Movements in EUR/RSD exchange rate and NBS FX interventions**



Source: NBS.
* + sale; - purchase.
** 1 EUR in RSD.

The continuation of positive trends in manufacturing impacted on higher FX demand of domestic enterprises, prompted by the need to pay for the imports of energy products, equipment and intermediate goods. In addition, banks and enterprises continued to reduce their foreign credit liabilities. Foreign investors also bought significant amounts of FX in the IFEM. They narrowed further their government securities portfolios against the background of diverging monetary policies of the leading central banks and the prevailing uncertainty in the international financial market.

The FDI growth in Q2 outstripped that of Q1. Exports also continued up. The high net FDI inflow – up by around 6.5% in H1 relative to the year before, testifies to investors' favourable perception of Serbia as a long-term investment destination. The inflow of remittances and the maturing of the remaining series of frozen FX savings bonds impacted on elevated purchases of foreign cash in exchange transactions in Q2. June also saw an increase in FX-indexed bank assets as banks

generated FX supply in order to match their FX positions, which had a strong impact on moderation of depreciation pressures.

The maintained relative stability of the dinar in the midst of turbulences in the international financial market, present for some time already, proves that the resilience of the domestic economy to external shocks has increased thanks to significant improvement in macroeconomic fundamentals. This is also confirmed by the June upgrade in Serbia's credit rating from B+ to BB- by Fitch. In early July, Standard & Poor's affirmed Serbia's rating at BB–, with a stable outlook.

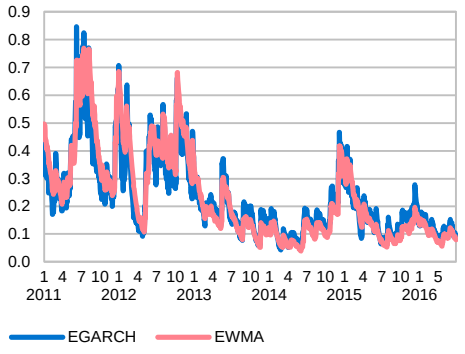
Average daily trading volumes in the IFEM contracted to EUR 25.4 mln in Q2, down by EUR 7.1 mln from Q1.[7] The lowest average daily trading volumes were recorded in April (EUR 24.4 mln) and the highest in June (EUR 26.8 mln). Volatility of the dinar against the euro, as measured by EWMA[8] and EGARCH[9], mirrored the trading trends – it was lower in April and May and increased slightly in June.

To ease excessive short-term volatility of the exchange rate, in Q2 the NBS intervened in the IFEM by net selling EUR 255.0 mln, mostly in April. It intervened on the buying side once in April (EUR 10.0 mln) and once in late June (EUR 30.0 mln). In July, it intervened only on the purchase side (EUR 355.0 mln).

The amount of FX swaps was somewhat lower than in Q1. At regular FX swap auctions organised by the NBS, EUR 74.0 mln was sold and bought at two-week auctions, and EUR 34.0 mln at three-month auctions. The amount of interbank FX swaps in Q2 (EUR 20.6 mln) was lower than in Q1.

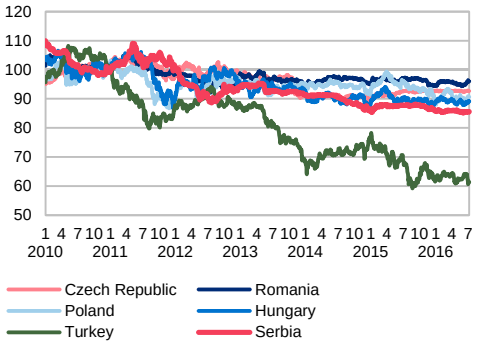
Most currencies of other countries of the region with a similar exchange rate regime depreciated vis-à-vis the euro during Q2. The Polish zloty depreciated the most (3.6%), followed by the Romanian leu (1.0%) and Hungarian forint (0.6%). The Czech koruna lost 0.3%, the same amount as the dinar. It was only the Turkish lira that appreciated slightly (0.1%).

Chart IV.1.15 **Short-term volatility of the RSD/EUR exchange rate**
(in %)



Source: NBS.

Chart IV.1.16 **Movements in exchange rates of national currencies against the euro***
(daily data, 31 December 2010 = 100)



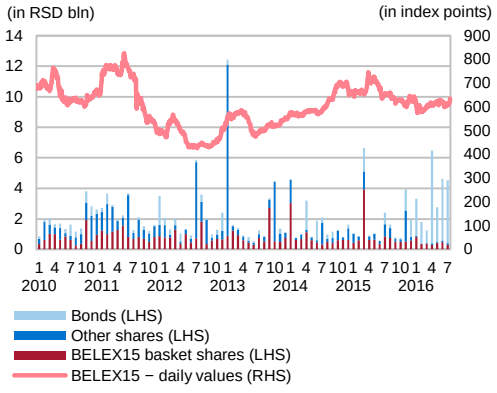
Sources: NBS and websites of central banks.
* Growth indicates appreciation.

[7] Excluding the NBS.

[8] EWMA – Exponentially Weighted Moving Average.

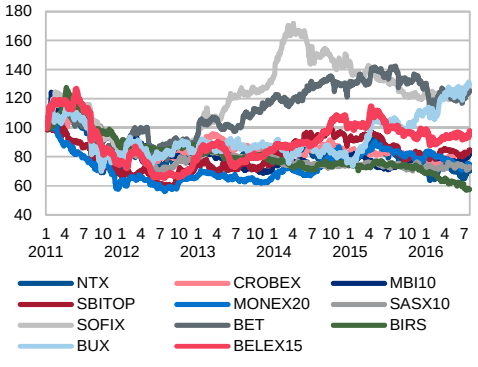
[9] EGARCH – Exponential General Autoregressive Conditional Heteroskedasticity.

Chart IV.1.17 **BELEX15 and Belgrade Stock Exchange turnover**



Source: Belgrade Stock Exchange.

Chart IV.1.18 **Stock exchange indices across the region**
(in index points, normalised, 31 December 2010 = 100)



Sources: BSE and websites of regional stock exchanges.

Stock exchange trends

Indices of the Belgrade Stock Exchange (BSE) fluctuated in both directions in Q2. In late June, following the publication of the UK referendum result, the turmoil on global stock exchanges was felt in the local capital market. End-of-period, BSE indices stayed broadly flat from end-Q1 – BELEX15 equalled 604.7 points and BELEXline 1,326.0 points, down by 0.2% and 0.3% from end-March respectively.

Total trading in shares was RSD 1.4 bln in Q2, down by RSD 0.2 bln from a quarter earlier. Over 80% of trading related to shares from the BELEX15 index basket, and the highest trading volumes (RSD 0.6 bln) were recorded in June. Foreign investor participation in stock trading amounted to RSD 0.6 bln. Due to the net sale in June, they sold RSD 21.3 mln net at the quarterly level.

By contrast, trading in bonds continued rising in Q2. Total trading in bonds (RSD 12.4 bln) was almost three times higher than in Q1, due primarily to increased trading in long-term RS bonds (RSD 11.4 bln).[10] Transactions with foreign investors accounted for around 20%. Trading in the remaining series of frozen FX savings bonds (A2016) reached RSD 1.0 bln. These securities were traded until 19 May, when they were removed from the listing as they fell due late that month. Municipal bonds were not traded in Q2.

BSE market capitalisation equalled RSD 646.7 bln at end-June, down by RSD 7.5 bln from end-March. Of this, regulated market capitalisation expanded by RSD 2.8 bln, while MTP[11] capitalisation fell by RSD 10.3 bln. The share of market capitalisation in estimated GDP fell by 0.3 pp to 16.0% at end-Q2.

Stock exchange indices in the region recorded divergent movements in Q2. The index on the Podgorica stock exchange declined the most (8.1%), while the highest growth (2.1%) was recorded on the Sofia stock exchange.

2. Money and loans

The money supply increased in Q2, on account of both its dinar and foreign currency components. Thanks to a

[10] In November 2015, trading in government long-term bonds on the BSE was enabled.

[11] 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.

recovery in economic activity, corporate deposits continued up, and dinar and foreign currency household savings increased. The rise in the money supply reflected higher private sector lending.

Monetary aggregates

In Q2, dinar reserve money gained 2.1% in nominal and 1.5% in real terms. This, together with somewhat higher FX deposits of banks with the NBS, pushed total reserve money up by a similar amount (2.0% in nominal and 1.5% in real terms). Still, at end-June, dinar reserve money was 6.0% and total reserve money 11.2% lower than a year ago.

Since due to the much improved fiscal position the government needed to borrow less, the amount of matured dinar securities exceeded the amount of new issues; as a result, government dinar deposits decreased by RSD 32.4 bln in Q2. A portion of dinar funds was used to buy FX from the NBS, mostly for the purpose of redeeming frozen FX savings bonds due in May. As a result, the government contributed RSD 16.5 bln in Q2 to the increase in dinar reserve money. Banks' liquidity increased also on account of FX payment transactions with Kosovo and Metohija and reduced bank investment in repo securities (a total of RSD 14.6 bln). Conversely, most of the created liquidity was mopped up through NBS interventions in the IFEM (RSD 30.1 bln).

The dinar money supply increased in real terms in Q2, with M1 and M2 gaining 5.8% and 5.6%, respectively. FX deposits also went up and, together with a rise in dinar money supply, led to a 3.4% increase in M3.[12]

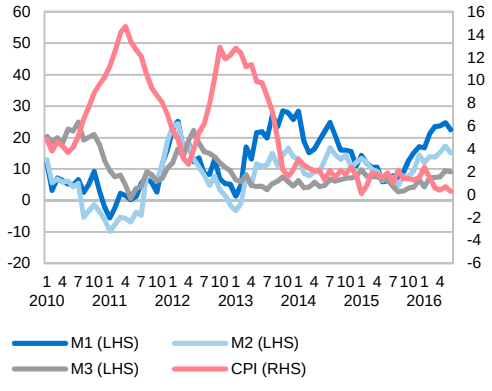
The structure of dinar money supply continued to change in favour of demand deposits, inducing faster y-o-y growth in M1 relative to M2. Demand deposits gained RSD 24.9 bln in Q2, mostly in accounts of companies belonging primarily to the manufacturing sector. Transaction deposits of other sectors, other than public enterprises, increased as well. Balances in longer-term dinar accounts rose by RSD 8.8 bln due to increased account balances of companies in the trade and industry sectors, balances in OFO accounts and dinar household savings.

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

	2015		2016		Share in M3 June 2016 (%)
	Sep.	Dec.	Mar.	June	
M3	1.5	5.0	6.6	8.7	100.0
FX deposits	-0.7	1.1	3.6	5.8	66.1
M2	6.2	12.7	13.1	14.8	33.9
Time and savings dinar deposits	2.9	6.6	-9.5	-3.5	8.1
M1	7.6	15.4	22.8	22.1	25.7
Demand deposit	10.6	19.6	26.3	24.8	18.9
Currency in circulation	0.4	5.6	14.2	15.1	6.8

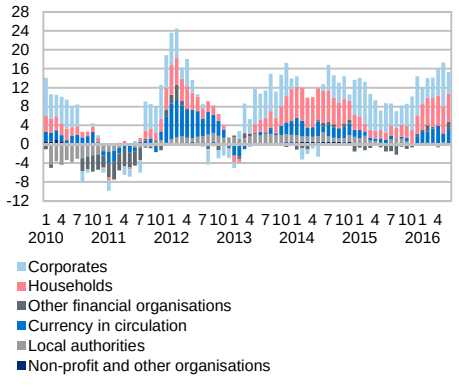
Source: NBS.

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



Sources: SORS and NBS.

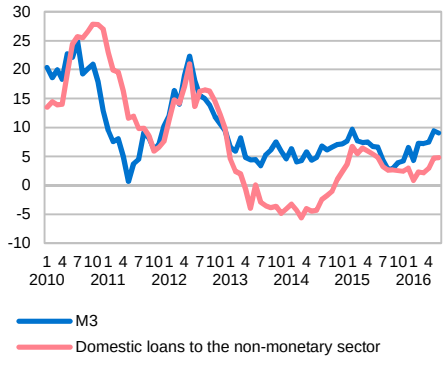
Chart IV.2.2 **Contribution to y-o-y growth in M2, by sector**
(in pp)



Source: NBS.

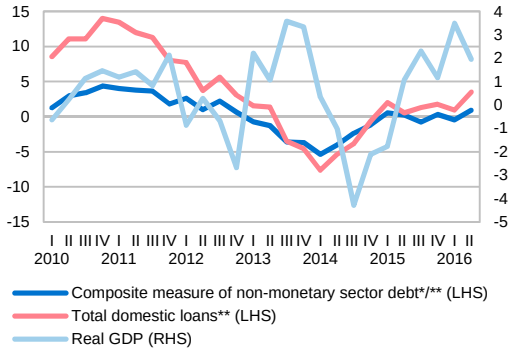
[12] Data series were adjusted during Q2 due to an upgrade of sector classification, in accordance with the decree on the classification of activities in force since August 2010.

Chart IV.2.3 **Domestic loans to the non-monetary sector and M3**
(nominal y-o-y rates, in %)



Source: NBS.

Chart IV.2.4 **Lending activity and GDP**
(y-o-y rates, in %)

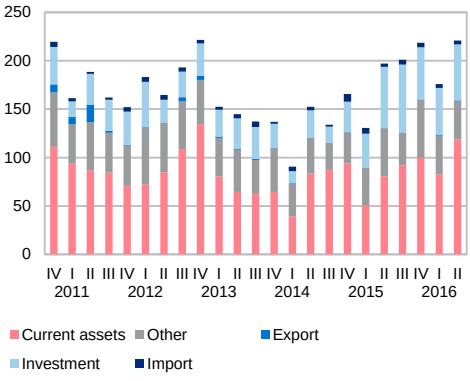


Sources: NBS and SORS.

* 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.

Chart IV.2.5 **Structure of new corporate loans**
(RSD bln)



Source: NBS.

An extended period of low and stable inflation, relative stability of the exchange rate, higher interest rates and preferential tax treatment of dinar relative to FX savings encouraged an increase in dinar household savings in Q2 by a further RSD 0.9 bln. In June, savings reached their historical high of RSD 47.7 bln, which is three and a half times higher than five years ago. FX household savings increased as well by EUR 141.5 mln to EUR 8.5 bln in June, thanks in part to the maturing of the final series of frozen FX savings bonds in May. In addition to household FX savings, corporate FX deposits increased as well, due to sound export performances.

Y-o-y, the growth in the money supply accelerated further – M1, M2 and M3 were higher by 22.1%, 14.8% and 8.7%, respectively, in June relative to the same month a year earlier. An impulse to this increase also came from economic recovery over the past year supported, among other things, by bank lending.

Loans

Following a temporary seasonal deceleration early in the year, domestic loan growth accelerated gradually over the coming months and came to 3.5% y-o-y in June, excluding the exchange rate effect. Household loans gave a stronger impulse (7.2% y-o-y in June) to the recovery in lending, whereas a renewed positive contribution of corporate loans was recorded from May onwards (growth of 1.2% y-o-y in June). Excluding the exchange rate effect,[13] domestic loans gained 2.4% in Q2, while their share in estimated GDP rose by 0.9 pp to 48.6%.

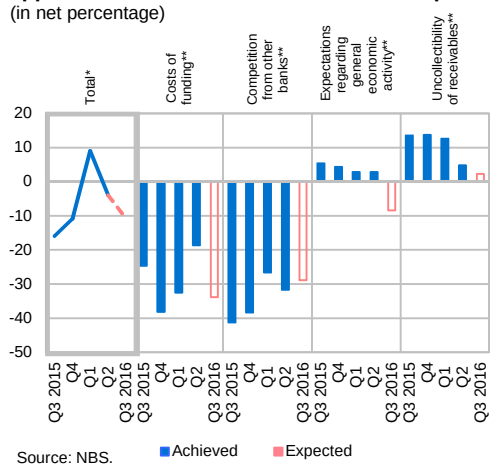
Looking forward, lending activity is expected to rise further, supported by the expected acceleration of economic activity in 2016, much lower lending rates owing to past monetary policy easing of the NBS and low international money market rates, as well as by increased interbank competition.

Corporate loans gained 1.5% or RSD 16.8 bln in Q2, excluding the exchange rate effect. This was due to increased lending to companies, while lending to public enterprises continued down. The negative impact of the maturing of subsidised loans on the stock of loan receivables waned steadily until end-June, when the last loans extended under this programme came due for payment.

[13] 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.

More favourable movements in Q2 are also indicated by the fact that total new corporate loans (RSD 220.8 bln) were 12% higher than in the same period a year earlier while 24% of this amount were loans refinanced with the same bank on more favourable terms. As before, corporate loan demand was guided primarily by the need to finance current assets, with current assets loans making up more than a half of new corporate loans (around 54%). The share of investment loans in new loans remained significant (around 26%), signalling increased reliance on loans for investment financing. Thanks to a recovery in investment lending, the share of this loan category in the stock of corporate loan receivables increased further to 34.2% in June, or 2.6 pp more than at end-2015. The maturity of the loan portfolio was lengthened further, as the share of loans with the maturity of over two years accounted for two-thirds of corporate loan receivables in June.

Chart IV.2.6 **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.

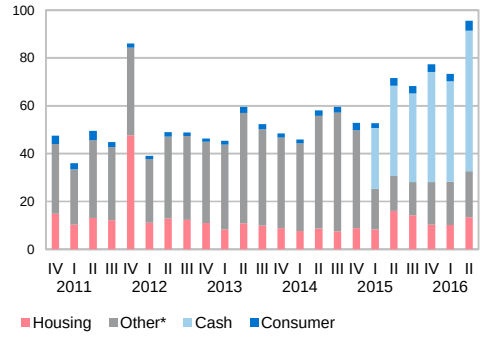
* Positive values indicate tightening and negative easing of credit standards relative to the previous quarter.

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

According to the results of the July bank lending survey,[14] banks eased their credit standards in Q2, after a temporary tightening early in the year. This was mostly due to increased interbank competition and cheaper sources of funding. Together with a faster-paced economic activity, these factors should contribute to a further easing of standards expected in Q3. Terms of borrowing were more favourable for corporates in Q2 on account of lower margins, associated costs and longer terms of repayment. Requirements with regard to maximum loan amount were tightened, as were those relating to collateral, which is consistent with the lengthening of loan maturity. According to banks, corporate demand for both dinar and FX loans continued up, guided primarily by the need to finance current assets, but also by debt restructuring and investment financing. The same factors are expected to drive demand further up in the period ahead.

Household loans continued rising in Q2. They gained 3.4% or RSD 25.5 bln, excluding the exchange rate effect, which is the largest quarterly increase in loans since Q3 2008. The volume of new household loans in Q2 (RSD 95.5 bln) was by a third higher than in the same period last year, and households still opted most for cash and refinancing loans. In Q2, these loans made up on average 61% of new household loans and were almost entirely dinar denominated (over 99%); of this, around 70% were loans with repayment periods of over five years. The amount of new housing loans also increased from prior

Chart IV.2.7 **Structure of new household loans**
(RSD bln)

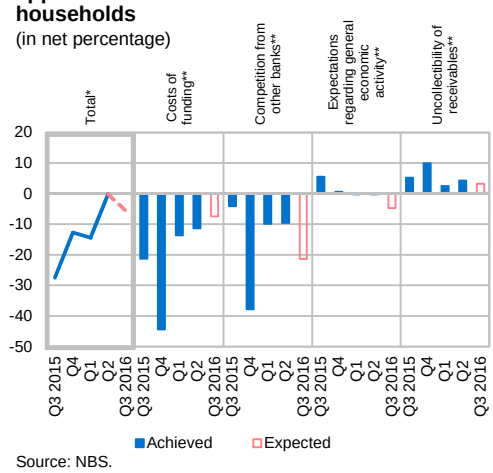


Source: NBS.

* Until December 2014, the 'Other loans' category included both cash and other loans.

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

Chart IV.2.8 **Impact of individual factors on changes in credit standards as applied to the approval of loans and credit lines to households**
(in net percentage)

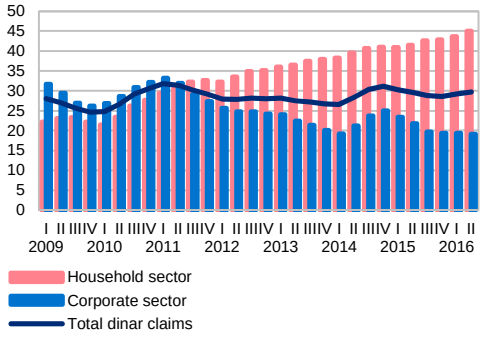


Source: NBS.

* 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.

Chart IV.2.9 **Share of dinar in total bank receivables from corporate and household sectors**
(in %)



Source: NBS.

months, but their share in total new loans remained relatively low (around 14% in Q2). Borrowing on credit cards and current account overdrafts stayed broadly unchanged from Q1.

According to the results of the July bank lending survey, banks continued to ease credit standards for households in Q2. As in the case of corporates, the easing of standards was mostly driven by cheaper sources of funding and increased interbank competition. Interest rate margins were reduced further and associated costs trimmed. Households were offered more favourable terms of repayment, and requirements with regard to collateral were slightly softened. Consistent with the banks' expectations, household demand continued rising. Dinar cash and refinancing loans were in highest demand. For the second quarter in a row, increased demand for housing loans was also observed in Q2. Household demand was driven primarily by the need to refinance current obligations and by real estate purchases. These factors are expected to continue to drive demand growth in Q3.

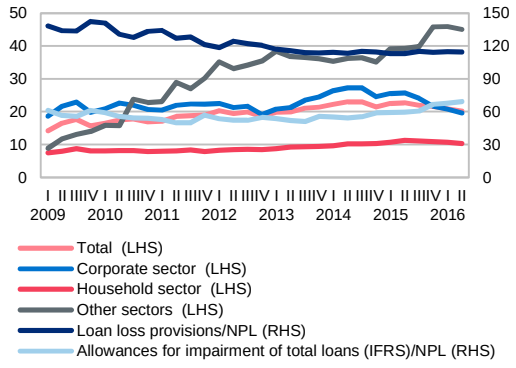
At end-June, 29.8% of bank receivables from corporates and households were in dinars, which is 1.1 pp more than at end-2015. Households increasingly borrowed in dinars – on average, 75% of new loans to households in H1 were in dinars. As a result, the dinarisation of household lending increased by 2.1 pp in H1 to 45.0% in June. By contrast, the degree of dinarisation of corporate lending (19.1%) lost 0.3 pp from end-2015, due in part to the maturing of dinar loans approved within the subsidised lending scheme. New corporate borrowing in dinars (around 22% on average in H1) was about 7 pp higher than in the same period last year.

The results of implementation of the NPL Resolution Strategy are already visible. Since the start of the year, the share of NPLs in total loans, on a gross basis, decreased by 1.4 pp to 20.2% in June. The share of NPLs decreased by 2.1 pp to 19.6% in the corporate and by 0.5 pp to 10.3%[15] in the household sector. On the one hand, the NPL share decreased as a result of collection, restructuring, write-off and sale of a part of NPLs and, on the other, due to an increase in new lending.

[15] With entrepreneurs and private households included, the share fell by 0.6 pp to 11.1%.

Despite the relatively high share of NPLs in total loans, the capital adequacy ratio of 21.6% indicates that the domestic banking sector is highly capitalised. In June, total allowances for loan impairment came at 69.5% of NPLs (9.9 pp more than a year earlier), while loan loss provisions,[16] at 114.7% in June, continued to fully cover the amount of gross NPLs.

Chart IV.2.10 **NPL share in total loans, gross principle**
(in %)



Source: NBS.

[16] Loan loss provisions are not an accounting category, meaning they are not recorded in the income statement but only serve for the calculation of 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).

Text box 1: Terms of financing small and medium-sized enterprises

With their potential to deliver innovative solutions and foster economic competitiveness, small and medium-sized enterprises (SMEs) have been recognised as drivers of successful and sustainable economic development. Acknowledging the above, Serbia also strives to encourage their growth. In March 2015 the Government of the Republic of Serbia adopted the Strategy to support the development of SMEs, entrepreneurship and competitiveness for the 2015–2020 period. The Strategy builds on the earlier policy and is fully aligned with the principles of EU regulations on entrepreneurship and competitiveness, most notably the Europe 2020 Strategy and the Small Business Act. The alignment of domestic regulations with the *acquis communautaire* will certainly help speed up negotiations with the EU (in this concrete case Chapter 20 – Enterprise and industrial policy).

The aims defined by the Strategy include the improvement of the business environment, ensuring better access to sources of funding, continuous development of human resources, strengthening the sustainability and competitiveness of micro, small and medium-sized enterprises and entrepreneurs (SMEEs), improving access to new markets, developing and promoting entrepreneurial spirit, encouraging the entrepreneurship of women and youth, and advancing social entrepreneurship. The number of SMEEs is expected to rise to 350,000 (vs. 324,272 in 2014), the number of employees in the sector to 950,000 (vs. 761,539 in 2014) and the average real gross value added rate to reach 3.0%±1% from 2015 to 2020. To support the implementation of the Strategy and further encourage growth and entrepreneurship, the Government launched in March the "Year of Entrepreneurship 2016" project, worth around RSD 16 bln and including 33 programmes to support entrepreneurs. Non-repayable funds account for one fourth, while the rest are loans and other arrangements. Besides, owing to government guarantees, SMEEs have access to credit lines of foreign creditors (the EIB, Italian Government, EAR etc.) via domestic banks. Over EUR 1 bln worth of loans were approved to SMEEs and local authorities from 2002 to June 2016 through the EIB's Apex line only. In addition, the 2014 subsidised lending programme worth RSD 136 bln was intended primarily for SMEEs (only 10% went to large enterprises).

According to the latest, 2014 data of the Serbian Statistical Office, 99.8% of all Serbian enterprises belong to the category of SMEs[1]. The most numerous are those employing up to nine persons, i.e. entrepreneurs and micro-enterprises. SMEs employ almost two thirds (64.8%) of the non-financial sector labour force and account for more than a half (56.0%) of total gross value added. Almost a third of SMEs are involved in trade, followed by manufacturing, professional, scientific, innovative and technical activities, and transportation and storage.

SMEEs rely primarily on their own funds. According to the 2015 Survey of 1,000 Serbian businesses[2], more than a half of respondents (62%) do not tap external sources at all. Own funds make up 85.3%, while 10.1% comes from bank loans. The rest consists of borrowing from friends and family members, foreign sources, loans by state institutions, leasing, grants and non-repayable funds. Still, the need for credit increased in 2015, as well as the average loan amount (to EUR 23,000). When applying for a loan, new SMEEs are in a more difficult position as banks consider them to be riskier than their current clients. All this points to the need for greater availability of alternative forms of funding. On its part, the NBS began to design the regulatory framework for the operation of non-deposit financial institutions, which will create an additional potential for SMEE funding, particularly in regard to the micro-segment and start-up enterprises.

The NBS bank lending survey indicates that borrowing terms for SMEEs have improved. Banks have been easing SMEE credit standards for more than a year. The borrowing terms are more favourable owing mainly to lower margins and associated costs, as well as longer terms of repayment. In H2 2015, collateral requirements were eased as well. According to banks, the demand of these enterprises has been on a constant rise since the survey was introduced (early 2014). Banks expect the rise to continue in Q3 2016. Participants in the most recent EIB's CESEE Bank Lending Survey[3], published in July, consider SMEs to be the main drivers of credit demand. They also expect the easing of credit standards for the corporate sector and a rise in demand, consistent with movements in the region and the region average.

[1] The definition of SMEs in Serbia differs from the standard EU definition. The Accounting and Auditing Law defines SMEs as enterprises which fulfil at least two of the following three criteria: the average number of employees up to 250, annual turnover up to EUR 10 mln and total assets up to EUR 5 mln.

[2] The Survey is conducted once a year within the USAID Business Enabling Project, with SMEs accounting for 98% of the respondents.

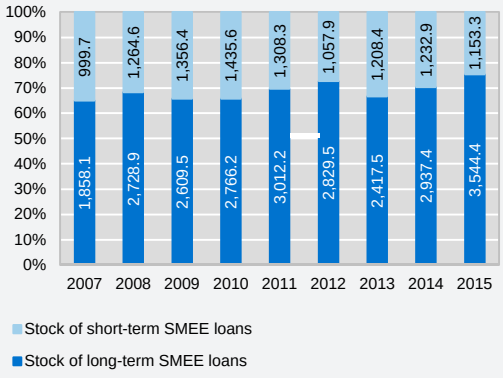
[3] Ten banks accounting for around 65% of total banking sector assets participate in the survey.

To collect data for the OECD Financing SMEs and Entrepreneurs Scoreboard project, the NBS conducts an annual survey on SMEE financing[4]. According to survey results, bank loan receivables on SMEEs expanded further in 2015 and their maturity structure improved – long-term borrowing by entrepreneurs increased, while short-term receivables declined. The percentage of enterprises required to provide collateral (excluding bills of exchange) remained unchanged from 2014 at 54%. Banks continue to approve loans to SMEEs at higher rates than charged to large enterprises, though a strong downward trend has been observed as well, notably for dinar loans, thanks to significant monetary policy easing by the NBS since May 2013. The weighted average rate on euro and euro-indexed loans declined (though to a lesser degree than on dinar loans), reflecting falling rates in the international money market and a decline in the country risk premium. Judging by survey results, in 2015 rates on dinar and FX SMEE loans averaged 12.3% and 6.6% respectively, down by 6.0 pp and 1.9 pp relative to 2013.

Besides, around 28% of SMEE credit applications were rejected in 2015 and the utilisation rate was 95%, which may be associated with more favourable lending terms (lower interest rates and longer repayment terms).

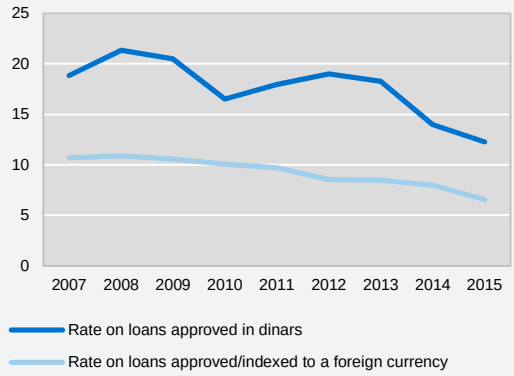
Positive tendencies in SMEE financing, confirmed by several sources, give reason for optimism that progress will continue in the coming period, leading to a greater contribution of SMEEs to gross value added and the opening of new jobs.

Chart O.1.1 **Short- and long-term SMEE loans**
(in %, EUR mln)



Source: NBS (Survey on SMEE financing).

Chart O.1.2 **Average rates on new SMEE loans**
(in %)



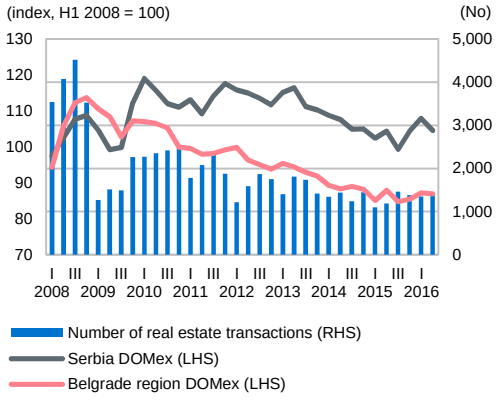
Source: NBS (Survey on SMEE financing).

[4] Total 27 banks accounting for 90% of the Serbian banking sector participate in the survey.

3. Real estate market

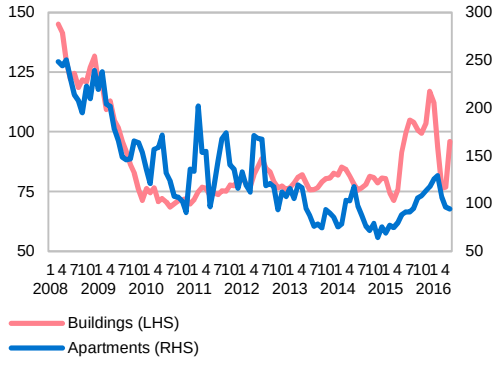
A mild recovery of the Serbian real estate market is signalled by a higher turnover in Q2 and greater demand for housing loans. Improved legislation continued to bear fruit inter alia in terms of rising supply in the real estate market.

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



Source: National Mortgage Insurance Corporation.

Chart IV.3.2 **Indices of the number of issued construction permits**
(3M averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

After two consecutive quarters of growth, Serbia's average real estate prices, as measured by DOMex[17], dropped by 3.2% in Q2. Prices declined across all regions, except in Šumadija and Western Serbia. In y-o-y terms, Q2 saw price stagnation, with the mild fall in the Belgrade region being compensated by the price rise in Vojvodina and Šumadija and Western Serbia.

Regional differences in average real estate prices remained relatively unchanged q-o-q and country-wide. In Q2, the average real estate price in Serbia was EUR 867.0 per square meter.

The number of real estate sales[18] rose by 6.0% relative to Q1. The turnover growth in Q2 was even more pronounced compared to the same period last year (20.5%), continuing the trend of strong y-o-y growth in place since Q1. In regional terms, the turnover increased across the entire country except in the Belgrade region.

More favourable trends in the real estate market are also anticipated by the results of the bank lending survey, which indicate higher household demand for housing loans and identify purchase of real estate property as one of the key factors underlying stronger loan demand. Other helping factors are a drop in rates on new housing loans and a mild loosening of housing loan credit standards.

Positive trends continued on the supply side as well, given that the number of completed dwellings (flats) in Q1 continued to grow, increasing by 84.6% y-o-y, while the floor area of newly built dwellings increased by 107.7% y-o-y in the same period. Higher supply may be expected in the coming period as well, given that the number of issued construction permits in April and May increased by 5.0% y-o-y for buildings and 19.0% y-o-y for dwellings.

[17] The DOMex is published by the National Mortgage Insurance Corporation and relates only to real estate purchased by insured loans.

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

4. Aggregate demand

The rise in imports, reflecting mainly higher purchases of equipment, intermediate goods and energy for industrial production and construction purposes exceeded the rise in exports, which resulted in a negative contribution of net exports in Q2. That explains why GDP, after strong growth in Q1, stagnated in Q2, while keeping a relatively high y-o-y growth rate of 1.8%. Investment, both private and government, saw the continuation of positive trends. The revival continued also in household consumption, propped up by private sector wage growth and lower cost of borrowing.

The NBS estimates that GDP growth in 2016 will amount to around 2.5% and be driven by investment and exports, while receiving a positive impetus from private consumption as well.

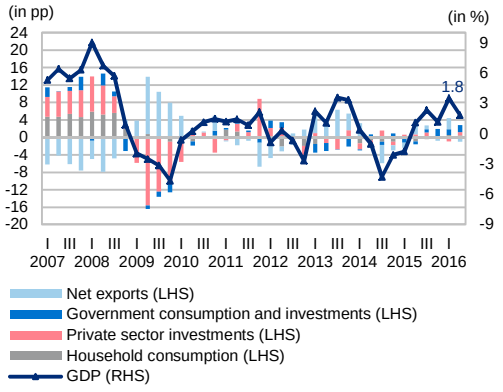
Domestic demand

Growth in **household consumption** extended into Q2 (0.2% s-a), adding 0.1 pp to GDP. This is primarily indicated by the strong growth in imports of consumer goods (7.5% s-a) and movement of indicators in trade, tourism and catering. Retail trade turnover edged up by 0.8% s-a, gaining 7.3% y-o-y. The y-o-y increase in household consumption is estimated at 0.6%, with a 0.4 pp positive contribution to GDP.

Driven mainly by the higher private sector wage bill (3.2% s-a), real net wage bill extended its rise into Q2 (1.9% s-a), becoming the main source of increase in household consumption. Disposable income benefited from lower costs of new borrowing which continued to support growth in consumer loans, but also from lower costs of repayment of existing loans. Inflow of remittances also increased relative to Q1, though remaining weaker than in the same period last year. On the other hand, social insurance transfers dropped mildly in Q2 (0.5% s-a), but increased in y-o-y terms.

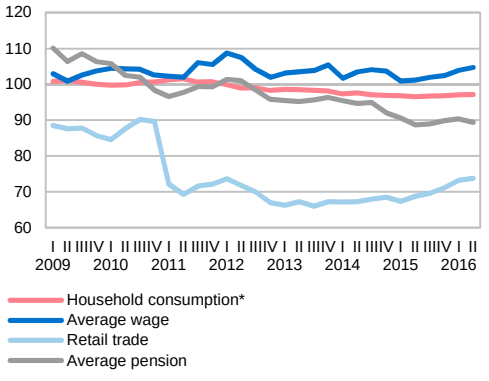
Particularly important from the standpoint of mid-term sustainability of economic growth is the continued upswing in **private investment**, which is estimated to have edged up by 2.4% s-a in Q2, giving a positive 0.4 pp contribution to GDP. Higher investment is indicated by a rise in: equipment imports (1.3% s-a), production of construction materials and construction workforce. Y-o-y, private investment stayed on an upward path (3.0%), giving a 0.5 pp boost to GDP growth.

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



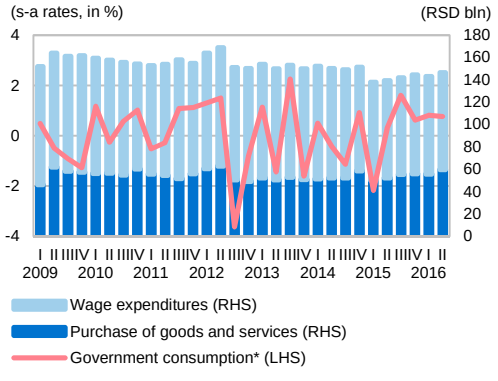
Sources: SORS and NBS calculation.
* NBS estimate.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q2 2016.

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



Sources: SORS, Ministry of Finance and NBS calculation.
* NBS estimate for Q2 2016.

Table IV.4.1 **Investment indicators**

	2015			2016	
	II	III	IV	I	II
Real indicators (seasonally-adjusted, quarterly growth, in %)					
Industrial inventories	0.1	0.2	-2.8	0.5	0.2
Industrial production of capital goods	-4.3	-9.3	6.5	5.5	-1.9
Exports of equipment*	1.5	3.0	5.1	25.7	-1.7
Imports of equipment*	1.6	-0.4	0.1	2.1	3.0
Inventories of capital goods	1.9	-3.9	2.3	5.0	1.4
Industrial production of intermediate goods	3.3	0.9	1.2	4.1	4.5
Exports of intermediate goods*	4.5	3.5	3.0	2.2	2.5
Imports of intermediate goods*	0.6	0.9	5.0	-1.3	2.4
Inventories of intermediate goods	1.1	-1.7	2.3	2.5	2.1
Industrial production of construction materials	0.2	1.6	7.4	-1.0	3.5
Inventories of construction materials	-2.5	-2.1	0.8	2.8	2.0
Government investment**	17.1	12.4	11.4	3.8	3.2

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

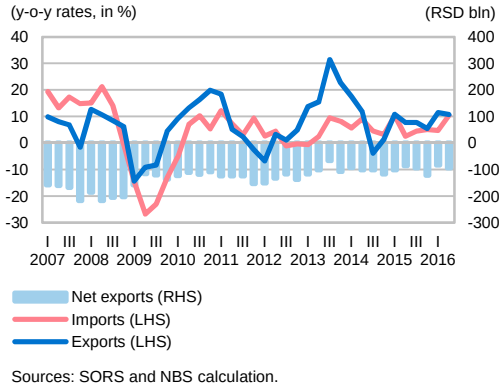
Further improvement in business and investment ambience and positive assessments of international rating agencies reflected positively on FDI inflow in Q2, which exceeded the Q1 level by around 50%. Similar movements are expected in the period ahead, even more so owing to the opening of the two most important chapters in Serbia's EU accession negotiations in July, which will additionally strengthen compliance of business practices and legal protection of investors. Other than on FDI, investment financing continued to draw on higher investment loans, which benefited from monetary policy easing and lower interest rates in the international financial market.

A **change in inventories**, in addition to fixed investment, gave a positive contribution to GDP growth in Q2 as suggested by the growth of finished product inventories in industrial production, particularly in oil, chemical, paper and wood processing industries, as well as in production of machinery and equipment.

An impetus to GDP growth also came from **government consumption** (0.2 pp), which edged up by 1.0% s-a. Such movements were prompted by higher outlays for the purchase of goods and services, while expenditures for public sector wages shrunk further. Government consumption continued to rise in y-o-y terms as well (4.6%), adding 0.8 pp to GDP growth.

As estimated by the NBS, **government investment** also went further up in Q2 (3.2% s-a), owing mainly to faster implementation of road infrastructure projects. Similar to other components of domestic demand, government investment extended its y-o-y growth as well (33.0%), giving a 0.8 pp boost to GDP.

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



Sources: SORS and NBS calculation.
* NBS estimate for Q2 2016.

Net external demand

Having expanded strongly in Q1 (10.6% s-a), real exports of goods and services kept the same level, adding 0.4% s-a in Q2, owing to an uninterrupted economic growth of the euro area and improvement in price and cost competitiveness. Such dynamics was also signalled by the external demand for Serbian exports[19], which remained at the level attained in the previous quarter. On the other hand, s-a growth in real imports of goods and services stayed relatively high in Q2 (2.4%), which led to a

[19] The 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 foriegn trade partners – their shares in Serbian exports being used as weights.

reversal in the contribution of net exports to GDP. After giving a positive impetus in the course of two quarters, contribution of net exports to GDP turned negative in Q2 (-1.3 pp).

Y-o-y, real exports of goods and services stayed on a relatively high growth path of 10.7%, but the strong acceleration of y-o-y growth of goods and services imports to 10.4% pushed the contribution of net exports into negative territory in Q2 (-1.0 pp).

A mild improvement in price and cost competitiveness of the domestic economy in Q2 is indicated by a 0.5% depreciation of the real effective exchange rate of the dinar relative to the euro and the dollar and lower unit labour costs in manufacturing (1.3% s-a). External trade was also positively affected by terms of trade, which improved in Q2 as a result of a steeper fall in export relative to import prices.

Growth of euro-denominated commodity exports, very pronounced in Q1 (9.1% s-a), slowed down to 1.8% s-a in Q2. The growth nevertheless remained widely dispersed, so 15 of the 23 branches in the manufacturing sector recorded an increase in exports in q-o-q terms.

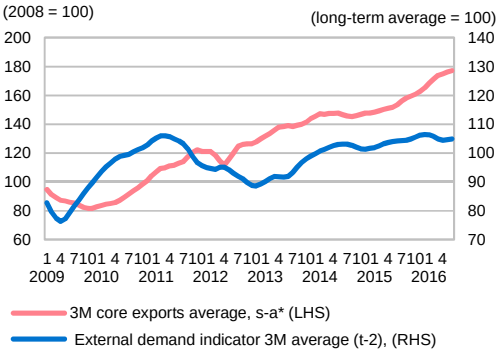
Following a Q1 decline, exports of petroleum products picked up in Q2 on the back of a revival in global oil prices. Exports of base metals trended similarly, benefiting from the bounce-back in prices of iron on the international market. Exports of machinery and equipment followed suit. Faster growth in exports was also recorded for electrical equipment, the largest single contributor to the growth in commodity exports. Positive contributions, though weaker than in Q1, continued also from tobacco, food, clothing, rubber, plastic and pharmaceutical products.

Agricultural products also posted good exports performance in Q2, i.e. a rise of 14.2% s-a. The main driver was corn, whose export volumes expanded by around 30% from Q1. A relatively high exports growth in Q2 was recorded also for fruit and vegetables (10.5% s-a).

On the other hand, following a relatively high growth in Q1, exports of motor vehicles fell back moderately in Q2 (1.3% s-a), being the main drag on commodity exports growth. Similar export movements were recorded in metal and chemical products, which also account for a sizeable share in manufacturing exports.

In addition to growth in commodity exports, Q2 also saw the continued growth of service exports (1.6% s-a),

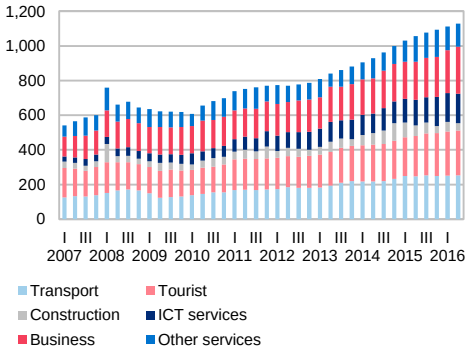
Chart IV.4.5 **Movements in external demand and core exports indicators**



Sources: European Commission, SORS and NBS.

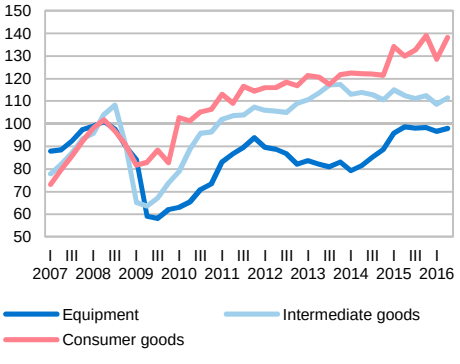
* Excluding agriculture, energy products, motor vehicles and base metals.

Chart IV.4.6 **Exports of services**
(s-a data, in EUR mln)



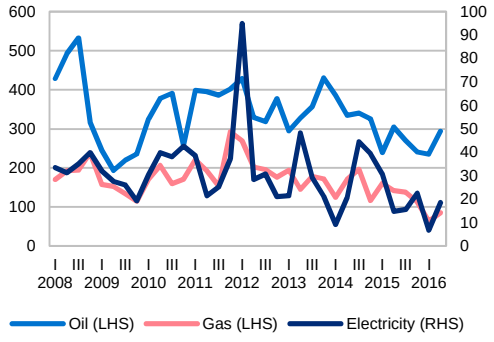
Sources: SORS and NBS calculation.

Chart IV.4.7 **Imports by key components**
(s-a, H1 2008 = 100)



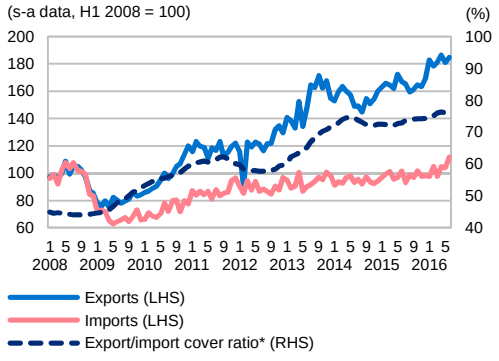
Sources: SORS and NBS calculation.

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



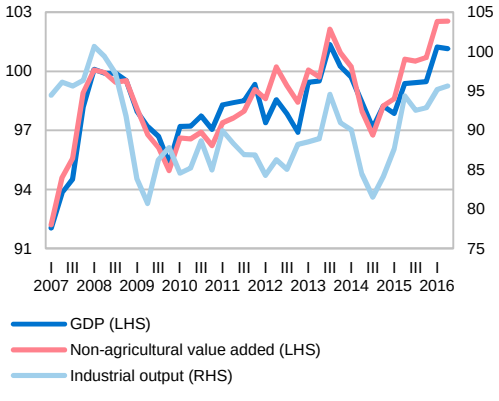
Sources: SORS and NBS calculation.

Chart IV.4.9 **Commodity trade in euros**
(s-a data, H1 2008 = 100)



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

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



Sources: SORS and NBS calculation.

mostly owing to higher exports of business services. After dropping mildly in Q1, exports of information and computer services also bounced back. Positive contributions, though lower than in the quarter before, continued also from exports of tourist and transportation services.

Strong growth of euro-denominated commodity imports of 6.8% s-a in Q2 was supported by the rise in imports across all components. Further growth in investment reflected on higher imports of equipment (1.3% s-a), while increased activity in manufacturing triggered an increase in imports of intermediate goods (2.6% s-a). In addition, the recovery of final consumption of households and the government led to higher imports of consumer goods (7.5% s-a).

Observed by economic destination of the EU, the greatest impetus to growth in commodity imports in Q2 came from energy imports, which rose by 17.5% s-a compared to Q1. This was prompted by the strong increase in imports of crude oil (24.8% s-a) and natural gas (32.8% s-a), which can be put down to the growing needs of industrial production and construction sectors. They also gave an upward push to imports of intermediate goods (0.8% s-a), while imports of capital goods rose on the back of invigorated investment spending (5.6% s-a). Imports were also spurred by higher imports of non-durable and durable consumer goods.

Commodity exports to imports cover ratio (measured by a 12-month moving average) reached 76.2% in June, rising by 0.2 pp from March. Also, in June 2016, s-a commodity exports stood at 84.8% and commodity imports at 11.6% above their pre-crisis levels[20].

5. Economic activity

Positive trends in manufacturing extended into Q2 which, along with the uninterrupted growth of some service sectors, gave a positive impetus to GDP. On the other hand, a major overhaul in the electric-energy system pushed the mining and energy contribution into negative territory, leading to GDP stagnation in Q2. According to the preliminary estimate of the Serbian Statistical Office, y-o-y growth of GDP measured 1.8%, and the slowdown resulted in part from the waning of the base effect in the mining and energy sectors.

The NBS estimates that GDP growth in 2016 will

[20] H1 2008.

accelerate to around 2.5%, mainly owing to the continuation of positive trends in industrial production and construction, as well as owing to the recovery in agriculture.

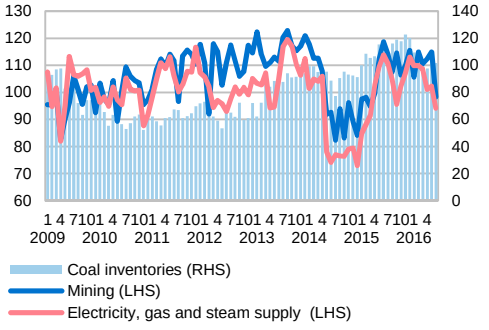
Following a relatively strong growth in Q1 (1.8% s-a), GDP is estimated to have stagnated in Q2 (-0.1% s-a). Manufacturing continued to provide a positive impetus, thanks to lower costs of financing, realisation of earlier investment, and further growth of the euro area economy. Positive economic movements continued also in trade, transportation and accommodation and food services, and estimates available so far place agriculture as well among positive contributors. On the other hand, mining and energy sectors, as well as some service sectors with a dominant government share, recorded a fall in activity. Economic activity measured by NAVA stagnated in Q2, standing at 2.5% above its pre-crisis level.[21]

The preliminary estimate of the Serbian Statistical Office for Q2 puts GDP growth at 1.8% y-o-y. The growth was mainly propped by positive trends in some service sectors, as well as in industrial production and construction.

As opposed to its relatively high increase in Q1, the physical volume of industrial production rose by 0.5% s-a in Q2. The slowdown reflected a contraction in electricity, gas and steam supply and a downturn in mining, where physical volumes of production dropped by 9.4% s-a and 1.7% s-a, respectively, due to the major overhaul in the electric-energy system aimed at extending the useful lifetime of existing capacities and laying the foundation for increased production in the coming period. On the other hand, positive movements continued in manufacturing which recorded a 2.6% s-a increase in the physical volume of production on the back of past investments and external demand.

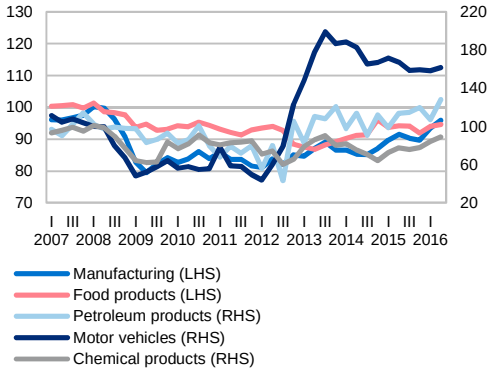
In Q2, s-a growth of the physical volume of production was recorded in 15 branches of manufacturing which account for around 80% of the sector and are largely export-oriented. Y-o-y, the physical volume of production expanded in 18 of the 24 branches. The greatest positive contribution came from production of petroleum products, which benefited from the bounce back in prices, while a valuable contribution also came from food production. Base metals production also gave a significant impetus to growth, reflecting an increase in world iron prices in Q2. Despite the downsizing of production in Fiat Automobiles Serbia, the automobile industry posted a mild output increase in Q2. Positive

Chart IV.5.2 **Physical volume of production in energy and mining**
(s-a, H1 2008 = 100)



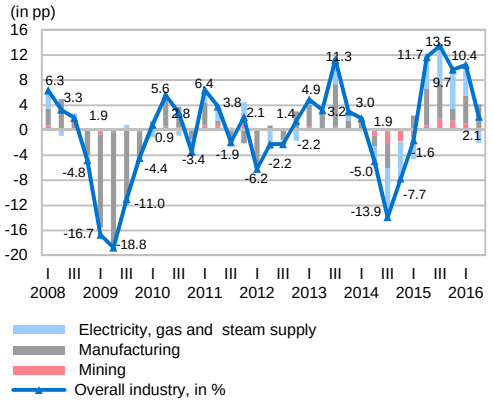
Sources: SORS and NBS calculation.

Chart IV.5.3 **Physical volume of production by branches of manufacturing**
(s-a, H1 2008 = 100)



Sources: SORS and NBS calculation.

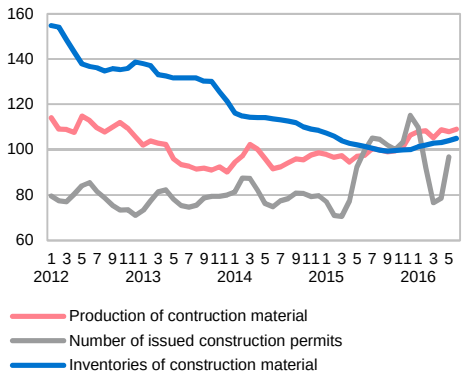
Chart IV.5.4 **Contributions to y-o-y growth of the physical volume of industrial production**
(in pp)



Sources: SORS and NBS calculation.

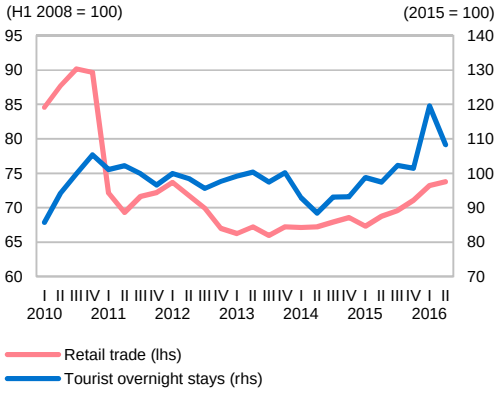
[21] H1 2008 level.

Chart IV.5.5. **Construction activity indicators**
(3M averages s-a, 2015 = 100)



Sources: SORS and NBS calculation.

Chart IV.5.6 **Service sector indicators**
(s-a data)



Sources: SORS and NBS calculation.

Table IV.5.1 **Contributions to quarterly s-a GDP growth** (in p.p.)

	2015			2016	
	Q2	Q3	Q4	Q1	Q2*
GDP (s-a, in %)	**1.6**	**0.0**	**0.0**	**1.8**	**-0.1**
Agriculture	0.0	0.1	0.0	0.1	0.0
Industry	1.2	-0.4	-0.2	0.8	0.1
Construction	0.3	0.1	0.0	0.1	0.0
Services	0.2	0.2	-0.1	0.7	-0.1
Net taxes	0.0	0.1	0.0	0.1	-0.1

Sources: SORS and NBS calculation.
* NBS estimate.

trends continued also in the chemical industry, production of electrical equipment, rubber, plastics and textile. A somewhat steeper fall in the physical volume of production was recorded in printing and reproduction of recorded audio and video media and in wood processing.

In line with the expectations, Q2 saw the slowdown in y-o-y growth of physical volume of industrial production to 2.1%, due to the waning of base effect in mining and energy sectors and the above mentioned overhauls. It was exactly these two sectors that lowered the physical volume of production y-o-y – energy by 1.9 pp and mining by 0.1 pp. The physical volume of production in manufacturing slowed down its y-o-y growth only mildly in Q2 – to 5.6%, giving a positive 4.1 pp contribution to the growth in physical volume of total industrial production.

Construction continued to give an upward boost to GDP in Q2. This is indicated by higher production of construction material (11.1% y-o-y) and an increase in construction workforce. In addition, the number of issued construction permits continued up y-o-y during April and May.

A strong impetus to GDP growth in 2016 is expected from agriculture, given that the output so far outperformed the earlier expectations based on ten-year average yields. According to the latest estimate of the Serbian Statistical Office, ample wheat yields in 2016 exceeded by 18.8% the last year's harvest. Expert estimates further indicate that this year's corn yields could rise 10% above the ten-year average, which would translate into a 20% y-o-y increase in corn output. This is also supported by the spells of favourable weather in the season to date, which have so far favourably affected corn and industrial plants growth. Still, in our current GDP projection we have kept the assumption about the average agricultural season, i.e. some 3% increase in agricultural output, with a 0.2 pp contribution to GDP growth.

Similar to the quarter before, positive contributions to GDP are expected also from some service sectors. The available indicators in trade and food and accommodation services indicate a further growth in activity. Retail trade turnover edged up by 0.8% s-a, while also continuing its y-o-y growth (by 7.3%). Y-o-y growth was extended also in tourist arrivals and overnight stays. Q2 saw an acceleration of y-o-y growth of the volume of new corporate and household loans, which is an indication of the financial sector's support to GDP growth.

Taking into account H1 trends and expectations for the rest of the year, the NBS estimates that GDP growth in 2016 will accelerate to around 2.5%, owing to continued positive tendencies in industrial production and construction, as well as to the recovery in agricultural production. The revival is expected in some service sectors as well, which will benefit from the rebound in final consumption.

6. Labour market developments

With the budding economic activity in Serbia gradually translating into job gains in the labour market, Q2 saw a perk up in employment and real wages. Concurrent with rising employment, unemployment figures declined, and in June reached the lowest level in 15 years, according to the National Employment Service.

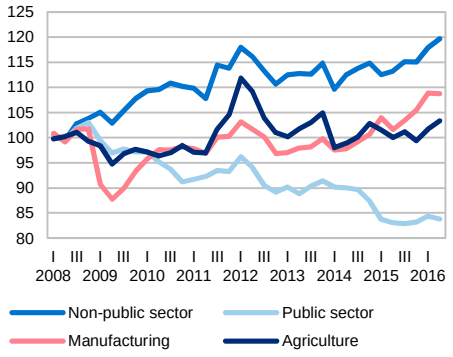
Wages and labour productivity

Total **real net wages** gained 0.7% s-a in Q2 on the back of rising private sector wages. By contrast, after posting growth for two quarters, real net wages in the public sector declined in Q2, largely on account of lower wages in the education and health sectors. This triggered a further narrowing of the pay gap between the two sectors, hence the average public sector wage in June was 4.9% above the private sector average. In April, for the first time since the new methodology for monitoring wages was applied, the average wage was higher in the private than in the public sector.

By activity, the largest s-a wage increase in Q2 was recorded in the real estate sector, professional, scientific, innovative and technical activities and transportation, whereas the sectors of agriculture and electricity, gas and steam supply saw less pronounced growth in wages. Average real wage in sectors employing the largest number of workers (manufacturing, construction and trade) stayed almost unchanged from a quarter earlier, while the drop in the average pay in mining, catering, and arts, entertainment and recreation was more perceptible.

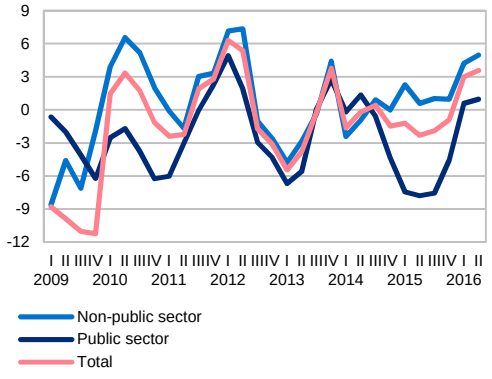
In Q2, relative to the same period last year, real wages were up by 3.6%, which is largely attributable to the continued rise in private sector wages (5.0%) that mirrored economic growth. In addition, real wages in the public sector also edged up on account of increased wages in the education and health sectors in early 2016.

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



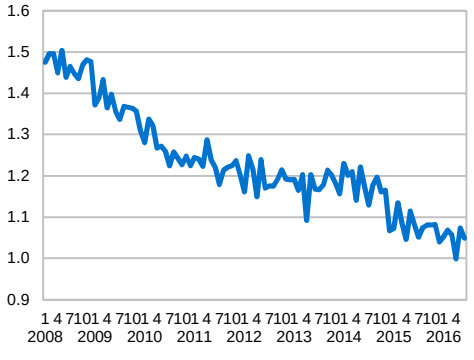
Sources: SORS and NBS calculation.

Chart IV.6.2 **Real net wage movements**
(y-o-y growth, in %)



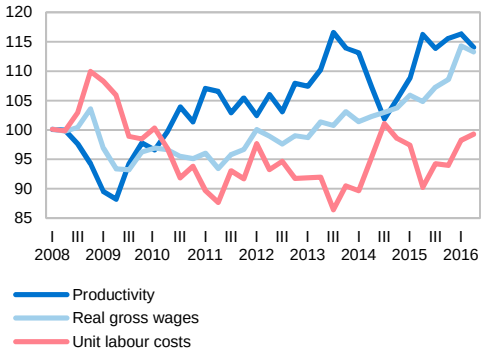
Sources: SORS and NBS calculation.

Chart IV.6.3 **Ratio of average nominal net wage in public and non-public sector**



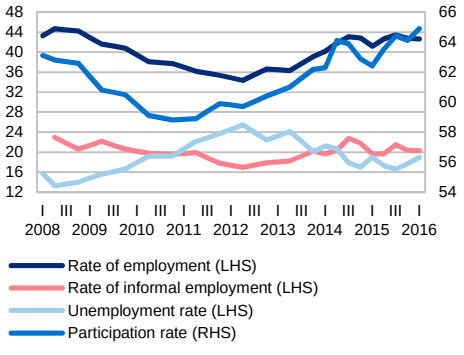
Sources: SORS and NBS calculation.

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.

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



Source: SORS.

Table IV.6.1 **Movements in formal employment and unemployment**
(quarterly growth rates, end-of-period)

	2015		2016	
	Q3	Q4	Q1	Q2
Total number of formally employed	0.7	-0.9	0.2	1.6
Employed with legal persons	0.7	-1.2	0.1	1.4
Entrepreneurs and their employees	1.4	0.5	1.1	3.5
Individual farmers	-1.4	-1.2	-0.9	-1.1
Unemployed persons	-1.3	-1.6	3.4	-5.7
First-time job seekers	-1.1	-1.7	1.6	-4.7
Used to be employed	-1.5	-1.6	4.4	-6.1

Sources: SORS and National Employment Service.

Relatively strong growth in Q2 was also recorded for the real net wage bill in the private sector (3.2% s-a); however, the public sector posted a decline in s-a terms. Average nominal net wage in Serbia in Q2 equalled RSD 46,549, up by 6.8% from Q1 and by 4.1% from the corresponding period last year.

Q2 saw a mild improvement in the cost competitiveness of the domestic economy as **unit labour costs** in manufacturing – the sector producing most of the tradable goods – declined by 1.3% s-a. This was aided by lower real gross wages, as well as higher productivity gains (0.4% s-a) triggered by the growth in the physical volume of production which outpaced the rise in employment. On the other hand, unit labour costs across the industry sector rose 1.1% s-a in Q2 in response to contracted productivity gains in energy and mining.

Employment

Robust economic growth from January onwards began to gradually translate into job gains in the labour market, where Q2 saw a rise in formal employment and a decline in unemployment. Data on formal employment obtained from the **Central Registry of Compulsory Social Insurance** show employment going up 1.6% in Q2 – legal entities increased their payrolls, and the number of private entrepreneurs and their workers also rose. On the other hand, the number of individual farmers decreased.

The rise in formal employment in Q2 was observed across sectors, most notably in manufacturing, construction and trade, i.e. sectors that have powered economic growth since the start of the year. Fewer employees in June relative to March were recorded only in the financial and education sectors.

The upswing in employment was accompanied by a decline in the number of unemployed persons. According to the **National Employment Service**, unemployment fell to its lowest in 15 years – 706,611 unemployed persons in June, which is 42,327 fewer than in March. As with employment, fewer unemployed persons were recorded in all occupation groups, while the sharpest fall was noted in groups linked to manufacturing. In addition, agriculture and food processing, and trade, tourism and catering also stand out as occupation groups with a relatively high fall in unemployment – a trend that can be ascribed to seasonal movements.

7. International environment

Despite solid economic performance at the start of the year, forecasts for global economic growth have been revised down. This was in part due to the United Kingdom's decision to withdraw from the EU. Even though it is bound to suffer the negative effects of Brexit, the euro area economy should continue to grow at a moderate pace. After somewhat weaker performance in early 2016, the US economy is expected to step up.

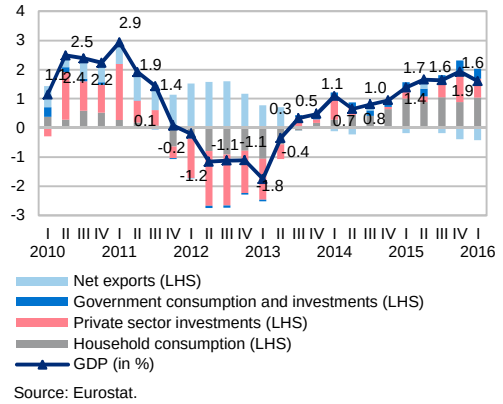
Slower than projected global economic recovery and the associated instability in the international financial market, along with extremely low inflationary pressures have increased the likelihood that major central banks will pursue more accommodative monetary policies than anticipated. The Bank of England adopted new measures in August and the market expects the same from the ECB in September. Further, analysts expect the Fed to postpone the next stage of monetary policy normalisation by waiting probably until December to increase the federal funds rate. High liquidity in the international market could reflect positively on capital flows in emerging economies, Serbia included.

Economic activity

Driven by domestic demand, **euro area's GDP growth** sped up considerably in Q1 to 0.6% s-a, with a notable acceleration in all major economies. Unlike Q4 2015, when the greatest contribution came from investment, GDP growth in Q1 was affected the most by household consumption, which continued to benefit from a rise in employment, low oil prices and subdued inflation. Investment also gave a positive contribution to GDP in Q1, though lesser than a quarter earlier, while net exports remained a drag because of slackened growth of key trade partners.

The movement of current indicators shows that GDP continued to grow in Q2, albeit at a slower pace than in Q1[22]. This is confirmed by Eurostat's flash estimate of 0.3% s-a. While the composite index of euro area economic activity in Q2 averaged lower than in Q1, it was still deep in the expansion territory, while the Economic Sentiment Indicator moved higher than in Q1. Observed by country, GDP growth is expected to slow

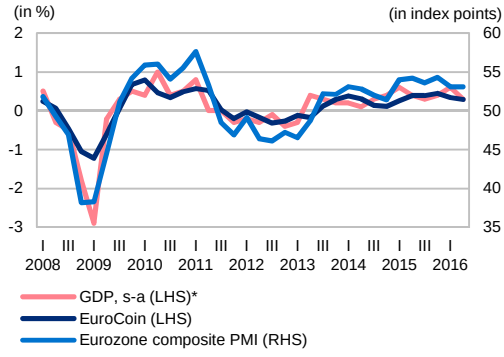
Chart IV.7.1 **Contributions to y-o-y GDP growth rate of the euro area**
(in pp)



Source: Eurostat.

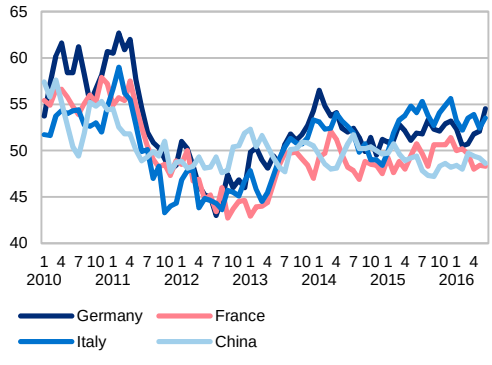
[22] S-a growth of 0.3% is expected both according to the Consensus Forecast estimate for June and based on the movement of PMI Composite published by Markit Economics.

Chart IV.7.2 **Movements in GDP and economic activity indicators of the euro area**
(quarterly rates)



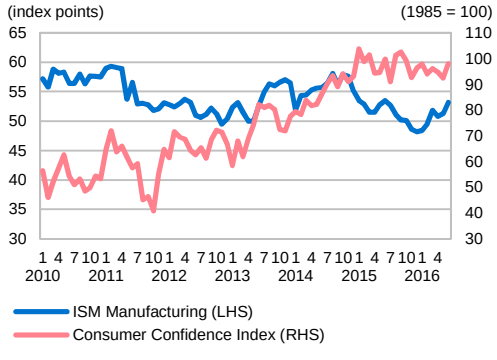
Sources: Eurostat, Markit Group and Banca d'Italia.
* Eurostat's preliminary flash estimate.

Chart IV.7.3 **PMI Manufacturing for selected countries**
(index points)



Source: Markit Group.

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



Source: Institute for Supply Management, Conference Board.

down in Germany due to weaker external demand, while domestic demand – household consumption in particular, will continue to give a strong positive contribution. This is indicated by the rise in the consumer confidence index owing to higher employment and increased expected cash flows, low inflation and lower costs of borrowing. According to Consensus Forecast, growth in Italy is expected to slow down relative to Q1, while GDP in France should stagnate in Q2 following the surge in Q1.

Euro area growth forecasts for 2016 and 2017 were revised down, mostly because of the negative effects of Brexit.[23] According to the Consensus Forecast estimate for July, expected euro area GDP growth is around 1.5% in 2016 and 1.3% in 2017 or by 0.1 pp and 0.3 pp lower, respectively, than the mid-June estimate. Note that the latest Consensus Forecast estimate is more favourable than the one made immediately after the referendum, which envisaged a downward revision of euro area growth rate by as much as 0.6 pp in 2017. The IMF also revised down its euro area GDP growth projection for 2017 (by 0.2 pp), while revising up the projection for 2016 by 0.1 pp due to better than expected results in Q1.

Still, despite the negative effects of Brexit, the euro area is expected to continue growing moderately in the medium run. Household consumption should remain a mainstay of growth in view of the improved situation in the labour market and higher real disposable income. Growth should also be spurred by investment, which benefits from low costs of borrowing and the fiscal stimuli in some countries. The euro's depreciation against the dollar should reflect positively on external demand, but its substantial recovery in the short term will likely continue to be hindered by dampened growth in emerging markets.

Household consumption continued to drive **GDP** growth in the **USA** at the same pace as in Q4 – 0.2% s-a. Positive contributors to GDP growth were government consumption and, after two quarters, net exports. Fixed investment, on the other hand, declined, giving a negative contribution. According to preliminary estimates, GDP accelerated to 0.3% s-a in Q2, which is below expectations. This quarter again, household consumption gave the greatest impetus to growth, as indicated by the continued growth in retail turnover and the movement of the Consumer Confidence Index that reached its highest value this year in June. Such

[23] See Text box 2 on page 47.

movements were strongly affected by positive labour market trends in Q2, i.e. further decline in the unemployment rate (by 0.1 pp to 4.9% in June) and robust nonfarm payroll employment gains in June.[24] On the other hand, y-o-y industrial production remained on the decline, mostly because of diminished extraction and processing of oil, whereas manufacturing was on the rise, as shown by the movement of ISM Manufacturing that reached its 18-month high in June.

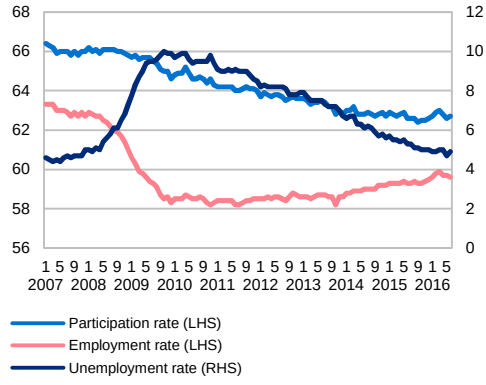
According to the IMF estimate, GDP in the USA should increase by 2.2% in 2016, or 0.2 pp less than previously expected because of weak performance in Q1. It is estimated that Brexit should moderately impact economic movements in the USA, since the negative effects of the dollar's strengthening are likely to be offset by slower policy normalisation and the protracted period of low long-term interest rates.

Economic activity continued to expand across most **Central and East Europe** in Q1, albeit at a slower pace than in 2015. The slowdown in almost all Central European countries was in part caused by the high last year's base, as well as by the lower implementation of EU funds which constituted an important source of investment financing in the preceding period. One exception is Romania, where accommodative fiscal measures gave a strong boost to private consumption and acceleration of GDP growth from the start of the year. In early 2016, solid performance was also recorded in Southeast Europe where economic growth is expected to step up during the year. Oil prices recovered since February, reflecting positively on the economic situation in **Russia** where the y-o-y GDP decline decelerated to 1.2% in Q1 and appreciation pressures on the ruble built up. The outlook for Russia's GDP in 2016 is now more favourable – the IMF expects a decline of 1.2% instead of the previously anticipated 1.8%, whereas Consensus Forecast analysts projected an 0.8% decline in July vs. 1.3% in April.

Supported by incentives of the Chinese authorities, **GDP growth in China** continued at the rate recorded in Q1 (6.7% y-o-y), which is somewhat above market expectations. The y-o-y growth in industrial production picked up in Q2 to 6.1%. Net exports also continued to give a positive contribution, additionally strengthened by the yuan's depreciation against the dollar. In light of this, the IMF revised China's growth forecast for 2016

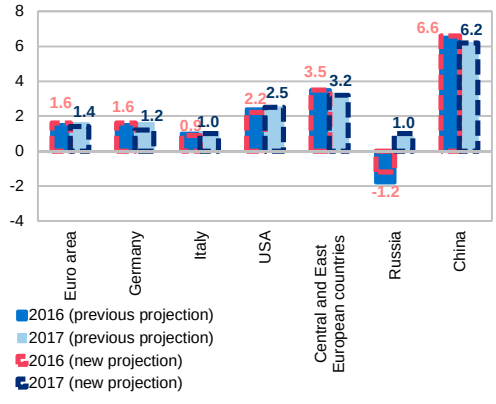
[24] This indicator recorded the highest value this year in June (292,000) after unexpectedly low levels in May (24,000).

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



Source: Bureau of Labor Statistics.

Chart IV.7.6 **Revisions of real GDP growth forecasts for 2016 and 2017 by the IMF**
(in %)



Sources: IMF WEO (April 2016) and IMF WEO Update (July 2016).

Table IV.7.1 **Economic growth estimate by country**
(in %)

	Consensus Forecast April 2016		Consensus Forecast July 2016	
	2016	2017	2016	2017
Poland	3.6	3.4	3.3	3.3
Czech Republic	2.4	2.7	2.4	2.5
Hungary	2.4	2.6	1.9	2.6
Albania	3.3	3.7	3.2	3.6
Bulgaria	2.7	2.8	2.6	2.8
Bosnia and Herzegovina	2.9	3.0	3.1	3.2
Macedonia	3.7	3.6	3.3	3.5
Montenegro	-	-	-	-
Romania	4.1	3.4	4.2	3.3
Slovenia	2.1	2.3	2.1	2.2
Croatia	1.5	1.8	1.8	1.9

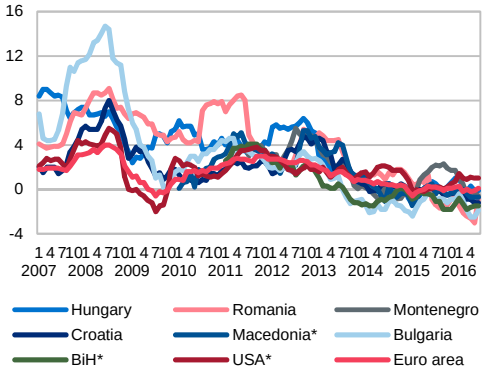
Source: Consensus Forecast.

slightly up (by 0.1 pp to 6.6%), while keeping the 2017 forecast unchanged (6.2%).

Inflation movements

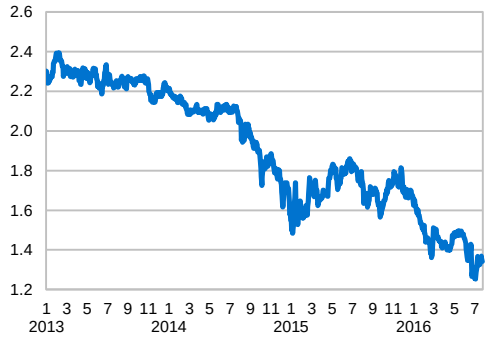
After five months, **euro area** inflation returned to the positive zone in June (0.1% y-o-y), mainly on the back of a slower decline in energy prices (-6.4% y-o-y). Note that core inflation, which excludes the most volatile components (food and energy prices) was higher, amounting to 0.8%, same as in May. The highest increase in the price index was recorded in the service sector (1.1%), the largest sector in the euro area economy. Based on oil futures, the ECB expects inflation to stay low for several months to come and to grow thereafter, largely due to the base effect of energy prices. The gradual rise in inflation should extend into 2017 and 2018, supported by the accommodative monetary policy and expectations of economic recovery. According to the July ECB Survey of Professional Forecasters, inflation expectations mostly stabilised at 0.3% for this year, 1.2% for the next year and 1.5% for 2018 (which, in spite of Brexit,[25] is only 0.1 pp lower than the expectations for 2017 and 2018 relative to the April Survey). Long-term inflation expectations (for 2021) remained unchanged at 1.8%. However, these survey-based inflation expectations differ from the market expectations, which went down considerably after Brexit. Following a temporary increase to 1.5% in May, long-term inflation expectations recorded another decline – in July the market expected that five-year ahead inflation expectations five years from now (in the year 2021 for the year 2026) would be 1.4%.[26]

Chart IV.7.7 **HICP across selected countries**
(y-o-y rates, in %)



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

Chart IV.7.8 **Long-term inflation expectations in the euro area**
(in %)



Source: Thomson Reuters.

Almost all countries in **Central and East Europe** recorded negative inflation in Q2, even more so than in the previous quarter. Deflation was the highest in Romania and Bulgaria. Deflation in Romania was contributed by the reduction in VAT rate since the beginning of the year. On the other hand, inflation was relatively high in Turkey and Russia (around 7.5% y-o-y in June), primarily because of the depreciation of their national currencies in the preceding period.

Supported by economic growth, inflation in the USA stabilised at around 1.0% y-o-y in Q2, which is below the ten-year average of 1.7%. Core inflation (excluding energy and food prices) also stabilised at 2.3%, i.e.

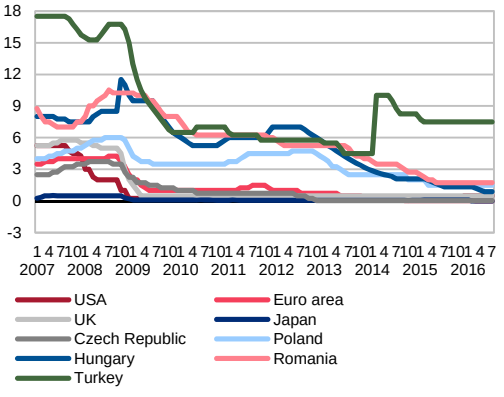
[25] The survey was carried out between 30 June and 6 July 2016.
[26] The five-year, five-year breakeven forward.

above the ten-year average of 1.9%. Producer prices increased the most in the year to June owing to an increase in prices of energy and services. Although inflation in the USA has moved below target since 2012, it is expected to rise gradually, which should, together with the strengthening of the US economy indicated by the July data, lead to further policy normalisation in the period ahead.

Monetary policy

Weaker outlook for global economic growth and continued dampened inflationary pressures give markets a reason to expect that monetary policies of leading central banks will be more accommodative than anticipated before. At the July meeting following Brexit, the **Bank of England** kept the bank rate unchanged at 0.5%, reduced the UK countercyclical capital buffer and raised banks' capacity for lending to households and businesses by GBP 150 bln. The bank rate was cut to 0.25% at the August meeting with the possibility of further reduction to close to zero this year. The Bank also made the decision to buy government bonds in the amount of GBP 60 bln over the following six months (expanding the purchase programme to GBP 435 bln), and to purchase corporate bonds in the amount of GBP 10 bln over the next eighteen months.

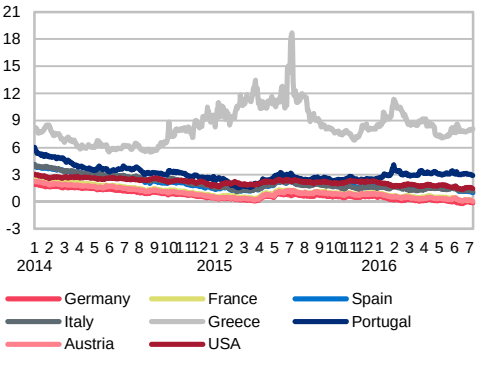
Chart IV.7.9 **Policy rates across selected countries**
(annual level, in %)



Sources: Central banks of selected countries.

The **ECB's** monetary policy has not changed so far. Noting that the economy continues to recover, the ECB added Brexit to the list of risks to the outlook in the coming period, in addition to the potential slowdown of growth of emerging economies and a tepid pace of structural reforms in the euro area. The conclusion from the July meeting was that the financial conditions are still highly conducive to credit growth. Domestic demand is supported by the growth in investment and a sustainable rise in employment, as well as by still relatively low oil prices that further contribute to real disposable household income. Also, according to estimates, fiscal policy in the euro area will be moderately accommodative in 2016 and neutral in 2017 and 2018.

Chart IV.7.10 **Yield on 10-year bonds of selected countries**
(daily data, in %)



Source: Bloomberg.

The ECB underlined that the financial market of the euro area showed reassuring resilience after the evident initial instability caused by Brexit. Accommodative monetary policy, regulation and supervision of the euro area's financial sector, and the readiness of leading central banks

to provide liquidity, if necessary, helped overcome the shock that Brexit caused in the markets. Still, uncertainties surrounding Brexit will affect not only the UK economy, but also the economy of the euro area. For this reason, the market expects that the ECB will react, despite having adopted new accommodative monetary policy measures only four months ago. Its interest rates are expected to stay the same, while the quantitative easing programme will be extended until September 2017.

The ECB postponed the decision to adopt potential additional monetary measures until September, when the new projections will take into account the effects of Brexit on the euro area. Inflation should stay considerably below the target (below, but close to 2%). Although inflationary pressures will increase gradually throughout the year, they should stay subdued due to the dissipation of effects of low oil prices.

The **Fed's** decision to normalise its monetary policy in June was delayed by events in the international environment, and by the weaker May performance of the US economy, mainly with regard to the creation of new jobs. After the promising labour market data in July, the Fed stated that the risks to economic outlook in the period ahead were reduced, but it did not change the federal funds rate. The market expects that the rate will probably be increased in December, though it might happen as early as in September. Expectations that the Fed's policy normalisation will be slowed and that liquidity in the international financial market will grow should positively affect capital flows into emerging economies, Serbia included.

Besides Serbia, monetary policy was eased in several other countries in **Central and East Europe**. Owing to disinflationary pressures and the inflation that has moved below the target for a while now, the Hungarian central bank cut its policy rate by 15 bp in March, April and May to 0.90%. The Albanian central bank also cut its policy rate, by 25 bp in April and May to 1.25%. In June, for the fifth consecutive month, the Turkish central bank cut the lending facilities rate to 8.75% in line with analysts' expectations, while the policy rate and the deposit facilities rate stayed the same (at 7.50% and 7.25%, respectively). For the first time in a year, the Russian central bank reduced its policy rate by 50 bp to 10.5%, owing to the stabilisation of oil prices and the ruble's strengthening. It announced the possibility of further policy rate cuts, judging that inflationary pressures should abate further in the coming period.

Financial and commodity markets

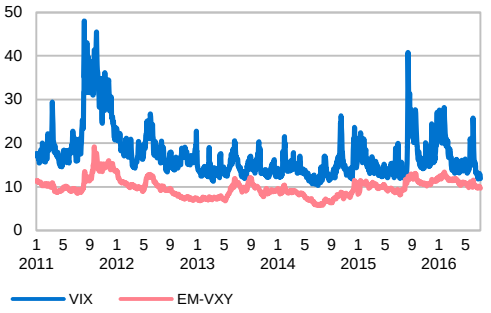
Movements in the international financial and commodity markets were marked by the Brexit referendum, whose surprising results initially sent the international financial markets into turmoil. In a single day, on 24 June, the euro weakened by 3.5% against the US dollar, while the pound sterling depreciated by as much as 11% against the dollar and reached its lowest point since 1985. The price of gold went up considerably, while the price of oil went down. Shares of companies worldwide declined, while the prices of US and German government securities increased.

Uncertainty in financial markets was reduced somewhat owing to the confirmed willingness of central banks to undertake new accommodative measures and to the expectations of the Fed's slower policy normalisation. The pound recovered after the initial fall caused by Brexit. The euro's situation was similar – at end-Q2 it was 2.0% weaker against the dollar, but the weakening was halted in July and the euro strengthened by 0.1%. The euro is still stronger against the dollar than in March this year or December last year. Also, most global stock exchange indices were higher in July than before the referendum. Lower uncertainty is indicated by VIX, tracking the S&P 500 index options, which surged to 26% after the announcement of referendum results, only to drop back to 12% by end-July. That the situation has calmed down somewhat can be seen from yields on five- and ten-year US government securities, which increased in July. However, they remained lower than in the several previous quarters.

At end-Q2, **oil** prices were around 25% higher than at end-Q1. In the second half of May, oil prices reached USD 50 per barrel, for the first time since November 2015. The price growth was also driven by lower supply, mainly because of fires in Canada, political instability in Venezuela and Nigeria and further cuts in US output. Demand also rose because of lower prices and a gradual economic recovery. In June, the price of oil was relatively stable, moving between USD 46 and 51 per barrel, only to decline by more than 7% in the several days after Brexit. Oil prices continued to fall and were 15.3% lower at end-July than at end-June. Oil futures indicate that Brent crude oil price should reach USD 45 per barrel in December 2016 and USD 49 per barrel in December 2017.

World food prices are rising gradually. Measured by FAO index, they rose for the fifth consecutive month in June. The June increase by 4.2% was the largest monthly increase in the last four years. At the quarterly level, food

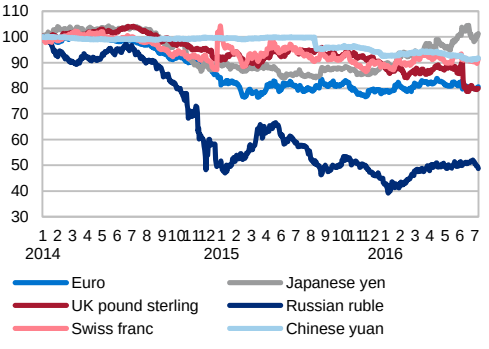
Chart IV.7.11 **Implied volatility of the global financial market***
(in %)



Source: Bloomberg.

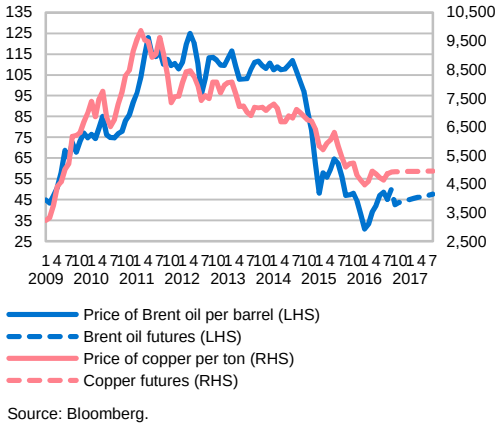
* VIX (Chicago Board Options Exchange Market Volatility Index) measures implied volatility of the S&P 500 index; EM-VXY (JPMorgan emerging markets implied volatility index) measures aggregate volatility of emerging market currencies based on three-month forward options.

Chart IV.7.12 **Exchange rates of selected national currencies against the dollar***
(daily data, 31 December 2013 = 100)



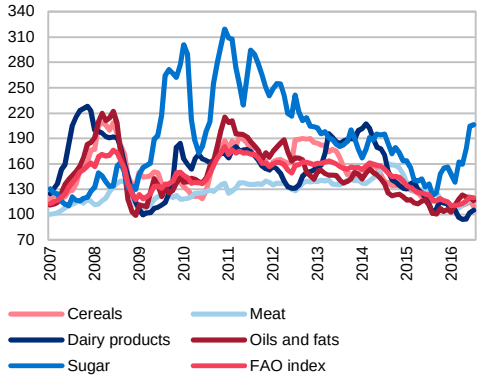
Source: IMF.
* Growth indicates appreciation.

Chart IV.7.13 **Oil and copper price movements**
(average monthly prices, in USD)



Source: Bloomberg.

Chart IV.7.14 **World food price index**
(in real terms, 2002–2004 = 100)



Source: FAO, UN.

prices were higher in both nominal and real terms by 8.4% compared to Q1. Still, relative to the same period last year, at end-Q2 food prices were lower by 2.4% in real terms and by 1.0% in nominal terms.

Prices of all food types rose in Q2. Sugar prices increased the most (by 26.0%), followed by meat (8.5%), cereals (6.3%), dairy (5.9%) and edible oil (1.4%). Cereal prices went up mainly because of the growth in corn prices caused by reduced imports from Brazil. Unfavourable weather in the US gave rise to concerns that the wheat yields would be lower. Dairy prices are recovering from the low levels recorded in the previous period. However, dairy prices remained 15.3% lower relative to end-Q2 2015, while meat prices were 7.9% lower in real terms.

In July, world food prices, measured by FAO index, declined 0.8% in real terms, due to falling prices of cereals and edible oil, whereas the prices of dairy, meat and sugar recorded further growth. Grain prices contracted on the news of a better than expected harvest in the US and the Black Sea Region.

Text box 2: Brexit and its impact on Serbia

The United Kingdom's decision to withdraw from the EU after 43 years fuelled the uncertainty already present in the international financial and commodity markets. On 24 June, in a single day, the euro weakened against the US dollar by 3.5%, whereas the value of the pound sterling against the dollar dropped by 11% to its lowest point since 1985. Share prices of UK banks fell by 20% on average in one week, and the decline was the sharpest for banks focused on the UK market. Share prices of domestic-oriented companies contracted by 10%. The global price of gold went up by 4.9% in just two days, while the price of oil went down by 7.1%. Global stock exchange indices were also on the decline. Conversely, prices of American and German government securities were on the rise. Against this background, expectations regarding global economic growth going forward were lowered, primarily with respect to the United Kingdom and the euro area.

It would appear that market participants worldwide had an exaggerated initial reaction to the UK referendum results after all, which is supported by the fact that the estimates of Brexit's negative impact on economic growth of the UK and the euro area made right after Brexit have been smoothed in the meantime. For example, according to the Consensus Forecast estimate for July, expected euro area GDP growth is around 1.5% in 2016 and 1.3% in 2017 or by 0.1 pp and 0.3 pp lower, respectively, than the mid-June estimate. However, immediately after the referendum, euro area growth estimate for 2017 was by as much as 0.6 pp lower. The initial weakening of the pound after Brexit halted in July. The situation was similar with the euro, which was 1.9% weaker against the dollar in Q2, a trend that was stopped as the euro strengthened by 0.1% in July. In July, most global stock exchange indices were higher than before the referendum. The situation was eased in July in large part owing to the readiness of central banks to undertake new accommodative measures, if necessary, and to the expectations of the Fed's slower policy normalisation.

Turbulences in the international financial market were also felt in the Serbian foreign exchange market. However, they were swiftly moderated by appropriate and timely interventions of the NBS in the foreign exchange market. By selling EUR 40.0 mln at the start of the day on Friday, 24 June, the NBS prevented panic from breaking out and maintained the stability of the foreign exchange market. Although the dinar weakened slightly on Friday, it recovered early next week without the need for any foreign exchange interventions. Actually, since 1 July the NBS has intervened only on the purchase side, buying a total of EUR 355.0 mln by end-July.

When assessing the potential impact of Brexit on Serbia note should be taken of the fact that its **direct effects are minimal**, given Serbia's limited direct exposure to the United Kingdom through the trade and financial channels. Serbia's trade linkages with the United Kingdom are weak: around 1.7% of total Serbian exports go to the United Kingdom (notably conductors for aircraft, road vehicles and ships, car tyres, fruit and vegetables), while 1.0% of our total imports originate from the UK (primarily road vehicles, medical and pharmaceutical products, and industrial machinery).[1] Also, the exposure of our banks and enterprises to the UK market is practically zero. Our banks did not extend loans to British economic entities and our enterprises invested little in the British economy. At end-2015, such investments were worth around EUR 35 mln or 1.3% of total FDI from Serbia. On the other hand, the United Kingdom is also only marginally exposed to Serbia, primarily through FDI. At end-2015, the stock of British FDI in Serbia was around EUR 590 mln or 2.2% of total FDI in Serbia (above all in the tobacco industry and the financial sector). While British banks did extend loans to Serbian enterprises, the total loan balance is only EUR 271.2 mln. Further, there is no considerable exposure to the United Kingdom with regard to the inflow of remittances, since their share in total remittances has ranged between 3 and 4% in the last several years.

Serbia, like other emerging economies, may eventually be **indirectly affected** by Brexit through the financial and real channels. When the results of the UK referendum were announced, emerging economies appeared to be the most vulnerable because of the withdrawal of investors to safe havens – currencies, shares and government securities of emerging economies were negatively impacted. However, after the initial fall, they started to record positive movement,

[1] Data for the first six months of 2016.

and the risk premium of most of these countries, Serbia included, began to decline. Though the uncertainty caused by Brexit spurred investors to transfer their assets from emerging economies to safe havens (these above all being American and German government securities and gold), a potential for greater than expected expansiveness of monetary policies of leading central banks could have a positive effect on capital flows in Serbia and other emerging economies. In August, the Bank of England cut its bank rate to 0.25% and increased the volume of purchases of government and private sector bonds, while September should see new measures by the ECB as well. The Fed is also expected to slow down the process of monetary policy normalisation. Still, caution is advised as positive trends in the US economy could easily renew investor expectations that the Fed will increase its federal funds rate before the year is out.

In addition to the financial channel, indirect negative effects of Brexit on Serbia are also possible through the real channel, mainly through its impact on the economic activity of the euro area, our key foreign trade partner. Serbian exports to the euro area could decline, as could investment from the euro area in Serbia. For the time being, it is difficult to anticipate the impact Brexit will have on euro area growth, since it depends on numerous factors. Some projects and investments will likely be delayed because of Brexit, but to what extent is as yet unknown. On the other hand, the ECB and the Bank of England expressed their willingness to use, if necessary, all means at their disposal, which supports the belief that after all the impact will not be a major one.

Despite the considerable resilience that the international financial market showed after the referendum, analysts concur that Brexit will be a long-running process that will be accompanied by a period of uncertainty and adjustments on a global scale. This will require particular attention and active observation on the part of monetary policy makers. By carefully monitoring movements in the international environment, the NBS will continue to assess potential risks in order to timely mitigate their potential spillover to the domestic market, to the extent possible.

V Inflation projection

Under our central projection, y-o-y inflation will start rising in the coming months, make its way back within the target tolerance band in H1 2017, and continue to move within the band until the end of the projection horizon. Such inflation movements will be driven primarily by the low base effect from prices of petroleum products and the gradual increase in domestic aggregate demand and inflation abroad, while low food production costs, as a result of good agricultural season and a further fall in primary agricultural commodity prices, will continue to hold inflation back for some time yet. The risks to the projected inflation path are symmetric and relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth at home, notably the prices of electricity.

GDP growth is projected to accelerate to around 2.5% in 2016 and to around 3.0% in 2017. Investment and exports will continue to be the main drivers of growth, with an increasing contribution from 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. The projection assumes an active monetary policy which seeks to keep inflation within the target tolerance band in the medium run and thus fulfil its principal role as defined by the current monetary policy framework.

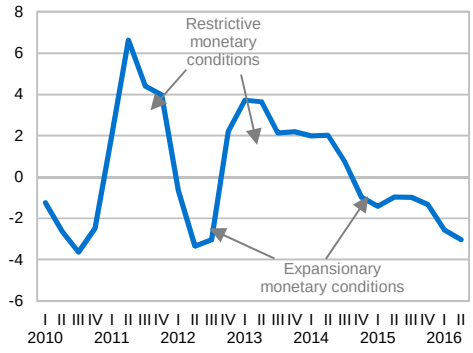
Initial conditions

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%), amounting to 0.3% at end-Q2. Like in the previous period, inflationary pressures remained subdued under the impact of the majority of domestic factors, as well as of the low international prices of primary commodities and generally low inflation abroad. Core inflation (CPI excluding food, energy, alcohol and cigarettes), which has been running below the target tolerance band since August 2014, equalled 1.5% y-o-y in June.

Q-o-q, consumer prices edged up by 0.5% in Q2. While petroleum product prices and the seasonally-induced increase in prices of travel packages and fruit spurred consumer price growth, vegetable prices worked in the opposite direction.

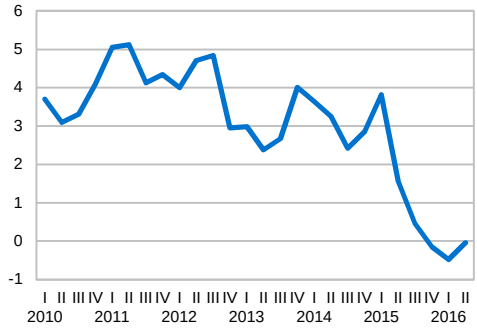
As inflationary pressures have been subdued for quite some time already, the inflation expectations of economic agents have gone further down. Based on Ninamedia

Chart V.0.1 **Monetary conditions index**
(in %)



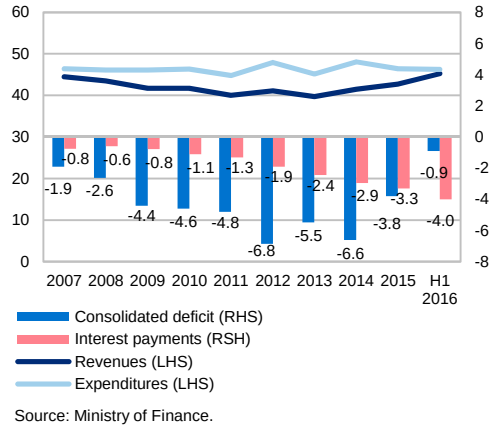
Source: NBS.

Chart V.0.2 **Real interest rate**
(in %)



Source: NBS.

Chart V.0.3 **Fiscal trends**
(in % of GDP)



Source: Ministry of Finance.

survey, one-year ahead inflation expectations of the financial sector fell to 2% in July. Two-year ahead inflation expectations of the financial sector are at the lower edge of the target tolerance band, while that of businesses are even lower, equalling 2%. According to the results of the Bloomberg survey, one-year ahead inflation expectations fell from 2.85% in July to 2.8% in August.

The value of the dinar against the euro remained broadly unchanged in Q2 – the dinar lost 0.1%.[27] Though depreciation pressures prevailed in Q2 (reflecting the withdrawal of foreign investors from government securities, heightened demand of domestic enterprises for foreign exchange, and Brexit in late June), they were moderated by increased FDI inflow, higher purchases of foreign exchange from natural persons in exchange offices, good export performance, growth in banks' net FX-indexed assets, as well as NBS interventions. In order to ease excessive short-term volatility of the exchange rate, the NBS sold to banks EUR 255.0 mln net in Q2, only to buy from them EUR 355.0 mln in July when appreciation pressures gathered pace.

The Monetary Conditions Index points to continuing expansionary monetary policy stance, which is consistent with the ongoing disinflationary pressures and open negative output gap. Monetary expansion increased in Q2 due to the widening of the depreciation gap of the real exchange rate, caused by the faster growth in euro area relative to domestic prices, on the one hand, and by a stable RSD/EUR exchange rate, on the other. The real interest rate[28] stayed below the neutral level, though slightly less so than in Q1.

Fiscal adjustment proceeded in Q2. Consolidated budget deficit in H1 was RSD 18.2 bln (0.9% of GDP) in H1, i.e. almost half the deficit recorded in the same period last year and more than four times lower than agreed within the third review of the arrangement with the IMF (RSD 78.3 bln). Interest payment expenses excluded, Serbia recorded a budget surplus of 3.1% of GDP. The narrowing of the deficit reflects primarily higher receipts from excise and VAT taxation. Based on the latest available estimate of the IMF (June), the deficit should be lowered to around 2.5% of GDP in 2016.

[27] Q-o-q change in the average exchange rate of the dinar.

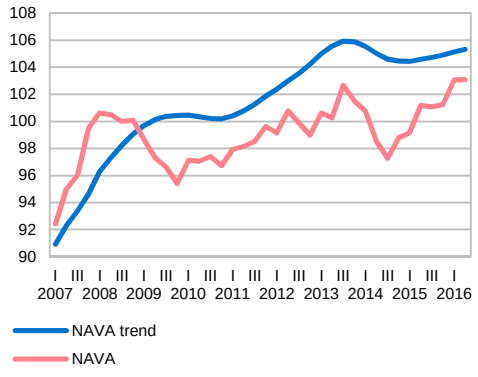
[28] Real interest rate is derived as the difference between one-week BELIBOR and one-year ahead inflation expectations of the financial sector measured by Bloomberg.

After robust growth in Q1 (1.8% s-a), GDP stagnated in Q2 (0.1% s-a decline). Y-o-y, GDP growth remains high. Export growth continued, while the strengthening of investment demand of enterprises and, to a lesser degree, of household consumption resulted in a solid import growth in Q2. Investment increased further, underpinned by continuing implementation of infrastructure projects and higher FDI inflow, while the recovery of household consumption can be associated with the wage and employment growth in the private sector, as well as with the rise in disposable income on account of lower cost of borrowing and oil prices.

NAVA[29] stagnated in Q2, causing a slight widening in the negative output gap[30] relative to Q1. This means that the intensity of disinflationary pressures from aggregate demand was somewhat higher than in the previous quarter.

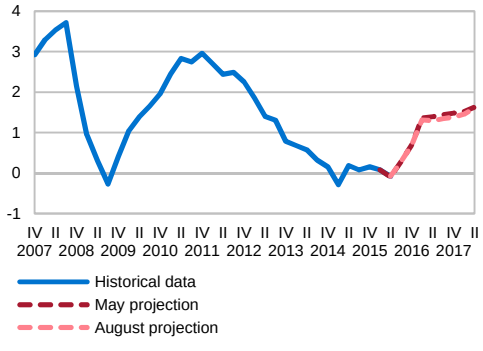
After 0.6% s-a growth in Q1, economic activity indicators suggest that the euro area's GDP slowed down to 0.3% s-a in Q2. Nevertheless, the recovery of the euro area economy continued to be supported by low oil prices and the accommodative monetary policy stance of the ECB. In June 2016, the ECB started a new round of targeted longer-term refinancing operations (TLTRO II), boosting bank liquidity by around EUR 400 bln. The ECB has kept its main interest rate at zero, while its portfolio boasted more than EUR 1,165 bln worth of purchased assets at end-July (the current volume of monthly asset purchases is EUR 80 bln). The Fed has not changed the level of its policy rate since last December. Most analysts think that the Fed is likely to raise its rate in December this year.

Chart V.0.4 **Output gap**
(Q3 2008 = 100)



Sources: SORS and NBS calculation.

Chart V.0.5 **Assumption for euro area inflation**
(y-o-y growth, in %)



Sources: Consensus Forecast and NBS estimate.

Inflation projection assumptions

External assumptions

The assumption for the euro area's GDP growth in 2016 has remained unchanged from the May projection at 1.5%, while that for the next year has been trimmed down from 1.6% to 1.3%.[31] The reason for the revision is Brexit, i.e. the UK's decision to leave the EU. Domestic demand in the euro area will continue to benefit from the ECB's accommodative monetary policy measures and the consequent improvement in financial conditions

[29] NAVA (non-agricultural value added) is GDP less agricultral production and net taxes.

[30] Output gap is calculated based on NAVA. NAVA trend estimated by the Kalman filter is used as an approximation of potential output.

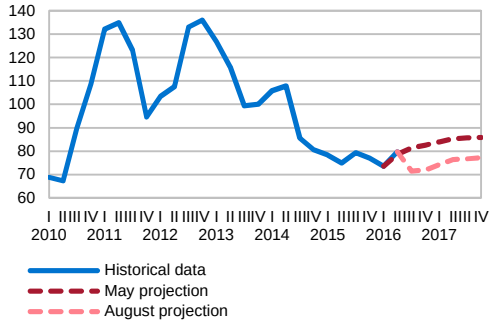
[31] The assumption for the euro area's GDP growth in 2016 and 2017 is consistent with the July Consensus Forecast.

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

	2016		2017	
External assumptions	May	Aug.	May	Aug.
EU inflation (annual average)	0.2%	0.3%	1.4%	1.3%
ECB policy rate (year-end)	0.0%	0.0%	0.0%	0.0%
Euro area GDP growth	1.5%	1.5%	1.6%	1.3%
International prices of primary agricult. commodities (Q4 to Q4)*	7.3%	-6.5%	4.0%	10.0%
Brent oil price per barrel (year-end, USD)	49	45	52.0	49
Internal assumptions				
Administered prices (Dec to Dec)	3.8%	3.5%	4.0%	4.0%
Trends				
Appreciation trend of the real exchange rate (average)	0.7%	0.7%	0.9%	0.7%
Real interest rate trend (average)	2.0%	2.0%	1.4%	1.6%

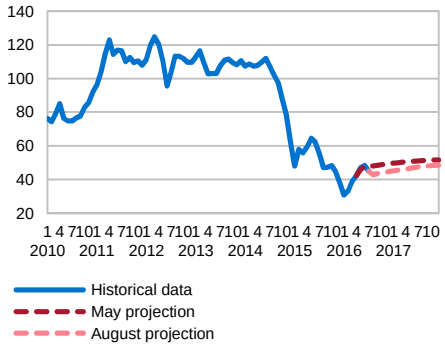
* Composite index of soybean, wheat and corn prices.
Source: NBS.

Chart V.0.6 **Assumption for international prices of primary agricultural commodities**
(Q4 2013 = 100)



Sources: BSE, CBOT and NBS.

Chart V.0.7 **Assumption for Brent oil prices**
(USD/barrel)



Sources: Bloomberg and NBS.

which is conducive to investment growth, as well as from the persistently low oil prices – which positively affect real disposable income of households and private consumption. On the other hand, downside risks to the above projections are embodied in Brexit-related uncertainty, ongoing geopolitical tensions and subdued growth prospects for emerging markets.

Euro area inflation remained low, ending Q2 at 0.1% y-o-y. It is expected to stay subdued over the coming months and to start rising late this year. Inflation growth should continue in 2017. Higher inflation will reflect the waning of the base effect from the fall in oil prices in the prior period, and will be supported by the ECB's measures and further economic recovery of the euro area. The assumption for average euro area inflation in 2016 and 2017 has remained almost unchanged from the May projection (0.3% and 1.3%, respectively). Given the statements of the ECB officials, we expect that the ECB's main refinancing rate will be kept on hold (0.0%) over the next twelve months and that the monthly asset purchases of EUR 80 bln will continue at least until end-March 2017.

After rising in Q2, international prices of primary agricultural commodities (corn, wheat, soybean)[32] entered a sharp decline in July (15% relative to June), prompting a downward revision to our assumption regarding the movement of these prices relative to May, when we expected they would grow at the annual level. Based on the latest available data from the futures markets, international prices of primary commodities will record a fall this year and trend only marginally upwards thereafter, meaning that they will remain relatively low.

Global oil prices[33] continued their recovery in April and May, exceeding USD 50 per barrel in early June. Since then, however, they have been on a mildly downward path that brought them in early August to around USD 42 per barrel, which is still by more than 50% higher than their January nadir. Based on the latest available oil futures, there should be no major recovery in oil prices in the period ahead – oil prices are expected to amount to EUR 45 per barrel at end-2016 and USD 49 per barrel at end-2017. Consistent with this, our assumption for global oil prices has been revised down relative to the May projection.

[32] Measured by the composite index which comprises dollar prices of wheat, corn and soybean on benchmark commodity markets.
[33] Brent.

Internal assumptions

In view of the outlook for international prices of primary agricultural commodities and the influence they have on their counterparts in Serbia, we have assumed that domestic primary agricultural commodity prices will record a decrease this year and an increase next year.

The assumption for administered price growth in 2016 has been slightly lowered relative to the May projection. The current projection envisages that this year's administered price growth will amount to around 3.5%, adding 0.7 pp to inflation. Most of that growth should come from the assumed increase in electricity (7%, 0.4 pp contribution to inflation) and cigarette prices (4.7%, 0.2 pp contribution). The increase in electricity prices has been assumed in our projection although at this point we do not know whether electricity prices will actually be increased. In 2017, administered prices are expected to grow by around 4%.

The results of fiscal consolidation have so far proved to be considerably better than planned and we expect the trend will continue in the period ahead. This should provide an additional contribution to public finance sustainability and the reduction in the share of public debt in GDP, reflecting positively on the country risk premium as well. In addition, the expected further narrowing of the current account deficit and FDI inflow above the deficit financing needs should support the stability of the foreign exchange market going forward.

The projection operates on the assumption of an appreciation trend of the real exchange rate, which is typical for transition economies and caused by the removal of price disparities, notably in terms of administered prices, and by the Balassa-Samuelson effect.[34]

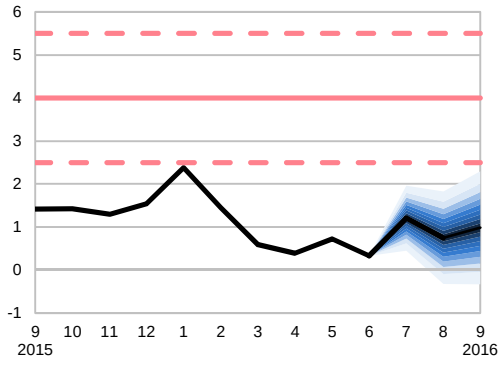
Projection

Inflation projection

Under our central projection, y-o-y inflation will start rising in the coming months, make its way back within the target tolerance band in H1 2017, and continue to move within the band until the end of the projection horizon.

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

Chart V.0.8 **Short-term inflation projection**
(y-o-y rates, in %)



Source: NBS.

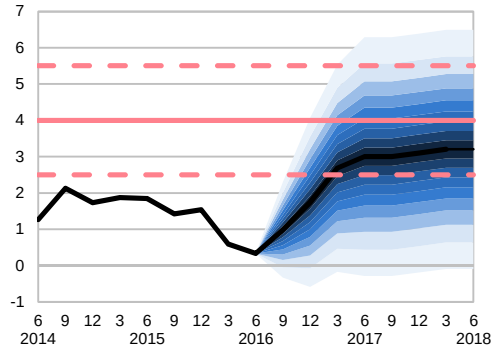
Short-term inflation projection

Under the short-term projection, y-o-y inflation will continue to move below the lower bound of the target tolerance band in Q3, exhibiting some monthly volatility. Namely, after rising in July, y-o-y inflation will fall in August (due to the drop-out of last year's electricity price hikes from the annual comparison), only to resume growth in September.

At quarterly level, consumer prices will record a rise in Q3, chiefly as a result of administered price growth (July increase in cigarette prices in particular). A somewhat smaller positive contribution is expected also from prices of food and non-food products and services. Within food, vegetable prices are poised for a sharp, seasonal drop and fruit prices for a seasonal growth. Prices of other food items will go up, driven primarily by the seasonal hike in fresh meat prices.[35]

Core inflation (CPI excluding food, energy, alcohol and cigarettes) should also continue to move below the lower bound of the target tolerance band in Q3. At quarterly level, core inflation will go up, led by the higher prices of industrial products.

Chart V.0.9 **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%. Each following shade includes 10% probability, which means that outturns of inflation somewhere within the entire fan chart are expected 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%.

Medium-term inflation projection

Y-o-y inflation is projected to start rising in the coming months, make its way back within the target tolerance band in H1 2017, and continue to move within the band until the end of the projection horizon (June 2018).

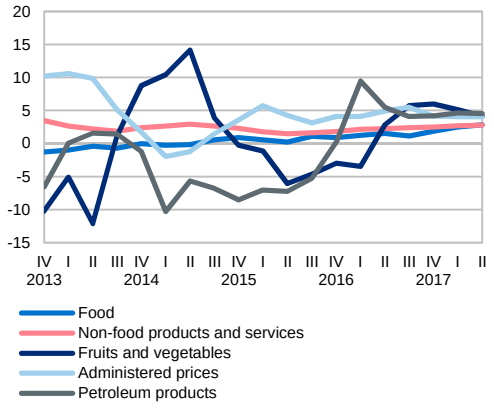
Such inflation movements will be driven primarily by the low base effect from prices of petroleum products and the gradual increase in domestic aggregate demand and inflation abroad (i.e. euro area), while low food production costs will continue to hold inflation back for some time yet.

Following the downward trend in global oil prices, domestic petroleum product prices decreased from August 2015 to February 2016 by close to 15%, knocking around 0.8 pp off the headline inflation rate. Though the recovery of global oil prices is likely to be rather sluggish, the said price decreases (i.e. low base) will be dropping out from the y-o-y inflation rate in the coming period. Hence, the disinflationary impact of petroleum product prices will grow weaker, fading out probably by the end of the year.

[35] The rise in meat prices is recorded in the EU, as well as in the global market.

This year is likely to see a domestic demand recovery, and consequently, weaker disinflationary pressures on account of the negative output gap. The gap opened back in 2008 following the spill-over of the global financial crisis to Serbia, but has been narrowing down for more than a year now. Though short-term deviations, such as the one in Q2, remain a possibility, we expect the output gap to continue down in the medium term. The narrowing of the negative output gap should be aided by the past monetary policy easing of the NBS, as well as by the ECB's monetary accommodation. The monetary policy stance of the ECB contributes to Serbia's economic growth not only through stronger demand for our exports, but also through interest rates on euro-indexed loans, given that low interest rates encourage credit and, by extension, economic activity.

Chart V.0.10 **Projection of inflation components**
(average y-o-y rate, in %)

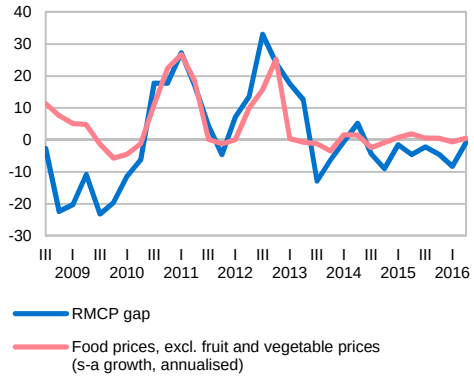


Source: NBS.

Observed by inflation component, the strengthening of aggregate demand should reflect primarily on the prices of non-food products and services, whose y-o-y growth has been low for quite some time already. In fact, in the last two and a half years, non-food inflation growth averaged 2.3%. In addition to low aggregate demand, the reason for this is the low inflation in the international environment which puts downward pressure on our import prices. Having this in mind, we expect that the future growth in euro area inflation and aggregate demand in Serbia will bring about a mildly upward trend in the prices of non-food products and services. The trend will also be aided by the closing of the depreciation gap of the real exchange rate. Under our central projection, non-food inflation will amount to close to 3% y-o-y at the end of the projection horizon (June 2018).

On the other hand, a dampening effect on inflation in the coming period should come from the low food production costs. This year's fruit and vegetable crops are estimated to be very good and corn and wheat yields 10% and 20% higher than the ten-year average. Vegetable prices experienced a steep fall already in Q2. According to our estimates, the negative contribution of fruit and vegetable prices to y-o-y inflation will persist until the start of the next agricultural season. The July fall in primary agricultural commodity prices (corn, wheat and soy) also lowered the food production costs (widening of the negative RMCP gap[36]), suggesting that the y-o-y food inflation[37] is likely to stay subdued for quite some time yet. In the last three years, y-o-y food inflation revolved around zero. At the same time, the

Chart V.0.11 **Impact of RMCP on food prices**
(in %)



Source: NBS.

[36] Real marginal costs of processed food producers (RMCP) are calculated as the ratio of primary agricultural commodity prices and food prices. Negative RMCP gap opens when these costs fall below the trend level.
[37] Measured as the y-o-y growth in prices of industrial food products.

increase in fresh meat prices will provide impetus to food inflation growth, and so will the expected modest recovery of international primary agricultural commodity prices starting from next year. Food inflation growth will be gradual – food inflation is forecast to amount to close to 3% at the end of the projection horizon (June 2018).

The projection envisages that administered price growth in 2016 will amount to around 3.5%, led mainly by the assumed increase in electricity and cigarette prices. Next year, administered prices are expected to grow by around 4%. Hence, the contribution of administered prices to y-o-y inflation over the entire forecast period should not exceed 1.0 pp.

The risks to the projected inflation path relate primarily to future developments in the international commodity and financial markets, and to a certain degree, to administered price growth at home, notably the prices of electricity.

Based on the latest available data from the futures markets, we have assumed that the prices of primary agricultural commodities will fall in 2016 and rise in 2017, and that oil prices will recover only slightly over the forecast period. However, as primary commodity prices are generally rather volatile, the likelihood that they will deviate from the assumed path is not at all negligible. At this point, our estimate is that primary commodity prices could deviate equally in both directions. Having in mind the impact of primary commodity prices on prices in Serbia, actual inflation could deviate from the projected path in either direction.

The risks associated with developments in the international financial markets continue to be tilted to the upside, even though liquidity in those markets should remain ample for at least some time to come and even though the domestic FX market proved resilient to (global) investor concerns caused by Brexit. The stability of the domestic market has been maintained owing to the NBS's well-timed reaction (intervention in the FX market) and transparent communication with the public. As regards future developments in the international markets and the associated risks that are asymmetric to the upside, the continued normalisation of the Fed's monetary policy could make capital flows to emerging

markets, Serbia included, more volatile. A potentially smaller capital inflow could lead to depreciation of the dinar and ultimately, to some upward pressure on the domestic prices. The accommodative monetary policy stance of the ECB, on the other hand, will continue to work in the opposite direction.

The risk surrounding administered prices is tilted to the downside. Namely, even though this is not certain yet, to be on the safe side, we have envisaged a 7% increase in electricity prices this year. If the increase fails to take place, y-o-y inflation will be around 0.4 pp lower than projected. Besides, the 2017 calendar of adjustments in excise tax on cigarettes has not been disclosed yet, which means that administered price growth next year could also be somewhat lower than envisaged now.

On balance, the risks to the projected inflation path are judged to be symmetric. Looking ahead, monetary policy decisions of the NBS will continue to depend on the Executive Board's assessment of the intensity of the (dis)inflationary impact of inflation factors, notably those from the international environment. As so far, the NBS will keep a close eye on global primary agricultural commodity and oil prices, as well as on developments in the international financial markets.

GDP projection

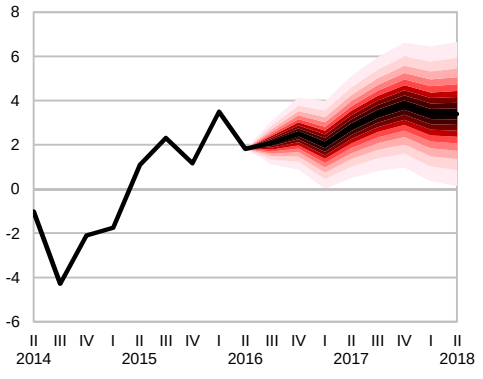
GDP is projected to grow by around 2.5% this year (the upper bound of the range projected in May[38]) and to step up to around 3.0% in 2017 (unchanged from May).

Similar to last year, growth in 2016 should be led by investment, as confirmed by data for the first half of the year. A further increase in investment activity is suggested by a number of factors – continuing structural reforms, more favourable terms of borrowing, increase in government capital expenditure, expected further recovery of the euro area, sustained relatively high inflow of FDI, and the still relatively low oil prices which reduce operating costs for businesses.

Positive impact on this year's GDP will also come from net exports and consumption, and their contributions will be probably similar in size.

Export growth did lose some steam in Q2, but export performances of the Serbian economy remain solid, i.e.

Chart V.0.12 **GDP growth projection**
(y-o-y rates, in %)

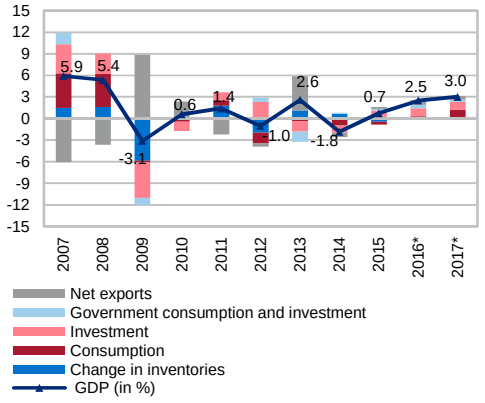


Source: NBS.

[38] In May, GDP growth in 2016 was projected at 2.25–2.5%.

exports remain relatively high. According to our estimates, this year's export growth rate could be even double digit. As a result, the contribution of net exports to GDP growth will stay positive, even though higher investment and consumption will lead to a certain pick-up in imports. The expectation of net export growth is supported also by improved terms of trade that are attributable to a smaller decline in export than in import prices.

Chart V.0.13 **Contributions to real GDP growth**
(in pp)



Sources: SORS and NBS calculation.
* NBS estimate.

In contrast to 2015, when household consumption acted as a drag on GDP growth due to fiscal consolidation, we expect it to become a positive contributor this year. Stronger household consumption will reflect investment and export movements, which should support the incipient real growth in private sector wages and employment, as well as lower cost of borrowing and the relatively low oil prices, which have a positive effect on the disposable income of households.

On the production side, higher investment should support the ongoing positive trends in manufacturing and construction, while higher consumption should have a positive impact on services. Positive contributions to GDP growth will also come from energy and mining, primarily thanks to the low base from early 2015. A positive contribution to growth is expected also from agricultural production, whose performance this year is still assumed at the level of the ten-year average (up by 3% relative to 2015).

Favourable trends in 2016 should continue in 2017, i.e. economic growth should continue to be underpinned by investment, exports and household consumption. Investment will continue to be the key driver of economic growth, followed probably by household consumption. The contribution of net exports should stay positive and in the region of that recorded in 2016.

The risks to GDP projection relate mainly to the speed of economic recovery of the euro area as our key trade partner and further pace of structural reforms at home. To a certain degree, risks are also associated with global oil prices, this year's agricultural production and output in the sectors of energy and mining.

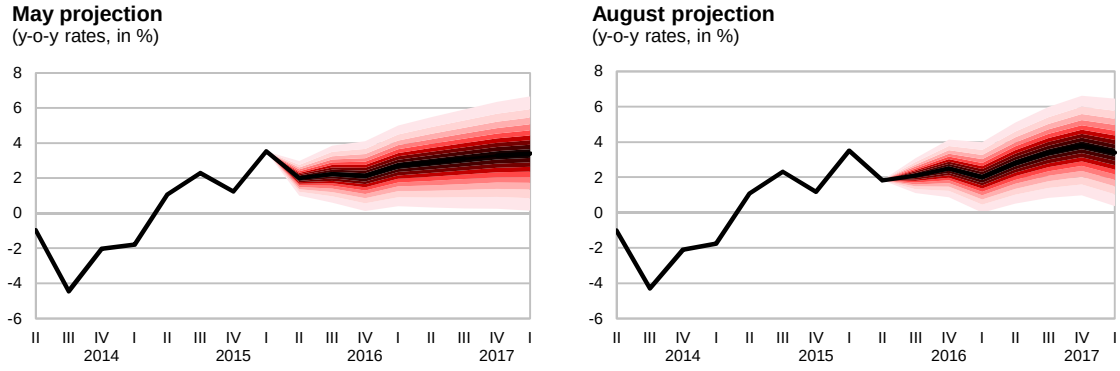
The sustained low level of oil prices and unconventional ECB measures could help accelerate the euro area recovery going forward, resulting in stronger demand for our exports and higher investment, and thus, higher than

projected growth of our economy. On the other hand, the recovery of the euro area could be slowed down by the slackening growth of emerging markets, notably China, as the reduction in their import demand is bound to weigh down on euro area exports. Headwinds to the recovery of the euro area could also come from Brexit[39] and the ongoing geopolitical tensions. If these downside risks materialised, Serbia would probably see a slowdown in investment and exports, and consequently, a lower than projected GDP growth.

Initiated structural reforms and the improvement in investment and business environment enhance Serbia's medium-term growth prospects. However, the pace of further implementation of structural reforms will determine whether growth will be faster or slower than projected. Symmetric are also the risks associated with global oil prices which may depart from the assumed path equally to the downside and upside and thus decelerate or accelerate GDP growth.

Downside risk to GDP projection for this year is embodied in developments in the sectors of energy and mining. More specifically, their output could turn out to be lower than assumed due to the recently initiated overhaul, whose impact on this year's output cannot be estimated with certainty yet. On the other hand, since it is expected that this year's fruit and vegetable crops will be very good and that corn and wheat yields will be significantly above the ten-year average, agricultural production growth this year may easily prove to be higher than envisaged in the projection. However, as final data

Chart V.0.14 **Current vs. previous GDP growth projection**



Source: NBS.

[39] Euro area growth forecast for 2017 has already been cut by 0.3 pp, to 1.3% because of Brexit (Consensus Forecast).

are not available yet, the projection operates on the assumption of an average agricultural season.

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

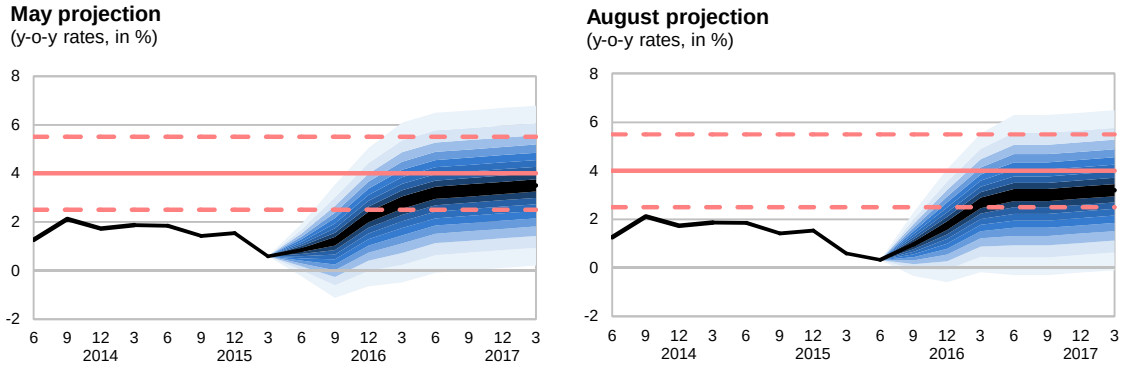
Comparison and outcome of inflation projections

The new inflation projection is slightly lower than the projection published in the May *Report*. The projection range stayed symmetric.

The projected lower inflation is attributable to the downward revision of the assumptions regarding international primary commodity prices relative to May, as well as to decline in domestic vegetable prices in Q2 which proved sharper than projected. Due to this, inflation's return within the target tolerance band will be somewhat slower – rather than in early 2017, inflation is now expected to make its way back within the target band by mid-2017.

It the last twelve months, y-o-y inflation was moving below the August 2015 central projection rate, but within the projection range. In June this year, it slipped to the lower edge of the projection range. Inflation

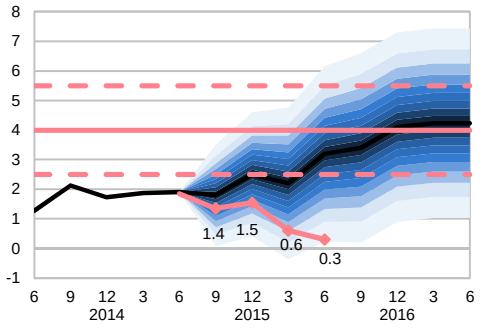
Chart V.0.15 **Current vs. previous inflation projection**



Source: NBS.

deviated south of the central projection rate mainly because of the stronger than anticipated disinflationary effects from the international environment. Instead of recovering steadily since the end of last year, euro area inflation stayed rather low, exerting downward pressure on our import prices. Also, despite some recovery over the past several months, international primary commodity prices are still below the level indicated by commodity futures a year ago. This helped sustain the sharp y-o-y fall in domestic petroleum product prices, as well as the relatively low y-o-y food inflation rates. Turning to domestic factors, the precipitous decline in vegetable prices in Q2 2016 played a key role in inflation falling short of the projected level.

Chart V.0.16 **Achievement of August 2015 inflation projection**
(y-o-y rates, in %)



Source: NBS.

Projections of other institutions

Macroeconomic projections for Serbia by other relevant institutions[40] have improved since the May *Inflation Report.* Namely, their expectations regarding inflation and the current account and budget deficits have been scaled down, while their expectations regarding Serbia's economic growth have been revised up.

Overall, these institutions expect inflation of around 1.5% this year and around 3% next year. In terms of economic performance, they expect Serbia's GDP to grow up to 2.5% both this and the next year. Also, they envisage the current account deficit to be slightly above 4% of GDP both this and the next year and the consolidated budget deficit to fall to 2.5–3.2% in 2016 and further down to below 3% in 2017.

The improvement in Serbia's macroeconomic performances has been recognised also by rating agencies. In June, Fitch raised our credit rating from B+ to BB-, forecasting Serbia's GDP growth to amount to 2.4% this year (upward revision from 1.7%) and the budget deficit to stabilise from 2017 at around 3% of GDP.

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

	2016		2017	
	Previous	New	Previous	New
Inflation (annual average, in %)				
IMF	1.7	1.3	3.1	-
European Commission	1.6	-	2.8	-
Consensus Forecast	2.0	1.5	3.4	3.0
Bloomberg	2.1	1.4	3	2.9
GDP (%)				
IMF	1.8	2.5	2.3	-
European Commission	2.0	-	2.5	-
Consensus Forecast	1.8	2.2	2.4	2.5
Bloomberg	1.8	2.3	2.3	2.5
Current account deficit (% of GDP)				
IMF	4.4	-	4.3	-
European Commission	4.3	-	4.3	-
Consensus Forecast*	4.3	4.1	4.1	3.9
Bloomberg	4.6	4.2	4.6	4.3
Fiscal deficit (% of GDP)				
IMF	4	2.5	2.6	-
European Commission	3.1	-	2.9	-
Consensus Forecast	-	-	-	-
Bloomberg	4.0	3.2	3	2.9

Sources: IMF (Republic of Serbia: Third Review under the Stand-By Arrangement, Country Report No. 15/347 and World Economic Outlook, April 2016 and Press Release of the IMF Mission to the Republic of Serbia, June 21, 2016), European Commission (Spring Forecast 2016), Consensus Forecast (April and July 2016) and Bloomberg Quarterly Survey (April and July 2016).

* Based on NBS projection of dollar GDP from May and August 2016.

[40] The only exception in this respect is the European Commission that will release its next forecast in November.

Text box 3: Improvement in Serbia's macroeconomic prospects in the last two years

Serbia has become a more attractive investment destination owing to the achievement of macroeconomic stability, consistent fiscal consolidation and implementation of structural reforms. The credibility of economic policy is confirmed by the sharp reduction in internal and external imbalances, while higher rankings on international competitiveness lists have helped improve investors' perception of Serbia. A valuable contribution of the NBS to macroeconomic stability and favourable business and investment environment was ensured through low and stable inflation, a sound financial sector, relative stability of the exchange rate, a considerable drop in lending rates for households and corporates and lower cost of borrowing for the government.

The progress achieved so far has been acknowledged by international rating agencies, which in the last two years upgraded/affirmed Serbia's credit rating (Fitch from B+ to BB- in June 2016) and raised the rating outlook.[1] An additional boost to the credibility of Serbian economic policy comes from a precautionary stand-by arrangement with the IMF concluded in February 2015. The main objectives of the arrangement are to strengthen public finances, to implement structural reforms and to increase stability of the financial sector. Three reviews of the arrangement have been concluded so far, while there is staff-level agreement on issues related to the conclusion of the fourth and fifth reviews.

Progress in fiscal consolidation is reflected in a notable improvement in key macroeconomic variables and their projections for the period ahead. Chart O.3.1 gives an overview of projections for the main macroeconomic indicators since the start of 2015 to date and illustrates their steady improvement.

Significant headway has been made in the area of public finances, as the general government deficit narrowed from 6.6% of GDP in 2014 to 3.8% in 2015. It is expected to continue down in the period ahead and stabilise below 2% by 2018. Also, after falling from 3.7% of GDP in 2014 to 0.5% in 2015, the primary budget deficit is projected to switch to a surplus already this year and to continue on that path in the coming years as well. Considering that the government's need for new borrowing grows weaker with the improvement in fiscal performances,the latest projection indicates that the share of public debt in GDP will embark on a downward path already in 2016. It is important to note that fiscal and public debt projections are harmonised with the IMF, which additionally strengthens their credibility.

Substantial improvement in macroeconomic performances has also been recorded in foreign trade flows, leading to a lower projection of the current account deficit. Owing to the realisation of earlier investments into export-oriented industries, real exports grew at a faster pace than imports in 2015. A similar trend has been observed since the beginning of 2016. Good foreign trade results are also attributable to fiscal consolidation measures, which held back imports, as well as to favourable conditions in the international market over the last two years which supported the improvement in Serbia's terms of trade, i.e. a steeper fall in import than in export prices. It should be noted that in 2015 the current account deficit was fully covered by net FDI inflow that soared by close to 50% at annual level owing to enhanced business environment and the implemented structural reforms. A similar level of FDI (around 5% of GDP) is expected in 2016 and beyond, as a result of continuing structural reforms and Serbia's progress in the EU accession negotiations.

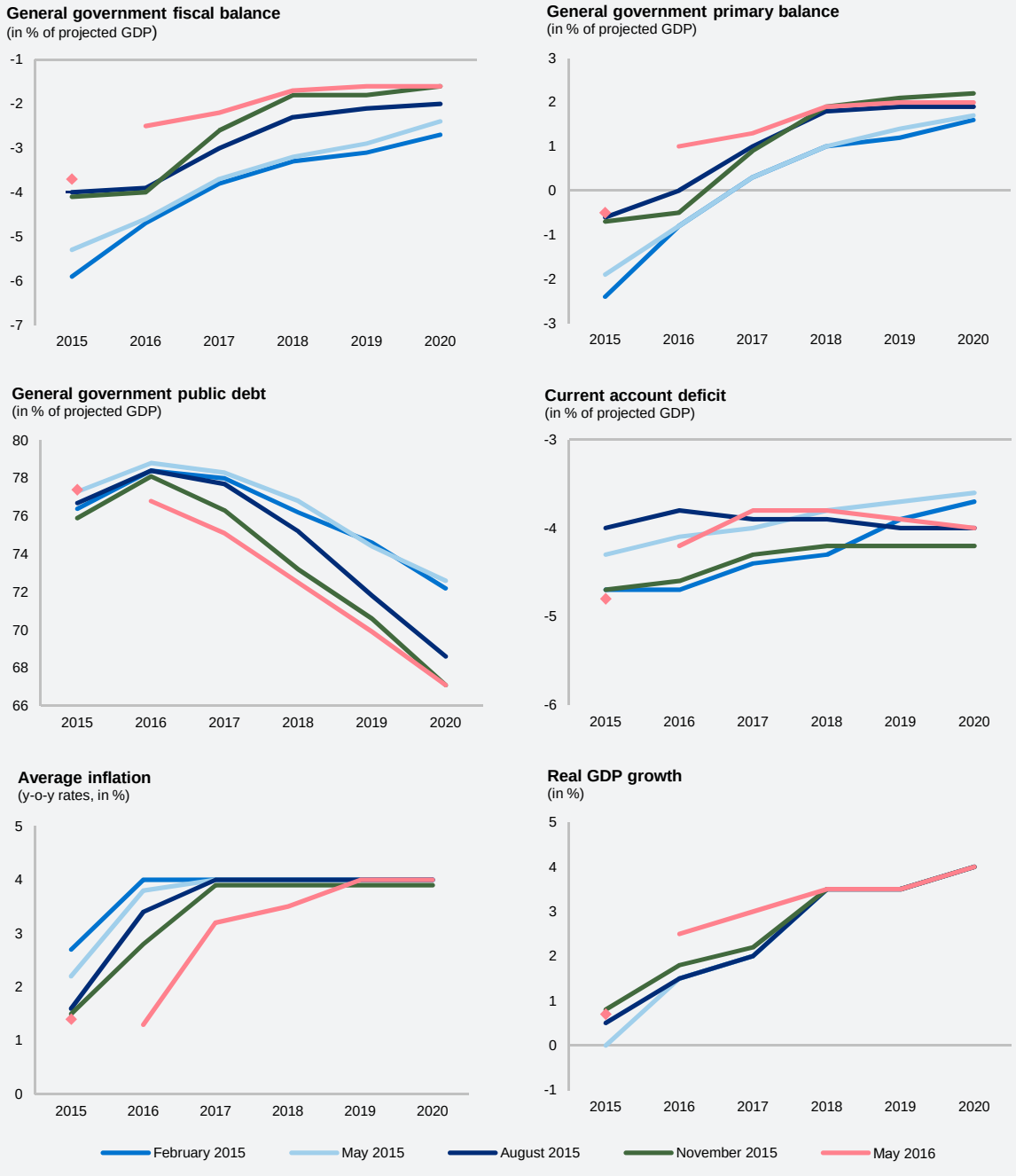
Despite headwinds from fiscal consolidation, Serbia's GDP grew by 0.74% in 2015 on the back of a robust growth in investment and exports. Note that the growth forecast for 2015 was revised upwards four times in the course of the year (from the initial -0.5% in February 2015), as investment growth proved stronger and the negative effects of fiscal consolidation on final consumption weaker than anticipated earlier. In May, the NBS was the first to announce an upward revision of GDP growth projection for 2016 – from 1.8% to 2.25–2.5%. In 2016, growth will continue to be led by investment and exports on the expenditure side and by industry and construction on the production side, which is a desirable growth structure from the aspect of medium-term sustainability.

In contrast to GDP growth projection, inflation projection was revised downwards in both 2015 and 2016. What played a key role in delaying inflation's return within the target tolerance band were the expected low inflationary pressures on account of domestic factors (tight fiscal policy, low domestic demand and relative stability of the exchange rate) and the

[1] In July 2016, Standard and Poor's affirmed Serbia's credit rating at BB- and maintained a stable outlook. In March 2016, Moody's affirmed Serbia's credit rating at B1 and raised its outlook from stable to positive.

unexpected strong pressures from prices in the international environment (sharp fall in international prices of oil and primary agricultural commodities). Nonetheless, y-o-y inflation is expected to rise steadily over the coming months and make its way back within the target tolerance band in H1 2017.

Chart O.3.1 **Revisions of the projections of key macroeconomic indicators**



Sources: Ministry of Finance, IMF and NBS.

Positive macroeconomic developments in the last two years attest to the adequacy of the monetary and fiscal policy mix that enabled Serbia to reduce considerably both external and internal imbalances and to record economic growth against the backdrop of increased challenges from the international environment. These positive trends are expected to continue in the coming period. In 2016, general government fiscal deficit is forecast to reach around 2.5% of GDP and the primary budget surplus around 1% of GDP. External imbalances are envisaged to narrow further – the current account deficit is projected at around 4.2% of GDP. This year again, the current account deficit is likely to be fully covered by net FDI inflow. Also, since the start of the year the European Commission, international financial institutions and rating agencies have been assessing Serbia's macroeconomic prospects as more favourable.

Table A
Indicators of Serbia's external position

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Q1 2016	Q2 2016
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	6.6	6.0	5.8
FX reserves/short-term debt	177.0	265.1	250.6	162.6	220.6	191.2	299.8	237.4	268.9	300.4	257.7	236.7	
FX reserves /GDP	23.3	36.9	32.7	24.2	34.6	33.6	36.1	34.5	32.7	29.7	31.5	28.7	28.0
Debt repayment/GDP	5.0	10.3	10.3	10.7	12.8	12.0	12.4	13.0	13.4	14.2	12.0	12.3	
Debt repayment/exports of goods and services	19.8	36.2	37.5	37.5	48.8	37.5	37.3	36.0	32.9	32.7	25.4	25.4	
EXTERNAL SOLVENCY INDICATORS (in %)													
External debt/GDP	59.3	58.5	59.0	62.3	72.7	79.0	72.2	80.9	74.8	77.1	80.1	78.2	
Short-term debt/GDP	13.2	13.9	13.1	14.9	15.7	17.6	12.0	14.5	12.1	9.9	12.2	12.1	
External debt/exports of goods and services	234.9	205.7	214.3	218.9	276.9	247.1	216.5	223.6	184.0	177.7	168.7	161.6	
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	250.2	238.5	220.1
FX reserves/reserve money	169.8	179.5	173.8	140.7	190.5	196.4	207.6	197.9	199.9	196.6	193.7	208.7	200.7
OPENNESS OF ECONOMY (EXPORTS+IMPORTS)/GDP	70.8	77.4	80.1	82.6	69.0	79.8	82.7	89.8	92.6	97.7	104.9	112.8	114.9
MEMORANDUM: (in EUR million)													
GDP [1]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	32,908	7,498	8,248 [2]
External debt	12,520	14,291	17,382	20,982	22,272	23,509	24,123	25,645	25,644	25,679	26,374	25,926	
External debt servicing	1,054	2,513	3,039	3,594	3,922	3,564	4,154	4,130	4,592	4,723	3,964	1,014	
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	10,378	9,501	9,291
Short-term debt [3]	951	968	1,044	1,832	1,852	1,758	612	455	196	99	316	353	
Current account balance	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1,577	-248	-387

CREDIT RATING (change of rating and outlook)	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2016
	July/May	Feb	July	March/ Dec	Dec	Nov	March	Aug	July	Jan	Dec	Jan/ March	June
S&P	BB- /stable	BB- /positive	BB- /stable	BB- /negative	BB- /stable		BB /stable	BB- /negative				BB- /stable	
Fitch	BB- /stable			BB- /negative		BB- /stable		BB- /negative		B+ /stable	B+ /positive		BB- /stable
Moody's									B1 /stable			B1 /positive	

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.

External debt/GDP – ratio of end-of-period outstanding debt to GDP.

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

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

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

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

[1] 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 482.6 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 976.3 mln, of which EUR 422.4 mln relates to domestic banks and EUR 553.9 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	2015	Q1 2016	Q2 2016
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	0.7	3.5	1.8
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	1.5	0.4	0.3
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	10,378	9,501	9,291
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	15,631	3,945	4,373
- 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	8.2	11.8	9.3
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	18,899	4,515	5,100
- 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	4.4	1.7	7.2
Current account balance[3]													
(in EUR million)	-1,778	-2,356	-5,474	-7,125	-2,032	-2,037	-3,656	-3,671	-2,098	-1,985	-1577	-248	-387
as % of GDP	-8.4	-9.6	-18.6	-21.1	-6.6	-6.8	-10.9	-11.6	-6.1	-6.0	-4.8	-3.3	-4.7
Unemployment according to the Survey (in %)	20.8	20.9	18.1	13.6	16.1	19.2	23.0	23.9	22.1	19.2[7]	17.7	19	
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	368.0	353.7	378.5
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	-6.3	-2.9	-1.0	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	-6.6	-3.8	-1.7	-0.2
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	70.4	75.9	72.4	71.9
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	108.85	111.37	109.02
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	111.25	108.60	111.07
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	120.73	122.87	123.02
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	121.63	122.92	123.31
MEMORANDUM:													
GDP (in EUR million)[5]	21,103	24,435	29,452	33,705	30,655	29,766	33,424	31,683	34,263	33,319	32,908	7,498	8,248[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 the break in the series for 2007, 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.

[7] Revised data for 2014 and 2015 according to the new methodology of Labour Force Survey.

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 for public debt: MoF.

Index of charts and tables

Charts

Tables

Tables

Charts in text boxes

Executive Board meetings and changes in the key policy rate

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	5.00	-50
15 October	4.50	-50
12 November	4.50	0
10 December	4.50	0

2016

Date	Key policy rate (p.a, in %)	Change (in basis points)
12 January	4.50	0
11 February	4.25	-25
17 March	4.25	0
7 April	4.25	0
17 May	4.25	0
9 June	4.25	0
7 July	4.00	-25
11 August	4.00	0
8 September		
13 October		
10 November		
8 December		

Press releases from NBS Executive Board meetings

Press release from Executive Board meeting held on 9 June 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4.25%.

Having in mind the current developments, the Board assessed that the present degree of monetary accommodation will help inflation return and stabilise within the target tolerance band early next year.

In deciding to keep the policy rate unchanged, the Board took into consideration persistent uncertainty in the international commodity and financial markets, as well as the expected weakening of disinflationary pressures on account of global primary commodity prices in the coming period. At the same time, the impact of external risks is moderated by domestic factors, primarily the achieved and expected further reduction in internal and external imbalances.

Global prices of oil and primary agricultural commodities continue their recovery. Along with the expected increase in euro area inflation and a faster recovery of the Serbian economy, this should help y-o-y inflation rise gradually in the period ahead. According to the medium-term projection of the National Bank of Serbia, inflation should make its way back within the target tolerance band early next year and continue moving around 3% thereafter.

The next rate-setting meeting will be held on 7 July.

Press release from Executive Board meeting held on 7 July 2016

At its meeting today, the NBS Executive Board decided to cut the key policy rate by 0.25 percentage points, to 4%.

Also, the Executive Board adopted amendments to the Decision on NBS Interest Rates, to narrow the interest rate corridor relative to the key policy rate from ±1.75% to ±1.50%. In the Board's best collective judgement, this measure will contribute to further stabilisation of interest rates in the interbank money market, gradual reduction of the spread between the weighted average repo rate and the key policy rate, as well as to the strengthening of transmission through the interest rate channel.

The decision to lower the key policy rate is based on the assessment that low inflationary pressures will persist in the period ahead, notably those stemming from the majority of domestic factors. Sustained low inflationary pressures are also signalled by the further fall in inflation expectations of market participants. The implementation of fiscal consolidation measures and structural reforms continues. External imbalances have decreased, and are expected to continue down in the period ahead. Improved macroeconomic performances of the Serbian economy and its prospects were acknowledged in June by the IMF, as well as by Fitch Ratings which raised Serbia's credit rating on 17 June.

As assessed by the NBS Executive Board, elevated uncertainties in the international environment warrant caution in the conduct of monetary policy. This primarily relates to the impact of Brexit on international financial and commodity markets, i.e. on emerging economies, including Serbia. External risks are expected to be moderated not only by Serbia's better macroeconomic performances, but also by the possible further monetary accommodation by the ECB and the Bank of England and slower than initially expected monetary tightening by the Fed.

The Executive Board concluded that, given the current circumstances, the lowering of the key policy rate to 4% will ensure inflation's return within the target tolerance band next year.

The next rate-setting meeting will be held on 11 August.

Press release from Executive Board meeting held on 11 August 2016

At its meeting today, the NBS Executive Board decided to keep the key policy rate unchanged at 4 percent.

In so deciding, the Executive Board took into consideration the effects of past monetary policy easing and the inflation outlook for the period ahead. As the Executive Board assessed, the return of year-on-year inflation within the target tolerance band will be led primarily by the low-base effect of petroleum product prices and the gradual increase in aggregate demand at home and inflation abroad, while low food production costs will continue to hold inflation back for some time to come.

In making the above decision, the Executive Board was also guided by persistent uncertainties in the international commodity and financial markets and their impact on inflation and capital flows to emerging market economies. However, the resilience of the Serbian economy to external shocks is now stronger than before as a result of consistent implementation of fiscal consolidation measures and structural reforms. Hence, fiscal and external imbalances have continued down and Serbia's macroeconomic prospects have improved further, as confirmed by the projections of relevant international institutions. Looking ahead, it may also be expected that the risks from the international environment will be moderated by the more accommodative monetary policy stance of leading central banks.

At its meeting today, the NBS Executive Board adopted the August Inflation Report, which will be presented to the public on Wednesday, 17 August. On that occasion, monetary policy decisions and the underlying macroeconomic developments will be explained in detail.

The next rate-setting meeting of the Executive Board is scheduled for 8 September.

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